

30 March 2007

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Dear John

### **DISCUSSION PAPER - PROMOTING AUDIT QUALITY**

IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of nearly £3 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our members represent 99% of funds under management in UK-authorized investment funds (i.e. unit trusts and open-ended investment companies).

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in those companies' financial reports and the information disclosed to our members as users.

IMA welcomes the FRC seeking to promote and maintain confidence in the audit process. As stated in the discussion paper, users of financial reports should be able to rely on "an audit report giving a robust and objective opinion on the financial statements<sup>1</sup>". However, our members are increasingly concerned about the quality of audits, particularly in view of the liability reforms in the Companies Act 2006 – exposure to liability induces service providers to be more diligent and reducing it could induce a lower quality of service. In this respect, we concur with the FRC that "the four main drivers of audit quality are:

- the culture within an audit firm;
- the skills and personal qualities of audit partners and staff;
- the effectiveness of the audit process; and
- the reliability and usefulness of audit reporting<sup>2</sup>".

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<sup>1</sup> Page 5

<sup>2</sup> Page 20

We set out in the attached Annex our answers to the specific questions raised, and set out below a summary of our key concerns and how we believe they could be addressed.

### *Culture*

- Audit firms have tended to shift to a more aggressive, commercial business model in recent years which can impact on audit quality. Firms are likely to need to make cultural changes to address this and, in order that the market has better information and can gain more confidence in them, they should be more transparent about their governance and business.
- Over concentration on non-audit services in a firm can affect audit quality and whilst we would not support such services being prohibited, there is a case for restricting them.

### *Skills and personal qualities*

- Beyond the initial qualification, responsibility for ensuring that individual auditors are up-to-date is left to the audit firms or the auditors themselves. We consider that it would be helpful if requirements in this area were to become more formalised.
- The increasing internationalisation of companies means that significant parts can be established and audited in economies where the local audit staff may not have the same skills or training as those from more developed economies. Global audit networks may not always share common firm wide standards and although auditing standards are being harmonised internationally, how effectively these standards are applied depends on the skills and expertise of the local workforce. We consider that qualification and training requirements should be reviewed in these less developed economies, rather than in the UK.
- Members would like to receive, should they request, more information on the senior staff assigned to an audit, their expertise in the industry concerned and the steps taken when an outside expert is relied upon.

### *Process*

- In principle, we support the development of a single set of international audit standards but the IAASB that sets them is part of IFAC, which is funded by the accounting professional bodies and the large firms. This structure runs the risk that ISAs serve solely the interests of the large firms. Whilst measures have been taken to address this, we do not consider that they go far enough and that there should be a formal review of the IAASB's governance and that a broader constituency should be involved in the development of ISAs.
- As regards the ISAs themselves:
  - there are significant historical differences between the UK

- shareholder-stewardship audit and a US regulatory audit which cannot be addressed with a single set of auditing standards;
- ISAs are considered to be too prescriptive and inflexible; and
  - UK auditors are able to report and comment freely in audit opinions especially if there is uncertainty, whereas with ISAs there is little freedom in what is reported in that they require reasonable assurance whether the financial statements are presented fairly in accordance with the applicable financial reporting framework.
- A threat to audit quality that is not identified in the DP is the concentration of audits around 31 December year ends, i.e. audit resources may be thinly spread at this time. The FRC may want to consider research into this and whether there is a case for trying to spread year ends and audits more throughout the year.

### *Reporting*

- For audit reports to be more useful to investors they need to be more informative and we consider that the Audit Quality Forum's report on auditor reporting<sup>3</sup> made some helpful suggestions in this respect.

### *Others*

- Audit committees would be more effective if they were available, if necessary, to explain to major shareholders any changes of auditor and consulted them on the selection of an alternative from a wider range of firms.
- In order that shareholders can raise concerns about the audit at the accounts meeting, auditors should attend such meetings, particularly where the board has "removed" the auditor or the auditor is retiring/resigning. Furthermore, we consider that the present notification and disclosure arrangements over the appointment and removal of auditors should be reviewed.

Please do call me on 020 7269 4668 if you would like to discuss any of the points in this letter or the attached or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall  
Senior Adviser – Corporate Governance

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<sup>3</sup> Page 4, Audit Quality, Fundamentals - Auditors Reporting, February 2007, Institute of Chartered Accountants in England and Wales.

## ANNEX

### IMA RESPONSE TO FRC DISCUSSION PAPER – PROMOTING AUDIT QUALITY

IMA's detailed comments on the questions in the DP are set out below.

#### CULTURE

The DP identifies that the culture within an audit firm can ensure quality by:

- creating an environment where achieving high quality is valued, invested in and rewarded;
- indicating that:
  - leadership emphasises the importance of auditors discharging their professional responsibilities;
  - there is respect for the principles underlying auditing and ethical standards;
  - there are development systems that promote personal characteristics essential to quality auditing;
  - financial considerations do not drive decisions;
  - consultation on difficult issues is promoted; and
  - there is an information infrastructure to support the audit function.

Possible threats include:

- audit leadership having insufficient input to management decisions;
- over-emphasis on winning and retaining audits;
- over-emphasis on non – audit services;
- excessive cost cutting in an economic down turn; and
- insufficient importance on technical training.

*Q 1 Are there other important indicators of an audit firm's culture that are not referred to above?*

*Q 2 Are there pressures that could compromise the culture of audit firms that have not been identified above?*

IMA considers that the DP has identified the main indicators of a firm's culture that will ensure quality and the main pressures that could compromise it. A firm's culture should encourage and foster professionalism and high standards of integrity. We note that the second report of the Audit Inspection Unit stated that the Big Four had made only limited progress in areas such as "the extent to which the overriding importance of audit quality is reflected in the firms' human resource processes"<sup>4</sup> and that "Other Significant Firms" "need to focus on audit quality in developing the firms' strategies and human resource systems"<sup>3</sup>.

We consider that one contributory factor in recent years to a decline in audit quality is the way firms have tended to shift to a more aggressive, commercial business model. As noted in the DP "audit clients are an important source of a firm's total

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<sup>4</sup> Page 2, Audit Inspection Unit, 2005/6 Audit Quality Inspections, Public Report, July 2006

income, but audit may not be the majority income stream<sup>5</sup>”.

This can result in “low ball” pitches in order to secure a new audit client or reduced fees in order to retain an existing one. Accountancy Age of 17 November 2004 referred to the pitch made by Price Waterhouse to secure the Prudential audit in 1990/91 where the audit fees were cut by almost 40% to win the contract. The Article “AA in the 1990s – how the Brits started the rot” states:

*“For a while, Price Waterhouse became Cut Price Waterhouse or Half Price Waterhouse, but the significance of the low balling and the selling of the audit soul for the good of the management consultancy fee income went beyond one particular tender and a few cheap cracks. For the accountancy profession, the PW/Pru debacle marked the low point...”<sup>6</sup>”*

The practice of “low balling” can have a number of adverse consequences on audit quality as noted in the DP<sup>7</sup>:

- over-emphasis on winning audits at the expense of quality;
- too much investment in non-audit services at the expense of audit and the consequent movement of talented staff to other areas of the practice;
- excessive cost cutting in an economic down turn that impacts on the quality of audits in the medium term; and
- training that focuses on improving client service at the expense of technical competence.

We consider that in order to address these matters, firms are likely to have to make cultural changes.

*Q 3 Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?*

IMA believes that improving the transparency of audit firms would help build confidence in their culture. Currently, we consider that there is a disconnect between major shareholders and the auditors of listed companies and giving shareholders more information would help improve their confidence in audit firms. For example, this could be achieved by taking the steps noted below.

- *Encouraging auditors to engage more with major shareholders.* In recent years auditors have not engaged much with major shareholders. More commitment for engagement on matters such as the firms’ governance, their client profiles and the policy issues they face would help ensure that major shareholders are better informed and manage their expectations. We recognise that the Department of Trade and Industry’s agreement with the larger audit firms sought to address this in that 13 of the 20 largest firms gave an undertaking to publish information on their internal governance arrangements and quality control processes in their annual reports. However, to date this has not been effective as the information published has tended to

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<sup>5</sup> Page 23

<sup>6</sup><http://www.accountancyage.com/accountancyage/comment/2039079/aa-1990s-brits-started-rot>

<sup>7</sup> Page 25

be too boilerplate and general to be of much value to investors. Nor do we consider that this position will change with the new 8<sup>th</sup> Company Law Directive which introduces a requirement for such transparency.

- *Requiring auditors to publish their terms of engagement.* It would be helpful if auditors had to give their terms of engagement to shareholders before the vote on their reappointment so shareholders could better understand the scope of the audit and the terms under which it is undertaken. (Currently, the Companies Act 2006 contains a reserve power for regulations to be made that would require the terms of engagement to be published.)

In addition to improving transparency, one of the threats to audit quality identified in the DP is the over concentration on non-audit services. One of the ways that this could be addressed is through restricting the provision of non-audit services to audit clients. IMA would not support such services being prohibited but considers there is a case for restricting them.

## SKILLS AND PERSONAL QUALITIES

The DP identifies the importance of skills and personal qualities of audit personnel, and that the key drivers are:

- the skills base of the partners and staff and the inexperience of on-site teams;
- training which is coordinated with audit work and which addresses a broad range of issues - managers and partners should provide mentoring and on the job training and post qualification training should focus on audit related issues; and
- appraisals should emphasise factors that promote audit quality.

Possible threats include:

- failure to develop the necessary characteristics through mentoring;
- failure to retain staff with the necessary expertise;
- allocating capable staff on the basis of client prestige rather than audit risk; and
- insufficient or ineffective training.

*Q 4 Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?*

*Q 5 Has this paper identified the issues that could result in an inadequately trained or skilled workforce for audit – if not, what other issues are there and why are they issues?*

*Q 6 Should there be a fundamental review of the qualification and training requirements for auditors?*

Although not an exhaustive list, IMA considers that technical skills, personal qualities and practical experience of accounting firms' staff are certain of the key drivers of audit quality. In this respect, should they request, our members would like to receive more information on the senior staff assigned to the audit and their level of expertise in the industry, and the steps taken when the auditor needs to rely on an

outside expert. Furthermore, beyond the initial qualification, the responsibility for ensuring that individual auditors are up to date is left to the audit firms or the individuals themselves. We consider that it may be helpful if this were to become more formalised.

One aspect that is not examined in the DP is the effect of the increasing internationalisation of companies such that significant parts can be established and audited in economies where the local audit staff may not have the same skills or training as those from more developed economies. Global audit networks may not always share common firm wide standards, and whilst global auditing standards seek to ensure that auditors use the same techniques and methods internationally, how effectively those standards are applied in practice will depend on the skills and expertise of the local workforce. We consider that qualification and training requirements should be reviewed in these less developed economies, rather than in the UK.

### **EFFECTIVENESS OF THE AUDIT PROCESS**

The DP highlights that an audit is likely to be more effective if:

- the structure, experience and knowledge of the team are appropriate;
- high quality technical support is available;
- the audit methodology:
  - provides a framework and procedures to obtain sufficient audit evidence;
  - provides for compliance with auditing standards without inhibiting judgment;
  - requires appropriate audit documentation;
  - ensures effective review of audit work;
- the objective of ethical standards is achieved; and
- audit control procedures are effective.

The possible threats identified are:

- increased use of computer methodologies;
- overly prescriptive auditing standards; and
- close client relationship impairing objectivity.

*Q 7 Are there other factors that determine whether an audit process is effective?*

*Q 8 Are there threats to the effectiveness of the audit process that have not been identified above?*

*Q 9 Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?*

The DP states that one of the key threats to an effective audit process is overly prescriptive auditing standards and regulation<sup>8</sup>. In this respect, in principle, we support the development of a single set of global audit standards so that auditors use the same techniques and methods internationally and that audit quality is the same regardless of where it is conducted. However, we have certain concerns about

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<sup>8</sup> page 32

the harmonisation of the International Federation of Accountants' (IFAC) International Standards on Auditing (ISAs) with national audit standards. The threats that this poses to the effectiveness of the audit process is not discussed in the DP and set out below are our specific concerns.

- *Governance of the bodies that set ISAs.* If ISAs are to be promulgated internationally then there needs to be a credible process over their development. However, we have concerns about the governance of the bodies that set ISAs - the International Audit and Assurance Board (IAASB) is part of IFAC which is funded by the accounting professional bodies and the large accounting firms.

We believe such a structure runs the risk that ISAs solely serve the interests of the large accounting firms. Measures have been taken to try to address this through:

- the establishment in 2005 of the Public Interest Oversight Board (PIOB) to oversee standard setting and IFAC's constitution; and
- the PIOB including representatives from the International Organization of Securities Commissioners, the Basle Committee on Banking Supervision, the International Association of Insurance Supervisors, the European Commission, and the World Bank.

Whilst these measures will help guard against standards being compromised by the interests of the large firms, we do not consider that they go far enough and that other steps should be taken in that:

- the PIOB could undertake a formal review of the IAASB's governance; and
  - a broader constituency should be involved in the development of ISAs and smaller audit firms, as well as investors and regulators, should be given the opportunity to participate.
- *A single set of standards does not address the fact that the underlying frameworks in the US and the UK are different.* There are significant historical differences between the UK shareholder-stewardship audit and a US regulatory audit. Thus in the UK auditors are appointed by and report to shareholders and the Law Lords in *Caparo Industries Plc*<sup>9</sup> ruled that auditors should ensure that financial information provides "shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided".

On the otherhand, in the US auditors are appointed by and report to Boards and ISA 260 states "the auditor should communicate audit matters of governance interest arising from the audit with those charged with governance [Boards of directors and those entrusted with the supervision, control and direction of an entity]."

- *ISAs are too prescriptive.* There are concerns that ISAs are too prescriptive. We consider that auditing standards should deal with basic principles and essential

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<sup>9</sup> *Caparo Industries Plc v Dickman and others* [1990] 1 All ER [1990] 2 WLR 358.

procedures, whereas many ISAs are unnecessarily detailed, prescriptive and inflexible. Thus there is a significant risk that they could result in additional costs to firms and their clients (particularly smaller entities) without any corresponding improvement in audit quality.

- *Different basis of opinions – true and fair view or reasonable assurance.* In principle, UK auditors are able to report and comment freely in audit opinions especially if there is uncertainty – they are engaged as agents under contract, they are not regulatory functionaries. Thus the auditor must give an opinion on whether the financial statements give a true and fair view of the state of affairs; are in accordance with the relevant reporting framework; and have been properly prepared in accordance with the Companies Act.

ISA's on the other hand give little freedom in what is reported and merely require reasonable assurance as to whether financial statements are presented fairly in all material respects in accordance with the applicable financial reporting framework.

- *Information covered.* Reporting has become increasingly complex and reporting both financial and non-financial information is vital in helping shareholders understand a company and its strategies and in the UK auditors have different responsibilities in relation to various parts of the annual report. Thus they are required to "audit" the financial statements, "review" the company's compliance with certain aspects of the Combined Code and "read" all information in the annual report that is not subject to any other requirements. Our understanding is that auditors have to review and read such "other information" because the credibility of the financial statements could be undermined by inconsistencies between the two or by apparent misstatements.

ISAs, on the otherhand, focus solely on the audit of the financial statements and do not consider the importance of narrative or non-financial reports.

IMA considers that another of the threats to audit quality that is not identified in the DP is the concentration of audits around 31 December year ends, i.e. audit resources may be thinly spread at this time. The FRC may want to conduct some research into this and consider whether there is a case for trying to spread year ends and audits more throughout the year.

## RELIABILITY AND REPORTING

The DP states that an audit report will command confidence when:

- it is highly codified and standardised in that key elements are specified in law and auditing standards; and
- there is good communication with the audit committee that encourages dialogue on the scope of the audit, provides a forum for a discussion of key risks and qualitative aspects of the entity's accounting and reporting and ways of improving reporting.

Threats to confidence in reporting are whether:

- auditors fulfill their responsibilities in relation to the adequacy of books and records.
- audit reports should be more informative about key audit issues.

*Q 10 Are there other factors that determine whether audit opinions command confidence?*

*Q 11 Are there other reasons why users may not have confidence in the audit opinion?*

*Q 12 Are there further steps that could be taken to reinforce confidence in an audit opinion? In particular, what changes to the form and content of the audit report should be considered?*

IMA considers that audit reports are only useful if they say something. Existing reports are too black and white and, as a qualified audit report can be damaging to a company, steps are taken to avoid this. If audit reports are to be more useful to investors they need to be more informative. In this respect, we consider that the Audit Quality Forum's report on auditor reporting<sup>10</sup> made some helpful suggestions that audit reports should contain the matters set out below.

- An opinion paragraph that adopts as soon as practicable the wording of section 495(3) of the Companies Act 2006 in its three distinct parts [as to whether the accounts:
  - give a true and fair view;
  - have been properly prepared in accordance with the relevant financial reporting framework; and
  - have been prepared in accordance with the Companies Act and, where appropriate, Article 4 of the IAS regulations].
- A positive statement that adequate accounting records have been kept as opposed to the current negative assurance.
- A positive statement that there are no matters that auditors should reasonably draw attention to by way of emphasis under Section 235 (2A)(b) of the Companies Act 1985 or Section 495 (4)(b) of the Companies Act 2006. In this respect, Section 495 (4)(b) currently states the audits "must include a

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<sup>10</sup> Page 4, Audit Quality, Fundamentals - Auditors Reporting, Fatal Flaw Review, January 2007, Institute of Chartered Accountants in England and Wales.

reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report". We believe this is too loosely worded and needs to be made tighter in order to ensure that the audit report reflects matters which arose during the course of the audit and which should be brought to the attention of members.

Furthermore, we consider that it would be helpful if audit reports contained more company specific information and, as noted by the Audit Quality Forum, the readability of audit reports would be enhanced by moving the opinion to the front of the report and much of the standardised text to the back or to an Appendix.

## **FACTORS OUTSIDE THE CONTROL OF AUDITORS**

The DP identifies factors outside the control of the auditors that affect quality as follows:

- management's approach to corporate governance and whether it would seek to obstruct the audit process;
- the role of audit committees in considering the audit scope, risk areas, plan and resources;
- shareholders support of auditors;
- role of litigation as a driver of quality;
- the approach of regulators and whether they have high quality staff; and
- tight reporting deadlines.

*Q 13 Are there other external factors that have the potential to adversely affect audit quality?*

*Q 14 Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective? Q 15 Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?*

*Q 16 Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?*

*Q 17 Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?*

We set out below our comments on the external factors that can influence the quality of audits.

- *Audit committees.* As reported by the Audit Quality Forum<sup>11</sup>, we consider the Combined Code recommendations for audit committees should be reviewed and amended so that audit committees' report to shareholders includes more specific information, such as, key issues and significant accounting and reporting matters discussed with auditors as a result of the audit. This would need to consider the auditors' role in relation to these disclosures.

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<sup>11</sup> Page 4, Audit Quality, Fundamentals- Auditors reporting, Fatal Flaw Review, January 2007, Institute of Chartered Accountants in England and Wales.

- *Auditors to attend Annual General Meetings.* In accordance with the Companies Act 2006, a certain minimum number of shareholders will be able to require the company to publish on its web site a statement relating to the audit or the circumstances connected with an auditor ceasing to hold office that they propose raising at the next Annual General Meeting.

IMA supports this, however, for it to be effective, auditors should be required to attend and be heard at such meetings. This should apply particularly where the board has “removed” the auditor or the auditor is retiring/resigning.

- *The appointment and removal of auditors.* Major shareholders would welcome more transparency as regards any changes of auditor and if they request, they should be consulted on the selection of an alternative from a wider range of firms. At present, shareholders ratify the appointment at the Annual General Meeting and are not involved in the selection process. Improved dialogue would also help shareholders support audit committees in responding to new information about potential problems faced by audit firms.

Furthermore, we consider that the requirements for the appointment and removal of auditors should be reviewed. The present notification and disclosure arrangements and the level of directors’ control over the appointment and removal of auditors can give rise to issues, particularly where fee income is significant (the current procedure where shareholders vote on the re-appointment of the auditors at the Annual General Meeting is not really effective). Improved arrangements should enable shareholders to engage with the company on the appointment and removal of auditors in a timely and efficient manner, where appropriate.