



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

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our ref: pb/cs

Ms C Trickett  
Professional Oversight Board  
The Financial Reporting Council  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

**Sent by email only**

Dear Ms Trickett

**Reporting on Audit Quality Monitoring – a consultation document**

The Institute of Chartered Accountants in England & Wales is pleased to respond to your request for comments on 'Reporting on Audit Quality Monitoring – implementing a new approach'. Thank you for allowing us a slightly longer period to submit our response.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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## **Reporting on Audit Quality Monitoring**

Memorandum of comment submitted in September 2007 by the Institute of Chartered Accountants in England & Wales, in response to the Financial Reporting Council's consultation paper 'Reporting on Audit Quality Monitoring – implementing a new approach', published in June 2007.

## INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales (the 'Institute') welcomes the opportunity to comment on the consultation paper 'Reporting on Audit Quality Monitoring – implementing a new approach' published by the Financial Reporting Council (FRC).
2. The Institute is the largest professional accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.
4. We are also a Recognised Supervisory Body under the Companies Act 1989 and register and monitor nearly 5,000 audit firms, including the vast majority of firms that will be potentially affected by the proposals in the consultation paper.

## EXECUTIVE SUMMARY

5. The Institute, and others, responded to the POB's previous consultation on audit report last year. It seems to us that the outcome of that consultation was not particularly clear-cut as to which of the suggested options to follow. In our view, the majority response seemed to be for the status quo of annual reporting on a no-names basis. Our response also preferred the status quo. However, we did suggest that once there was a general accepted definition of audit quality, individual reporting could take place. We are unclear if such a definition exists, which would then act as a basis for the reporting framework.
6. While we recognise that matters have changed since the first consultation on this topic, we remain concerned at the speed with which these changes are proposed notwithstanding our comments on a definition of audit quality. The current method of reporting has barely had time to become established and has yet to extend to the 'smaller' firms in the AIU's remit. Coupled with this is our concern about the possible consequences in the proposed form of public reporting. These could undermine, without any foundation in fact, the very public confidence that the process is meant to enhance.
7. We are also concerned about the proposal to publish a list of companies that have been reviewed. The objective seems to be to 'encourage' firms to provide the client with a copy of the high level report on the audit of the client. Quite apart from the point that this may not be permissible under draft revisions to the Companies Act 2006 (which are being made to comply with the EU's Statutory Audit Directive), we do not believe that firms need such encouragement. However, no consideration seems to have been given to the possible market implications. It is inevitable that third parties will apply matters raised in the public report on the firm to all the companies included in the list and draw erroneous conclusions that lead to a potentially serious impact on the companies' stock market position. We have seen such events in recent weeks and we do not believe that this is in the public interest or in the interests of increasing confidence in the capital markets. Therefore, in our view, no such list should be published.

8. Our point about market confidence also applies to the whole reporting framework. There is a very high risk that the erroneous conclusions are drawn from the reports. In our view, the method of public reporting in the US recognises this public interest issue and only publishes detailed matters after the firm has had an opportunity to take action. Further consideration should be given to this model.
9. Despite our deep reservations, we have made a number of detailed comments in response to the individual questions. Of these, we regard it as very important that the report should be balanced and set any 'issues' in the context of the totality of the firm's work which should have the right to include its comments in the report.
10. Finally, we do not believe that it is appropriate for either the AIU (or any other part of the Financial Reporting Council) or the firm, to indulge in public comment on the report once it is published, unless such statements are jointly agreed. Otherwise the whole process is undermined and reduces to a process of claims and counterclaims.
11. We are pleased to see that the role of the Audit Registration Committee (ARC), through which the Institute discharges its regulatory functions as a Recognised Supervisory Body, is acknowledged in the consultation document. It is only the Institute, acting through the ARC, which can take action against registered audit firms, even if that action is based on a report from the AIU. However, it is our considered view that the ARC should also be part of the reporting process and see the draft reports before they are finalised.

## **RESPONSES TO SPECIFIC QUESTIONS**

### **Question 1**

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

12. We note the proposed processes for producing the high level reports on individual firms. In our view there needs to be a much more detailed reporting framework, which would assist the AIU and firms. To this end we believe that the AIU should produce a prototypedraft report, not on a particular firm, to show how the final version is likely to appear. This should then be shared with the firms and the ARC.
13. The crucial point is that the report has to be balanced and not a listing of matters which, in the AIU's view, could be done differently / better. There should be a clear exposition of all the work that the audit firm undertakes to produce high quality audit work. This will enable any issues raised by the AIU to be read in context. As well as a description of the process, it may be possible for firms to indicate the cost of training etc to show the investment that is made in audit work.
14. Any matters that the AIU does raise should also indicate whether this is a one-off matter or is likely to be systemic in the firm. Again, the whole issue is to present a balanced picture so that matters raised are not taken in isolation and out of proportion so that a reader does not draw an incorrect conclusion on the audit work produced by the firm. The report must also be clearly written and avoid the unnecessary use of jargon.
15. The report should avoid identifying specific circumstances that are to be the subject of disciplinary investigation. Amendments to the Companies Act 2006 provide that information about an audited person should not be disclosed. We think that it is equally important that reports about firms should not identify particular individuals within an

audit firm. To do otherwise would lend to speculation, hamper the disciplinary processes and be unfair to the firm or individual subject to the disciplinary investigation.

16. Just as an audit report is an opinion, then so is the AIU's report. There can be different opinions on the same set of underlying factors and the reporting process should recognise this. So while the consultation draft mentions that a firm will have the opportunity to provide written comments, in our view it should have the right to have its comments included within the report. This will also assist in providing a balanced report.
17. The consultation draft mentions that the report on the firm will only be published after consideration by the relevant Audit Registration Committee (ARC) of the detailed private report. This is important but we would take this further. The ARC, as part of the AIU's report to it, should see a copy of the draft high-level report. It is the Institute, acting via the ARC, that is the regulatory body and it is very important that it is involved in the process. Also, if, in dealing with the ARC's queries, a firm advances new material that is relevant to the high-level report, the AIU should take this into account before it finalises the report.
18. The above points should also be considered from a different perspective. Part of the original rationale for the creation of the current arrangements was to increase public confidence in audit work. The utmost care must be taken to avoid readers misinterpreting the report and so undermining the very confidence that the process is trying to enhance.
19. Following on from this, and our comment that firms should be allowed to contribute to the report, no further public comment should be made on the report. This would apply to the AIU (and any other part of the Financial Reporting Council) and the firm, unless they both agree to issue a joint statement.
20. The timing of the issue of the reports is another key consideration. We agree that it would be inappropriate to issue reports one by one. Our preference would be to publish all the reports at once but we appreciate the practical problems that this would cause. The consultation document mentions that two or three publication dates would be established in advance. In addition we suggest that a detailed timetable is developed in consultation with the firms and the ARC, so that there is a greater chance that the publication dates can be met.

## **Question 2**

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

21. Many of our comments on reporting on individual firms apply to reporting on individual audits:
  - there should be clarity of reporting
  - the report should be balanced and any issues raised in an appropriate context
  - the firm, as well as being able to comment to the AIU on the draft report, should be able to add its comments to the report.
22. However, we have some additional comments. One of the main provisions of the EU's statutory Audit Directive, which will need transposing into UK law, is the confidentiality of the review process. In our view, the proposals in this consultation document, and in

particular in this section, run counter to these provisions. In our view this has a number of possible consequences but we wish to discuss two in particular.

23. Firstly, the AIU intends to publish the names of the companies where audits have been reviewed. From the consultation document, it would appear that this publication is only to 'encourage' firms to provide the client with a copy of the high level report on the audit of the client. Quite apart from our understanding of the revisions to the Companies Act 2006 that such a list of names cannot be published, this will inevitably be linked to the particular reports on the firms. We are concerned about the effect that ill-informed comment could have on the company in terms of its reputation and market standing. In view of this risk, our view is that a list is not published and other methods of 'encouragement' are considered, if these are needed.
24. Our second point relates to the confidentiality of the report once it is in the possession of the audit client. While we have no wish to impugn the integrity of the audit client's directors, there are no proposals in the consultation document for maintaining the confidentiality of the report once released to the client. We believe that it is essential that the importance of maintaining confidentiality is stressed in the report on the client and that they are made aware of the legal obligations for maintaining confidentiality.

### **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 Trade and Industry?**

25. We agree that it is sensible to reduce the extent of an overall annual report. The consultation document refers to the need to continue to document 'principal themes and issues arising'. While we agree that there should be sufficient detail to communicate any such matters, the use of such phrases indicates to us a certain perspective, that there will be issues, of a negative nature, to report.
26. It is just as important that this annual report is balanced and highlights good work practices that all firms can benefit from, as well as warning of areas that firms should review for possible improvements.

### **Question 4**

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

27. We cannot comment on the possible costs that may be faced by the firms. However, we do wish to comment on the observation in the consultation document that the costs are dependent on the firms' approach to report finalisation. While we agree that this is true, the firm is only part of the finalisation process. The other element is the AIU which has a key part to play.
28. Where a firm is challenged on its audit work, with the possibility of publication in two reports, it will seek to satisfy itself that such a challenge is warranted. It is therefore key that such issues are raised with the firm as soon as possible to allow the maximum time for consideration. The AIU should also put its concerns clearly, supported by appropriate evidence. Providing as much notice and information about the issue would also allow the firm to consider, in a timely manner, how it may wish to amend its processes to address the matter raised so that its response could also be included in

the report. It is for this reason that we previously suggested that a firm should be allowed to include its comments in the report.

29. The consultation document, as is the case with many regulatory impact assessments, assumes that benefits will arise but has difficulty in listing / quantifying what these would be. In our view there are considerable risks in the proposed approach which could result from unwarranted action taken by a company, or the market, based on a misunderstanding of an AIU report. We do not feel that this risk has been addressed in the impact assessment.