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Dear Sirs

Audit Quality Monitoring

We welcome the opportunity to respond to your consultation document in connection with reporting on audit quality monitoring. Audit quality is paramount and we are fully supportive of the FRC position.

Your paper sets out clearly the background to the reporting debate but we feel that it should also be read in the context of the current wider debates concerning auditor liability and the issue of competition in the marketplace. We do not consider the three topics to be mutually exclusive and this is referred to further below.

To put the debate in perspective, the AIU monitors the quality of auditing of economically significant entities with the overall objective of raising audit quality and hence maintaining confidence in the veracity of financial reporting to the capital markets. This is achieved by way of extended visits to audit firms concluding with a detailed private report to the firm and a generic report to the wider market.

Calls for the publication of private reports on the grounds that it would “better serve the public interest” and that publication “may demonstrate that firms outside the Big 4 can do large listed audits” are both judgemental and will do little to address the issue of competition in the marketplace. In our opinion, it is not audit quality that distinguishes the Big 4 from other firms. With the exception of the audits of only truly global companies and those with specialist auditing requirements, significant firms outside the Big 4 can, and do, undertake this work and it is, inter alia, the reticence of audit committees and finance directors to pursue other options that lies at the heart of the competition debate.

Some commentators have attempted to group these debates together, perhaps in the mistaken belief that the AIU process might provide some kitemark of quality that can be used for the purposes of market positioning. This is plainly not the case and we believe it is naive to assume that it could ever be so. The AIU process is focussed on identifying opportunities for improvement in quality not on benchmarking



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performance between dissimilar firms. We believe that the current process is very effective at focussing on quality improvements and allows for full and frank discussions between the audit firms and the regulator. Preparation of detailed reports for public consumption would involve increased costs, additional resource, detailed legal review, time delays and, inevitably an anodyne, boilerplated report which is likely to have little impact on audit quality or perceptions of quality.

Misplaced comments could be detrimental to firms, clients and potentially the operation and competitiveness of capital markets. Furthermore a "name and shame" approach runs completely counter to the light touch regulation which underlies the operation of much of the UK capital markets and governance regimes. It would significantly change the dynamic and the dialogue between the regulated and the regulator.

Audit committees can best satisfy their duties in assessing auditor effectiveness by rigorously reviewing actual performance in the conduct of the audit of a companies financial statements. If they wish to test performance against other audit firms they can do so by inviting tenders from those firms. The fact that switch rates are so low (<3% on average) implies that dissatisfaction is low. In reality, audit committees and others may be better served by the transparency reporting requirements for auditors of public interest entities that are proposed under the EU 8th Company Law directive and which are subject to a separate consultation.

Furthermore, the publication of reports that intentionally identify only areas of weakness in a firm's systems and procedures is, in our opinion, inconsistent with maintaining confidence in the capital markets.

Negative based reporting, as a statement of intent, invites legal challenge and a firm will in reality never achieve a "clean" report. We consider that the AIU reporting mechanism to the relevant Audit Registration Committees is incentive enough for firms to constantly improve audit quality and both the firms and the AIU should continuously seek to raise the quality bar. The loss of audit registration could effectively destroy a firm.

The link to auditor liability should also not be lost. The publication of private reports is effectively a "litigator's charter" and the points on boilerplate reporting and delays to publication are very well made and should certainly be emphasised in the overall debate. A firm will rigorously defend its reputation (and arguably its very existence) by all means available to it. The current modus operandi in terms of negative based reporting will almost certainly require review, particularly when the approach is likely to have to be relied upon in court. Effectively the AIU will be acting as prosecutor, judge and jury which in many cases may be based on their judgement of someone else's judgement.....hardly robust, transparent or, indeed, supportable.

The boilerplating case is well demonstrated in the PCAOB method of reporting where their reports state that ".....a Board inspection should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report." Firms



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in the US then have twelve months to action PCAOB recommendations or face the possibility of their private reports being made public. It is interesting to note that, since January 2005, over 330 reports have been issued by the PCAOB, none of which to our knowledge has been made public. This is surely evidence enough that firms take the inspection process seriously and that audit quality improvements are being implemented by firms continuously. This achieves the very objective of the AIU itself.

The audit committee transparency debate should also be viewed in light of the differences between the US and UK regulatory positions. The ability of audit committees, the press or other commentators to benchmark the relative performances of 330 firms is far more onerous than for the 9 firms currently reviewed in the UK. At worst, a whole industry will be created in the UK in an attempt to rank firms, with any outcome dependent, potentially, on the interpretation and context of individual words or sentences within an overall report. Again, a boilerplating approach will be adopted by firms with little or no progress being made in achieving the stated objective of improving audit quality. The evaluation criteria of audit committees would then be, seemingly, to select the “least poor” firm.

The rate of change faced by the auditing profession over recent years has been extraordinary both in terms of the quantum of new accounting requirements and the transition, from both an accounting and auditing viewpoint, to International Standards. The recent round of AIU visits concentrated, in the main, on compliance with SAS's and the next round will be under ISA. Firms' policies and procedures have coped well with these changes and AIU comments during this transition stage must be taken in that context. Procedures continue to be enhanced and publication of private reports during this period may be ill-timed and indeed, in some cases, misleading as to the audit quality standards of that firm. We would recommend, therefore, that there be no changes to the reporting methodology at the current time provided that the AIU continues to raise the quality bar with firms and that firms, in turn, respond positively to the findings. Should a firm fail to respond appropriately to the agreed AIU findings, we consider that the mechanism is already in place to effect necessary action, namely by referral to the relevant Audit Registration Committee.

In conclusion, we consider that there are a number of interlinked issues surrounding the report publication debate, none of which can be taken in isolation. The various agenda, ranging from liability issues through to audit concentration and perceived competitive advantage by some, must not detract from the overriding objective of the AIU which is to monitor and enhance audit quality for economically significant entities....nothing more, nothing less.

Yours faithfully

Nigel Tristem
National Head of Audit