



PROFESSIONAL OVERSIGHT BOARD

REPORTING ON AUDIT QUALITY MONITORING – IMPLEMENTING A NEW APPROACH

A CONSULTATION DOCUMENT

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One – Background 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 year to 18 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 and/or make relevant information available privately to audit committees.

1.3 The Oversight Board consulted publicly on this issue last year (“the Board’s 2006 consultation document”)¹. An analysis of the responses to this consultation was published in November 2006. After the period for responding to the consultation had expired, an amendment to the Companies Bill (now the Companies Act 2006) had the effect of bringing the Oversight Board, including the AIU, within the scope of the Freedom of Information Act 2000 (FOIA) with effect from a date likely to be April 2008.

1.4 The Board’s intention had been to come to a decision on how the existing reporting arrangements for audit quality monitoring by the AIU should be changed for the future by the end of 2006. However, in the light of both the prospective application of the FOIA to the Oversight Board and the Parliamentary debate on this issue, the Board decided that further informal consultation with key stakeholders was necessary before making firm proposals for change.

1.5 During the early part of this year the Board consulted with a range of interested parties, including major audit firms, professional bodies, the 100 Group of FTSE 100 Finance Directors and Audit Committee Chairs. A clear consensus emerged that greater transparency as to the findings of the AIU’s work was needed, primarily to meet increased expectations on the part of stakeholders, and that the current reporting arrangements were therefore no longer appropriate. The proposals for change set out in this paper have been discussed, in broad terms, with key stakeholders.

1.6 This paper deals solely with reporting by the AIU. The Board intends to consult on its proposed publication scheme under the FOIA, covering all its activities, later in the year. Any requests for the disclosure of information beyond that to be published under the scheme will be considered on a case-by-case basis, applying a public interest test where relevant.

¹ 'Reporting on Audit Quality Monitoring' (FRC, June 2006)

1.7 In relation to the AIU's work, the Board's considered view is that the proposed reporting model set out in this paper will achieve the maximum level of transparency that is consistent with maintaining the effectiveness of the inspection process. While proper consideration will be given to any requests under the FOIA for further information to be disclosed, the Board does not envisage being required in normal circumstances to disclose such information. It recognises, however, that this will ultimately be a matter for the Information Commissioner to determine.

1.8 The views expressed in the extensive formal and informal consultations that have taken place over the past year have been taken into account by the Board in developing the proposed revised reporting model for the AIU set out in this paper. Accordingly, this consultation is focused on issues relating to the implementation of these proposals.

1.9 The Board recognises that implementing the revised reporting model will have material cost implications. However, it considers that the additional costs involved are proportionate to the need to meet increased stakeholder expectations. A provisional regulatory impact assessment is set out in Section 5.

1.10 Details of how to respond to this consultation are set out in Section 6. We invite comments by 20 September 2007 at the latest.

Issues for consultation

1.11 The matters on which we would particularly welcome comments are set out at the end of the sections of this paper to which they relate and are summarised below:

- The appropriateness of the processes we intend to follow before reports on audit firms and individual audits are finalised.
- The proposed form of future annual reporting on generic themes and issues identified by the AIU.
- The Board's provisional regulatory impact assessment.

Two – Reporting on Inspections of Individual Firms

2.1 The AIU prepares a detailed report on each inspection it carries out of the Big 4 firms and other large firms subject to full scope AIU inspections (there are currently five firms in the latter category). The reports cover:

- 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;
- an assessment of the progress made by the firm in implementing prior year recommendations;
- the current year recommendations to the firm arising from the AIU's work; and
- the firm's responses to those recommendations.

Currently the primary purpose of these reports is to enable the Audit Registration Committee of the professional body with which the firm is registered (currently either the ICAEW or the ICAS) to satisfy itself that the firm is committed to meeting its obligations as a Registered Auditor and has given appropriate undertakings to the AIU to address any areas for improvement identified through the inspection process. The reports are addressed to the relevant Audit Registration Committee but are discussed in draft with the firm concerned before they are finalised. A copy of the final report is also sent to the firm by the AIU.

2.2 The detailed reports on each firm subject to full scope AIU inspections are prepared specifically for regulatory purposes. The Board believes that the publication of these reports is likely to reduce the effectiveness of the inspection process and be counter-productive in terms of the overriding objective of promoting improvements in audit quality. It might also affect the ability of the Audit Registration Committees to carry out their responsibilities in a proper manner.

2.3 The Board's 2006 consultation document identified a number of potential benefits associated with publishing inspection reports on individual firms. These included:

- Providing decision useful information to audit committees. Under the FRC's Combined Code on Corporate Governance, audit committees have a responsibility to assess the effectiveness of the audit process and the independence and objectivity of the external auditors.
- Promoting greater choice in the audit market by helping investors and others reach a more informed view as to the appropriateness of a non Big 4 firm acting as auditors of certain types of listed entities.
- Promoting improvements in audit quality by increasing the incentives for firms to be able to demonstrate improvements from one year to the next.

- Overcoming inherent difficulties with the current form of public reporting, which involves grouping together the findings from inspections at a number of firms whose market focus may be different and whose audit work may be of varying quality.

2.4 While the Board does not believe that publishing the detailed reports prepared for regulatory purposes would be appropriate, it considers that the potential benefits identified above point to a clear need for greater transparency. The Board's 2006 consultation document identified a range of possible options for change. The Board's considered view is that one of these options (originally described as Option F), publishing a summary of each private report on an individual firm setting out the main findings of both the firm-wide review and the reviews of individual audits, strikes the right balance between providing greater transparency and ensuring that the effectiveness of the inspection process is maintained.

2.5 The Board therefore proposes that high-level reports on the findings of each inspection undertaken by the AIU of the Big 4 firms and other larger firms subject to full scope inspections should be prepared and published for all inspections commencing on or after 1 April 2007. The Board's current thinking is that it will set two or three publication dates each year on which all reports finalised by that date will be published, with the first publication date likely to be in the first half of 2008. The high-level report on a firm will not, however, be published in advance of the consideration by the relevant Audit Registration Committee of the detailed private report on the firm.

2.6 The Board proposes that the existing arrangements for preparing detailed private reports on each firm subject to full scope inspection, discussing these in draft with the firms and obtaining their responses to the AIU's recommendations will continue unchanged. The high-level reports prepared for publication on each firm will contain no additional material and be subject to appropriate quality control procedures within the AIU and the Oversight Board. In addition, firms will be given an opportunity, within a specified timescale, to provide written comments on a draft of their high-level report before it is finalised for publication.

Question 1

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

Three – Reporting on Reviews of Individual Audits

3.1 As explained in the Board’s 2006 consultation document, the AIU currently prepares a detailed private report on each audit engagement reviewed at both the larger firms subject to full scope inspections and other firms within the AIU’s remit. These reports include:

- detailed comments on aspects of the conduct of the audit concerned; and
- responses from the audit team to the issues raised by the AIU.

The purpose of these reports is both to provide detailed feedback to the audit team on areas for improvement identified and to support the summary of issues arising from audit file reviews contained in the overall report on the firm’s inspection.

3.2 The detailed private reports prepared on individual audits are copied to the Head of Audit or equivalent at each firm inspected. However, they do not form part of either the AIU’s private reports on the firms for which it has primary responsibility or, for other firms, the private reports prepared by the monitoring unit of the relevant professional body. In the latter case, a high-level summary is prepared by the AIU to enable the professional body’s monitoring unit to take the main findings into account in their report to the Audit Registration Committee.

3.3 Accordingly, the detailed private reports prepared by the AIU on individual audits are not intended for distribution outside the AIU and the audit firm concerned and, in the Board’s view, are not suitable for wider distribution. The AIU places restrictions on the firms preventing them from discussing these reports with their clients. However, the Board recognises that there is a strong case for allowing audit firms to provide information on the main findings arising from the review of an individual audit to the client concerned. Such information may be particularly relevant to the client’s audit committee which is charged with assessing the effectiveness of the audit process.

3.4 The Board therefore proposes to change the reporting model for audit file reviews such that a high-level report is in future prepared on each individual audit reviewed by the AIU. The restriction currently imposed which prevents firms discussing reports with their clients will be lifted to allow firms to share these new-style reports in confidence with the audit client concerned. The existing arrangements for documenting issues arising from reviews in detail, discussing and sharing them with the audit team and obtaining their responses will continue. The new-style reports prepared on each audit will contain no additional material and be subject to appropriate quality control procedures within the AIU and the Oversight Board. In addition, firms will be given an opportunity, within a specified timescale, to provide written comments on a draft of each new-style report before it is finalised.

3.5 The Board expects that clients whose audits have been reviewed by the AIU will be advised of this fact by their auditors and assumes that firms will adopt a policy of sharing reports with their clients as a matter of routine. The Board proposes, however, to publish an annual list of the audits reviewed by the AIU in the prior year in order to ensure that appropriate transparency in this area is achieved.

Question 2

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

Four – Annual Reporting

4.1 The AIU currently prepares an annual public report on the principal themes and issues arising from its inspections without naming the specific firm or firms at which the issues covered were identified. The first public report, published in June 2005, commented on the issues arising from its first year inspections at the Big 4 firms. The second public report, published in July 2006, covered both second year inspections at the Big 4 firms and first year inspections at the other larger firms for which the AIU has primary responsibility. A third public report, to be published shortly, will cover the AIU's 2006/7 inspections, including the first reviews carried out at a selection of the other firms within the AIU's remit.

4.2 The AIU's public reports provide generic information on the quality of the auditing of listed and other major public interest entities in the UK far beyond the limited information previously available. They have attracted considerable interest, both in the UK and in other major jurisdictions, and for the most part have been well-received.

4.3 The decision to publish annual reports of this nature was linked to the decision taken in 2003, by the Steering Group responsible for overseeing the setting up of both the Oversight Board and the AIU, that neither firm-specific reports on AIU inspections nor reports on individual audits reviewed by the AIU should be published. Publication of an annual public report on generic themes and issues arising was viewed as an alternative means of achieving appropriate transparency.

4.4 The Oversight Board has a statutory obligation to provide an annual report on its activities to the Secretary of State for Trade and Industry and this report is published after it has been laid before Parliament. The Oversight Board's report includes an overview of the findings of the AIU's inspections during the year and there is therefore overlap with the AIU's public report. There is currently no statutory or other obligation for the AIU to prepare a separate public report. It is therefore for the Oversight Board in consultation with its stakeholders to decide whether this should continue in its current form.

4.5 The Oversight Board believes that the level of interest in a generic AIU public report in its current form will fall once firm-specific reports start to be published. Accordingly, the primary reason for deciding to publish such a report will no longer apply. It also wishes to avoid requiring the AIU to devote a disproportionate level of resources to reporting. The current form of public report is relatively resource intensive in ensuring that it fully reflects the inspection findings across all firms visited and is demonstrably supported by the underlying evidence base.

4.6 The Board therefore proposes that, with effect from the 2007/8 round of inspections, annual reporting on the coverage and overall results of the AIU's work, together with the principal themes and issues arising, should take the form of an expanded section in the Oversight Board's annual report to the Secretary of State for Trade and Industry rather than a separate AIU annual report.

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?

Five – Regulatory Impact Assessment

5.1 This section sets out the Board’s assessment of the additional costs that will be incurred in implementing the revised reporting model set out in this paper and, based on the current practice of the relevant professional bodies, of the likely distribution of these costs between firms. The principal benefits expected to arise from the new reporting arrangements are described in paragraph 2.3 above and not repeated here.

5.2 The Board estimates that the additional costs that would be incurred by the AIU in preparing high-level summary reports on individual firms for publication would be in the order of 5% of direct inspection costs, or £125,000 per annum on a baseline figure of £2.5 million. The additional costs incurred by the firms themselves, principally the additional time commitment likely to be required from senior personnel, will vary between firms and are more difficult for the Board to estimate. However, the Board believes that they should not exceed the additional costs likely to be incurred by the AIU.

5.3 The Board estimates that the additional costs likely to arise from the preparation of new-style reports on each individual audit reviewed, which firms will be allowed to share with their clients, are in the order of 15% of direct inspection costs, or £375,000 per annum on a baseline figure of £2.5 million. Again, while the additional costs which will be incurred by the firms themselves are more difficult for the Board to estimate, it believes that they should not exceed the additional costs likely to be incurred by the AIU. It has been assumed for this purpose that no cost savings will be achieved through a more efficient process for finalising the reviews of individual audits being implemented at certain firms. The Board notes that the total costs incurred in this area are partly within the hands of firms themselves and dependent on their approach to report finalisation.

5.4 The Board therefore estimates that the total additional AIU costs will be in the order of 20% of direct inspection costs, or £500,000 per annum on a baseline figure of £2.5 million, with additional costs within the firms themselves of a similar or lower level. This does not take account of any cost savings that may be achieved through adopting the proposed new form of annual reporting (in the order of perhaps £50,000 per annum).

5.5 The professional bodies in the UK which register firms conducting audits within the scope of independent inspection have a statutory obligation to meet the costs incurred by the AIU in undertaking this work. The manner in which they choose to recover these costs from registered firms or others is for the bodies themselves to decide, rather than a matter for the Oversight Board or the AIU. However, the bodies’ current practice is to take account of the proportion of total costs attributable to inspections of the three broad groups of firms within scope (Big 4 firms, other larger firms subject to full scope inspections and other firms). The AIU provides information to the bodies for this purpose on the level of staff resources devoted to inspections of firms within the three broad groups.

5.6 On the basis of the bodies' current practice, the Board believes that the proportion of the additional AIU costs which will fall to be borne by firms not subject to full scope inspections is likely to be very low. The reasons for this are as follows:

- The additional costs arising from the preparation and publication of high-level reports on firms are entirely attributable to the Big 4 firms and other larger firms for which the AIU has primary responsibility.
- The preparation of the new-style reports on reviews of individual audits will involve only limited change for firms not subject to full scope inspections, since the AIU already prepares high-level summaries of the reviews undertaken in respect of these firms.

5.7 The Board does not believe it is possible for it to quantify the principal benefits expected to arise from the new reporting arrangements described in paragraph 2.3 above. Notwithstanding this, given the modest overall impact, the Board concludes that the additional costs arising from the revised reporting arrangements for the AIU are likely to be outweighed by the benefits anticipated by stakeholders.

Question 4

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

Six – How to Respond

6.1 Please respond by **20 September 2007** at the latest. Earlier responses would be appreciated.

6.2 Responses should be sent by e-mail if possible to c.trickett@frc-pob.org.uk

Alternatively you may send comments by post to:

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

6.3 All responses will be acknowledged. Comments will be made publicly available on the Oversight Board section of the FRC website (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

6.4 Any questions about the issues raised in this consultation document should be directed to Paul George, Director of the Professional Oversight Board (telephone 0207 492 2340).

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