



Professional Oversight Board

**Response to Consultation Document: Reporting on
Audit Quality Monitoring**

September 2006

Contents

- 1 Introduction 1
- 2 Responses to Questions..... 2
 - 2.1 Question 1 2
 - 2.2 Question 2 4
 - 2.3 Question 3 5
 - 2.4 Question 4 6

1 Introduction

This paper sets out Deloitte's response to the Professional Oversight Board's (POB's) consultation document of June 2006 entitled "Reporting on Audit Quality Monitoring".

The current form of reporting by the POB works well. Its reports are thorough and, together with exchanges between AIU inspectors and audit firms, they encourage firms to improve continually their audit quality systems. As a result, the POB makes an important contribution to the high – and improving – level of confidence in the auditing of UK companies.

Nevertheless, we recognise that the current form of reporting should not be set in stone. Potential changes should be judged according to whether they improve audit quality and promote increased confidence in corporate reporting. Whilst we support extended public reporting in principle, we believe that it should be implemented in such a way as to minimise the disadvantages and unintended consequences.

On balance, and following discussions internally and with some of our clients, we recommend that reporting is extended to include a section in the annual Public Report on a named audit firm, where in the opinion of the Oversight Board the audit firm has made insufficient progress in addressing AIU recommendations (Option C).

Our reasoning is set out in detail in the rest of this document.

2 Responses to Questions

2.1 Question 1

To which of the arguments set out in Part 5, for and against extending public reporting of AIU inspection findings, do you attach most weight and why? Are there other significant arguments which we have not captured?

The provision of reliable information to investors and other stakeholders is critical to the success of capital markets. Audit firms play a key role in this and thus they must deliver consistently high quality work. In our view, quality, and the related promotion of confidence in corporate reporting, should be the main drivers of change in this area.

Confidence among stakeholders in the auditing of UK companies is high and has improved significantly over the last four years, as shown below (source: Ipsos MORI poll in April 2006, reported on page 24 of the FRC's 2005/6 Annual Report).

Confidence in Auditing of UK Companies

	<i>2006: Very confident (%)</i>	<i>2006: Fairly confident (%)</i>	<i>2005: Very confident (%)</i>	<i>2005: Fairly confident (%)</i>	<i>Increased confidence over last 4 years (%)</i>	<i>Confidence stayed the same over the last 4 years (%)</i>
<i>Directors</i>	41	53	37	50	44	42
<i>Investors</i>	20	66	20	70	36	42
<i>Auditors</i>	38	58	n/a	n/a	60	38

The current form of reporting by POB works well. The existing individual reports on firms are lengthy and thorough, and provide the appropriate Recognised Supervisory Body's (RSB's) Registration Committee with full information on whole firm procedures and the results of firms' inspections. The reports and the exchanges between AIU inspectors and the firms encourage firms to improve continually their audit quality systems. In our view, this positive aspect of monitoring should not be lost or jeopardised, though this does not imply that we are opposed to possible improvements in the style or transparency of reporting.

Although paragraph 5.2 of the consultation document sets out the potential advantages of extended public reporting, it does not set out compelling evidence to support radical change. Indeed, as set out in paragraph 5.3 of the consultation document, there is a danger that a significant extension of the level of public reporting could lead to audit firms adopting a more defensive, legalistic approach to the inspection process. The current quality improvement focus could be jeopardised. The resulting reports would take longer to be published and could ultimately be less meaningful than those currently prepared. In addition:

- by POB publishing individual reports, the role of Registration Committees would be brought into question. In particular, since they would be under pressure to react to the POB reports, their independence could be compromised;
- confidence in UK audits generally could be undermined; and
- there is no evidence from the US that a more extensive reporting regime improves the choice of firms available to carry out the audits of large companies.

Our relationship with the AIU's inspectors is constructive and co-operative. This helps the inspection process run smoothly and should only be put at risk if a new approach were to deliver significant additional benefits. Therefore, whilst we support the concept of extended public reporting in principle, given the arguments set out above, care should be taken to ensure that the advantages of any new approach are not outweighed by the disadvantages.

2.2 Question 2

Which of the options at 6.1 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 cooperate with the AIU?

Given our response to question 1, we support Option C. It strikes a pragmatic balance of alerting stakeholders to any major issues, while giving audit firms a fair opportunity to put their house in order and ensuring that the likelihood of a slower, more legalistic reporting process is slim.

The style of presentation of any reports to the media and the wider public is also important. It needs to be unbiased and free from “spin”. We therefore stress the need for consultation on the protocol and timing of publication, once the level of public reporting has been determined. An issue around the most recent reports was that firms were not consulted sufficiently and two firms claim that individual reports were not signed off before the overall report was published.

2.3 Question 3

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? If so, what do you think is the most appropriate way of achieving this?

We are concerned, for a number of reasons, about making information about individual audit firms and/or the audits of individual companies available to audit committees.

- The purpose of inspection is to give an overall view about the quality of work carried out by the audit firm, rather than specific views about particular audits. Audit committees are themselves able to undertake any enquiries of their auditors that they feel appropriate and complaints about specific audits are already handled through the complaints procedures set out in all audit engagement letters. This may involve referring specific cases to the RSB's investigation procedures or, in public interest cases, to the AIDB.
- Inspectors' reports focus mainly on negative aspects at firms and deliberately omit positive points. Any conclusions drawn from these reports by external stakeholders are likely to lack balance and would inappropriately reduce overall confidence in the quality of auditing.
- There is a risk of a breach of client confidentiality. Describing the particular problems associated with one audit may lead audit committee members to speculate on or to determine the name of the audit client. This risk will increase for firms with fewer public interest audits.
- There is a risk that information given to specific audit committees will be leaked. In such circumstances the report would, in effect, become public, though neither the POB nor the relevant audit firm would have any control over whether the information presented a fair picture. This could impact company share prices as well as the reputation of audit firms. It is easy to imagine that audit firms whose inspections became public first could be treated more harshly in the media, before the "novelty factor" wore off.
- Audit committees may come under pressure to justify appointing an auditor with any negative comments when by their nature AIU reports focus on only negative points.

It is relevant to note that the results of inspections of financial services institutions – for example by the FSA and the Bank of England – are not automatically released to the institutions' customers.

2.4 Question 4

How would you quantify the costs and/or benefits of the options set out at 6.1, taking into account Annex A?

The direct financial impact of Option C would be relatively small, assuming the option is viewed as something to be used sparingly and does not change the nature of AIU inspections. Although we have not modelled this in any detail, our initial view of the costs and benefits matches the POB's.

In considering other, more extensive reporting options (options D, E, F, G, and H) we have little to say in respect of the POB's calculations of the direct inspection costs. However, we would argue that the unintended consequences associated with the options could be significant and should be considered in more detail if the adoption of one of these options looks likely. Given the likely move to a more legalistic inspection and reporting process and a move away from principles-based auditing, these costs could be very substantial.