

RESPONSE OF ERNST & YOUNG LLP (UK) TO THE POB'S CONSULTATION PAPER "REPORTING ON AUDIT QUALITY MONITORING"

INTRODUCTION

1. This is the response of the UK firm of Ernst & Young to the Public Oversight Board's (POB) consultation document "Reporting on Audit Quality Monitoring". We share fully the POB's objective of promoting high quality auditing and are pleased to work with the Audit Inspection Unit (AIU) in agreeing areas for improvement and appropriate actions to address agreed findings arising out of their annual audit quality monitoring.
2. Ernst & Young also believes in openness, transparency and constructive dialogue which are the hallmarks of our approach to working with regulators, including POB and the AIU.
3. We also acknowledge that appropriate public reporting of AIU's activities is a key component of demonstrating its own transparency, accountability and indeed effectiveness.
4. Ernst & Young believes that the current approach of the AIU to private and public reporting is about right. We are currently in only the third year of audit quality monitoring by the AIU and, in our view, neither the early experience here in the UK nor the international comparisons (US, Canada, Japan) set out in the consultation paper, present a compelling case for extended public reporting.
5. We do not see parallels elsewhere that suggest that public reporting is either critical to or even a main driver of audit quality. For example, the FSA has achieved significant progress in promoting good governance and appropriate behaviours without routinely reporting detailed findings in a "naming and shaming" approach to public reporting.
6. For the reasons explained in section 5 of the consultation paper, we believe that the public publication of what are currently private reports is not in the best interests of promoting high audit quality.
7. Furthermore, Ernst & Young is concerned that in contrast to the open, constructive dialogue that currently exists, extended public reporting will create a defensive stance between the regulator and firms with a consequential negative impact on the timely agreement of findings and recommendations for improvements.

RESPONSES TO SPECIFIC QUESTIONS

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 important arguments that have not been captured?*

8. We are not convinced by the arguments put forward in section 5.2 for extending public reporting because:
 - 8.1. We believe that transparency as regards the POB's/AIU's activities and effectiveness is already adequately addressed through publication of the FRC's Regulatory Strategy and the AIU's Annual Public Report on generic themes and issues identified by its monitoring activity.

- 8.2. Currently private reports are a very detailed list of findings, conclusions and recommendations arising out of engagement reviews and consideration of the firmwide policies and procedures that affect audit quality. As such the report is not a ‘balanced scorecard’ of strengths and weaknesses and does not provide an overall assessment of audit quality against an agreed and widely understood definition of audit quality. Consequently we do not believe that publication of private reports in their current form would provide investor groups, audit committees or the public at large with a better understanding of audit quality and, therefore, would not demonstrate greater transparency.
- 8.3. Without an agreed and widely understood definition of audit quality, the key drivers of audit quality and a framework for the objective measurement and comparison of audit quality, we do not believe that publication of the current form of private reports could possibly provide relevant and meaningful information for decision making by audit committees and investor groups for the purposes the selection of auditors or otherwise.
- 8.4. We already have every incentive to address agreed areas for improvement arising from monitoring of audit quality. Quite apart from our professionalism as a driver of audit quality, the reputational and financial risks around audit are such that there is no rational reason why a firm would not seek to address identified and agreed weaknesses in a timely manner. In addition, the Audit Regulatory Committee (ARC) of the ICAEW has the power to sanction a firm that is not addressing identified issues and can decide to publish such sanctions. Consequently, we do not believe that routinely ‘naming and shaming’ in annual public reports is either necessary or appropriate as an incentive to ‘show year on year’ improvements.
- 8.5. Whatever the practical difficulties of grouping together the findings of different firms into a generic report, we believe that moving to extended public reporting on individual firms is a disproportionate and inappropriate solution with many adverse consequences (described below) that would outweigh any perceived benefit.
9. We agree with all the disadvantages of extended public reporting set out in section 5.3 of the consultation document.
 - 9.1. We think it is inevitable that firms will be more defensive in their approach to inspections and that a relationship that is currently based on openness and constructive dialogue with a mutual objective of achieving consistently high audit quality will become much more confrontational and far less constructive.
 - 9.2. We also agree that time and effort will become more heavily focused on challenging findings, conclusions and recommendations and also on the precise wording of the public report. In particular, we would challenge much more rigorously than we do in the private reporting regime a, conclusion which is based on a sample of findings that UK Auditing Standards would treat as an unreliable basis for a conclusion using basic audit sampling principles. We perceive two possible outcomes. In one outcome, the AIU will have to develop a new form of monitoring based on testing a pre-determined set of characteristics using sufficiently large samples to be representative so that observations, conclusions and recommendations are soundly based on statistically valid testing. This will require much more time and effort spent on the monitoring process by the AIU with consequential impact on resources and cost. Alternatively, the content of the individual firm’s public report will become a litany of factual findings with fewer

observations about quality, conclusions and recommendations. This outcome cannot be in the best interests of promoting audit quality.

- 9.3. POB/AIU have previously stated in various meetings that, in promoting high quality auditing, they are not constrained by the letter of extant auditing standards. While we believe that POB/AIU should avoid becoming a de facto standard setter we fully support the promotion of 'best practice' as part of their remit. If public reporting were to be extended there would need to be far greater clarity as to what constituted acceptable quality in accordance with auditing standards and what represented 'best practice'. Undoubtedly this area would also lead to far greater challenge with the danger that monitoring and reporting become more compliance focused. We do not consider that such a development would be in the interest of promoting and improving high quality auditing.
 - 9.4. For the above reasons we agree that the process would become more legalistic and, undoubtedly, take far longer for reports to be finalised.
 - 9.5. Even now private reports reflect auditing conditions that are historical and potentially out of date. For example, a private report finalised in the first quarter of 2006 is a record of the inspection process carried out during 2005 which is based on the quality of auditing conducted during 2004 and in the early part of 2005. Adding a further 6 months or more to the reporting process (as suggested in the consultation paper) means that by the time the public report is published it will be based on a state of audit quality that is up to 2 years old. Consequently, such reports might be positively misleading as to the current state of audit quality and hardly relevant for decision making for investor groups and audit committees.
10. An essential part of the FRC's remit is to promote trust and confidence in corporate reporting and governance which also implies avoiding any activities and reporting that would destabilise the markets. We agree that there would be a very real and significant risk that publication of individual firm reports (currently formulated as private reports) could have a prejudicial effect on a firm's clients' commercial position. Auditing is complex and ultimately a matter of judgement. We believe it would be extremely challenging for POB/AIU to ensure that sufficient context and technical background was given in a public report, such that the external reader with no audit background could possibly assess the relevant importance and implications of issues raised in the report. Again, the absence of a common understanding and framework around audit quality would leave a public report open to highly variable and potentially extreme interpretation with a consequential adverse impact on the standing of the firm's clients with the financial markets.

Question 2: *which of the options set out at para 6.1 do you favour and why? In particular, do you consider that the nature of weaknesses at named firms 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?*

11. We believe that neither the early experiences of the existing reporting approach in the UK, nor the international comparisons with the US, Canada and Japan, present a compelling case for extended public reporting. We also consider that extending public reporting would not have the desired effect of enhancing audit quality for the reasons set out above. Furthermore, we do not believe it is necessary for the purposes of demonstrating transparency of the monitoring process. Accordingly, we strongly favour option A.

12. If a firm is considered to have failed to respond positively to issues and recommendations raised in private reports then the appropriate action would be for the ARC to determine what action should be taken since they are the licensing body for audit firms and have the authority to impose appropriate sanctions on a firm, including the ultimate sanction of withdrawing a firm's licence to carry out the business of auditing. We do not understand why the threat of public disclosure by the AIU would be necessary if the processes of the ARC are operating satisfactorily. The ARC also has the power to publish any sanctions it imposes on the firm.
13. Similarly, if a firm is failing to "cooperate" with the AIU, then we suggest that the appropriate course of action is for the ARC to require the relevant firm to cooperate or to impose appropriate sanctions.
14. In summary, we believe that using the threat of public disclosure by the AIU as a sanction as an alternative to the existing ARC process and authority is unnecessary and inappropriate.
15. Nevertheless, if POB reach the conclusion that there is a case for extending public reporting then we would favour option C. However, we believe that fairness and the need to protect orderly financial markets would require an early follow up by the AIU and updated public reporting as and when the firm in question had satisfactorily addressed the issues. This cannot wait until the following scheduled inspection visit which may be three years time for some firms.

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?*

16. We do not believe that private reports in their current form or the results of individual engagement reviews should be provided to audit committees for many of the reasons explained above which can be summarised as follows:
 - a) The private report is not a balanced scorecard of audit quality.
 - b) There is no agreed or well understood definition of audit quality and its drivers and no agreed framework for the objective measurement of audit quality.
 - c) There is a risk that decisions would be made based on out of date information as regards the state of audit quality.
 - d) There may be undue reliance placed on conclusions that are drawn from samples that UK Auditing Standards would treat as an unreliable basis for a conclusion.

In addition, audit committees would not have access to comparable information related to other firms. Therefore they would have insufficient information on which to base decisions.

We do not believe private reports in their current form would be a sound basis for decision making by audit committees.

17. In addition, audit committee members sit on different company boards and there must be a risk of highly confidential and sensitive information becoming public knowledge with the same commercial risks referred to earlier.
18. Furthermore, as regards individual engagement reviews, we do not believe it is necessary for the audit committee to be appraised of the findings because:

- a) If a finding concerns the appropriate application of GAAP then the AIU will refer the matter to the Financial Reporting Review Panel for consideration and follow up.
- b) If the finding is a gap in audit evidence to support the audit opinion, then there would need to be a remedial action plan to address the gap.

Question 4: *How would you quantify the costs and/or benefits of the options set out at 6.1 taking into account Annex A?*

- 19. We believe the likely costs involved in extending public reporting are likely to be substantially greater than suggested by ANNEX A where a simple arbitrary ratchet of 5% seems to have been applied to each option.
- 20. In particular, we believe the following need to be properly assessed:
 - a) Costs of establishing an agreed and universally understood definition of audit quality, its drivers and a framework for its objective measurement.
 - b) Costs of developing and applying an inspection process that ensures statistically valid testing programmes to provide sound evidential matter as a basis for reported observations, conclusions and recommendations.
 - c) Costs to firms of responding to a) and b) above and dealing with the extended inspection and reporting process and timeline.
 - d) Costs to the AIU/POB and to the firms of an external communication process including responding to the reactions, appropriate or inappropriate, of external parties.
- 21. At present the AIU is inspecting a relatively small number of audit firms. The cost of completing firm coverage in the UK and then overseas firms in accordance with the EU 8th Directive will have a dramatic impact on the resource requirements and costs of the AIU and will present even greater practical as well as legal difficulties in extending public reporting.

CONCLUSION

- 22. We share fully the POB's objective of promoting audit quality and we believe in the importance of openness and transparency in both our regulator's activities and in our approach to working with regulators. For the reasons explained above we are concerned that extended public reporting will create a defensive stance between auditors and regulators with a consequential material negative impact on the process. We believe that the publication of what are currently private reports is not in the best interests of promoting audit quality.

Ernst & Young LLP, 22.09.06