



The Regulation and Ethics Review Panel of The London Society of Chartered Accountants

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Dear Ms Trickett,

Consultation on "Reporting on Audit Quality Monitoring"

I am writing as Chairman of the Regulation and Ethics Review Panel (RERP) of the London Society of Chartered Accountants (LSCA). The LSCA is by far the largest of the 22 district societies affiliated to the Institute of Chartered Accountants in England and Wales (ICAEW). It has a membership of 30,000, representing nearly one quarter of all ICAEW members, and also provides services for other ICAEW members who live or work in London. London members, like those of the Institute as a whole, comprise a mixture of those working in all sizes of practice and those working in businesses both large and small, or otherwise not in practice. They also include many of the ablest and most senior Chartered Accountants, together with a wide range of specialists.

RERP welcomes the opportunity to comment on this consultation document about whether, and if so how fully, details of the AIU's inspection reports on individual audit firms should be published.

GENERAL COMMENTS

We note that the consultation paper reports recent heightened interest in the form and content of public reporting by the AIU of its monitoring of the quality of audit work by major UK firms, including calls for publication, in whole or in part, of the AIU's private reports on findings at individual audit firms. However, we are concerned that such a development could detract from the AIU's objective of improving audit quality. In our view, there seems little justification for changing the present system.

We are also concerned about possible conflict with the proper role of the Recognised Supervisory Bodies (RSBs), mainly ICAEW, as set out below. We have raised this concern previously in our response to earlier consultation documents.

We feel that there are two separate issues: one of public reporting and the other of audit committees wanting information. We believe that the AIU's reports are for regulatory purposes and not for the general public. There might also be legal implications for general publication, because the AIU will not have looked at every aspect of a firm's operations. We are also concerned that, in certain circumstances, it might be possible to identify the company that was the subject of the audit, or that the press might publish such results, which would destroy the obligation for confidentiality.

RESPONSES TO SPECIFIC QUESTIONS

Q.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 which we have not captured?*

The arguments for extending public reporting.

In our opinion the most important and relevant argument for extending public reporting of AIU inspection findings is that it would provide greater transparency. However, this would be for the public, not specifically for the benefit of audit committees, as we believe that there are better ways of satisfying any requirement that audit committees may have for additional information about their auditors.

We also feel that the third argument, namely that extending public reporting might "help investors to reach a more informed view as to the appropriateness of a non Big 4 firm acting as auditors of certain types of listed entities", has some appeal. However, we are not convinced that the quality of audit alone is a big deciding factor for major enterprises, as it is often more about resources, worldwide coverage, etc. In any case, we note that only five firms outside the Big 4 audit a significant number of entities falling within the AIU's scope.

We are less convinced by the other arguments, which appear somewhat contrived.

The arguments against extending public reporting.

We share the concerns set out on page 15 that extending the level of public reporting by the AIU might weaken the essential purpose of audit inspection, namely to improve audit quality. In our opinion, it would indeed be likely to make firms more defensive and increase the risk of their devoting substantial time and effort to challenging points, rather than to responding positively to any underlying quality issues. We also agree that there is a danger that the process would become more legalistic, as a higher level of evidence would be required before matters were made public. If this led to changes in the AIU's operating procedures and to fewer points being raised with audit firms, to ensure that they were legally defensible, it would be in direct contradiction of the AIU's purpose of improving audit quality. Any tendency for the inspection process to become more compliance focused or for a 'tick box' approach to auditing to be adopted would seriously damage the AIU's purpose.

We are also concerned that, in the light of experience in the US, reports would be less timely. We feel it likely that the increased costs of the inspection system, due to the time and effort required to finalise reports, would outweigh any benefits. If this led to fewer visits being conducted, it would again work against the aim of improving audit quality.

Another of our concerns, as mentioned earlier, is the relationship between the professional bodies' ARCs and the AIU, and we are pleased to see that the list of arguments against extending public reporting includes that it "may make it more difficult for the professional bodies' registration committees and their own audit monitoring teams to carry out their functions".

We also feel that there could be a real danger of reports on individual audit firms adversely affecting the commercial position of companies whose auditors had been criticised publicly, by casting doubt on the robustness of the audit after their financial statements had been published.

We do not believe that the benefits of greater transparency that might come from changing the system justify the real dangers set out above.

Q.2 Which of the options set out at para. 6.1 below do you favour, and why? In particular, do you share our view, set out at para. 6.2 below, 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 favour Option A (continuance of the status quo) or, if a real wish for additional information can be demonstrated, Option B, allowing the publication of limited firm specific information.

Nevertheless, in the context of the Board's decision that change is desirable, we understand why it favours Option C, as this would provide a sanction on the rare occasions that one may be needed, but, as already mentioned, we are concerned about possible conflicts with the role of RSBs. We believe that punishing errors is not the AIU's job, but properly that of the RSBs. Moreover, we do not understand the logic, in terms of the aim of improving audit quality, of the possible scenario of two firms having made the same errors, but details only being published about the one that has not cooperated with the AIU. We believe that the correct route if a firm does not cooperate is for the AIU to go to the relevant RSB to investigate and either cancel the firm's audit registration or take whatever other action is deemed appropriate. If the ARC passes its findings on to the Disciplinary Committee and this finds against the firm, these results are published in *Accountancy*. We also wonder what would happen under Option C if a firm did not make the changes set out by AIU, but the ARC had decided that the case did not warrant further action.

Under the present system, a copy of the AIU's formal private report on its work at individual firms is already passed to the relevant ARC, which therefore has the opportunity to take action if this is considered necessary, and its decision about what action to take is already subject to monitoring by POB. In addition, the inspection teams already prepare a schedule of issues arising from individual audit files that they discuss with the audit firm, and we feel it very unlikely that a firm would ignore the AIU's recommendations.

We are also not convinced that, if reports are to be published, they should be restricted to bad reports. If one intention is to help mid-tier firms, logically good reports should be published as well, as would be the case under Options G and H, although personally we would not favour such extension.

We note that Baroness Noakes has claimed that audit committees want to have information about individual firms, but wonder what evidence there is for this. In any case, as we set out below, if audit committees do require additional information to assess the quality of their audit, we believe that a better way would be for them to receive the AIU's published annual report, together with the findings about their particular audit.

Q.3 Do you think that information from AIU inspections on individual audit 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?

We feel that it could be useful for an audit committee to receive the AIU's findings on its own particular audit, rather than just the overall report on its audit firm as at present, in order to help it fulfil its duty of assessing the effectiveness of its external auditor. Companies above a certain size have a legal obligation to have an audit, so why should they not receive feedback on the quality of that audit, although more thought may be needed about the content of the report to make it really useful for companies.

We also appreciate that, if a company wants to appoint or change its auditor, it might wish to have specific information about the quality of audits conducted by firms under consideration. However,

rather than the information being made public, a possible alternative might be to allow companies to ask firms for the copy of the AIU's report on the firm, although not specific information on its audit of other companies, provided that the confidentiality issue can be addressed. This would work both ways, as a firm with a good report would have the opportunity to benefit from it. If the AIU is concerned that firms might use good reports as marketing tools (*we are aware that under the JMU it was not unknown for a firm to ask for permission to publish a favourable report, but that this was denied in all cases*), this could be dealt with by only allowing disclosure if the company/audit committee initiated the request.

We are aware that even this limited disclosure might make the AIU more careful about what it included in the report, and lead to some of the problems identified under Question 1 above. However, these would be somewhat mitigated, as the firm would at least have the opportunity to talk to the company and explain matters, which it would not have if the reports were made fully public.

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

We feel that, in addition to any increase in direct costs, a major factor to be borne in mind if there is to be greater disclosure is the likely reduction in the number of inspections carried out by the AIU in a given period, for the reasons identified under Question 1 above. In addition, any increase in the direct costs, however small it appears, could lead to a further reduction in the number of inspections, with the consequential detrimental impact on the AIU's aim of improving audit quality.

If you would like to discuss any of our comments in further detail, or wish additional clarification of our views, please do not hesitate to contact me.

Yours sincerely,

Bruce Picking, MSc, FCA
Chairman, Regulation and Ethics Review Panel