



LONDON SOCIETY
OF CHARTERED
ACCOUNTANTS

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Regulation and Ethics Review Panel

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Dear Jon,

FRC Discussion Paper on “Promoting Audit Quality”

I am writing as Chairman of the Regulation and Ethics Review Panel (RERP) of the London Society of Chartered Accountants (LSCA). The LSCA is by far the largest of the 22 district societies affiliated to the Institute of Chartered Accountants in England and Wales (ICAEW). It has a membership of 30,000, representing nearly one quarter of all ICAEW members, and also provides services for other ICAEW members who live or work in London. London members, like those of the Institute as a whole, comprise a mixture of those working in all sizes of practice and those working in businesses, both large and small, or otherwise not in practice. They also include many of the ablest and most senior Chartered Accountants, together with a wide range of specialists.

RERP welcomes the opportunity to comment on this discussion paper. We have concentrated on those parts of the paper that fall within the Panel's remit, namely regulation, ethics and training, but have also received valuable contributions from members of the LSCA's Technical Committee in preparing this response.

GENERAL COMMENTS

We note from page 6 that that the FRC has focussed its initial work, and the Discussion Paper, on audit quality in relation to UK listed companies and other public interest entities, but believes that its initiative will contribute to an understanding of audit quality in its broadest sense. **We are particularly concerned that no measures should be introduced that would adversely affect the practicalities of conducting audits of smaller entities.** These make up by far the greatest majority of audits and we would urge that the position of their auditors be taken fully into account in any changes that the FRC may wish to introduce.

We also believe that the whole issue would benefit from being viewed in the context of the wider financial reporting scene, as audit should not operate in a vacuum, and that the emphasis should be placed on principles and judgements, rather than on rules and detailed prescription.

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We note that the FRC refers throughout to the 'audit firm', which we believe in many cases is a misnomer, since many accountancy firms just have audit as a specialist division within the firm, although others have, of course, hived off the audit function into a specialist LLP.

However, subject to our various reservations and concerns, in broad terms we welcome this paper and the FRC's interest in audit quality.

RESPONSES TO SPECIFIC QUESTIONS

The culture within an audit firm

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

There appears to be no mention of the ownership and control of an audit firm and of the influence that this can have on the conduct of audit work. An audit firm needs to have rules in place to cover this point, as there needs to be a trade-off between the competitiveness of a firm and putting restrictions on who can own an audit firm.

We agree that effective and involved leadership with sufficient input into management decisions is very important.

It is also important that there is good technical training and support, both in the central and any regional offices. This needs to cover not just a firm's own audit methodology, but also wider issues, including ethics and risk management.

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

Stretched staff resources and tedium can both cause stress on an audit firm's culture.

We are also concerned that, if audit becomes too regulated and specialist, it will start failing to attract good candidates, as few well-qualified people look to a permanent career in which auditing is the sole activity. It is important that firms provide a range of experience, not least because these wider skills can be of benefit in conducting a high quality audit. In addition, over-regulation and increasingly complex and lengthy standards can lead to a 'box-ticking' approach.

Another potential threat is that audit fees are not currently set at a level that adequately rewards the service provided. If the audit of listed companies and other public interest entities cannot stand as a profitable activity in its own right, it is difficult to see how audit quality can be maintained or improved. Although these days ethical standards should prevent audits from being used as a lever to obtain other work, there is more profitable and interesting work in, say, corporate finance, so the best professionals will tend to gravitate to such areas.

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?

As the AIU mentioned in its report on Audit Quality 2005-06, it is important that firms have sufficient technical and other central resources adequately to take on board major changes in the regulatory framework and other relevant developments, if they are to take on the audit of public interest and similar entities. At the same time, steps should be taken to stagger the introduction of such changes as far as possible, in order to avoid firms being swamped by the attempt to integrate them all.

There is a role for both the FRC and the recognised bodies to play in promoting confidence in auditing.

Greater involvement of audit committees can support the role of the auditor.

The skills and personal qualities of audit partners and staff

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

We agree.

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?

We agree that the paper has identified some areas that need to be borne in mind, but do not believe that the current situation is such as to lead to an inadequately trained or skilled workforce for audit. One other matter that should perhaps be considered, when one audit team spends a high proportion of its time on the affairs of a single client, is the need for good independent partner involvement to guard against over-dependence.

We also believe that over-specialism in itself can be a problem, as it can result in too theoretical an approach without regard to the wider practicalities. One needs a breadth of experience within an audit team to ensure the highest quality.

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

We see no compelling evidence to suggest that a fundamental review is required. As you will know, ICAEW is in the process of introducing a new ACA examination with an updated syllabus, which we believe fully covers the required technical elements, whilst setting audit in a practical and realistic business environment. Auditing remains an essential element of both pre and post qualification training through the examinations and through CPD for those involved in this area. As stated above, if audit becomes too specialist, we are concerned that many potentially high quality auditors will be lost, as few people will wish to make a long-term career in auditing.

In any case, ethical standards should prevent an individual from undertaking work that he or she is not qualified and competent to perform.

The effectiveness of the audit process

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

We note that paragraphs 5.14 to 5.16 discuss the inherent limitations of an audit. We suggest that the FRC has a role to play in educating the public about what an audit is, what they should expect from it, and the limitations of the audit process. This would enable the effectiveness of the audit process to be assessed more realistically. Many people just see an audit as a way of detecting fraud, rather than checking that the figures presented give a true and fair picture. By educating people, the FRC could help to inspire public confidence in the audit process.

We disagree with the premise that seems to be implicit in the current initiative that audit quality is lacking.

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

We feel that, although identified in the chapter, insufficient weight has been given to the very real threat posed by over-prescription and reliance on standards and regulation, rather than considering whether the appropriate approach is being taken for each individual audit. We feel that much of the responsibility for this lies at the door of the FRC and its subsidiaries themselves in the way in which they promulgate standards. The APB in its Ethical Standards has recognised the need for them to be principles-based, and we urge that this approach be followed for all standards relating to audits.

There is also the potential risk caused by a domineering chief executive or client, which does not appear to be mentioned in this paper.

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

Emphasising the risk-based approach and designing the audit accordingly, rather than working by rote, can help to counter threats to the efficiency of the audit. Audit committees have an important role to play in discussing the approach to be taken.

The ICAEW's Audit Faculty has produced documents explaining the purpose of an audit, which we suggest the FRC might wish to support.

Research should be carried out into the practical difficulties caused by enforced partner rotation, particularly with regard to smaller firms.

The reliability and usefulness of audit reporting

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

This is about reputation risk, and it is possibly the name as much as the 'clean' audit report that inspires confidence.

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

Because of the long filing deadlines, it is quite possible that the information is out of date before users have access to it. They may also not have confidence in the report if they do not understand it, and from this perspective the proposal to replace a simple statement about 'true and fair' by additional verbiage, including disclosure of the basis of the auditors' conclusions, is unhelpful.

Users may also not have confidence in the audit opinion if they learn about it through the media rather than directly.

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?

We believe that reports should be kept simple, with straightforward statements about any qualifications.

Factors outside the control of auditors affecting audit quality

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

The quality of a client's staff and of the information produced can have a significant impact, and put pressure, both on independence and on the quality of the audit.

The need to be able to make a quick announcement of a company's profit or loss position puts additional pressure on the auditors.

The complexity of financial reporting standards is leading to pressures that threaten audit quality. Even many public companies cannot understand the standards and therefore need to get experts in, but may be reluctant to do so given the additional cost involved. This creates pressure on the resources of auditors and possible threats to their independence. Many AIM companies in particular are often relatively small entities.

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?

If the chairman of the committee were required to put his signature to the annual report, it could encourage a greater focus on his responsibilities.

Q.15 Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?

There is already guidance available for audit committees. We remain to be convinced of the need for any further guidance or, if there should be such a need, that the FRC would be the best body to develop it.

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

We feel that it might be advantageous for audit committees to produce a brief report of what they have done during the year and why they have taken the actions they did. In some sectors, summaries of the work of the audit committee already appear in annual reports.

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

None that we can ascertain.

If you would like to discuss any of our comments in further detail, or wish additional clarification of our views, please do not hesitate to contact me.

Yours sincerely,

Bruce Picking, MSc, FCA
Chairman, Regulation and Ethics Review Panel