

# Reporting on audit quality monitoring

**Consultation response to the Professional Oversight  
Board of the Financial Reporting Council**

The Audit Commission is an independent body responsible for ensuring that public money is spent economically, efficiently and effectively, to achieve high-quality local services for the public. Our remit covers around 11,000 bodies in England, which between them spend more than £180 billion of public money each year. Our work covers local government, health, housing, community safety and fire and rescue services.

As an independent watchdog, we provide important information on the quality of public services. As a driving force for improvement in those services, we provide practical recommendations and spread best practice. As an independent auditor, we ensure that public services are good value for money and that public money is properly spent.

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# The Audit Commission's response

## Summary

- 1 In this paper, the Audit Commission (the Commission) sets out its response to the Professional Oversight Board's consultation document on the approach the Audit and Inspection Unit (AIU) should follow when reporting publicly on the results of its inspection activity.
- 2 In summary our response to the questions for consultation are as follows:
  - the arguments for extended public reporting of AIU inspection findings which we attach most weight to are that it:
    - will provide greater transparency;
    - may have a positive impact on audit quality by providing an incentive to firms to improve; and
    - may overcome practical difficulties in the current form of reporting;
  - the arguments against extended public reporting which we attach most weight to are:
    - publication of reports on individual firms may adversely affect companies whose auditors have been criticised publicly; and
    - reports are likely to be less timely;
  - of the options presented in the consultation document, we recommend the AIU considers a combination of Option B and Option C as follows:
    - providing limited firm-specific information in the annual public report where issues are identified that are considered of such significance and importance to warrant public disclosure that year; and
    - including a section in the annual public report on a named audit firm where it has made insufficient progress in addressing AIU recommendations or has failed to co-operate with the AIU; and
  - if this approach is followed, we do not think it will be necessary or practical to make information from AIU inspections available privately to audit committees.
- 3 A more detailed response to each of these questions follows.

## Detailed response

### Introduction

- 4 The Commission has a statutory responsibility to regulate the audit of local government and NHS bodies in England. In particular, the Commission is responsible for:

- appointing auditors to local government and NHS bodies;
  - setting the required standards for its appointed auditors; and
  - regulating the quality of audits.
- 5 The Commission's response to the Professional Oversight Board's consultation is based on two areas of interest. Firstly, we appoint auditors not only from our own staff but also private firms of auditors, including many of the firms regulated by the AIU. As a significant purchaser of audit services, we have an interest in the reported results of the AIU's work in relation to those firms.
- 6 Secondly, we are a major provider of audit services in our own right; indeed, we are the fifth largest audit practice in the UK. The current scope of the AIU's inspections concentrates on the 'Big Four' audit firms and 'Other Significant Firms', and its definition of public interest entities currently does not extend to the public sector bodies within our audit regime. If this were to change, our in-house audit practice could potentially be subject to inspections by the AIU.
- 7 In preparing our response, we have:
- drawn on our experience of regulating our audit market, including reporting publicly on the results of this process; and
  - considered what form of public reporting by the AIU would be beneficial both to the Commission, to inform our regulatory function, and to other interested parties.
- 8 The principal means by which we monitor the performance of our appointed auditors is through an annual quality review process (QRP). We have recently changed our policy on reporting publicly the results of the annual QRP. In previous years, the published summary of QRP findings was on a regime-wide basis only, with no details on the findings for individual audit firms. However, following a fundamental review of the QRP we decided that, in the spirit of openness and transparency that informs all other aspects of the Commission's work, we should provide a high level summary of the QRP findings for each audit firm.
- 9 Our QRP annual report for 2005<sup>1</sup> was the first under the current policy. It summarises the relative performance of, and where relevant highlights particular issues relating to, individual audit firms. Copies have been sent to various stakeholders in the public sector and auditing profession, including the AIU.

### **Question 1 - Advantages and disadvantages of extended public reporting**

*To which of the arguments in section 5 do you attach most weight and why?*

- 10 All the advantages of extending public reporting set out in the consultation document are pertinent, but we believe the most important are:

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<sup>1</sup> 'Auditing the Auditors: The annual report of the Audit Commission's quality review process 2005', September 2006. Copies are available at [www.audit-commission.gov.uk](http://www.audit-commission.gov.uk).

- **It will provide greater transparency:** confidence in the quality of audit, and therefore ultimately in corporate reporting and governance, requires that sufficient information should be made available to interested parties. We place great importance on openness and transparency in our business and believe it is a key attribute of the effective regulation of public interest entities. Extending the information available publicly will enhance the AIU's ability to bolster confidence in the auditing of the bodies within its remit by more fully informing interested parties.
- **It may have a positive impact on audit quality by providing an incentive to firms to improve:** extended public reporting could act as an effective driver in promoting improvements in the quality of auditing, thereby supporting a key objective of the AIU.
- **It may overcome practical difficulties in the current form of reporting:** moving away from the current approach of grouping together findings for a number of firms, whose market focus may be different and whose audit work may be of varying quality, would not only enhance openness and transparency, but also be more equitable. It would allow the AIU to report fully on important issues that apply to certain firms without associating other firms in the same grouping with such findings when they do not apply. At present, by not indicating which firms the issues apply to (and by implication which they do not) a reader of the report is no better placed to assess the competence or performance of a particular firm. Knowing that an issue applies to one or some firms within a group, but not which ones, is not useful information.

11 We believe that the advantages of extended public reporting outweigh the principal arguments against such a change. However, in our opinion the most significant of the disadvantages outlined in the consultation paper are:

- **Publication of reports on individual firms may adversely affect companies whose auditors have been criticised publicly:** this could be an unfortunate consequence of extended public reporting and would go against the Financial Reporting Council's aim of promoting confidence in corporate reporting and governance. The magnitude of this risk will depend on the nature and extent of the inspection findings made available publicly and, importantly, whether the incidence and potential impact of such findings are made clear so that readers of the reports can assess the relevance of the findings to their circumstances.
- **Reports are likely to be less timely:** the recent change to our policy on public QRP reporting did not adversely impact on the reporting timetable, but we acknowledge from our past experience that this could be a greater risk for the AIU given the volume and depth of inspection activity and the higher degree of interest in the AIU's reported findings. In particular, this may lead to firms dedicating more time and resources into challenging findings and agreeing inspection reports, which may slow down the process.

12 We do not agree that extended public reporting may weaken the essential purpose of audit inspections because firms will be more likely to adopt a

defensive approach. Our experience has been that even where a firm takes a more defensive approach, this does not necessarily hinder the degree of access to, or co-operation from, the firm in supporting the regulatory process or lessen the extent to which it subsequently responds to underlying quality issues once these have been highlighted.

- 13 While we agree that giving firms an opportunity to correct weaknesses on the basis of confidential reports, linked to the possibility of disclosure where the firm's response is inadequate, may provide a stronger incentive to act to improve audit quality, this still seems to us to be an argument supporting a form of extended public reporting. The threat of public disclosure should provide a strong incentive to act.

## Question 2 - Options for change

*Which of the options outlined in the consultation document do you favour and why? In particular, do you consider that the nature of weaknesses at a named firm should be disclosed only after the firm, in the opinion of the Oversight Board, has failed to respond positively and promptly to recommendations made to them by the AIU or has failed to co-operate with the AIU?*

- 14 We believe it is important to follow an open and transparent approach to reporting the results of regulation. However, it is equally important that the nature and extent of information made available publicly is considered carefully. Ultimately, the process of public reporting should support the objective of promoting confidence in corporate reporting and governance. Adverse findings which may undermine this confidence should only be made public when they are of such significance that the public interest in their disclosure outweighs any potential negative impact. Many of the issues currently highlighted anonymously in the AIU's annual reports may not be deemed significant enough for named public reporting.
- 15 Our own public QRP reporting follows a positive emphasis, with the primary objective being to provide assurance on the work of our appointed auditors. We seek to emphasise our appointed auditors' compliance with professional standards and achievement of our other quality requirements. This approach assures the public sector bodies to whom we appoint auditors, the Commission's other external stakeholders and other interested parties that the vital role our auditors play in the governance of public services and stewardship of public money is performed competently and effectively.
- 16 We will, however, highlight any significant failings if they occur and, importantly, support this with assurance that necessary action is being taken to avoid similar recurrence in the future and/or rectify any adverse situations. The high level public summary of each firm's QRP findings will therefore include, where appropriate, summarised information on any significant adverse findings. Such instances are rare and we will not report all findings and issues publicly, rather the majority will remain within the private reports to the firms.

- 17 We believe this strikes a pragmatic and sensible balance between openness and transparency, and avoiding complications that could arise from more detailed public reporting of other issues that are less significant.
- 18 For this reason, **we recommend that the AIU follows a combination of Option B and Option C** as follows:
- providing limited firm-specific information in the annual public report where issues are identified that are considered to be of such significance to warrant public disclosure that year; and
  - including a section in the annual public report on a named audit firm where it has made insufficient progress in addressing AIU recommendations or has failed to co-operate with the AIU.
- 19 It is not expected that this approach would lead to large numbers of issues being disclosed publicly, indeed it may be quite rare. By focusing on the most significant issues (for example fundamental weaknesses in firm-wide policies and procedures or major failings in the audit of individual entities), the AIU could continue the current approach of reporting the majority of findings to firms privately. This gives firms the opportunity to respond to the AIU's recommendations, with Option C ensuring there is sufficient incentive to do so. It also means that issues that are important but not considered to be critical are not reported publicly, thereby avoiding the potential disadvantages set out in the consultation document.
- 20 Issues reported publicly under Option C will not be of such significance as those under Option B, but would be elevated to public reporting status if firms do not respond appropriately or if they fail to co-operate.
- 21 There are arguments in favour of the other options presented in the consultation document, but we believe the balance of advantages and disadvantages for each is less favourable than the recommended approach. In particular:
- Option A does not address the arguments in support of extended public reporting.
  - Option D may not give firms a reasonable chance to respond to recommendations. As such, it is less favourable than Option C, which allows the AIU to assess the sufficiency of a firm's response over a longer timeframe than a single inspection will allow (although this option may be appropriate as a supplement to options B and C where the AIU considers insufficient progress has been made on a follow up inspection).
  - Option E may result in the AIU not including important points about firm-wide procedures and other issues which it would otherwise have reported, because they are not considered significant enough for public disclosure. Consequently, these points may not be raised formally with firms.
  - Option F offers only a partial insight into the AIU's findings for an individual firm and is therefore not as useful as an annual report summarising the most important findings from all aspects of its work, which Option B would provide.

- Options G and H may provide a degree of detail unnecessary for a public audience.

### **Recommendation**

*The Commission recommends a combination of:*

- *Option B: providing limited firm-specific information in the annual public report; and*
- *Option C: including a section in the annual public report on a named audit firm where it has made insufficient progress in addressing AIU recommendations or has failed to co-operate with the AIU.*

### **Question 3 - Audit committees**

*Do you think that information from AIU inspections on individual audit firms and/or their audits of individual companies should be made available to audit committees?*

- 22 Yes. An Audit Committee should have as much information as possible to help it evaluate the quality of the work of the auditors and to inform its decisions and recommendations about audit appointments. Sharing a copy of an inspection report with an audit committee could be helpful, and would also be a good test of the wider usefulness of the inspection process. However, it is important that the nature and extent of the information made available is considered carefully. While it would be helpful to provide an audit committee with information on any critical failings at an audit firm or any significant issues that have been identified in relation to the entity's audit, the argument is less strong for providing details on all inspection findings, as this may erode unduly a company's confidence in its auditors.
- 23 The public reporting approach recommended above is essentially one of exception reporting, whereby the AIU continues to report in general terms about its findings, but also highlights any significant concerns relating to individual firms if they arise. This approach may offer some useful high level information for audit committees.

### **Question 4: Quantifying costs and benefits**

*How would you quantify the costs and/or benefits of the options set out in the consultation document?*

- 24 We have no suggestions on how to quantify the costs and/or benefits of the options over and above the details provided in Annex A of the consultation document.
- 25 We do suggest, however, that the potential costs of our recommended approach (a combination of Options B and C) would not necessarily be the sum of the two amounts set out in Annex A of the consultation document. The approach suggested will still result in a single annual report, rather than two discrete public reports that would require discussion and agreement with audit firms. The incentive for firms to act positively and avoid public disclosure under Option C

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may also mean that the need to apply that option could be rare. If this is the case, the AIU would not necessarily incur additional costs in every period and/or in relation to each audit firm.