



**PROFESSIONAL OVERSIGHT BOARD**

**REVIEW OF AUDIT MONITORING BY THE RECOGNISED  
SUPERVISORY BODIES FOR AUDIT IN THE UK**

**JULY 2006**





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## One – Introduction

The Professional Oversight Board (the “Oversight Board”) contributes to the achievement of the Financial Reporting Council’s (FRC) aim of promoting confidence in corporate reporting and governance through independent oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies.

### 1.1 *Background of the review*

Three areas of accountancy are statutorily regulated in the UK – audit, insolvency and investment activities. Company audit is regulated through the Companies Act 1989. This requires that persons eligible to be appointed as a company auditor must be a member of a Recognised Supervisory Body (RSB). The five RSBs currently recognised in the UK are the Association of Authorised Public Accountants, the Association of Chartered Certified Accountants, the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants in Ireland and the Institute of Chartered Accountants of Scotland. Schedule 11 of the Companies Act 1989, as amended by the Companies (Audit Investigation and Community Enterprise) Act 2004, sets out the requirements that all RSBs must meet. These requirements are fulfilled by the Bodies through four key processes; audit registration, audit monitoring, complaints and discipline procedures and continuous professional development (CPD) procedures.

The Oversight Board has certain responsibilities delegated to it by the Secretary of State under The Companies Act 1989 (Delegation) Order 2005 relating to the regulation of audit in the UK. The oversight of the regulatory activities of the RSBs is discharged in three ways;

- documenting and understanding each Body’s regulatory system including information on how it complies with relevant legislation
- annual compliance testing of the operation of each Body’s regulatory systems
- periodic evaluation of the effectiveness of a specific aspect of the regulatory system i.e. complaints and discipline procedures, audit monitoring visits, audit registration procedures etc.

The RSBs’ monitoring of audit registrants is a major part of their regulatory system. Audit monitoring is the primary method of the policing of auditors’ compliance with auditing ethical and quality control standards, and disseminating areas of best practice. It is therefore a key element in ensuring that high standards of audit are achieved and maintained in the UK. The quality of audit directly impacts on public confidence in financial reporting and as such, it is critical that the monitoring of this is performed effectively and efficiently so as to ensure high standards. It is for this reason that the Oversight Board has decided to conduct this review of the effectiveness of the RSBs’ audit monitoring activities.

## *1.2 Scope and objective of the review*

The review was conducted in three stages. In the first stage we consulted with parties involved with the monitoring of audit quality, including practitioners, users of accounts, regulators and staff at each of the monitoring units at the accountancy Bodies. In the second stage we shadowed inspection visits at each of the Bodies' monitoring units, interviewed staff and management at each unit, reviewed inspection reports, committee minutes and other documentation and attended training events. In the third stage we analysed the evidence gained at the second stage, documented our findings and developed our conclusions and recommendations and discussed these with the Bodies.

This work was carried out in the period from August 2005 to March 2006. The key objective of the review was to assess the adequacy, effectiveness and efficiency of procedures which the Bodies have in place to monitor audit registrants in line with the Companies Act requirement.

## *1.3 Overview of findings and conclusions*

Audit monitoring is a statutory responsibility of the RSBs and the requirement is detailed within the Companies Act. The method and approach adopted to audit monitoring varies between the Bodies.

The Oversight Board believes the arrangements and the resources applied by the Bodies for monitoring fulfil the requirement set out in the Companies Act Schedule 11, Para 10 (1). However, this review has identified areas where the monitoring approach or application of the approach could be improved. These improvements are detailed within the body of the report and, in our opinion, will help to promote further confidence in the work of the profession.

The key recommendations are that the Bodies:

- Consider tailoring their audit approach for file selection to ensure an adequate coverage of audit engagements and audit principles (Section 2.3)
- Maintain a clear focus on the overall quality of audit alongside the focus on compliance with the Bodies' regulations (Section 2.4)
- Include a detailed review of the financial statements and notes of audits reviewed within the monitoring process (Section 2.5 and 2.6)
- Not tolerate any actions of their members which hinder the monitoring process (Section 2.7)
- Clarify their guidance on grading visit outcomes (Section 3.1)
- Hold a cross-body workshop, together with the Oversight Board, to discuss the issues identified in this report and other current challenges in audit monitoring (Section 4).

Where recommendations have been made, we expect these to be implemented on a timely basis. We will review the extent to which progress on the implementation of our recommendations have been put into effect during our annual compliance review in 2006/7 and will comment on this in our Report to the Secretary of State in respect of that year. We would expect Bodies to fully comply with our recommendations by the time of our 2007/8 review.

## **Two – The Bodies’ approach to audit monitoring**

### *2.1 Background to UK audit monitoring*

The current regime of audit regulation is derived from the 8th European Directive on company law as implemented in the UK through the 1989 Companies Act. The Directive itself did not include a requirement to monitor audit work; however, the UK government has required this from the commencement of audit regulation.

The Companies Act 1989, Schedule 11, Para 10(1) details that:

“The Body must have adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules”

The revised EU 8th directive, which is expected to be fully implemented in the UK by mid 2008, will require all audit registrants to be monitored at least once every six years.

Following their recognition in 1991, the RSBs started monitoring their member firms. The three territorial Institutes formed a single Joint Monitoring Unit (JMU) and the ACCA set up a separate monitoring department.

With effect from 1st January 2005 the JMU was disbanded and monitoring of firms was undertaken by each Institute independently. The ICAEW formed a Quality Assurance Directorate with staff from the JMU and this is now the ICAEW’s monitoring unit. The other territorial institutes have established their own teams to undertake this work although the ICAEW’s QAD continues to assist the ICAI on visits to larger firms.

The Audit Inspection Unit (AIU) was set up following the Government’s post-Enron review of the regulation of the UK accountancy profession which reported in January 2003. The Government’s report recommended enhancing the monitoring of the audits of listed and other major public interest entities through a new independent inspection unit (the AIU) reporting to a professional oversight board within an integrated independent regulator (the FRC). The AIU monitors the auditors of all listed and other major public interest entities and reports its findings to the Audit Registration Committee (ARC).

The quality of the monitoring of public interest entities has not been assessed or commented on within this report. There is a separate report that summarises the approach and findings of the AIU. The AIU’s first report was published in June 2005 with the second report being published in July 2006.

### *2.2 The overall quality of monitoring*

The Oversight Board believes that the introduction of audit monitoring over the last 14 years has contributed to improving the quality of auditing. Many initial inspection visits found basic weaknesses, such as many small firms using no formal audit methodology.

Following the implementation of improvements agreed between such firms and inspectors, such as the wide-spread adoption of audit methodology workpacks by small firms, many such fundamental weaknesses have been eliminated, leading to a positive contribution to audit quality. The monitoring process undertaken by the Bodies has evolved over time and, the experience gained has ensured that emerging themes and issues are addressed. Some improvement in audit quality can be attributed to the removal or voluntary de-registration of sub-standard audit firms from the register following monitoring inspections. Those firms who are being visited for a second or third time should have implemented the recommendations made at previous visits, ensuring that the standard of the firm's audit work has improved. All Bodies view the education of practitioners to be a key aspect and challenge of the monitoring process.

The new EU 8th Directive requires all audit registrants to be monitored at least once every six years which will ensure that firms are visited regularly and support the Bodies' efforts to improve quality.

During the course of discussions with staff from the monitoring units within the Bodies and from the visits that we attended it appeared that the monitoring units generally require a higher standard of work than commercial firms who also provide quality control reviews. Such commercial firms are often employed by practitioners to perform compliance reviews on behalf of the practice. For example, at one visit shadowed by the Oversight Board the practitioner questioned their Body as to why, despite scoring highly with an external commercial reviewer, the issues identified by the Body's inspector resulted in an unsatisfactory outcome for their monitoring visit. We understand from monitoring staff that this is not uncommon; this gives the Oversight Board some comfort as to the quality of the Bodies' monitoring activities.

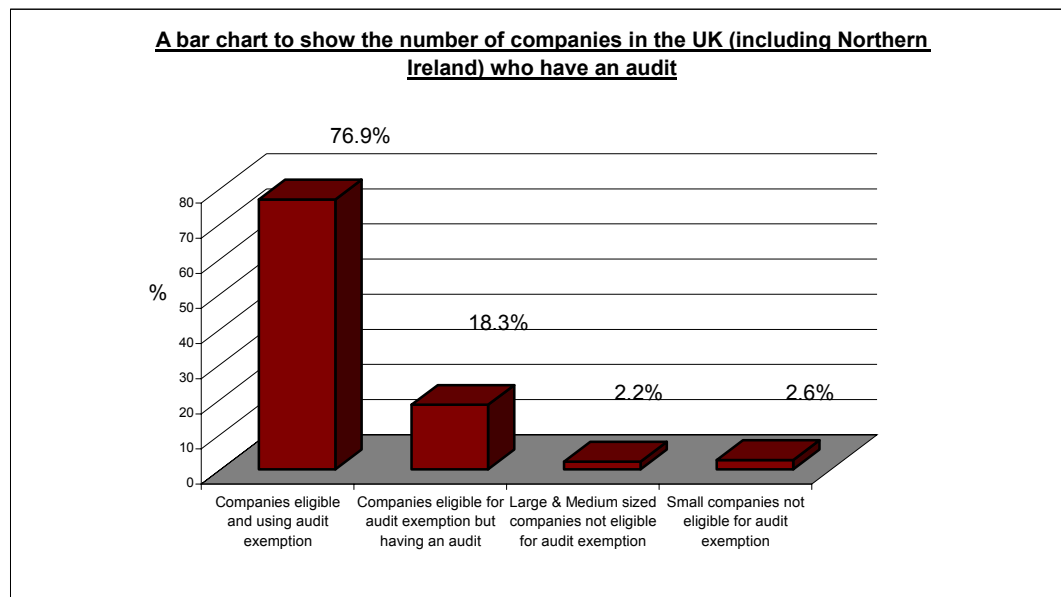
Many of the staff involved in monitoring have extensive experience within the field; some have worked as a monitoring inspector for over 10 years. This experience results in knowledgeable inspectors who are aware of common issues and areas of weakness. Furthermore, the monitoring unit can benefit from the cumulative knowledge gained from previous visits. This results in a focused and informed approach, contributing to the development in the standards of audit.

Overall the Oversight Board believes the arrangements and the resources applied by the Bodies for monitoring fulfils the Companies Act requirement. The Bodies are commended for their commitment to this area and their considerable efforts in improving the standard and quality of audit over the last 14 years.

### **2.3 *The monitoring of registered firms with few or no audit clients***

The 2005 data from Companies House and the Companies Registry indicates that of the 1.2 million companies in the UK (including Northern Ireland) over 75% are eligible for and use the audit exemption. Of the remainder, approximately 180,000 companies are small companies entitled to the audit exemption which have elected to have an audit.

The balance relates to those companies that are required to have an audit due to their size or the nature of their activities. The bar chart presents this data graphically.



Following the rise in the audit threshold the number of firms applying for audit registration is falling. Many of those retaining audit registration are experiencing a decline in the number of audit clients, often leaving audit as a small part of the firm's overall business. Practices with 2-5 audit clients out of 400 clients in total are typical. It is common for firms to retain audit registration for clients below the audit threshold and in some circumstances 'just in case' an audit client is gained.

The Oversight Board visited a variety of practices during the review including sole practitioners and several partner practices. Our review highlighted that within each Body inspectors tended to use the same monitoring approach for all audit firms regardless of size and number of audit clients. With respect to the firm wide procedures and general elements of monitoring the Oversight Board commend the Bodies efforts to devote the same attention, time and resources for practices of different sizes. The consistent approach taken includes a review of CPD records of partners and other qualified staff, discussions with key personnel and ensuring that appropriate and up to date material is available. In adopting uniform approaches for practices of various sizes the Bodies help to emphasise the importance and regulatory requirements of audit engagements.

In relation to the number of audit files selected for review, the Oversight Board noted that the number of files selected did not tend to vary with the size of the practice inspected. We would encourage the Bodies to consider the benefits of varying the number of files selected depending on the size of practice to ensure reasonable coverage of audit clients, partners and responsible individuals.

The Oversight Board has delegated responsibilities in overseeing the Bodies' role regarding the audit of companies. Where monitoring is undertaken to support the quality of work performed under other legislation, such as charities legislation, the Bodies should discuss specific monitoring requirements with the relevant regulatory Bodies such as the Charities Commission.

**Recommendation: The Bodies should consider tailoring their approach for file selection to ensure that an adequate coverage of audit engagements and audit principles is achieved during the monitoring inspection, whilst continuing to adopt the same general approach to firm wide procedures across all sizes of practice.**

**The Bodies should discuss the monitoring requirements of other relevant legislative Bodies to ensure that the Bodies' approach satisfies their needs.**

#### *2.4 Focus on audit quality*

The Companies Act requires the Bodies to have 'adequate arrangements and resources for the effective monitoring and enforcement of compliance with [their] rules'. A literal interpretation of this requirement would lead to the main, or even sole, focus of monitoring to be compliance with the Bodies' own audit regulations and any other applicable rules. These regulations require compliance with relevant standards. However, if the focus on the Bodies' rules and regulations is too narrow there is a risk of loss of the wider perspective of the overall quality of the audit and the degree to which the audit opinion is supported by the audit work performed and recorded. The fact that a regulation has been 'breached' may be less relevant than the degree or effect of the breach, i.e. the impact of the breach on the quality of the audit opinion. The Bodies maintain that compliance with the Bodies' own regulations results in compliance with auditing and accounting standards and thus such compliance leads to overall high quality of the firm's audit work.

During the course of our shadowing visits we found some examples where the focus on regulations was narrow and the reporting was related to compliance with the Bodies' own regulations rather than more widely on the overall quality of the firm's audit work. The outcome and recording of the visit was often recorded in terms of which regulations were breached rather than whether the firm's audit opinion was sufficiently supported by the work done and recorded.

**Recommendation: Whilst meeting their statutory requirement to monitor compliance with their regulations, the Bodies should establish a clear focus on assessing the overall quality of audit.**

#### *2.5 Initial review of the financial statements*

During the course of their monitoring visits all the Bodies review the key lines on the primary financial statements. The degree of analysis and purpose to which it was applied

varied between the Bodies. Two Bodies perform a detailed review of the audited financial statements prior to commencing the audit file review to establish the key issues to target within the audit file itself, the others did not place as much reliance on the financial statements but concentrated on a complete audit file review.

A detailed assessment of the Profit and Loss, Balance Sheet and notes is an important part of the monitoring process as it ensures that the key areas of risk and material items are identified by the inspector. An assessment of the audit work for these key items and areas can then be made to ensure the work performed is sufficient and supports the audit opinion.

The Bodies' approaches in this area have diverged following the separate establishment of monitoring units in the three territorial institutes in recent years. We believe that all of the Bodies could benefit from comparing and contrasting their methods. This will form part of the cross-body workshop as recommended in Section 4.

**Recommendation: All of the Bodies should perform detailed assessments of the audited financial statements and relate this assessment to the audit file as part of their monitoring approach.**

#### *2.6 Focus on the quality of the accounts in audit monitoring and quality assurance programmes*

The audit opinion on the financial statements is the publicly available output of an audit; as such the quality of the financial statements opined on is vital. A review of the financial statements and notes can highlight any issues that may reduce the accuracy and usefulness of the accounts.

As part of the Oversight Board's review of how accountants support the needs of small and medium sized companies and their stakeholders the Bodies have recognised that improvements are required in the quality of accounts that are prepared with the involvement of professional accountants. The Bodies have agreed to take action to improve the situation. One way in which they will address this is through a review and modification of their quality assurance programmes through which quality procedures of member firms are reviewed.

**Recommendation: The Bodies should incorporate into the monitoring programme a review of the quality of the financial statements and notes as audited by the registrant.**

#### *2.7 Registrants' approach to regulation*

Audit monitoring is a requirement under the Companies Act, which in turn enacts a requirement of an EU Directive. Firms that wish to register as auditors must accept monitoring as a part of ongoing registration. Negative perceptions of audit monitoring were evident from monitoring staff's descriptions of some registrants' reaction to the

monitoring visits and from descriptions of the efforts required to attain cooperation at some visits.

The Oversight Board supports the activities of the monitoring units in completing their necessary function in occasionally difficult circumstances; registrants should not be allowed to hinder or obstruct this process in any way.

**Recommendation: The Bodies should highlight to their members and to the public the benefits of monitoring and the impact it has on audit quality. This will help clarify to the public the benefits of using a regulated accountant. At the same time, the Bodies should not tolerate any actions of their members which hinder the monitoring process, or any non-cooperation with the monitoring process or the Bodies' regulatory committees.**

## **Three – the Bodies’ responses to poor audit work**

### *3.1 Grading a firm following a visit*

All of the Bodies grade firms following a visit A to D. An A graded visit indicates that there are no significant findings; a D graded visit is reported to the Bodies’ licensing or registration committees. However, the gradings are not comparable across the Bodies as different reasoning and approaches are used to determine gradings by different Bodies. Further, the explanation of the basis of grading provided varied across Bodies who purport to have the same system and in some cases the explanation varied within a specific Body.

Based on our discussion we understand that one approach is that the firm is graded following a visit first on the inspector’s overall impression of i) the audit work performed and ii) an assessment of the firm’s commitment and willingness to implement any changes proposed and the firm’s desire to improve. At the end of a visit the inspector presents their findings to the firm during a closing meeting, following which the inspector sends a report of findings to the firm. The firm will comment on the findings and confirm the actions they intend to implement to resolve any issues identified. The inspector will assess this response and determine whether the firm is willing and able to address the issues found.

If the inspector is persuaded that the firm can implement the required improvements then the firm is graded B, with no further follow up action by the Body. If the inspector believes that some follow up action by the Body’s secretariat is required, such as written undertakings by the firm or the voluntary submission of cold file reviews, then the firm is graded C. If the inspector does not believe that the firm is willing and able to implement the necessary improvements then the firm is graded D and the committee is asked to impose conditions such as hot or cold file reviews on the firm. A firm can be graded D either for unsatisfactory work or for an unsatisfactory response to suggested improvements.

All C graded reports are considered by the Secretariat of the registration committee, who follow up any recommendations and undertakings with the firm and ensure that evidence is submitted or follow up visits are scheduled to confirm that agreed actions have been taken. All grade D reports are considered by the registration committee of the Body which can impose conditions and/or restrictions on the firm, or remove its registration.

Another approach applied is to grade firms solely on the quality of the work found in the review. A and B gradings are termed as ‘satisfactory’ and C and D as ‘unsatisfactory’. When a monitoring visit is deemed unsatisfactory, it identifies deficiencies in compliance with auditing standards the officer will agree corrective procedures with the firm and recommend a follow up visit within a certain period of time. If the subsequent visit results in an unsatisfactory outcome the firm is reported to the registration committee

and a hot file review condition is usually imposed on the firm, together with a follow up monitoring visit at the firm's cost and the firm is given a formal warning. Following a third unsatisfactory visit, the Body's registration committee will consider whether there are mitigating circumstances. These are assessed and the registration committee will determine whether to withdraw the firm's registration. It is not necessary for the two unsatisfactory outcomes to be consecutive for a formal warning to be issued.

The second approach has advantages in terms of clarity for both the committee and the firm being monitored. The policy is clearly explained to all parties and helps to ensure that where consistently poor quality audit work has been performed the firm's registration will be removed. The first approach creates greater scope for inconsistency.

The initial grading at all Bodies is dependent on the judgement of the inspectors and their experience of dealing with similar cases. The outcome is reviewed by another inspector/ reviewer within the Body to determine whether, from the report and the work done, the grading appears reasonable and consistent. The key difference between the two approaches is the clarity that the firms, the inspectors and the registration committees have with respect to the procedure following the visit and the subsequent grading.

The Oversight Board recognises that the inspectors and committee should consider each case individually and apply appropriate judgement, assessing whether there are any mitigating circumstances that affect the outcome.

**Recommendation: The Oversight Board recommends that all Bodies produce clearer guidance for inspectors, firms and the registration committees on the gradings of visits. In addition it would be helpful if examples of previous cases with justification of the grading were given so these can be used as a guide for similar cases in the future. Clear explanation and justification as to why a specific grade has been given on individual inspections, will provide greater clarity for reviewers and the registration committee and will help to ensure consistency across the individual reviewers at each Body.**

## Four – Cross-body cooperation and other issues

The RSBs face many of the same challenges in monitoring the registered auditors in the UK. The Oversight Board acknowledges there may be some aspects where the Bodies compete, and this competition can help to push up standards. However, the challenges that the Bodies face in effectively monitoring auditors are often common and several Bodies have cooperated closely in the past to meet the challenges. Examples of such challenges include;

- The common risks that registrants will challenge regulatory decisions through judicial review
- Monitoring the efficacy of the various measures taken such as hot and cold file reviews orders, ordered training courses etc.
- Experience of the typical quality issues found when practitioners use common commercial audit methodology work packs

As part of our research for this project we shadowed various monitoring visits with each RSB. This enabled us to ascertain the procedures each Body has in place to satisfy the requirements of the Companies Act with respect to the monitoring of audit registrants. The approach and techniques used by each Body varied, there were advantages of the different approaches seen at all visits. The Oversight Board has considered the various methods used and will share with the Bodies potential areas of best practice.

Some of the key areas we will cover will include:

- Approach to planning.
- Structure of the opening meeting.
- Adequacy and purpose of the administrative checks performed.
- Methodologies of the audit file review.
- Structure of the closing meeting.

The Oversight Board believes that it should not be possible for a registering firm to effect regulatory arbitrage – the monitoring that a firm gets from one registering Body should be of similar quality to another, though not necessarily identical in format or approach. No firm should choose to register with one Body over another so that it gets ‘an easy ride’. During this review, the Oversight Board has not found any evidence or even any impression that this happens, as all Bodies have a professional and comprehensive approach to monitoring.

The Oversight Board believes the Bodies can helpfully work together in this non competitive area to meet the challenges noted in this report and can share experiences of other common themes and problems to ensure that the quality of audit is raised.

**Recommendation: That the Bodies and the Oversight Board hold a workshop to discuss the issues identified in this report and other current challenges in audit monitoring.**

## Appendix 1

Persons interviewed in the process of this review include:

The Joint Audit Committee of the ICAEW, ICAI and ICAS.

Karen Honnoraty	ACCA
Steven Essayan	ACCA
Andrew Teague	ACCA
Ian Pickering	ACCA
Paul Simkins	QAD, ICAEW
Chris Joy	QAD, ICAEW
Pervez Sorabji	QAD, ICAEW
Alan Hind	QAD, ICAEW
Heather Briers	ICAI
Nigel Anderson	ICAI
Laura Stead	ICAI
Dr Tom McMorrow	ICAS
Leslie Marshall	ICAS
Andrew Jones	AIU
Colin Brown	AIU
Tom Barrett	AIU, formerly JMU
Stella Fearnley	University of Portsmouth, Professional Oversight Board member
Jon Grant	APB
Hazel O'Sullivan	APB
Stephen Thomas	Former Head of JMU
John Welsford	Mercia
Emma Ward	DTI

Practitioners at small and large accountancy firms in England and Scotland

**The Professional Oversight Board would like to thank all the above and all others who have contributed to this review.**

ISBN: 1-84140-826-3

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