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Paul George Esq
Professional Oversight Board of the FRC
5th Floor
Aldwych House
71-91 Aldwych
LONDON
WC2B 4HN

FROM THE PRESIDENT'S OFFICE

Email: c.trickett@frc-pob.org.uk

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Dear Mr George

REPORTING ON AUDIT QUALITY MONITORING: A CONSULTATION DOCUMENT

The consultation document 'Reporting on Audit Quality Monitoring' has been considered by the Business Law Committee and the Council of The Institute of Chartered Accountants of Scotland and our views are set out below and in the attached appendix.

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should face appropriate regulatory or disciplinary procedures, with the ultimate sanction of having their registration withdrawn, and there should be a single, transparent, process for dealing with underperforming firms.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. The public interest in high quality audit will also be served by the transparency reporting requirements of the 8th Company Law Directive, which are the subject of another current consultation exercise.

In summary, our views are:

Overall View: We believe that the public interest would not be better served if all, or parts of, or some Audit Inspection Unit (AIU) reports on individual audit firms were to be published.

Option C: The Oversight Board has said its preferred option is to include a section in its annual Public Report on a named audit firm if the audit firm has not addressed recommendations or is not cooperative. Audit monitoring and, where necessary, improving audit practices should be a function of effective cooperation between the profession, the regulator, and the monitoring body, a dynamic which is unlikely to be enhanced by the threat of negative publishing.

Publication of criticism, which may simply reflect a difference of opinion and ultimately prove to be transitory and unjust, may weaken a firm's commercial standing and therefore adversely affect choice in the UK audit market.

We would prefer a variant of Option A where an annual report from POB discusses, in general terms, the elements of good practice as well as a list of the negative points found during the monitoring process. There is concern that the overall effect on public perception is unhelpful if only negative reports are made, whether in general terms or in relation to specific firms. This is not in line with the remit of the Financial Reporting Council, which is stated as being 'to promote confidence in corporate reporting and governance'.

Reasons for publication. This consultation document lacks clarity and fails to make the case for publication. We think the underlying rationale for publication should be further specified, analysed, and then debated. If publication is to provide 'public interest' information then all reports should be published – the good, bad and indifferent with each providing a full portrayal of the audit rather than focusing simply on the weaknesses.

Our principal concern, however, is that the act of publishing reports critical of firms is to a very material extent substitutive of the function of RSBs, whose role is to grant, withhold or withdraw audit practising rights on cause shown. Where firms have continuing or repeated systemic or operational weaknesses, then it falls to the regulator under statute (i.e. the RSB), to address them. Publicity by the monitor would have significant deleterious consequences for firms without the intervention of due process, an absence which a right-thinking society would deplore. In our view, publicity is an unwarranted surrogate for punitive sanction and quite misplaced in the hands of the monitor.

Appeals process. If there is to be publication of any report that could be commercially damaging then there must be an independent, transparent and unrestricted appeals process.

In conclusion, whilst we note that the key advantages put forward in the consultation paper for extending public reporting by the AIU might have some merit, we do not believe that the case has been made for extending public reporting by the AIU. In our view, the virtually certain disadvantages outweigh the possible advantages.

We hope our comments are helpful in your consideration of this issue. Please do not hesitate to contact me should you wish to discuss any of the above points further.

Yours sincerely

NORMAN MURRAY
President

REPORTING ON AUDIT QUALITY MONITORING: A CONSULTATION DOCUMENT**General comments**

We hold the view that the public interest would not be better served if all, or parts of, or some AIU reports on individual audit firms were to be published.

We note that the option for change favoured by the Oversight Board is Option C, under which a section on a named audit firm would only be included in the annual Public Report where in the opinion of the Oversight Board the audit firm has made insufficient progress in addressing AIU recommendations, or has failed to cooperate with the AIU. Otherwise the Oversight Board would continue as at present. In other words, it would appear that the preferred option would result in only negative reports being publicised.

The consequences of only publishing negative reports would be detrimental to individual audit firms and the auditing profession. More importantly, selective, negative reports would unjustly damage the reputation of the accountancy and auditing profession amongst the wider public. It is also contrary to the FRC remit which is to promote confidence on corporate reporting and governance.

The scale and speed of the break-up of Andersens has acted as a warning of how quickly a professional firm can disappear. Good reputation is vital and it is very important that measures are not adopted that may unjustly weaken a reputation. Therefore, we disagree with 'name and shame' type measures where a one-off instance of a problem or issue may be portrayed or interpreted as a more fundamental problem with a firm and which could be unnecessarily destructive. In turn this could have a negative impact on choice in the UK audit market.

We would also be concerned at the publication of any critical points, which subsequently prove to be incorrect, (and in fact this may be the reason that the firm has failed to cooperate in adopting the AIU's recommendations). In such cases, some form of appeal mechanism would be necessary, and this is discussed further below.

The key to audit monitoring and, where necessary, improving audit practices, rests upon effective cooperation between the profession and the monitoring body. However, we believe that effective cooperation is unlikely to be enhanced by the threat of potential publication of negative AIU reports on individual firms. It is more likely to lead to defensive attitudes, potential litigation, and a focus upon maintaining a position rather than improving quality. And whilst negotiations behind closed doors may not be transparent, they can achieve a relatively fair and quick position from which both parties can benefit.

The consultation document lists a number of advantages of publishing AIU reports into individual firms, however, we remain concerned that the underlying objectives are not clearly analysed. If it is to provide 'public interest' information then the public should know about the 'good' reports as well as the 'bad' reports. On this basis all reports should be published with each providing a full portrayal of the audit rather than focusing simply on the weaknesses. However, if the AIU only seeks to publish a report which contains adverse comments that an audit firm has not addressed, the implication is that some form of sanction is needed to enforce compliance.

If this is the case, one needs to question, first, whether the Oversight Board has faced non-compliance with its recommendations and, therefore, really does need some form of sanction. Secondly, if some form of sanction is required, is the threat of potential publication of adverse reports an appropriate tool? We think that this should be the crux of the debate and, if sanctions are required, a range of options could then be considered together with a transparent independent appeal process. It is a fundamental principle of justice that there should be no enforceable sanctions without an appeal mechanism.

It is also the case under the present regulatory regime that if the Oversight Board publishes a report that is critical of a firm it would subvert the function of the existing regulator, the RSBs. Where firms have continuing or repeated weaknesses, then it falls to the regulator under statute (i.e. the RSB), to address them. Publicity by the monitor could cause significant damage to firms without the intervention of due process.

Specific questions in the consultation document

Q1 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 which we have not captured?

The advantages detailed in part 5.2 are subjective and not clear cut. Whilst publication of AIU inspections may provide information to an audit committee, we question the value of this when the existing reports focus primarily on the weaknesses identified. There is a danger that audit committees may place too much reliance on the AIU's evaluation and that the audit committee, the directors, and shareholders of a company fail to evaluate the full credentials of their auditors for themselves. One of the most important aspects of appointing an auditor is for the audit committee to be confident in the audit partner and key audit staff.

The consultation document suggests that the publication of private reports on findings at individual audit firms might demonstrate to investors that firms outside the Big Four are capable of undertaking large listed company audits. There is no publicly available evidence to substantiate this suggestion. On the other hand, the publication of reports on individual audit firms may, through highlighting one-off issues or problems, adversely affect their commercial standing and this in turn may lessen choice in the audit market.

The fourth advantage listed in section 5.2 suggests that extended public reporting may give firms an incentive to show year on year improvements in the quality of their work as measured by the content of their public reports. This implies that the general quality of audit needs improvement and will always do so, which we question.

We attach the greatest weight to the disadvantages. The potential for an adverse report to weaken an audit firm's commercial position may result in protracted and costly disputes, for both the AIU and the firm, and at the same time this removes the focus from ways in which to improve quality. We also agree that audit firms would probably adopt a defensive position to inspections if there was to be public reporting of individual audit firms. We do not think this would be particularly constructive and should prefer to encourage a more cooperative regime between audit firms and the AIU.

We note that there are no specific legal requirements determining the AIU policy on publication, although there is provision under the Audit Regulations for the AIU to disclose information for the purpose of meeting public reporting requirements. A public reporting requirement is not necessarily easy to define but, as discussed above, we consider it to be the maintenance and promotion of confidence in both auditors and the audit market. However, it is not clear how potential publication of adverse points in a report on an individual firm could be anything other than a time consuming and potentially litigious affair. Furthermore, monitoring of the Oversight Board's conduct is not clear: to whom does a firm appeal if it does not agree with the Oversight Board?

Q2 Which of the options set out in paragraph 6.1 do you favour and why? In particular, do you share our view, set out at paragraph 6.2, that the nature of weaknesses at a named firm 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?

We would prefer a variant of Option A, in other words to continue the current practice of publishing an annual report that does not attribute weaknesses to individual audit firms. However, we would prefer the Oversight Board's annual report to discuss the elements of good practice as well as a list of the negative points found during the monitoring process in order to provide a balanced view of the audit firms and thus maintain confidence in the auditing profession where this is justified.

Suggestions to publish individual firm reports after a period when the firm has failed to respond positively in the opinion of the Oversight Board, are likely to lead to a less constructive relationship between professional firms and the Oversight Board and we would not welcome any such proposals.

As we discuss above, the rationale for publication of reports on individual firms is not particularly clear and under such circumstances we do not agree with any of the proposals in Part 6.1 (apart from Option A). It would be more understandable to have automatic publication of all reports, in the public interest, or further consideration could be given to 'name and shame' measures if it is clearly demonstrated that sanctions for non-compliance are required, that this is an appropriate sanction, and a transparent appeals process is established at the same time. We do not believe that the case for either full publication or 'name and shame' sanctions has been made.

Q3 Do you think that information from AIU inspections on individual firms and/or their audits of individual companies should be made available privately to audit committees? If so, what do you think is the most appropriate way of achieving this?

The audit committee would undoubtedly be interested in the AIU's comments on the effectiveness of the company's audit. We question, however, whether it is part of the monitoring body's statutory remit to provide information about an individual auditor on a private basis to the audit client. Against the background of increasing public transparency and the Freedom of Information Act, there should be no place for a public monitoring body distributing selective information on a private basis to certain individuals or committees.

In our opinion, the issue of sensitive information, whether good or bad, can only be justified if it is in the public interest. In that event, this would require publication of all reports. However, as noted elsewhere, we do not believe that a case has been made for this.

Q4 How would you quantify the costs and/or benefits of the options set out at 6.1, taking into account Annex A?

As indicated above we have reservations about whether there are benefits in any proposal to publish AIU inspection reports into individual audit firms. On the other hand, costs are likely to increase. The Oversight Board would probably need to undertake further work in order to prove any potentially negative comment if it is to be published, and costs will increase for the audit firm which would seek to refute or downplay anything which was not complimentary. Negotiations behind closed doors may not be transparent but they can achieve a relatively fair and quick position from which both parties can benefit.

Further costs would also be incurred with the establishing of a transparent and independent appeals mechanism, which is an essential part of any public reporting regime.