

# RSM Robson Rhodes

JEC Grant  
Financial Reporting Council  
5th Floor, Aldwych House  
71-91 Aldwych  
London  
WC2B 4HN

RSM Robson Rhodes LLP  
30 Finsbury Square, London EC2P 2YU  
United Kingdom  
T: +44 (0)20 7184 4300 F: +44 (0)20 7184 4301  
www.rsmi.co.uk

Dear Mr Grant

## **The FRC discussion paper: 'Promoting Audit Quality'**

We welcome the opportunity to comment on the above discussion paper. You will find our detailed responses to the questions posed attached as Appendix 1.

All our comments are given in the context that we believe there is currently no systemic failure in audit quality. Our view is that most, if not all, the major firms are performing work of a high quality and, if this is not the case, the AIU and other regulatory bodies should make this clear. We believe that the atmosphere of continual questioning as to the fundamental existence of audit quality in UK audit firms over the past two years has been one of the main drivers to undermining user confidence. Additionally, a regulator who only reports negatively can have a profoundly damaging effect. Whilst we still want to see weaknesses identified, if this is done in a vacuum, free of positive comment, then the investor community, the press and the general public only see failure, and trust in the auditor and in the audit opinion is eroded. If UK audits are being performed to a standard or level of quality that satisfies all relevant stakeholders, then the regulators should be clear about this, call a halt to any notions of seeking the holy grail of perfection and, in so doing, restore confidence in audit opinions given.

With this in mind, we would like to highlight some of the key themes which are reflected in our detailed responses.

### ***Quality, fee pressures and conflicting stakeholder objectives***

Whilst recent regulatory changes have increased the quantity of work to be performed by the auditor, the pressure on audit fees has increased. The interaction between more onerous auditing requirements and increasing fee pressure has the potential to impede the delivery of quality audit work.

Related to this is the potential disconnect between management and shareholders. All too often a conflict of objectives is revealed. Management's objective with regard to the audit can often be to minimise cost – to achieve the cheapest possible audit opinion from a firm with a reputation which will ensure confidence from the market. However, the shareholders' objective will normally be for an audit to be thorough and of a high quality – to give them confidence that their investment decisions are secure.

We therefore believe there is need for research to be performed and advice to be given to directors on audit fees. We believe the FRC should consider the long-term viability of the audit profession in the light of substantial fee pressure by considering what is a fair fee to be charged by firms. This should examine the cost of providing partner-led teams of high quality trained and experienced staff supported by appropriate technical resource. We believe that such a study would also, in and of itself, help audit committees better understand the audit process and recognise the value of an effective audit.

### ***Dangers of two tier regulation***

AIU inspections have taken a key place in the pursuit of audit quality. Their rigorous inspections demand substantial dedicated resource from firms. However, they only focus only on clients within their scope – mainly fully listed companies. The QAD retains the responsibility for inspecting all other audit engagements, however these inspections are much less detailed and, in our experience, there is little or no effective communication or coordination between the two bodies.

Inherent in this two tier system is a significant danger for the firms – the temptation to create a two tier approach to audits: one to satisfy the rigours of the AIU; and another for the rest. We fear that some

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firms may be driven into accepting such an approach, with the delivery of high quality audits to listed companies with others receiving something less. This is not in the interests of the many stakeholders in UK entities which fall outside the AIU regime.

Where government mandates that a statutory audit is required, we believe there should be a standard regulatory process to oversee the provision of audit services. We propose that the QAD and AIU should work much more closely together and bring the level of detail of their reviews into line. From the viewpoint of the firms, there would then be consistency in inspections and we would avoid the possibility of two tiers of audit quality across the UK audit profession.

#### ***Regulator - Investor expectation gap***

Despite efforts of standard setters to engage with investors, our discussions with the market evidence a consistent voice that this has not been effective. Investors do not feel they are being sufficiently involved in the audit quality debate. It is they, as primary stakeholders in audit quality, who need to have confidence in the culture and work of audit firms. We recommend that further steps should be taken towards a more proactive and meaningful dialogue between the FRC and investors.

Furthermore, in our experience, only a small proportion of the investment community understand the purpose of an audit. An even smaller percentage of investors understand auditing and financial reporting standards. Consequently, there continues to be an expectation gap between the investment community and standard setters. It will be difficult to improve confidence in the audit process until this gap has been narrowed or closed. Part of this will involve the FRC and other regulatory bodies proactively seeking the views of investors. However, a significant element of the responsibility rests with investors who will need to commit time and energy to improving the skillset of their people. There will be a price to pay for continued improvements in audit quality and we should ensure that both the users and preparers of financial statements understand the costs as well as the benefits of these improvements.

#### ***Pace of regulatory change***

The recent pace of regulatory change towards a more prescriptive and complex regime has been unprecedented.

Two weaknesses arising from detailed prescription are that audit staff may become less thoughtful as to how they conduct their audit work and that the partner's application of judgement might be undermined. First, there is a trend for staff to be increasingly encouraged to believe that, so long as they complete the correct boxes, they will have performed a good audit – one which will stand up to internal and AIU scrutiny. Second, partners' long developed experience and intuition (the "sniff test") is under pressure to be ousted from the quality firm's bank of audit tools as anything incapable of being articulated and measured appears to have no value in this new environment. Both factors expose firms to the danger that ever-increasing audit regulation may lead us directly away from improvements in audit quality.

The combination of over-prescription and increasing complexity of auditing, ethical and accounting standards are placing a substantial strain on audit partners and staff. Entirely new concepts and reams of new rules mean that audit partners and managers are continually playing catch-up with knowledge, rather than being a mentoring resource for experienced application of tried and tested approaches. This in turn places a great burden on technical resource. We believe that the pace of regulatory change is self-defeating – although intended to improve quality, in reality it is placing strain on the ability of audit firms to deliver in an optimum way.

If you would like to discuss these matters further, please contact Glyn Williams, head of our audit practice.

Yours faithfully,



RSM Robson Rhodes LLP

## Appendix 1

<b>Question 1</b>	<b>Are there other important indicators of an audit firm's culture that are not referred to in the discussion paper?</b>
<p>The paper identifies the following as the principal indicators of whether a firm has an appropriate culture from the perspective of enhancing audit quality:</p> <ul style="list-style-type: none"><li>• Whether the firm's leadership promotes effectively the importance of the firm properly discharging its professional responsibility as an auditor.</li><li>• Whether in complying with ethical and professional conduct standards, the firm has regard to the fundamental principles of those standards and acts in a way that respects those principles.</li><li>• Whether the firm's training, counselling, appraisal, promotion and remuneration structures promote the personal characteristics – such as integrity, objectivity, rigour, scepticism, perseverance and robustness – that are essential to quality auditing.</li><li>• Whether the firm avoids decisions dictated by short term financial considerations where those decisions would have a negative effect on audit quality.</li><li>• Whether the firm attaches importance to the effective provision of technical support, to risk management and to compliance with ethical standards.</li><li>• Whether appropriate emphasis is given to the development of an information infrastructure to support the audit function.</li></ul> <p>We consider that these are important indicators of a strong quality culture. In particular, in our view, it is the effectiveness of partner leadership on quality matters (the "tone at the top") combined with the cascade of this through the business, which underpins a quality culture within the firm.</p> <p>We would also highlight the important work already undertaken in this area by the Audit Quality Forum and the ICAEW, in particular "Audit Quality" published by the ICAEW Audit and Assurance Faculty in 2002. A key aspect of firms' culture highlighted within this report is the approach to the management of client relationships. Client and other stakeholder feedback, both formal and informal, is a relatively objective indicator of how an audit firm demonstrates its commitment to a quality culture.</p>	

<b>Question 2</b>	<b>Are there pressures that could compromise the culture of audit firms that have not been identified in the discussion paper?</b>
<p>The pressures identified within the paper were:</p> <ul style="list-style-type: none"> <li>• The leadership of the audit function having insufficient input into management decisions because of the competing interests of other parts of the practice.</li> <li>• Over-emphasis on winning audit appointments and on the retention of audit clients at the expense of the quality of audit judgments.</li> <li>• Over-emphasis on non-audit services combined with under-investment in audit, with the consequential migration of valuable talent to other practice areas and to industry.</li> <li>• Excessive cost cutting (including by reducing partners and staff) in the audit practice during times of economic downturn that damage the provision of audit quality in the medium term.</li> <li>• Internal training that is focused on improving client service at the expense of necessary training in technical competence and understanding the public interest aspect of auditing.</li> </ul> <p>We concur that these represent threats to a culture of quality. However, we believe there are at least two other pressures which can compromise culture:</p> <ul style="list-style-type: none"> <li>• First, whilst recent regulatory changes have increased the quantity of work to be performed by the auditor, the pressure on audit fees has increased. The interaction between more onerous auditing requirements and increasing fee pressure has the potential to impede the delivery of quality audit work.</li> <li>• Second, but related, is the potential disconnect between management and shareholders. As auditors we have to manage relationships with both parties, however, all too often a conflict of objectives is present. Management's objective with regard to the audit can often be to minimise cost – to achieve the cheapest possible audit opinion from a firm with a reputation which will ensure confidence from the market. However, the shareholders' objective will normally be for an audit to be thorough and of a high quality – to give them confidence that their investment decisions are secure.</li> </ul> <p>We therefore highlight our comments in response to question 14 which call for research work to be performed, and guidance to be issued to management as to what might constitute appropriate audit fee levels for their organisation</p>	

<b>Question 3</b>	<b>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?</b>
<p>The discussion paper highlights that, under UK implementation of the 8<sup>th</sup> Directive, all auditors of public interest entities will be required to publish annual “transparency reports”. This process will give information on audit firms, including details of structure, governance and the firm's systems for ensuring audit quality. Clearly the first round of mandatory “transparency reports” will communicate something of the ethos of firms, and the quality systems commentary in particular should assist stakeholders gain a high level overview of the level of priority a firm places on quality. However, we fear that the qualitative information within reports will quickly become highly standardised, and from this point the additional regulatory reporting burden will not add significantly to the objective of generating assurance as to the real quality of firms' audit work.</p> <p>Looking to the bigger picture, despite efforts of standard setters to engage with investors, our discussions with the market evidence a consistent voice that this has not been effective. Investors do not feel they are being sufficiently involved in the audit quality debate. It is they, as primary stakeholders in audit quality, who need to have confidence in the culture and work of audit firms. Rather than seeking to keep raising the bar of audit quality towards a utopian ideal, we need to ensure quality alignment with those whose confidence needs to be gained. We recommend that further steps should be taken towards a more proactive and meaningful dialogue between the FRC and investors.</p>	

<b>Question 4</b>	<b>Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?</b>
<p>We certainly agree that technical skills, personal qualities and practical experience are all key to an audit business and all feed into the firms' abilities to carry out quality audit work.</p> <p>Technical skills, including knowledge and the application of that knowledge, are essential to the conduct of every audit. For this reason we would like to see a continuing re-emphasis on these core skills within the professional qualifications. Firms have the responsibility to build on this training to invest in maintaining their own quality culture – this will include an ongoing focus on developing sound business understanding, continual reminders of professional ethics, as well as CPD tracks appropriate for the individuals concerned. It is this emphasis on professional and technical excellence, tailored to the individual, which ensures that quality is engendered and maintained at all partner and staff member levels. Practical experience is then initiated by a strong mentoring culture coupled with an environment of on-the-job training.</p> <p>We and, in our experience, other major firms invest substantially in these areas.</p>	

<b>Question 5</b>	<b>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?</b>
<p>The paper identifies that at least the following issues could result in an inadequately trained or skilled audit workforce:</p> <ul style="list-style-type: none"> <li>• A lack of mentoring resource, or pressure on these individuals to spend their time elsewhere;</li> <li>• Difficulties retaining experienced staff who may leave after qualification;</li> <li>• Best resource being allocated to most prestigious clients, leaving other clients poorly served; and</li> <li>• Higher risk clients being passed over by the best firms in the interests of risk management, leaving them to firms without the requisite skills and experience.</li> </ul> <p>We would also like to highlight the pressure on finding top quality talent. In September 2007, the largest nine firms will be recruiting around 5,000 new graduates into audit – most of these into positions within the Big 4. There could be difficulties, especially for smaller and less well known firms, in ensuring that the quality of new recruits is not compromised.</p>	

<b>Question 6</b>	<b>Should there be a fundamental review of the qualification and training requirements for auditors?</b>
<p>As noted in our response to question 4, technical skills, including knowledge and the application of that knowledge, are essential to the conduct of every audit. For this reason we support continuing emphasis on these core skills within the professional qualifications. We believe, the ICAEW and ICAS are both moving in the right direction in this regard.</p> <p>Further improvement can continue to be made to the quality of firms' in-house training and CPD programmes. However, the AIU spend considerable time focusing on this and the overall staff development processes and, to date, their comments to us have been positive. We believe that occasional recommendations from the AIU in the light of their best practice observations are the most appropriate means of ensuring continual improvement.</p> <p>Overall, we do not believe that a fundamental review of either pre-qualification or post-qualification training, with the inevitable cost and time commitment implications, is either necessary or desirable.</p>	

<b>Question 7</b>	<b>Are there other factors that determine whether an audit process is effective?</b>
<p>The factors identified within the paper are:</p> <ul style="list-style-type: none"> <li>• the structure of the audit team;</li> <li>• access to appropriate technical support;</li> <li>• the audit methodology;</li> <li>• achieving the objectives of ethical standards; and</li> <li>• firm-wide quality control procedures.</li> </ul> <p>We agree that these represent the key factors in the effectiveness of the audit process. In particular we would highlight the importance of the audit team's collective responsibility to deliver a quality audit, under the leadership of the partner. Like any good team, the whole should be much greater than the sum of the parts, critically because of the essential process of formal and informal mentoring. The partner should be on site in the audit room – not to be seen by the client to be there, but to demonstrate the practical application of audit judgment and to mentor the team. Effective audit work is not a box-ticking, process driven exercise – it is a professional skill learned in the field, not a set of rules taught in the classroom.</p>	

<b>Question 8</b>	<b>Are there threats to the effectiveness of the audit process that have not been identified above?</b>
<p>The specific key threats identified in the paper are:</p> <ul style="list-style-type: none"> <li>• increased use of computerised audit methodologies;</li> <li>• over-prescriptive auditing standards and regulation; and</li> <li>• client capture.</li> </ul> <p>It is clearly important to document work performed to a high standard, and to this extent we welcome standards such as the revised ISA 230 (UK and Ireland). However, two weaknesses arising from detailed prescription are that audit staff may become less thoughtful as to how they conduct their audit work and that the partner's application of judgement might be undermined. First, there is a trend for staff to be increasingly encouraged to believe that, so long as they complete the correct boxes, they will have performed a good audit – one which will stand up to internal and AIU scrutiny. Second, partners' long developed experience and intuition (the "sniff test") is under pressure to be ousted from the quality firm's bank of audit tools as anything incapable of being articulated and measured appears to have no value in this new environment. Both factors expose firms to the danger that ever-increasing audit regulation may lead us directly away from improvements in audit quality.</p> <p>The combination of over-prescription and increasing complexity of auditing standards, ethical standards and accounting standards are placing a substantial strain on audit partners and staff. Entirely new concepts and reams of new rules mean that audit partners and managers are continually playing catch-up with knowledge, rather than being a resource for experienced application of tried and tested approaches. This in turn places a great burden on technical resource. We believe that the pace of regulatory change is self-defeating – although intended to improve quality, in reality it is placing strain on the ability of audit firms to deliver in an optimum way.</p> <p>Finally, we understand the dangers of client capture – that the auditor's scepticism may be eroded by a close relationship with the client. However, we must again ensure that our thinking in this regard is balanced in order to achieve an outcome of quality. An audit partner who applies sound professional judgement and robust challenge, overseen by an independent partner, ethics partner and an engagement quality control review function, will be most effective when that partner has a deep knowledge of the client's business. Upon partner rotation (or even more so, firm rotation), the lower level of business understanding is likely to impair audit effectiveness at least for the first one or two years.</p>	

<b>Question 9</b>	<b>Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?</b>
<p>Our comments in response to question 8 are not intended to sound like “humbug” in regard to progress and a harking back to the good old days. As inferred, there is much relating to the modern regulatory regime which is sound, beneficial and is strengthening audit effectiveness in the UK and international arena. However, there is a danger that we will continue to pursue change for change's sake, and this should be resisted. Continual moving of the goal posts is disorienting to those setting firms' policies and the partners and staff trying to follow those policies.</p> <p>We have noted the AIU's key interest in ensuring our audit processes are in compliance with new standards. Whilst we understand their focus on these areas, a grading on a firm's ability to keep pace with continuing change is surely not the priority in the search for quality and, incidentally, will always favour the largest firms with the greatest resources. We believe that a period of stability in the regulatory regime would facilitate a bedding-down of audit processes, which in turn would assist firms in their desire to focus on quality work.</p> <p>Furthermore, the AIU's own tick-box approach to review worsens the situation. Two important considerations:</p> <ul style="list-style-type: none"> <li>• Can you have an audit which doesn't meet the AIU's quality definition, but which is effective?</li> <li>• Can you have an audit which does meet the AIU criteria, but which will fail shareholders?</li> </ul> <p>We believe the answer to both is “Yes”. It is essential that we note the dangers inherent in mechanical audit documentation in an increasingly prescriptive environment. Regulators must take a bigger picture approach if they are to assess real quality. Ultimately, if the regulatory regime (standard setting and quality inspection) has a negative effect on the quality of UK audit work, then it is not fit for purpose.</p>	

<b>Question 10</b>	<b>Are there other factors that determine whether audit opinions demand confidence?</b>
<p>The factors identified in the paper as determining the confidence demanded by audit reporting are:</p> <ul style="list-style-type: none"> <li>• the form of the audit report; and</li> <li>• good communication with audit committees.</li> </ul> <p>We firmly believe that confidence in the audit opinion is derived from confidence in the provider of the audit opinion. This in turn is driven by reputation and market perception of the auditor community and, to a varying degree, the reputation and standing of the firm issuing the report. We would underline that confidence is in the existence of an opinion, not in the form or wording of the audit report. We therefore believe that the form of the standard audit report should be changed infrequently and kept as straightforward as possible.</p> <p>There have been substantial improvements in auditor's reporting to audit committees over the past 10 years. In consultation with non-executives, we believe there is scope for this improvement to continue. Of greater concern, however, is the impact of regulatory overload on the audit committees themselves – in this regard we refer to our comments in response to question 14.</p>	

<b>Question 11</b>	<b>Are there other reasons why users may not have confidence in the audit opinion?</b>
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The reasons identified in the paper are:

- Changes or restrictions in the scope of the audit report;
- Concerns that auditors do not properly discharge responsibilities relating to duties regarding adequacy of accounting records; and
- Restriction of audit reports to standard wording, rather than setting out key audit issues and their resolution.

Critically, we believe that the atmosphere of questioning the fundamental existence of audit quality in UK audit firms over the past two years has been the main driver to undermining user confidence. A regulator who only reports negatively has a profoundly damaging effect. Whilst we still want to see weaknesses identified, if this is done in a vacuum free of positive comment, then the investor community, the press and the general public will always see failure and trust in the auditor is eroded.

In our view, audit quality is here. Most, if not all, the major firms are performing work to this level. If this is not the case, the AIU should make this plain. However, if UK audit work is being performed to a standard which is of a level of quality to satisfy all relevant stakeholders, then the regulators should be clear about this and, in so doing, restore confidence in opinions given.

<b>Question 12</b>	<b>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?</b>
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We highlight our comments made in response to questions 10 and 11 above and would also draw attention to the work performed by the Audit Quality Forum in this regard.

<b>Question 13</b>	<b>Are there other external factors that have the potential to adversely affect audit quality?</b>
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The factors identified in the paper are:

- the approach taken by management;
- the contribution made by audit committees;
- the role of shareholders and commentators;
- the role of litigation as a driver of audit quality;
- the approach of regulators; and
- the pressures caused by the accelerating reporting regime.

Whilst we believe that these fairly represent the external influences on audit quality, we believe that some of the most significant adverse effects arise from the interaction between these factors.

<b>Question 14</b>	<b>Are audit committees discharging their responsibilities in relation to audit quality adequately and, if not, what further steps might be taken to make their role more effective?</b>
<p>The board has a statutory responsibility to produce financial statements which are “True and Fair”. However, we have observed that, in too many situations, audit committees (and indeed, directors more generally) have a poor understanding of financial reporting. Therefore, before an audit committee can be expected to understand audit effectiveness, the level of directors’ understanding needs to be raised.</p> <p>When considering effectiveness, however, our experience is that management, audit committees and other non-executives often believe that an effective audit is one completed on time and to budget at a low price. The audit may or may not have been completed well from a quality perspective.</p> <p>To this effect, we believe there is need for research to be performed and advice to be given to directors on assessing the effectiveness of external auditors, including guidance on appropriate and adequate remuneration for the provision of audit services. We believe the FRC should consider the long-term viability of the audit profession in the light of substantial fee pressure by considering what is a fair fee to be charged by firms. This should examine the cost of providing partner-led teams of high quality trained and experienced staff supported by appropriate technical resource. We believe that such a study would also, in and of itself, help audit committees better understand the audit process and recognise the value of effective audit.</p> <p>Finally, despite recent advice to the contrary, the audit committees of many listed companies are still under the misapprehension that the supply of their audit services is the preserve of the Big 4 firms. This would be understandable were it based on evidence of differential quality. However, as revealed in the first AIU public report to comment on the Significant Five firms, issued last summer, high quality audit work can be found in all nine firms reviewed. The report comments that the audits reviewed at all nine firms had “been conducted to a high or acceptable standard”. We accept that a small number of audits require the services of firms with networks extending to dozens of countries which might disadvantage those smaller firms who do not have access to a well-developed international network. However, putting these aside, we would urge audit committees to make decisions based primarily on quality, and not on a misconception that a Big 4 firm buys the best safety net.</p>	
<b>Question 15</b>	<b>Should the FRC develop more detailed guidance for audit committees in relation the evaluation of audit effectiveness?</b>
<p>We believe there is a need for practical audit committee guidance.</p> <p>For many companies, the audit committee’s interaction with the auditor is predominantly one way – the auditor keeps the committee informed of matters as and when appropriate. Although very few committees fail entirely to debate and discuss issues with the auditor, we believe there is significant scope for better informed committees to improve their awareness of financial reporting and audit matters. However, we also believe that this would best be provided by the Institutes, or by consultants who are independent of the agendas of audit firms.</p>	
<b>Question 16</b>	<b>Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?</b>
<p>Continually increasing disclosure to the annual report clearly does not automatically mean an improvement for stakeholders. However, as we have publicised before, although we do not support mandatory rotation and re-tendering, we do believe that boards should be required to consider on a regular basis whether or not their shareholders are getting good service from their auditor. This consideration and the justification for the decision reached should be noted in the corporate governance report.</p>	

<b>Question 17</b>	<b>Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?</b>
<p>As the discussion paper notes, AIU inspections have taken a key place in the pursuit of audit quality. Their rigorous inspections demand substantial dedicated resource from firms. However, they focus only on clients within their scope – mainly fully listed companies. The QAD retains the responsibility for inspecting all other audit engagements, however these inspections are much less detailed and, in our experience, there is little or no effective communication or coordination between the two bodies.</p> <p>Inherent in this two tier system is a significant danger for the firms – the temptation to create a two tier approach to audits: one to satisfy the rigours of the AIU; and another for the rest. We fear that some firms may be driven into accepting such an approach, with the delivery of high quality audits to listed companies with others receiving something less. This is not in the interests of the many stakeholders in UK entities which fall outside the AIU regime.</p> <p>Where government mandates that a statutory audit is required, we believe there should be a standard regulatory process to oversee the provision of audit services. We propose that the QAD and AIU should work much more closely together and bring the level of detail of their reviews into line. From the viewpoint of the firms, there would then be consistency in inspections and we would avoid two tiers of audit quality across the UK audit profession.</p> <p>Finally, we return to our concerns raised in our response to question 3 about the poor interaction between the regulator and investors. In our experience, only a small proportion of the investment community understand the purpose of an audit. An even smaller percentage of investors understand auditing and financial reporting standards. Consequently, there continues to be an expectation gap between the investment community and standard setters. It will be difficult to improve confidence in the audit process until this gap has been narrowed or closed. Part of this will involve the FRC and other regulatory bodies proactively seeking the views of investors. However, a significant element of the responsibility rests with investors who will need to commit time and energy to improving the skill-set of their people. There will be a price to pay for continued improvements in audit quality and we should ensure that both the users and preparers of financial statements understand the costs as well as the benefits of these improvements.</p>	