

**National Office**

**Grant Thornton UK LLP**  
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Your Ref REPORTING

Professional Oversight Board of the FRC  
Financial Reporting Council  
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For the attention of Ms Christina Trickett

19 September 2007

Dear Sirs

## **REPORTING ON AUDIT QUALITY MONITORING - IMPLEMENTING A NEW APPROACH**

We welcome the opportunity to comment on the above consultation document. We support initiatives that will further enhance confidence of the capital markets in high quality financial and audit reporting.

Grant Thornton supports the principle of transparent reporting of the overall results of independent inspections on the suitability of individual audit firms to audit public interest entities. We believe that appropriate public reporting is a useful component of the package of information that allows stakeholders, particularly share owners, to form their own views on the overall quality of individual audit firms. We recognise that the Financial Reporting Council (FRC) faces significant challenges in developing an appropriate public reporting framework and therefore we strongly support the approach taken by the FRC in seeking views from stakeholders. In our view the most significant challenges are the need for:

- published reports to be focused and balanced so that users can draw meaningful conclusions from them
- published firm reports to present findings consistently across all firms
- all published reports to be issued simultaneously so that no firm or company is unfairly advantaged or disadvantaged by the timing of publication
- further consultation on the format and style of reports on individual assignments, about which we have serious reservations
- further consultation on the impact of the Freedom of Information Act.

### **Reports should be balanced to enable meaningful conclusions to be drawn**

The AIU's remit is to advise the Audit Registration Committee (ARC) on its "audit registration" decision. The Professional Oversight Board (POB) website describes the work as "The professional accountancy bodies continue to register firms to conduct audit work with their regulatory activities being overseen by the POB. The audit registration committees

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of the accountancy bodies receive formal reports from the AIU [Audit Inspection Unit] on our monitoring work, with the POB overseeing the action taken by them in response to our recommendations". The published reports should focus on this key issue of whether the firm is fit to audit such entities, since we believe users should have access to information on high level issues to enable them to make meaningful judgements on a firm's commitment and ability to deliver high quality, reliable audits on a consistent basis.

We believe that any comments raised in the report of an individual firm should be put into the context of the firm's overall attitude and ability to delivering high quality, reliable audits on a consistent basis. We observe the comment in the AIU's public report dated 27 June 2007 "On the basis of our work, we consider the quality of auditing in the UK to be fundamentally sound. Subject to the agreement of satisfactory action plans by firms in response to our recommendations, we anticipate recommending the continued audit registration of all firms for which we undertake full scope inspections."

It appears to us that the AIU has to date interpreted its obligation in a broad sense. The style of reports to the ARC has been extremely detailed without, perhaps, a great deal of reference to the relative materiality of issues raised in the context of the reliability of the audit reports examined. Similarly, sometimes recommendations might be raised by the AIU that have a bearing over the longer term on audit quality but do not of themselves indicate that the firm has issued unreliable audit reports in the past or is at immediate risk of doing so. While such points might be appropriate to the private report to the firm, we do not believe it would be helpful for users of public reports to be diverted by such comments, unless the firm's responses over time cause the AIU to question the firm's commitment to quality.

We believe the experience of public reporting in the US supports our view. We hear concerns from some users that they find it difficult to draw meaningful conclusions on the reports on individual firms where these consist of a long list of points raised with little guidance as to the relative importance of those points or any context on the attitude to quality of the firm or its record on delivering high quality audits.

### **Matters should be presented on a consistent basis across all firms**

We believe the FRC has demonstrated its ability to deal with the some of the challenges posed by public reporting, since it is our view that the presentation of the AIU's public reports on Audit Quality Inspections (which have not previously included comments on individual firms) has improved over the first three years of reporting. However, balance, context and consistency are particularly important in respect of public reporting on individual firms.

The recent transaction between Grant Thornton and Robson Rhodes has enabled us to compare the way similar findings have been presented to the ARC. We believe that there have been inconsistencies in some areas. This may well be expected since the AIU is still in a relatively early stage of its existence. Different inspectors of varying experience will have carried out different reviews at different firms. Indeed the AIU has refined its reporting style over time, and we do not make this observation as a criticism of the AIU's work to date.

However, we do believe it is essential that the AIU embeds robust controls to ensure that it presents its findings on a consistent basis across each of the firms.

We recommend that the FRC considers a further consultation on the specific framework which will underpin the structure of the public reports on individual firms. We believe that this could assist the AIU in developing a methodology which will ensure that where it singles out a firm or set of firms for comment (either positive or negative) it does so based upon robust evidence and not based on an isolated finding or individual reporting styles of inspectors. Whilst we believe the AIU might publicly report serious weaknesses identified in a single audit, we also believe the AIU should be careful about drawing broad conclusions where matters arising are isolated and less serious.

We believe that firms should have the opportunity to comment on the draft public reports and that their reasonable concerns are addressed prior to publication. In this context, the AIU should make clear to the firm if a point included in its draft report is to be raised across all firms or is specific to that firm or a set of firms.

### **Reports should be published simultaneously to prevent any one firm being advantaged or disadvantaged**

We strongly recommend that the public reports on all firms be issued simultaneously.

If reports are published periodically during the year there is the danger that concerns raised on a "slow news day" might attract undue media attention. Similarly, where there are serious matters that the AIU brings into the public domain, these might be downplayed if publication coincides with, say, a major news story.

Also, where the profession as a whole faces a significant challenge, for example the issuance of a new auditing standard, those firms who are reported on first are likely to be disadvantaged. They will be at an earlier point in the learning curve, and therefore at risk of attracting greater (adverse) comment, than those firms who are inspected and reported on subsequently.

We also believe that simultaneous reporting will make it easier for the POB to ensure that the presentation of findings is consistent between firms.

### **Dangers of preparing reports on individual assignments**

We have serious reservations about the proposals for the preparation of reports on individual assignments. The AIU's remit and operating practices were not developed with such an output in mind and there are significant potential dangers, such as the inadvertent release of price sensitive information.

The AIU has access to significant amounts of information on audit firms which serve to inform the review team's opinion of the audit firm as a whole. The opinion on the firm is based on far more than just the result of individual assignments, and the AIU monitoring process is set up to report on the firm as a whole, not on individual assignments. In our view

preparation of individual assignment reports will give findings on an individual audit undue prominence and risks diverting users from the key issue, which is whether the firm is fit to audit public entities.

For example, an audit engagement team might face considerable difficulties where the audit client is under-resourced, say, through illness or a significant transaction occurring near the year end. If a client is under-resourced or unprepared it often means that even the best planned audit will be disrupted, with a consequent impact on the organisation of the audit documentation. Consequently, the audit file might be a less "clean file", less easy to follow for an external reviewer, even though the audit opinion given is robust and reliable and the audit documentation is of high quality (albeit not presented as clearly as on some other audits). We have concerns that in such instances some AIU inspection teams might comment adversely on "audit quality" whereas in reality the issues lie elsewhere.

We have significant concerns around the proposal to publish the list of assignments that have been reviewed by the AIU. It is not evident how the AIU will guard against publishing information in firm reports that allows a third party to guess, or possibly incorrectly infer, which comments relate to which assignments. For example, we could envisage a public report in which the AIU notes it has referred an accounting policy to the FRRP. A user might infer incorrectly which company's accounts are under scrutiny. Similarly, a reader might infer correctly which company's accounts are under scrutiny, and take action, when in due course the FRRP supports the original accounting treatment. Such situations could create severe problems for the company, the firm and the FRC.

We have concerns with the FRC's proposals to make reports on individual assignments available to the audit committee via the audit firm. This increases the risk of price sensitive information eventually finding its way into the public domain, or of isolated comments being taken out of context.

In our view the public interest case for making assignment reports available to the audit committee has not yet been made. Neither are we aware that share owner groups or audit committees at large are calling for publication of assignment reports. Instead we believe it would be better for the AIU to remove its restriction on audit firms discussing the AIU findings with audit committees.

If the FRC concludes that it must prepare individual assignment reports, we believe these should only contain that information (likely to be exceptional) not in the published report on the firm as a whole that the relevant audit committee chair requires to reach a reliable conclusion on that particular audit. If assignment reports are to be prepared, therefore, these should be published no earlier than publication of the report on the firm as a whole.

The AIU has made progress on firm reports but has no experience of assignment reporting. The AIU will need to develop a new process, and might wish to trial the process prior to making assignment reports available to audit committees. The comments we make above on timing, consistency and simultaneous publication of firm reports apply equally to assignment reports. Again, it is possible that if the FRC were to consult further based upon a proposed

framework and wording for such assignment reports, some of these concerns might be allayed to some extent.

## **Conclusion**

We support the principle of greater transparency of the results of the independent audit inspections of individual firms, but not of individual assignment reports. Public reporting presents some significant challenges and we support the FRC's process of careful consultation on this matter. We believe there is scope for an additional round of consultation on the proposed form of public reports or reports that might be presented to audit committees.

We respond to specific questions raised by the consultation paper in Appendix 1. In light of the POB's welcome proposal to consult further on the impact of the Freedom of Information Act we give some initial comments in Appendix 2.

If you have any questions on this response, please contact Steve Maslin (phone: 020 7728 2736; email [Steve.Maslin@gtuk.com](mailto:Steve.Maslin@gtuk.com)) or Nick Jeffrey (phone: 020 7728 2787; email [Nick.Jeffrey@gtuk.com](mailto:Nick.Jeffrey@gtuk.com)).

Yours faithfully

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## **APPENDIX 1 - GRANT THORNTON'S RESPONSE TO SPECIFIC QUESTIONS RAISED IN THE CONSULTATION DOCUMENT**

*Question 1: Are the processes we intend to follow before high-level reports on individual firms are published appropriate?*

**Grant Thornton view:** We support the principle of POB publishing high level reports on individual firms. We have identified in the covering letter the substantial challenges it faces in so doing and some recommendations on how these challenges can be dealt with. We make certain additional comments below.

### ***Private reporting to be retained***

We support the FRC's view expressed in the consultation paper that the AIU should have considerable scope for making less serious (but probably more numerous) recommendations in a report which remains private between the AIU and the firm, provided the audit firm is seen to be taking appropriate steps to address proportionate recommendations within a reasonable timescale. We believe that such private reporting is essential to maintaining the trust with firms which is necessary for the AIU to perform its work properly.

### ***POB dialogue with the press***

We expect that the POB dialogue with the press will be similar to the FSA's approach in that the POB will publish the firm reports with a press release and enter into no further dialogue with the press. In the interests of clarity it would also be useful if the POB were to advise companies not to enter into discussion with the press about review reports.

### ***Early communication of key themes would be welcomed***

Where the AIU have key themes they are looking for (for example, whether the firms implemented remuneration frameworks that focus on audit quality and not rewarding the selling of non audit services), they should be highlighted at the beginning of each review so that the firms can ensure they are fairly focussing on such concerns during the visit. This will also be relevant to AIU reporting.

### ***Opportunity to comment on draft reports***

The points for possible inclusion in the public report should evolve during the review and be reported to and discussed with the firm as they arise so that the firm has a reasonable chance to start addressing them before the final report is published.

Grant Thornton would welcome an interim meeting prior to commencement of the audit busy season which would provide a oral outline of preliminary findings and so allow the firm an opportunity to respond to key issues before the next year's audit season.

### ***Standards for regulatory review***

Reviews should be performed in accordance with well defined and publicly available “review” standards for regulatory review. These standards should be developed in consultation or conjunction with IFIAR. This would help ensure consistency between inspectors and equity between firms to facilitate comparison by third party stakeholders. The current review process would benefit from a review of assignment selection, scope for review efficiencies, review approach and focus of review work

*Question 2: Are the processes we intend to follow before new-style reports on individual audits are finalised appropriate?*

**Grant Thornton view:** We have serious reservations about the proposals to prepare reports on individual audits for the reasons we have identified in the covering letter. We have explained these reservations in the covering letter.

### ***Reviews are in progress whilst style and content of reports are not finalised***

In addition, the AIU has already commenced reviews on assignments of some firms which, it has indicated, will fall within the scope of the first round of published reports. This is most unfortunate because our understanding is that the AIU has yet to settle on the style and content of published reports. We are concerned that these early assignment reviews will not generate the evidence that the AIU will eventually need to support public reports on the assignment and the firm, ie that the existing operating procedures will be found to be unsuitable for the style and format of reporting. There are other dangers associated with conducting reviews prior to training review teams on the nature of evidence required for public reports, primarily related to the impact of the Freedom of Information Act on evidence gathering and documentation by review teams.

The POB should be aware that because review rules are not yet in place for assignment reviews of audits that are already in progress, they have created a relationship issue between the audit committee and the audit team. Audits are already in progress for assignments that we know will be reviewed, so we are already meeting with Audit Committees, but we are unable to raise the AIU review with them due to confidentiality agreements in place between us and the AIU. This is not only unhelpful to audit firms, but also creates unnecessary and undesirable uncertainty for Audit Committees. All parties need a proper review system in place which is workable and ultimately gives audit committees what they need when they need it.

### ***Procedures for public reporting on the POB website***

We also have serious concerns about the proposals for individual assignment reports. In the absence of further explanation, we are unclear how the FRC's proposals will prevent third parties from gaining access to confidential information by use of the Freedom of Information Act (FOIA), which in turn could lead to price sensitive information getting into the public domain in an uncontrolled fashion or comments on audit firms being taken out of context. We recommend that that AIU posts its procedures for public reporting on its website,

otherwise the AIU risks the benefits of public reports being undermined. In Appendix 2, we have raised some more detailed comments and questions concerning the FOIA.

### ***Assignment selection***

The POB states that assignment selection is on a risk basis but it is not apparent how the POB will manage market or company responses to the AIU's (public by implication) assertion that a particular audit is "risky".

*Question 3: 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 Business, Enterprise and Regulatory Reform (formerly Trade and Industry)?*

**Grant Thornton view:** We disagree that the annual reporting should be incorporated in the POB's report to the Secretary of State. The annual report contains important information for the capital markets on the profession as a whole. Past reports have included helpful positive messages on IFRS implementation and how audit firms have addressed developments such as implementation of ISAs and the consequent additional audit work on fraud and internal controls. These messages are important because they serve to put reports on individual firms in context, they add to stakeholder knowledge about the quality of the UK audit profession, and should reinforce the UK market view that UK audits are completed to a consistently high standard.

*Question 4: Do you have any comments on the Board's provisional regulatory impact assessment?*

**Grant Thornton view:** Our understanding is that the summary reports will not contain new information. It would also be appropriate that, over time, the AIU would be establishing procedures for ensuring that there are procedures for quality control, consistency and relevancy tests in place for private reporting. Therefore, whilst we accept that there will be some element of additional costs for public reporting on individual firms, in our view the document does not explain why public reporting will increase AIU costs by 20%.

Indeed, it is possible that the ARC might conclude that, given the evidence contained in the public reports on individual firms, it does not need such lengthy private reports to carry out its assessment of the firms, and that in due course any additional costs of public reporting will be mitigated or eliminated by consequent reductions in the length of the private reports.

## **APPENDIX 2 - FREEDOM OF INFORMATION ACT 2000**

We note that the FRC and in consequence, the AIU is now a "public authority" for the purposes of the FOIA.

Pursuant to S.1 of FOIA there is a general right of access to information held by a public authority, such information being defined as "... *the information in question held at the time when the request is received...*". Accordingly, any information which we provide to the AIU about our clients will be "held" by you. In consequence, such information will be subject to request by a third party in accordance with the FOIA's general right of access to information.

### **Client Confidentiality**

The critical issues are with regard to the AIU's status as a "public authority" as defined under the FOIA, the consequential requirement for you to disclose information held by you to a third party, and the implications which such disclosure has upon both the duty of confidentiality (which our clients are ordinarily entitled to assume exists) and our clients themselves. The role of the AIU and our disclosure of information to you is not an issue of contention per se. For the avoidance of doubt, our letter of engagement contains a standard provision expressly informing the client that we will provide information to regulatory bodies in accordance with our regulatory obligations.

We do not intend to rehearse in full the legal and ethical duties which we as a firm of accounting professionals owe to our clients. However, pursuant to Section 140 of the Institute of Chartered Accountants in England and Wales' Code of Ethics provides "*The principle of confidentiality is not only to keep information confidential, but also to take all reasonable steps to preserve confidentiality...A safe and proper approach for professional accountants to adopt is to assume that all unpublished information about a client's or employer's affairs, however gained, is confidential...*".

The legal duty of confidentiality, our fiduciary duty, arises having regard to our status as professional advisors to our client.

Our concern is that information which is client confidential in all other situations is now exposed to challenge for production by a third party, exclusive of the AIU, in accordance with FOIA's principle of a general right of access. The entity who requests the information may be a journalist or a competitor of our client and, having regard to the scope of the Act the information that is otherwise available to the public, for example that which is requested, would be wider than the information held at Companies House.

### **How has the AIU dealt with this concern and is it adequate?**

The AIU has standard confidentiality terms that apply to all firms.

We anticipate that the argument which the AIU will submit is, having regard to the aforementioned confidentiality terms, that all of the information which Grant Thornton UK

LLP provide to you will be "confidential" and, pursuant to section 41 of the Act, will be privileged from disclosure.

Section 41 provides:

*(1) Information is exemption information if -*

*(a) it was obtained by the public authority from any other person (including another public authority, and*

*(b) the disclosure of the information to the public (otherwise than under this Act) by the public authority holding it would constitute a breach of confidence actionable by that other person.*

Accordingly, there are two components to this section. Firstly, that the information was obtained by the public authority and secondly, that the disclosure of information would give rise to an actionable breach of confidence. The component which creates greater concern to us is the first as it is clear that the statutory exemption applies to information which the public authority has obtained from another entity. In consequence, notwithstanding the existence of the confidentiality agreement between ourselves, documents created by the AIU referring to or otherwise including the confidential information which we provide will not enjoy the benefits of exemption from production provided for under Section 41.

It is accepted that certain other arguments exist to preclude disclosure from information, specifically Section 43 of the Act. However, as you are aware this exemption is a qualified exemption and subject to the over-riding public interest test.

Whilst Grant Thornton acknowledges the purpose of the AIU's role as an independent assurance assessor of the audit profession, we are most concerned about the impact your status as a public authority will have upon our clients.

We strongly suggest that the POB highlights or consults on the procedures that will be implemented in the event that an application for access is made pursuant to Section 1 of the FOIA. Clearly, Grant Thornton would want the opportunity to make representations to the POB on the issue of disclosure and also ensure that no duties of care for us are created by POB disclosure of information to third parties. We have no doubt that our clients, to whom the information of course relates, would also want to make representations to the POB.