

ODCE RESPONSE TO FRC PAPER “PROMOTING AUDIT QUALITY”

Introduction

The Office of the Director of Corporate Enforcement (ODCE) is pleased to be able to respond to the FRC Discussion Paper ‘Promoting Audit Quality.’ The paper outlines a number of important issues facing the audit profession, in the light of the controversies surrounding high-profile collapses such as Enron as well as the recent changes to International Financial Reporting Standards and International Standards on Auditing.

The underlying perspective of the paper is that audit is fundamentally sound but that there are threats that need to be addressed. In general the ODCE would agree with this proposition. The paper goes on to ask several questions divided into separate areas. These are the culture within audit firms, skills and qualities required of staff, threats to the audit process, reliability and usefulness of audit reporting, and factors outside the auditor’s control affecting audit quality. In all seventeen questions are posed based on the paper’s contents.

ODCE position

Many of the questions posed are not of relevance to the ODCE, and the ODCE would have little to add to the discussion in these areas. That being said, our position as being in receipt of reports from auditors based on their audit work and informed by the quality of that work brings into focus some of the threats to quality that are identified in the paper. In addition based on discussions within the Office we would have serious concerns as to the quality of some audits which is not given as much emphasis by the FRC.

FRC Questions and ODCE position

The Culture within an audit firm

1. Are there other important factors of an audit firm’s culture?

ODCE Response: The ODCE believes that complete and ongoing training, including specifically the auditor’s legal responsibilities under the Companies Acts, should be emphasised within an audit firm.

2. Are there other pressures that could compromise the culture of audit firms?

ODCE Response: None that the ODCE can specifically attest to.

3. Are there further steps that could be taken to build confidence in the culture of audit firms?

ODCE Response: Audit firms tend towards doing the legal minimum in their dealings with the ODCE. We do not believe that this reflects well on the culture of promoting quality and independence. The ODCE believes that firms should be encouraged to assist regulatory authorities as much as possible in carrying out their regulatory work, especially where auditors have reported evidence of potential wrongdoing.

The Skills and Personal Qualities of Audit Staff

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

ODCE Response: Yes

5. Has the paper adequately identified the issues that could result in an inadequately trained or skilled workforce?

ODCE Response: The ODCE believes that there are particular issues with smaller audit firms, where the level of in-house training and keeping abreast of in particular legal developments may not match those provided for example by the Big 4. The ODCE has come across numerous examples of very poor quality audits, including evidence of auditors being unaware of their legal obligations both to this Office and to their clients in circumstances when an obligation to report an indictable offence under the Companies Acts arises. Other examples of poor audit quality are outlined in response to questions 10 and 12 below.

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

ODCE Response: The ODCE believes that there may be deficiencies in auditors being sufficiently trained on their company law obligations, and in particular on how these have developed as the law has changed. Moreover the fact that these are requirements under law should mean that auditors should be required to bring themselves up to speed on these developments in particular.

The Effectiveness of the Audit Process

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

ODCE Response: The key factors are outlined in the Paper. However the Office has concerns as to what extent in practice the factors supporting audit quality are present in all audit firms, especially smaller firms.

8. Are there other threats to effectiveness?

ODCE Response: The ODCE concurs with the view that “box-ticking” and an overly prescriptive approach to auditing can endanger audit quality. The Office has seen situations where systems audits have become so much the focus of the audit process that for example stocktakes have not been attended. The comments made in the paper to the effect that audit staff could become demotivated and therefore difficult to retain as a result of the diminution in audit skill due to the increasing mechanical nature of audit are relevant.

9. Are there further steps to be taken to counter the threats?

ODCE Response: As indicated above the ODCE has concerns that the structures alluded to in the document, such as access to technical support and a strong audit methodology, are not universally in place, and this problem is more serious in smaller audit firms. Such small firms in particular need enhanced oversight from their professional bodies. In some circumstances this appears to be related to the size of and resources available to these bodies.

The Reliability and Usefulness of Audit Reporting

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

ODCE Response: The quality of the wording of audit reports has been a source of concern to the ODCE. For example some reports have indicated clearly that there have been issues with the maintenance of accounting records, yet the reports go on to state that proper books of account have been kept in accordance with Section 202, Companies Act 1990 (ROI). Clearly these statements are incompatible and this is not a rare occurrence.

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

ODCE Response: The ODCE cannot comment on the views of other users but perhaps they may share some of the concerns of the ODCE as outlined above.

12. What further steps can be taken to reinforce confidence in the audit opinion?
Should there be any changes to the form and content?

ODCE Response: The ODCE would like to see more information in the audit report where it is qualified. For example we have seen audit reports incorporating a limitation in audit scope due to the existence of cash sales. However if the report accompanies abridged accounts then there is insufficient information supplied to ascertain the materiality of this scope limitation. In addition the ODCE is aware of situations where auditors uncover issues with earlier sets of accounts and deal with them by means of a prior year adjustment and then only disclose limited information about the problems that gave rise to the adjustment. A similar issue has arisen where an auditor has had issues with books for a particular year, and rather than having a qualified audit the company has replaced the current auditor with a new auditor who provides a clean audit report for a two year period.

Factors Outside the Control of Auditors Affecting Audit Quality

13. Are there other external factors that could affect audit quality?

ODCE Response: Increasingly the ODCE has had to take on a small role in improving audit quality by informing auditors of their legal responsibilities. However while the Office has this type of role, we feel that in this area the primary responsibility lies with the representative bodies to which audit firms and auditors are themselves attached.

14. Are Audit committees discharging their responsibilities in relation to audit adequately?

ODCE Response: The ODCE has had little exposure to date to the work of audit committees, other than in one case in particular which dates back to the early 1990's. In that case a report of Inspectors appointed by the High Court stated that they were dissatisfied with the work of the Audit Committee. Recent legislation in Ireland will require plc's to establish audit committees, as well as requiring large private companies to either establish such committees or detail the reasons why they have chosen not to do so. This may serve to boost the role of audit committees in the Irish corporate landscape.

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

ODCE Response: The aforementioned Irish legislation sets out clear requirements of audit committees in the area of determining audit effectiveness. In conjunction with the guidance issued by this Office on the legislation and the forthcoming Eighth Directive, this could form the basis for FRC Guidance on best practice in this area. A copy of our Guidance is included with this submission.

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

ODCE Response: The Irish legislation provides for the inclusion in the report of the directors a report by the audit committee on their work during the year, including specifically their work in monitoring the performance and quality of the auditor's work and his/her independence from the company

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

ODCE Response: Forthcoming Irish legislation will impose on directors of all plc's and medium and large companies (turnover over €25m and balance sheet over €12.5m) the requirement to accept responsibility for the company's compliance with tax law and significant company law obligations. This will be combined with the requirement to put into place appropriate arrangements or structures and to ensure that such obligations are complied with. (A copy of this proposed legislation is include at Appendix 1, although it remains the ODCE view that a stronger provision would be more useful.) On enactment in Ireland, auditors should ensure that there is proper supporting evidence for the directors' assertions. Evidence that management are taking their responsibilities seriously will enable auditors to deliver a higher quality product. This may again serve as a useful template for wider application.

Office of the Director of Corporate Enforcement
4 April 2007

Appendix 1

Proposed legislation on Directors' Compliance Statements (note, all references are to Irish legislation)

X.—(1) In this section—

'amount of turnover' and 'balance sheet total' have the same meanings as in section 8 of Companies (Amendment) Act 1986;

'relevant obligations', in relation to a company, means the company's obligations under—

(a) the Companies Acts, where the failure to comply with any such obligation is an indictable offence under the Companies Acts, and

(b) tax law,

'tax law' means—

(a) the Customs Acts,

(b) the statutes relating to the duties of excise and to the management of those duties,

(c) the Tax Acts,

(d) the Capital Gains Tax Acts,

(e) the Value-Added Tax Act 1972 and the enactments amending or extending that Act,

(f) the Capital Acquisitions Tax Act 1976 and the enactments amending or extending that Act,

(g) the statutes relating to stamp duty and to the management of that duty, and

(h) any instruments made under an enactment referred to in any of paragraphs

(a) to (g) or made under any other enactment and relating to tax.

(2) This section applies to—

(a) a public limited company (whether listed or unlisted), and

(b) a private company limited by shares, but it does not apply to a company referred to in paragraph (a) or (b) that is of a class exempted under *section 48(1)(j)* of the *Act of 2003* from this section or to a company referred to in paragraph (b) while that company qualifies for an exemption under subsection (6).

(3) The directors of a company to which this section applies shall also include in their report under section 158 of the Principal Act a statement—

(a) acknowledging that they are responsible for securing the company's compliance with its relevant obligations, and

(b) confirming that the company has in place a compliance policy statement that is, in the opinion of the directors, appropriate for the company; and, if this is not the case, specifying the reasons, and

(c) confirming that the company has in place, appropriate arrangements or structures that are, in the opinion of the directors, designed to secure material compliance with its relevant obligations, which arrangements or structures may (at the discretion of the directors) include the company's reliance upon internal and or external advisors who appear to the directors to have the requisite knowledge and experience to advise the company on compliance with its relevant obligations); and, if this is not the case, specifying the reasons, and

(d) confirming that the company's arrangements or structures referred to in paragraph (c), have been reviewed during the financial year to which the report relates, and, if this is not the case, specifying the reasons.

(4) For the purposes of this section, a company's arrangements or structures are considered to be designed to secure material compliance with its relevant obligations if they provide a reasonable assurance of compliance in all material respects with those obligations.

(5) Where the directors of a company to which this section applies fail to comply with subsection (3), each director to whom the failure is attributable is guilty of an offence.

(6) A private company limited by shares qualifies for an exemption from this section in respect of any financial year of the company if, either—

(a) its balance sheet total for the year does not exceed—

(i) €12,500,000, or

(ii) if an amount is prescribed under *section 48(1)(l)* of the *Act of 2003* for the purpose of this provision, the prescribed amount,

or, in the alternative to the provisions in (a),

(b) the amount of its turnover for the year does not exceed—

(i) €25,000,000, or

(ii) if an amount is prescribed under *section 48(1)(l)* of the *Act of 2003* for the purpose of this provision, the prescribed amount.