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Our ref C190/EP4.015/rt/PLW

Dear Madam

**Reporting on Audit Quality Monitoring – Implementing a new approach – PwC’s response to the POB consultation.**

PricewaterhouseCoopers LLP (PwC) is pleased to respond to the Professional Oversight Board (POB) second discussion paper addressing the form and content of the public reporting by the Audit Inspection Unit (AIU) of its monitoring of the quality of audit work at the major UK audit firms.

As we identified in our response (dated 22 September 2006) to the POB’s first discussion paper, we believe that robust, well respected, and comprehensible public reporting of the audit inspection process is an important factor in the maintenance and promotion of confidence in the quality of UK auditing. We support the principle of audit firm specific annual reports but consider that the proposals contained in this consultation document have failed to meet the evidential requirements of companies, audit committees and audit firms.

We are very concerned about three areas contained in this consultation document.

Proposal for publishing a list of Companies whose audits have been subject to AIU review.

The inevitable effect of publishing this list will be to create ‘a feeding frenzy’ for companies and the regulator to disclose the contents of AIU private reports with the result that those reports enter the public domain. This will have serious consequences, as

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identified in our response to question 2, for the company and its auditors that would also impact upon the regulator and ultimately the capital markets.

We strongly object to the proposition in paragraph 3.5 of the consultation document that publishing a list of AIU inspections is the only way for the POB to have assurance that audit clients will be made aware that their audit has been subject to inspection. The removal of the current prohibition on auditors discussing AIU findings with audit clients and placing a specific requirement to do so will fulfil the POBs aim in this regard. Furthermore the AIU can use subsequent visits to confirm that disclosure/discussions have taken place.

We would draw your attention to the Draft Regulations<sup>1</sup>, published by the Department for Business, Enterprise and Regulatory Reform, required to implement requirements contained in the Statutory Audit Directive. Schedule 11A, part 2, paragraph 61 prevents the disclosure of information that would identify any audited person subject to independent monitoring under Schedule 10 section 23 (1) of the 2006 Companies Act. We recognise that these provisions relate to monitoring and inspections carried out by the Recognised Supervisory Bodies. However, the policy implication of this provision is clear – nothing should be published that would identify those entities whose audits have been subject to review. We support the Government's position on this policy and we strongly recommend that the POB also adopts this policy with respect to its proposal to publish a list of AIU inspections.

#### Inclusion with public and private AIU reports of formal firm response.

If the purpose of publishing audit firm specific reports is to assist users of audited accounts (companies; audit committees; and other stakeholders) – a stated aim of the POB in publishing these reports - then audit firms must be given the opportunity of making formal comments on AIU findings contained in the report (the addition of this provision would fulfil good practice principles and is consistent with the approach of the PCAOB). This will provide users of these reports with all the facts on which to make decisions regarding the auditor.

Based on our past experiences of AIU press conferences we consider there is significant risk that the findings contained in AIU reports are mis-interpreted with the corresponding damage that would cause companies, audit firms, the regulator and the capital markets. To avoid this we believe it essential that audit firms are invited to any FRC press conferences or media briefings where these reports are discussed so that the views of audit firms are given equal prominence in any press statements or media comments.

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<sup>1</sup> Link to document: <http://www.berr.gov.uk/files/file40555.pdf>

Evidential basis for further period of consultation.

In its 2006 consultation paper on AIU reporting the POB identified that it was minded to adopt option C, i.e. including a section within the AIU annual report on a named audit firm, 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.

The rationale behind this suggestion (para. 6.2 refers) was a belief that this option would 'encourage audit firms to respond positively and quickly to recommendations made in AIU reports'. This option was either fully or partly supported by 22 of the 38 respondents to that consultation document (including a significant number of audit committee Chairman and Companies).

Whilst we accept that the debate on AIU public reporting has continued since these responses were received, we are concerned that the POB is now proposing a much wider reporting model for the AIU, which mirrors option F of the June 2006 paper, which was only supported either fully or partly by 5 of the 38 respondents.

Therefore the responses to the previous consultation clearly show that the current POB proposals are contrary to the evidence and do not meet better regulation principles.

We have responded to each of the four detailed questions posed in the consultation document and would be pleased to discuss these views in further detail if that would be of assistance.

**Question 1.**

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

It is very important, to enable Audit Committees and Companies to make properly informed decisions regarding the appointment of their auditor, that AIU public reports contain reference to the complexity of the audited entities subject to AIU monitoring.

With respect to paragraph 2.4 of the consultation document, we are concerned that the conflicting demands of interested parties on this report will result in a document that is of little use or disproportionately damaging to the audit firm or audited entities reported on. For example, an Audit Committee of an Oil company looking to engage a new auditor will be particularly interested in the work of audit firms within that sector. However, if an audit firm has only one client from the oil sector identification of the client, either directly or by inference, could have an adverse affect on the client's market value if audit issues were identified.

As John Wroe (British Telecom) said in his 22 September 2006 response to the POBs first consultation document:

Of the arguments set out against extending public reporting the risk of adversely impacting the commercial position of companies whose auditors have been adversely criticised is an important factor. This could also result in companies being publicly pressurised to change their auditors which in turn could result in undue pressure on the business of the particular audit firm that has been publicly criticised. This might well be despite the audit firm having already taken appropriate action to address the particular issue. This, in turn, may well lead to a further reduction in the choice of audit firms in the market.

For these reasons we consider that all public reports should be generic in nature that would not lead to identification, either directly or by inference, of the audited entity (ies).

We consider that the proposal to publish annual firm specific reports on either two or three publication dates is likely to give an unfair competitive advantage or disadvantage to firms with an earlier reporting cycle. We maintain that the current AIU Annual reporting system (one publication date) will remove any unfairness solely dependent upon timing but also provide the clarity of one publication date for users of this information.

Whilst we welcome the indication that the current level of engagement between the AIU and the audit firm in the preparation of its annual report will continue we consider that audit firms must be given the opportunity of making formal comments on AIU findings contained in the report. This will provide users of the annual public report with all the facts which will, in turn, give greater clarity and transparency.

## **Question 2.**

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

We are very surprised that the POB is pursuing this option in light of the non supportive responses it received to this area (question 3) in the first consultation document. An example is the comment of Douglas Flint CBE (Group Finance Director of HSBC):

I do not think there is any need for information from AIU inspections on individual firms to be made available to audit committees. It is open to audit committees to request information from their auditors regarding how the AIU inspections have gone and I believe this will be very likely in the circumstances of an audit tender. It would then be up to audit committees to determine whether the transparency and completeness of the reply was valuable to them.

We reiterate our comments contained in our September 2006 response to this issue. We are extremely concerned at the risk of information leaks which could have damaging consequences both for the individual audit firm and company concerned as well as the wider capital market. Consideration of these reports, in the knowledge that they may be disclosed more widely, will impose significant additional costs on audit firms and we do not believe that the POB has made out an argument that these reports will be beneficial (in fact, evidence to date shows the opposite). We suggest, therefore, that the POB maintains the existing regime regarding private reporting on individual audit engagements.

We are particularly concerned by the comments contained in paragraph 3.5 of the current consultation document. It appears that the justification for publicly publishing a list of AIU reviews is to ensure that audit committees are aware of AIU inspections in the event the auditor has not made them aware of that fact. As identified in paragraph 3.4, there is currently a restriction on auditors discussing this fact with audited entities and this proposal seems to be using the principle of ‘cracking a nut with a sledgehammer’.

We anticipate publicly publishing the names of audits reviewed by the AIU will cause a number of problems:

- For companies – dealing with requests from shareholders on the contents of the private report with the prospect that findings enter the public domain and adverse findings affect the share price of the company;
- For audit firms – private reports entering the public arena with possible adverse effect on the competitiveness of the audit market;
- For the POB – dealing with the effects on companies and audit firms of private reports entering the public arena. Identifying areas for FOIA requests.

However, if the POB is determined to follow the route it has proposed regarding private reports we consider that audit firms must be given the opportunity of making formal comments on AIU findings contained in the report. This will provide users of this report with all the facts which will, in turn, give greater clarity and transparency.

### **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 (now Business, Enterprise and Regulatory Reform)?**

We support the Board’s proposal regarding the annual report. However, we would urge caution that this report should not include anything that identifies, either directly or by inference, an audit firm or audited entity.

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**Question 4.**

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

We remain concerned that the figures identified in Section 5 of the consultation document has not been subject to a thorough and robust cost analysis and we strongly suggest that the POB engages with audit firms in assessing these costs prior to any decision on changing the current reporting regime.

Paragraph 5.7 says 'the Board does not believe it is possible for it to quantify the principal benefits expected to arise from the new reporting arrangements.....'. As previously identified, we believe that the reason for this is that the POB has failed to make out an evidence based argument for the changes it is proposing. The majority of respondents to the first consultation document only supported minor changes to the current reporting regime. We suggest that applying or slightly modifying those changes would better meet the demands of business and audit firms without imposing dis-proportionate cost.

Please do not hesitate contacting me if you require any further information regarding this response and we are content for this response to be published.

Yours sincerely

Peter L Wyman