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THE  
INSTITUTE OF  
CHARTERED  
ACCOUNTANTS  
OF SCOTLAND



Ms Christina Trickett  
Professional Oversight Board of the FRC  
5<sup>th</sup> Floor  
Aldwych House  
71-91 Aldwych  
LONDON  
WC2B 4HN

Email: [c.trickett@frc-pob.org.uk](mailto:c.trickett@frc-pob.org.uk)

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Dear Ms Trickett

**REPORTING ON AUDIT QUALITY MONITORING – IMPLEMENTING A NEW APPROACH**

The consultation document 'Reporting on Audit Quality Monitoring – Implementing a New Approach' has been considered by the Audit Registration Committee and the Business Law Committee of The Institute of Chartered Accountants of Scotland and our views are set out below.

**In summary our key points are:**

- We believe that the public interest would not be better served if all, or parts of, Audit Inspection Unit (AIU) reports on individual audit firms were to be published. Nor do we support the publication of high level summary reports on these firms.
- We believe that if confidentiality prevents publication of the detail, then any true summary should be confidential as well. Otherwise, the 'high level report' is unlikely to be a valid summary.
- If any form of report is to be published which could have commercial implications it is essential that there is an independent, and unrestricted appeals process.
- In our view, once any information is made available outwith the firm there is no longer any control over that information and inevitably it may become available to a wider public. The viability of each firm rests on its reputation and it is therefore vital that any material that could be commercially damaging remains confidential.
- We believe that if high level reports are to be published there should be only one annual publication date, which is the same as the AIU annual report.
- The processes that POB intends to follow before high level reports on individual firms and individual audits are published require further consideration and refinement.

## **General points**

In the context of this response we consider the public interest to be maintaining and promoting confidence in both auditors and the audit market. This means that firms which are incompetent or incapable of undertaking audits of high quality should face appropriate regulatory or disciplinary procedures, with the ultimate sanction of having their registration withdrawn, and there should be a single, transparent, process for dealing with underperforming firms. Firms demonstrating limited difficulties, however, should be given assistance to improve without damaging their reputation or that of the audit market.

We understand the pressures on the regulator to be as transparent as possible but this needs to be balanced with commercial reality. We believe that in order for the Professional Oversight Board (POB) to meet its objective, of contributing to the Financial Reporting Council aim of supporting confidence in the financial and governance stewardship of entities, further consideration is needed regarding the proposals in this consultation document, and our comments below discuss some of the pertinent issues.

We responded to the consultation document 'Reporting on Audit Quality Monitoring' that was issued by the POB last year. Our overall view remains the same that we believe that the public interest would not be better served if all, or parts of, Audit Inspection Unit (AIU) reports on individual audit firms were to be published. Nor do we support the publication of high level summary reports on these firms.

We note that the POB appears to have decided in favour of publication of 'high level' reports on individual firms, and to prepare 'high level' reports on individual audits that have been reviewed, whilst removing the current restrictions that prevent firms from discussing their audit inspection with the client. The consultation paper says that this is in part due to the POB and AIU having been brought within the scope of the Freedom of Information Act (FOIA). In our view being within the scope of the FOIA does not necessarily mean that the POB needs to publish all or parts of its reports, and we do not accept that this merits the implementation of a regime whereby high level reports are routinely published. We believe that the requirement for a publication scheme would be satisfied by the existing AIU annual report.

If any form of publication is to take place then it should be undertaken on a consistent basis. The AIU has in the past had different scope visits in different firms, for example, a firm might get a full scope detailed visit or a more overview interim visit. It would not be appropriate to compare one firm that had received an interim visit with very few findings with a firm that had a detailed visit resulting in wider findings. All individual firm inspections and all individual audit inspections, good, bad or indifferent, should be subject to the same treatment and we note that this is what is proposed. Nevertheless, we anticipate that it is only the negative aspects of those reports that are likely to be of much interest to the media and thus portrayed to the wider public. Therefore, publication by the AIU may be damaging to both auditors and the audit market.

## **Reporting on Inspections of Individual Firms: are the processes we intend to follow before high-level reports on individual firms are published appropriate?**

Our comments below are made on the assumption that it is only reports which contain negative comments that are likely to be of interest to the media and thus portrayed to a wider audience.

We agree with the conclusions expressed in paragraph 2.2 of the consultation document, that the publication of each detailed inspection report would be likely to reduce the effectiveness of the inspection process and be counter productive. The publication of full reports would lead to defensive attitudes, potential litigation and a focus upon maintaining a position rather than improving quality. It would also be time consuming and expensive. We believe, however, that if confidentiality prevents publication of the detail, then any true summary should be confidential as well. Otherwise, the 'high level report' is unlikely to be a valid summary.

The existing full AIU audit firm reports have a tendency to focus on a list of alleged failures rather than providing a balanced portrayal of each firm. We note that refocusing the reports and drafting summary high level reports to provide a rounded portrayal of a firm would be a change of emphasis for the AIU.

We note that it is intended to withhold publication of each high level report until after the underlying detailed report has been considered by the relevant Audit Registration Committee. We agree with this timing. It is essential that the RSBs, who are responsible for the supervision of auditors, can consider the AIU report and, if necessary, undertake any appropriate regulatory or disciplinary procedures before any findings are made public. This timing does lead to questions, however, of whether the high level report is to reflect the position after any action has been taken. If it does not take account of any corrective action then it will be out of date. We are unsure whether the AIU proposes to detail any agreed corrective action, or that corrective action was deemed unnecessary by the RSB, in the high level report. We would not expect the AIU to comment on prospective actions, or inactions, that have been decided upon by the RSB, which is responsible for the ongoing decisions regarding the firm's audit registration. These issues need to be addressed but their resolution returns to the question of whether the publication of such reports serves a constructive purpose.

Paragraph 2.6 of the consultation document indicates that quality control procedures will be put in place but does not specify what these will be. And whilst firms will be given an opportunity to comment within a specified timescale on the high level report, there is no indication of how these comments will be incorporated into the report. We believe this could lead to disputes and a souring of the relationships between the regulator and the regulated. In the USA, for example, the comments made by an audit firm in relation to its inspection report are published by the PCAOB as an Appendix to the published inspection report. This practice should be considered in relation to the high level report by the POB, as should the possibility of asking the Audit Registration Committee to review each high level report, before publication, given that the ARC is the only other party that will have seen the detailed report. The ARC would also wish to be comfortable that the overall report gives a fair and balanced view of the firm.

As we discussed in our previous submission, if any form of report is to be published which could have commercial implications it is essential that there is an independent, and unrestricted appeals process. It is a fundamental principle of justice that there should be no enforceable sanctions without an appeal mechanism.

Unintended consequences may also occur. For example, the high level reports could be used as part of a firm's marketing material and, in a tender situation, it could be unfair if some firms could use such a report whilst other firms which had not been visited by the AIU could not. We doubt if this would help to develop a wider choice in the UK audit market.

There would also be sensitivity in the timing of the publication of the high level reports: we believe that if high level reports are to be published there should be only one annual publication date, which is the same as the AIU annual report.

The processes that POB intends to follow before high level reports on individual firms are published require further consideration and refinement.

**Reporting on Reviews of Individual Audits: Are the processes we intend to follow before new-style reports on individual audits are finalised appropriate?**

We note the comments in paragraph 3.3 of the consultation document and agree with the view of the POB that the detailed AIU reports on individual audits are not suitable for distribution beyond the AIU and the audit firm concerned. AIU reports on individual audits have a tendency to focus on a list of negative points and publication of a summary of these points would lead to a confrontational and time consuming relationship with the potential for litigation. As discussed above, if the contents of a report are unsuitable for publication then we question how any true summary could be suitable for publication.

Where practical and commercial considerations prevent full transparency, we do not believe it appropriate to make available information only to selected parties, and the proposal to 'allow' firms to share the new style high level reports in confidence with the audit client concerned appears to be semi-compulsory. We also question whether confidential information about an audit firm's work on an audit may inadvertently pass between companies, particularly when many audit committee members have more than one directorship. There would be concerns that an audit firm's reputation may be damaged in this way through the passage of incomplete or selective information across the corporate sector.

In our view, once any information is made available outwith the firm there is no longer any control over that information and inevitably it may become available to a wider public. As demonstrated by the demise of Andersens, the viability of each firm rests on its reputation and it is therefore vital that any material that could be commercially damaging remains confidential.

Should the proposal go ahead, liability issues may require further consideration. For example, if the high level report is to be shared with the audit committee then, arguably, there may be some duty owed by the AIU to the audit committee. There is also the concern that the reporting of any inaccuracies by the AIU will lead to claims against the AIU by the audit firm.

The processes that POB intends to follow to produce high level reports on the review of individual audits, and to then make them available on a selective basis, require further consideration.

**Annual Reporting: 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?**

The current AIU annual report provides useful generic information that shows the trends and issues in the auditing of public interest entities and listed companies. This information is vital if individual firm reports are published so that readers can place the individual report in context. We support the publication of a generic report, although we do not have strong views about where the information is published as long as it is still collated, analysed and made available. Our preference, however, would be to retain it as a separate report.

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

As we discussed in our response to the Audit Quality Monitoring consultation document last year we consider that the benefits, which are detailed in paragraph 2.3 of this consultation document, are subjective and not clear cut. We believe that the potential for any adverse report to weaken an audit firm's commercial position may result in costly disputes, and lead to a deterioration in the relations between POB and the audit firms.

Please do not hesitate to contact me should you wish to discuss any of the above points further.

Yours sincerely



CHARLOTTE M BARBOUR  
Assistant Director, Accounting and Auditing  
Secretary to the Business Law Committee