



PROFESSIONAL OVERSIGHT BOARD

REPORTING ON AUDIT QUALITY MONITORING

A CONSULTATION DOCUMENT

JUNE 2006

Professional Oversight Board
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One – Introduction and issues for consultation

1.1 The Professional Oversight Board (“Oversight Board”) is the body within the UK’s Financial Reporting Council (FRC) which has overall responsibility for audit regulation in the UK. It is also responsible, through its Audit Inspection Unit (AIU), for monitoring directly the quality of the auditing of economically significant entities.

1.2 In the last few months there has been heightened interest in the form and content of public reporting by the AIU of its monitoring of the quality of audit work at the major UK audit firms. In particular there have been calls for the AIU to publish, in whole or in part, its private reports on findings at individual audit firms. Some commentators have suggested that firm specific reports would better serve the public interest and point to comparisons with the Public Company Accounting Oversight Board in the US, which publishes parts of its reports on individual audit firms. In part these calls reflect the view, linked to concerns at the high level of concentration in the audit market, that publication might demonstrate that firms outside the Big 4 are capable of undertaking large listed company audits.

1.3 The Oversight Board’s existing policy that inspection reports on individual audit firms should not be published was originally established by the Group under the auspices of the UK Government overseeing implementation of the “post-Enron” reforms in the UK at the end of 2003. In the absence of any specific legal requirements, it is now for the Oversight Board, in consultation with companies, investors, the accountancy profession, Government, other parts of the FRC, and other interested parties, to determine the policy on publication¹. The Oversight Board has had it in mind to look again at this issue once the new inspection arrangements had been in operation for a reasonable time and took the decision in May to consult publicly.

1.4 Subsequently, several members of the House of Lords have argued during debate on the Company Law Reform Bill that current anonymised reporting provides no decision useful information to Audit Committees, who are charged with assessing the effectiveness of their external auditors, and that publication of firm specific reports would help meet that need. The House of Lords agreed to an amendment which would make the Oversight Board subject to the Freedom of Information Act. That issue is not a matter for this consultation. However, in the course of the debate, Lord Mackenzie of Luton, who spoke for the Government, commented that applying the Freedom of Information Act to the Oversight Board

¹ The confidentiality obligations to which the AIU is subject under the Audit Regulations, which apply to all firms currently within its scope, make provision for it to disclose information for the purpose of meeting public reporting obligations.

would not necessarily lead to publication in response to requests for the private AIU Reports, since one of several exemptions might apply. He also indicated that the Oversight Board would be consulting shortly on the extent of public reporting by the AIU.

1.5 This paper sets out the background to the reporting of inspection findings; it considers the advantages and disadvantages of extended public reporting by the AIU; it invites comments on the strength of the arguments for and against public reporting on individual audit firms; and it invites your input into our current thinking on the options for changing our current reporting policy.

1.6 There is a related but separate issue as to what information from audit inspections should be made available to audit committees, and, if so, in what way this might be done. Whilst this is outside the scope of this consultation, and will be subject to future research and consideration by the Oversight Board, we have included a question below so that we can take your views into account in that further work.

1.7 The **questions for consultation** are set out in the relevant sections and repeated below for convenience.

1.8 **How to reply** to this consultation is set out in **Section 7**. We invite comments by **Friday 22 September 2006** at the latest.

1.9 A short partial **Regulatory Impact Assessment** is attached at **Annex A**.

Questions for consultation

We would welcome comments in particular on the following.

Question 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?

Question 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?

Question 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?

Question 4

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

Two – Background

Review of Regulatory Regime

2.1 Following Enron and other well-publicised corporate failures, the UK Government reviewed the regulatory regime for auditors and accountants in the UK. The report, 'Review of the Regulatory Regime of the Accountancy Profession' (the Swift Report) was published in January 2003. That 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 (the Oversight Board) within an integrated independent regulator (the FRC). The Government also determined that the professional accountancy bodies, in their capacity as Recognised Supervisory Bodies (RSBs), should continue to register all audit firms, subject to statutory oversight by the Oversight Board².

2.2 Detailed implementation of the Swift recommendations was overseen by a Steering Group comprising a senior DTI official, the Chairman of the FRC, and the Chairman of the CCAB. Following discussion with the accounting profession and the FRC, the Steering Group concluded at the end of 2003 that the AIU would not publish reports on individual audits or auditors.

2.3 Under these arrangements, which started in 2004, the formal private reports on the AIU's work at individual firms are given both to the firm in question and to the audit registration committees of the relevant RSB, in most cases the ICAEW. This report covers the AIU's findings on firmwide procedures and a summary of the issues across all audits reviewed at a particular firm. The handling of such cases by the audit registration committees, in particular action taken by them in response to the AIU reports, is subject to monitoring by the Oversight Board. The inspection teams also prepare a schedule of the issues arising from reviews of individual audit files. These are shared and discussed with the audit firm but not more widely.

2.4 The decision not to publish individual AIU reports was influenced by concerns that to do so would encourage a rules-driven, litigious approach; that the publication of such reports would prejudice the decisions of the audit registration committees; and that publication could impact on the commercial standing of the companies audited by the firms which were criticised. Although individual reports are not published, transparency is achieved through the publication by the AIU of an annual Public Report on generic themes and issues identified by it.

² The Government's conclusions following consultation were published in February 2004: http://www.consumer.gov.uk/cld/gov_response_to_consultation.pdf

Remit of the Independent Inspection Arrangements

2.5 The current scope of the AIU's inspections is the audits of all UK entities with listed securities (both equity and non-equity securities) and other entities in whose financial condition there is considered to be a major public interest.

2.6 The Oversight Board is responsible for approving the AIU's work programme and, in particular, for determining which audited entities fall within the "major public interest" category and therefore within scope. The monitoring units of the professional bodies, in their role as RSBs, remain responsible for the monitoring of all other audits within the scope of audit regulation in the UK.

2.7 This approach is designed to ensure that independent inspection is focused on those audited entities and audit firms in respect of which the level of public interest is highest. There are currently only five firms outside the Big 4 that audit a significant number of entities within the AIU's scope ("other significant firms").

2.8 For all other firms the AIU focus their inspections on reviews of the small number of listed or other major public interest entities audited by them and rely, where appropriate, on firmwide reviews undertaken by the monitoring unit of the RSB with which the firm is registered.

Three – Current position in the UK

3.1 The Oversight Board's existing policy is that the AIU should report on the following basis, until such time as there is either a legal obligation to make such reports publicly available, or it concludes, following discussion with interested parties and through a public consultation, that an alternative form of reporting will enhance audit quality.

AIU implementation of the agreed arrangements

3.2 The AIU has implemented the arrangements agreed in 2003 through a three-tiered reporting process as follows:

- Private reporting to the audit firm
- Reporting to the audit registration committee
- Public reporting

Private reporting to the audit firm

3.3 The AIU's reporting to the individual firms comprises:

(a) an overall private report on the firm which includes:

- a detailed review and assessment of the firm's systems, policies and procedures designed to deliver quality audits and comply with relevant regulations;
- a summary of the issues arising from reviews of individual audit files;
- the recommendations arising from the inspection work;
- the firm's response to those recommendations; and

(b) a private report on each audit reviewed by the AIU which includes:

- detailed comments on aspects of the conduct of the audit;
- a response by the audit team to the issues raised by the AIU.

The Head of Audit of the relevant firm receives copies of the private reports on each audit reviewed.

Reporting to the audit registration committees

3.4 The AIU also sends the private report, referred to in (a) above, to the audit registration committee. On grounds of confidentiality the AIU does not provide the private reports on each individual audit reviewed by the AIU, referred to in (b) above. However, the overall private report on the firm concerned includes a summary of the issues raised on individual file reviews without identifying the audited entity.

Public reporting

3.5 The AIU publishes annually a public report on its inspection activity. The first AIU public report, published in June 2005, commented on the issues arising from its inspection activity at the Big 4 firms and their audits of FTSE 350 clients. The report was segmented between those issues principally arising from the firmwide procedures and those from the application of those procedures on specific audits. The report indicated where issues were relevant to all firms, one firm or some of the firms but did not name the firms in relation to specific issues.

3.6 To reflect the widened scope of the AIU's work during 2005/6, to include firms outside the Big 4, this year's report, due to be published in July, will segment the findings between those firms which have been visited for a second time (i.e. the Big 4) and those firms which have been visited for the first time. Such segmentation will provide public information on the AIU's assessment of the quality of work of the Big 4 and the other significant firms.

Four – International perspective

4.1 We are aware of three countries other than the UK in which there is public reporting by independent audit inspection bodies, as follows:

- Public Company Accounting Oversight Board (US)
- Canadian Public Accountability Board
- Certified Public Accountants and Auditing Oversight Board (Japan)

Public Company Accounting Oversight Board

4.2 The PCAOB has the following approach to reporting:

- A report on individual audit firms covering
 - a. firmwide procedures and
 - b. the application of those procedures on individual audits.
- Part I of the individual reports above is made public. This includes a description of the types of matters on which the PCAOB focused its inspection procedures and the issues identified by the staff in reviewing the firm's performance on selected audit engagements, though audit clients are not identified.
- Parts II and III of the report are initially non-public. These include discussion of a firm's quality control procedures. Parts II and III are made public only if, in the opinion of the PCAOB, insufficient progress has been made with regard to the recommendations in the non-public portion in the twelve month period since issuing their private reports to that specific firm.

We are not aware of any non-public parts of individual reports subsequently being made public by the PCAOB.

4.3 In March 2006 the PCAOB issued Release No 104-2006-077, which explained the process for 'determinations' as regards firms' efforts to address quality control criticisms in inspection reports. This explained the PCAOB's approach, reflecting the legislative choice made in the Sarbanes-Oxley Act, to seek through constructive dialogue with the firms to improve practices and procedures. The PCAOB makes clear in its reports to audit firms that by responding positively and entering into a dialogue with the PCAOB about how the firm intends to respond to criticisms, the firm has the opportunity to prevent such criticisms becoming public.

4.4 The PCAOB issued a public report in March 2006 which addresses in general terms the firmwide issues raised with the largest four audit firms in the private parts of their reports and the progress those firms had made to address those points. Whilst this shows the main issues raised it does not give the names of the firms to which particular issues applied. This report was issued some 18 months after the original PCAOB reports to which it relates.

4.5 The essential differences between the PCAOB and the AIU are therefore as follows:

- the AIU issues an Annual Public Report identifying issues arising both from reviews of firmwide systems and procedures and individual audits but does not identify individual audit firms;
- the PCAOB does not normally identify issues arising from reviews of firmwide systems and procedures
- the PCAOB's primary public reporting on individual audit firms is on the application of the firm's procedures to individual audits.

Canadian Public Accountability Board

4.6 CPAB follows a three-tier process as follows:

- a private report to individual audit firms containing findings from both firmwide procedures and the application of those procedures on individual audits;
- an annual report across all firms on the general issues and themes arising from inspection activity. While this public reporting provides some segmented information it does not name individual audit firms; and
- a public report on an individual firm if, in the opinion of the CPAB, insufficient progress has been made in addressing the issues raised within the private report of a specific firm within a six month period. CPAB has now issued its first comments on a specific firm for failure to implement recommendations within a reasonable time period.

4.7 With the exception of the last bullet point, reporting by the CPAB and the AIU is very similar. CPAB issues two public reports a year, one on the Big Four firms and the other on the inspection of all other firms within its remit. To date it has issued three public reports, the first (October 2004) and the third (December 2005) on the Big Four firms, and the second (August 2005) on other Canadian public accounting firms.

Certified Public Accountants and Auditing Oversight Board (Japan)

4.8 CPAAOB's first annual report issued in 2005 described its activities which included their monitoring of the accounting profession's own review of audit quality control and their own inspections of some audit firms. Since October 2005, the CPAAOB has conducted inspections at the Big 4 firms. We understand that the CPAAOB will report privately to the audit firms but will also publish a public report on the audit quality controls of the Big 4 at the end of June 2006. The public report will not name individual auditors or audit clients and we expect that CPAAOB reporting will be similar to that of the AIU.

Five – Advantages and disadvantages of extended public reporting

5.1 We summarised in the introduction some arguments which have been made recently in favour of the AIU publishing inspection reports on individual audit firms. In this section we set out more fully our understanding of the arguments for and against extending the public reporting on the results of AIU inspections.

Advantages of extended public reporting

5.2 The principal arguments for extending public reporting by the AIU are:

- It provides greater transparency.
- It may provide decision useful information to audit committees. Under the Smith Guidance, which forms part of the Combined Code³, the audit committee has primary responsibility for making a recommendation on the appointment of the external auditors; and it should assess annually the qualification, expertise, resources and independence of the external auditors⁴.
- It may 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;
- It may have a positive impact on audit quality by giving firms the incentive to show year on year improvements in the quality of their work as measured by the content of their public reports; and
- It may overcome practical difficulties in the current form of public reporting, which involves grouping together the findings from a number of firms whose market focus may be different and whose audit work may be of varying quality.

³ <http://www.frc.org.uk/corporate/combinedcode.cfm>

⁴ Paras 4.17 and 4.19 of the Smith Guidance

Disadvantages of extended public reporting

5.3 The principal arguments against extending the level of public reporting by the AIU are:

- It may weaken the essential purpose of audit inspection, which is to improve audit quality:
 - Audit firms are likely to adopt a more defensive approach to inspections than under private reporting on individual audit firms. In particular there is an increased risk that firms will devote substantial time and effort to challenging points rather than to responding positively to any underlying quality issues.
 - Giving audit firms the opportunity to correct weaknesses on the basis of confidential reports, linked to the possibility of public disclosure where the audit firm's response is inadequate, may provide a stronger incentive for audit firms to take timely steps to improve audit quality than automatically publishing reports on individual firms.
 - There is a risk that the process becomes more legalistic, as the level of evidence required before matters can be made public is likely to increase. This may lead to changes in the AIU's operating procedures and result in fewer points being raised with the audit firms, to ensure that they are legally defensible.
 - The inspection process may become more compliance focused and result in a more 'tick box' approach to auditing.
- Reports are likely to be less timely:
 - Based on the experience of the PCAOB, which publishes parts of the individual reports, reports may typically take some 6 months longer to finalise. One reason the PCAOB takes longer to issue reports is because of the need to subject them to a detailed legal review.
 - At present the AIU completes inspection visits and finalises reports throughout the year. If reports are published it may be desirable to issue reports on a number of firms simultaneously to avoid unfair media coverage. This would add further delays.
 - The increased costs of the inspection system, due to the time and effort required to finalise reports, may outweigh any benefits.
 - The public reports could tend to become anodyne and thus of limited value.

- Public reporting may make it more difficult for the professional bodies' registration committees and their own audit monitoring teams to carry out their functions.
- Publication of reports on individual audit firms runs the risk of adversely affecting the commercial position of companies whose auditors have been criticised publicly by casting doubt on the robustness of the audit after their financial statements have been published.

Question 1

To which of the arguments set out above do you attach most weight and why? Are there other significant arguments which we have not included?

Six – Options for change

6.1 There is a range of options for the level of public reporting by the AIU.

Option A

Continue the current practice of publishing an annual Public Report which does not attribute weaknesses to individual audit firms

Option B

Provide limited firm specific information in our annual Public Report, for example by identifying the firms to which specific issues apply, but otherwise continue as at present.

Option C

Include a section in the annual Public 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, but otherwise continue as at present.

Option D

Publish individual inspection reports in whole or in part where in the opinion of the Board the audit firm has made insufficient progress in addressing AIU recommendations, or has failed to cooperate with the AIU, but otherwise continue as at present.

Option E

Adopt the PCAOB approach of publishing in full those parts of the private reports which comment on specific audits, but do not name individual audit clients.

Option F

Publish a summary of each private report on an individual audit firm which sets out the main themes of the firm-wide review and/or individual audit engagement reviews.

Option G

Publish reports on individual audit firms in full, which at present go to the Audit Registration Committee of the relevant Supervisory Body

Option H

Publish reports on individual audit firms in full, together with the findings on individual audits. (The findings on an individual audit at present go only to the audit firm.)

Not all the options are mutually exclusive.

6.2 The Oversight Board's preliminary view is that a key consideration, given the objective of improving audit quality, is to encourage audit firms to respond positively and quickly to recommendations made in the AIU reports. We believe that this is best provided by giving firms an opportunity to address concerns in private reports, but with the prospect of disclosing publicly the name of the audit firm and the nature of the weaknesses which have been identified where this opportunity for improvement is not taken. We are therefore minded to adopt option C

6.3 We recognise, however, the argument that audit committees have a responsibility to review the effectiveness of their auditors and that the findings from AIU inspections are likely to be relevant to that task. However, publishing AIU reports on audit firms is not necessarily the best way of meeting this need. We are considering separately whether there are other ways in which relevant information from inspections can be shared with audit committees, particularly any summary of issues arising from reviews of individual audit files. Whilst this is not the main purpose of this consultation, we would welcome ideas and views on whether this is desirable and, if so, how it might best be done.

Question 2

Which of the options at 6.1 above do you favour, and why? In particular, do you consider 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 or has failed to cooperate with the AIU?

Question 3

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

Seven – How to Reply

7.1 We invite comments by **Friday 22 September 2006** at the latest. Earlier responses would be very welcome.

7.2 Responses should be sent by email if possible to c.trickett@frc-pob.org.uk

Alternatively you should send comments by post to

Christina Trickett
Professional Oversight Board of the FRC
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

7.3 All responses will be acknowledged. Comments will be made publicly available on the FRC web-site (www.frc.org.uk/pob) unless respondents specifically request otherwise. If you send an E-mail response which includes an automatically generated notice stating that the content is to be treated as confidential you should make it clear in the body of your message whether or not you wish your comments to be treated as confidential.

Questions

7.4 If you have questions about the issues raised in this consultation document please speak to Paul George, Director, Professional Oversight Board on 0207 492 2340

PARTIAL REGULATORY IMPACT ASSESSMENT: REPORTING ON AUDIT QUALITY MONITORING

This partial Regulatory Impact Assessment does not repeat the analysis and arguments set out in the consultation document above and should be read in conjunction with it. It gives a preliminary view of the costs and benefits of the options identified in Part 6, against the base-line of Option A, which is to continue current practice.

Impact on Small Business.

None of the options identified affect small companies.

Option A

Continue the current practice of publishing an annual Public Report which does not attribute weaknesses to individual audit firms.

This is the base-line option. The direct cost of inspections by the Audit Inspection Unit for 2005/2006 was £1.7 million and the budget for 2006/2007 is £2.5 million, as the scope of work is extended. This excludes the substantial costs in the firms themselves, particularly in terms of management time, in facilitating the inspection process and responding to AIU recommendations. These are difficult to estimate but perhaps are of a similar magnitude to the costs of inspection.

Option B

Provide limited firm specific information in our annual Public Report, for example by identifying in some circumstances the firms to which specific issues apply, but otherwise continue as at present

Both the advantages and disadvantages of extended public reporting set out in Part 5 would apply at least in some measure to this option.

In terms of the impact on the costs of inspections, and the timeliness of finalising reports, this option is likely to increase the cost, since audit firms will have a stronger incentive to challenge and query points which apply to them and would now be made public before they had an opportunity to address them. This is likely to delay the public report somewhat, while firm-specific points are confirmed more fully.

It is difficult to put a figure to this but this option might add to direct inspection costs to the order of 5% of costs or some £125,000 per year, with similar additional costs in the firms.

Option C

Include a section in the annual Public 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, but otherwise continue as at present.

This provides a strong incentive for audit firms to take timely measures in response to recommendations in inspection reports, and offers reassurance to audit committees, investors and other users of accounts that there are not serious weaknesses in major audits which have been identified by the AIU and have not been addressed. It does not, however, offer the full transparency of reporting which some are calling for.

This option is likely to add somewhat to costs, as we discuss with the firms the extent of the progress they have made in addressing recommendations. Again it is difficult to put a figure to this but again this might add to direct inspection costs, to the order of 5% of costs, or some £125,000 per year, with similar additional costs in the firms.

Option D

Publish individual inspection reports in whole or in part where in the opinion of the Board the audit firm has made insufficient progress in addressing AIU recommendations, or has failed to cooperate with the AIU, but otherwise continue as at present.

This is a variation on Option C, though the increase in direct inspection costs is likely to be higher than under Option C, as the firms are more likely to query and challenge points in the reports in the knowledge that they could subsequently be published. A rough estimate is that this might add 10%, or some £250,000 to direct inspection costs, with similar additional costs in the firms.

Option E

Adopt the PCAOB approach of publishing in full those parts of the reports which comment on specific audits but do not name individual audit clients.

Although this option would provide no information on the results of the inspection of the firm-wide procedures, it entails publishing reports on all the audit firms inspected. We expect that the additional costs and delays associated with challenges and queries from the audit firms on specific points would result in a larger increase in direct inspection costs than under option D, perhaps of the order of magnitude of 15% or £375,000 per year, with similar additional costs in the firms.

Option F

Publish a summary of each private report on an individual audit firm which sets out the main themes of the firm-wide review and/or individual audit engagement reviews.

The costs associated with challenges and queries from the audit firm are likely to be somewhat greater than under Option E, given that what is published would include the main themes from the reviews of firm-wide procedures. This is perhaps of the order of 20% of direct inspection costs, or £500,000 per annum, with similar additional costs in the firms.

Option G

Publish reports on individual audit firms in full. At present these go to the Audit Registration Committee of the relevant Supervisory Body.

This is a stronger version of Option F, with broadly the same characteristics. The additional costs associated with it are arguably somewhat higher than under Option F, roughly 25%, or £625,000 per annum with similar additional costs in the firms.

Option H

Publish reports on individual audit firms in full, together with the findings on individual audits.

This provides the greatest transparency of all the options, but equally the disadvantages of public reporting are greater than under other options. In particular, the costs and delays in finalising reports are likely to be the greatest. Challenges to findings are likely to be greater, as the public information will now include not only comments in the overall report but also the schedule of comments on each audit file inspected. Again it is difficult to estimate the increase in direct inspection costs over the base-line but would suggest that this would be of the order of 30%, or £750,000 per year, with similar additional costs in the firms.