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20 September 2007

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Dear Christina

Professional Oversight Board – Reporting on Audit Quality Monitoring – Implementing a New Approach: Ernst & Young LLP Response

INTRODUCTION

Ernst & Young LLP welcomes the opportunity to review and comment on the consultation document entitled “*Reporting on Audit Quality Monitoring – Implementing a New Approach*” (“the Consultation Paper”) issued by the Professional Oversight Board (“POB”).

We share fully POB’s objective of promoting audit quality and we believe in the importance of openness and transparency in both the activities of our regulator and in our approach to working with regulators.

In responding to the Consultation Paper, we have a number of overall observations that we outline below before commenting on POB’s specific questions.

OVERALL OBSERVATIONS

Support for transparency

As a firm, we have a history of promoting transparency both for ourselves and other organisations which have a public interest element and/or external ownership. We believe in openness, transparency and constructive dialogue which also form the basis of our approach to working with regulators including POB and the Audit Inspection Unit (“AIU”). It is in this spirit of openness that in 1996 Ernst & Young became the first large firm in the UK to publish voluntarily an annual report and accounts for the whole of its business. This was done some time before such disclosure was required by LLP legislation. We did this because we believed at the time (and continue to believe) that it was the right thing to do.

We remain of the view that Option A proposed in POB’s 2006 consultation entitled “*Reporting on Audit Quality Monitoring*” (“the Original Consultation”) is the right approach for public reporting about audit quality monitoring under the **current** inspection regime. However, we recognise that, politically and legally, matters have moved on and that reporting must change in response.

Confidentiality for companies

We have some concerns about POB's proposals for extended public reporting based on the current inspection regime. Looked at in the round, these proposals, while focused on audit firms, will create the most intrusive regime for audited companies in the world (including the US), with disclosures extending beyond those of other jurisdictions to name the companies selected in the regulatory "audit sampling". This creates the potential for unintended consequences that could unfairly damage the UK's global reputation.

We are particularly concerned with POB's proposal to publish a list of all the companies whose audits have been inspected by the AIU. As per the FRC's Strategic Framework, the FRC's overall aim is to promote confidence in corporate reporting and governance. We recognise that stakeholders will have different views about what this means. However, at a minimum, it must mean that the FRC and its Operating Bodies are under a duty to avoid any activities, including forms of reporting which may, of themselves, destabilise the markets.

Publishing a list of companies whose audits have been inspected has the potential to cause such harm. It is also very likely to encourage, rather than discourage, FOIA requests for POB. We accept that it will be a matter for POB whether any exemptions would properly apply but, in our view, (i) the framework under which POB/AIU receives information in confidence about companies, audit firms and individuals; (ii) the damaging effect on the financial markets that releasing some information may have and (iii) the overriding need for POB to carry out its public functions properly to achieve its objectives would each allow POB to refuse disclosure legitimately in most cases.

Usefulness

We believe that the way the AIU inspects and reports needs to change fundamentally if its public reports are to be useful to audit committees, investors and other stakeholders. We also continue to be concerned that, without changes, there is the potential to create a more defensive stance between auditors and regulators with a consequential material negative impact on the inspection process making it longer and more cumbersome. This would be regrettable. We therefore make some suggestions below about how inspections and public reporting might look to mitigate these risks.

RESPONSE TO SPECIFIC QUESTIONS

Reporting on Inspections of Individual Firms

Q1 *Are the processes we intend to follow before high level reports on individual firms are published appropriate?*

Our comments on POB's proposals are set out below:

Publication of reports to be simultaneous

We believe that batched reporting could be anti-competitive. In an audit tender situation, an audit committee will find it very difficult to assess all audit firms tendering if only some of the firm-specific reports are available.

Therefore we would like all firm-specific public reports to be published at the same time especially in year one of this new regime. This will provide the greatest opportunity for balanced media reporting without repeated assaults on the profession's reputation about the same points every time a new firm-specific report is released.

We accept that simultaneous publication could create a logistical challenge for POB. This could be eased by setting a reasonable period in which to agree all reports with a "drop dead" end date at which time all those reports which have been finalised could be released together.

This would create an incentive for all firms to agree their reports with the AIU on a timely basis.

Recommended inspection process enhancements to encourage more rapid improvements by audit firms

To provide an opportunity for audit quality to be improved more quickly as a result of the inspection process, we recommend that key areas of focus/themes are communicated by the AIU to the firms as early as possible in the AIU planning process. The earlier the firms can respond to risk, the more audit quality is enhanced.

Standards for "auditing" auditors

POB needs to work towards a future where the AIU's inspections are performed in accordance with a well defined framework so that opinions can be formed objectively and with consistency. Such a framework could be embodied in "audit" standards for regulatory review which would help to ensure consistency between inspectors and equity between firms. In turn, this would facilitate comparative reviews by stakeholders.

Such standards could be adopted internationally and assist with greater efficiency in the pursuit of cross-border regulatory recognition and/or convergence.

Recommended reporting enhancements to help ensure context and to avoid inadvertent damage to the capital markets

In paragraphs 2.5 and 3.4 of the Consultation Paper, POB proposes to publish "high-level reports". This term is vague and therefore we would welcome more details so that we may comment further.

Consistent with our response to the Original Consultation, we are still concerned that there is no agreed and widely understood definition of audit quality, its key drivers and a framework to measure and compare it objectively. Without such a definition, we are doubtful that publication of the proposed high-level firm specific reports will provide enough relevant information to audit committees and investor groups for the purposes of the selection of auditors or at all. We are grateful however that the FRC has started a project along this route in its 2007 Discussion Paper "*Promoting Audit Quality*".

The AIU's current private report on a firm is very similar in nature to a private management letter which auditors issue to the companies they audit. As POB will be aware, management letters are not written with publication in mind. Without significant context being given around what is covered in a management letter, publication to the market could in most cases be damaging to a company. In addition, the current private reporting model risks leaving the lay reader with an impression that there are major problems with an audit firm when, in reality, the AIU's view is that the way the audit firm conducts audits and runs its business supports the continuation of its licence to operate.

To give the necessary element of balance and clarity to the new form reporting, we recommend the following:

- *Right of reply* - at least one draft of the firm-specific public report should be provided to the firms in advance so that any questions of factual accuracy may be resolved before publication. The report should also include the firm's response rather than the firm having to make a separate public statement.

- *Reporting needs to be balanced* - reporting must include some recognition of the quality that is delivered as well as material failures to do so. Fair reporting would take on an audit opinion style, including proper background and context, to promote public understanding of the issues raised by AIU inspections. Reporting will best serve stakeholders' needs if the format allows comparisons between firms and a balanced view to be formed.
- *Audience-focused reporting* – firm specific public reporting will have a very broad audience many of whom will not be familiar with auditing and/or financial reporting. As such, it will need to be written in clear plain language so as to minimise the possibility of misinterpretation.

Reporting on Reviews of Individual Audits

Q2 Are the processes we intend to follow before new-style reports on individual audits are finalised appropriate?

First, for the reasons set out in the Consultation Paper, we agree with POB that detailed private reports currently prepared by the AIU on individual audits are not suitable for wider distribution outside the AIU and the audit firm concerned.

In most respects, the comments that we make in response to Question 1 apply equally to the process that POB intends to follow before new-style reports on individual audits are finalised because, as we explain below, for all practical purposes these reports will also be public.

Confidentiality for companies

As the legal position has changed to allow firms to share the results of inspections with their clients, we expect clients and firms to ensure that this occurs as a matter of course. Audit committees will have access to the information as sought by the drafters of the relevant parts of the Companies Act 2006. However, as we have said above, we are particularly concerned with POB's proposal to publish a list of all the companies whose audits have been inspected by the AIU. As per the FRC's Strategic Framework, the FRC's overall aim is to promote confidence in corporate reporting and governance. We recognise that stakeholders will have different views about what this means. However, at a minimum, it must mean that the FRC and its Operating Bodies are under a duty to avoid any activities, including forms of reporting, which may of themselves, destabilise the markets.

Publishing a list of companies whose audits have been inspected has the potential to cause such harm. It is also very likely to encourage, rather than discourage, FOIA requests to POB. These requests will not come from the companies or the firms as they will already have the information. Therefore this list would most likely be used by those in a position to cause market mischief.

We accept that it will be a matter for POB whether any exemptions would properly apply but, in our view, (i) the framework under which POB/AIU receives information in confidence about companies, audit firms and individuals; (ii) the damaging effect on the financial markets that releasing some information may have and (iii) the overriding need for POB to carry out its public functions properly to achieve its objectives, would each allow POB to refuse disclosure legitimately in most cases.

We would also like to understand why POB's position under the FOIA is different from the position of other regulators. The PCAOB, which is subject to a similar freedom of

information regime, does not publish a list of the audits it has reviewed. Similarly, we are not aware of any other audit regulator making such disclosures. Closer to home, the FSA operates an inspection regime and has been subject to the FOIA since April 2004 yet it does not publish a list of the entities which it inspects or a list of those customers whose information it might have seen as part of that inspection.

In summary, we are against publication of a list of all the companies whose audits have been inspected by the AIU given the high potential for damage to the companies selected for inspection. Based on comparisons to the application by various regulators in the UK, we do not believe that POB/AIU is required under the FOIA to publish a list of companies whose audits it has inspected nor would it be required to disclose one following an FOIA request.

Confidentiality of individual audit reports

Although applying equally to high level firm-specific reports, our main issue with individual audit reports is one of lost confidentiality to the detriment of the company audited. Our concerns can be summarised as follows:

- Ensuring confidentiality of individual audit reports will be challenging given the number of parties who will be privy to the reports.
- If disclosed, individual audit reports will have the potential to harm companies needlessly through no fault of their own.
- Once a private individual audit report has been issued, it may be years before the relevant company's audit is reviewed again. This is not a satisfactory position for the company and, in the event of an unfavourable report, it will require comfort about its auditors within a short time frame.

If POB has legitimate concerns about whether an audit firm has shared the results of the inspection process with its audit client(s), we believe that POB could write to companies privately to inform them that their audit has been inspected.

Even if POB were to write directly, we still have confidentiality concerns. Companies do have a real interest in keeping the contents of the new style reports confidential but the fact that audit committee members (to whom they have corresponding duties) often sit on different company boards and committees brings with it a real risk of highly confidential and sensitive information becoming public knowledge with the attendant commercial risks. As should be painfully apparent, the prospect of having to bring an injunction against a company or members of its audit committee to enforce confidentiality obligations will not be practical or relished by either audit firms or companies. Moreover, neither POB nor the FRC are in a legal position to require that audit committees and companies keep the new style reports confidential.

Recommended reporting enhancements to help ensure context and to avoid inadvertent damage to the capital markets

In addition to the points we make in response to Question 1 above, to give the necessary element of balance and clarity to the new form reports new-style reports on individual audits, we recommend the following:

- *Greater clarity around gravity of issue* - We believe that the reader of an individual audit report will find it of greater benefit if readers have a clear understanding of the gravity of a particular issue disclosed with a clearer classification than the "Significant" or "Other"

classification used under the current regime. To do this, the individual audit report would need to include an assessment of materiality or seriousness of the particular issues. As we say in our response to Question 1, this would also mean individual audit reporting taking the form of a balanced scorecard so that either credit is given where credit is due and/or deficiencies are placed into context.

- *Right of reply* – The individual audit report should also include the firm’s response, rather than the firm having to make a separate public statement. This will avoid the position being played out in the press in the event that one of these reports was ever disclosed outside the audited company.
- *Early follow up* - In circumstances where there are a number of findings or where the issues raised are of particular importance, it is likely that an early follow-up by the AIU with updated reporting about what steps the firm has taken to address the issues will be necessary to restore confidence in the audit. This might be requested by companies and, in view of our concerns about the risk of wider disclosure, may be required as a matter of fairness and in order to protect orderly capital markets.

Annual reporting

Q3 Do you have any comments on the Board’s proposal that annual reporting on the AIU’s work should in future be incorporated in the Oversight Board’s annual report to the Secretary of State for Trade and Industry?

This proposal seems sensible based on our assumption that the annual reporting proposed will be at a high-level and about the audit market generally. If it is proposed that the reporting will include information on individual firms, we would expect the draft wording to be discussed with the firms beforehand. In that case, firms would be allowed to respond as part of any report to the Secretary of State on the same basis as we propose in our answer to Question 1.

Regulatory impact assessment

Q4 Do you have any comments on the Board’s provisional regulatory impact assessment?

The assumptions made in the provisional regulatory impact assessment are logical, although the monetary amounts are less than we would expect, especially in the initial year of implementation. We do recognise however that it is always difficult at the outset of any new process to estimate the increased costs accurately.

We sincerely hope that this response, and any other comments which POB receives, will help enhance the future of AIU audit quality monitoring. If you would find it useful, we would be more than happy to discuss further with you or your colleagues any of the points we have raised. We look forward to reading the responses and POB’s feedback in due course.

Yours sincerely



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