



**FINANCIAL REPORTING COUNCIL**

**PROMOTING AUDIT QUALITY**

**OCTOBER 2007**





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# 1 Introduction

1.1 “Promoting Audit Quality” was published in November 2006 with a deadline for comment of 31 March 2007.

1.2 In that discussion paper the FRC acknowledged that there is no single agreed definition of audit quality that can be used as a ‘standard’ against which actual performance can be assessed and that limited transparency makes an assessment of audit quality difficult by those who rely on it.

1.3 In “Promoting Audit Quality” the FRC identified what it considered to be the drivers of audit quality, and considered threats to those drivers, in the areas of:

- The culture within an audit firm;
- The skills and personal qualities of audit partners and staff;
- The effectiveness of the audit process;
- The reliability and usefulness of audit reporting; and
- Factors outside the control of auditors affecting audit quality.

1.4 The discussion paper sought views on whether the FRC:

- had identified all the relevant drivers;
- had identified the threats to those drivers and whether there were other threats that should be considered;
- should be taking any additional action to improve the likelihood of audits being of a consistently high quality.

1.5 There were 39 responses to the discussion paper<sup>1</sup>. Respondents by type of stakeholder were as follows:

Accountancy firms	8
Professional Bodies	10
Investors	9
Corporates	2
Others	10
<b>Total</b>	<b>39</b>

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<sup>1</sup> A list of respondents is set out in Appendix 3

- 1.6 The discussion paper was prepared in the context of the current financial reporting framework in the UK and the Republic of Ireland. However, because of the increasingly international context in which standard setting takes place, the FRC was keen to receive the views of stakeholders and all those interested in promoting high quality audits wherever they might be located.
- 1.7 The FRC is pleased to have received so many carefully considered responses from such a broad range of stakeholders. The responses will provide a valuable database of views and ideas that will help focus and inform the FRC's work in the area of audit regulation in the coming years.
- 1.8 The FRC believes that the responses will be of interest to others and has therefore made the non-confidential responses available on its website at:  
  
<http://www.frc.org.uk/about/promotingauditqualityresponses.cfm>
- 1.9 This report summarises the comments that were either put forward by a significant number of respondents or which seem particularly pertinent to the issues concerned and the approach that the FRC proposes to take in response.



## 2 Overall Comments

- 2.1 Most respondents welcome the FRC's initiative in issuing 'Promoting Audit Quality' at this time, notwithstanding that many of the respondents to the discussion paper consider that financial reporting in the UK currently operates effectively and that audit is fundamentally sound.
- 2.2 Many respondents acknowledge that the FRC has an important role in supporting confidence in audit quality in the UK and that the FRC's actions would influence the ongoing viability of the profession. The ICAEW observes that *"The FRC has a significant role to play in promoting sound audit principles and appropriate regulation that will assist in building market confidence in the value and quality of audit opinions"*.
- 2.3 The discussion paper is generally considered to cover the main drivers of audit quality and the main threats to them. However, a number of audit firms note that some of the threats identified are theoretical, and they are concerned that the FRC should not take action unless there is clear evidence that any particular threat is likely in practice to affect UK audits adversely. They are concerned that such actions could have unintended detrimental consequences for the auditing profession. PwC, for example says, *"We do not believe that the case for additional or extended audit regulation or related initiatives has been made"*.
- 2.4 Many respondents note the interaction between the discussion paper and other FRC work on topics such as audit monitoring, competition and choice and transparency reporting by the audit firms and the recent work of the Audit Quality Forum<sup>2</sup>.
- 2.5 Audit firms are generally of the view that any action taken by the FRC that increases audit regulation should be:
- focussed only on the key issues,
  - subject to cost: benefit evaluation; and
  - proportionate in terms of its impact on smaller audits and public sector audits.
- 2.6 The FRC recognises that these criteria should guide any action it and its Operating Boards may take, always recognising that it may be bound to comply with external requirements (e.g. the requirements of EC directives and other regulation). Indeed the FRC's own regulatory philosophy is that a well-informed market is the best regulator. In the event, as will be apparent from the following paragraphs, the FRC is not proposing any additional regulation as a result of the issues raised.

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<sup>2</sup> The Audit Quality Forum is a body, set up by the ICAEW, which brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together to generate practical ideas for further enhancing confidence in independent audit by improving audit transparency and supporting shareholder involvement in the audit process.

### 3 The FRC's approach to the issues raised in response to the discussion paper

3.1 Significant points made in the responses and the FRC's approach to them are as follows:

- (a) There is a high degree of support for the FRC's framework of **drivers of audit quality**. The FRC therefore intends to publish a summary of drivers for the information and use of stakeholders especially audit firms, audit committees and investors.

The FRC recognises that audit quality is a dynamic concept and that the drivers of audit quality may change over time. The first edition of the framework of drivers of audit quality is attached as Appendix 1. The FRC will periodically update this framework in the light of comments received.

The FRC hopes that audit firms will use the framework to structure **annual communications** about their policies and the actions they take to ensure high quality audits are performed. Such communications could form part of the 'Transparency Reports' that are already being issued by the major audit firms and which will be required by regulations to be made by the Professional Oversight Board. While at this stage it is not envisaged that these regulations for Transparency Reports will go beyond the requirements of the Statutory Audit Directive<sup>3</sup>, using the audit quality framework voluntarily as the basis for such reporting would give audit firms the opportunity to differentiate themselves on their approach to audit quality within an agreed framework.

- (b) Both the responses to the discussion paper and the interim report of the Market Participants Group (MPG)<sup>4</sup>, demonstrate a demand from investors for greater transparency about the **corporate governance of the major audit firms** and a desire that they should comply with the FRC's Combined Code. **Further work in this area, if any, will be undertaken in light of the final recommendations of the Market Participants Group.**
- (c) A number of the responses to the discussion paper support the view that audit committees should be more active in their **evaluation of the effectiveness of the external audit** and propose that the reports on audit committee activities in annual reports should be extended to provide information on the actions taken. Others took the view that the audit committee's time was already stretched and that lengthening reports on audit committee activities would not be beneficial. **Further work in this area, if any, will be undertaken as part of the FRC's work on**

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<sup>3</sup> Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts came into force on 29 June 2006 and must be implemented by 29 June 2008. Regulations to be made by the POB are expected to come into force on 6 April 2008 and apply in respect of the accounts of the relevant audit firms relating to financial years starting after that date.

<sup>4</sup> The MPG was established to consider competition and choice within the audit market, its interim report can be found at <http://www.frc.org.uk/press/pub1302.html>

**the Combined Code in light of the responses to the discussion paper and the final recommendations of the Market Participants Group.**

(d) The responses indicate that a number of companies and investor representatives have reservations about **the way that audit fieldwork is undertaken**. These concerns arise from their view that much of the detailed work is undertaken by relatively inexperienced staff who, in order to ensure that their work is comprehensive and consistent, are required by their firms to adhere to somewhat rigid methodologies. As a consequence these commentators are concerned that:

- Staff undertaking the fieldwork may not be sufficiently experienced to audit the increasingly complex transactions undertaken by modern, global businesses;
- The methodologies may be demotivating; and
- This approach may mean that inexperienced staff may not be able to develop effective auditing skills from ‘on-the-job’ coaching and mentoring.

In raising this issue, the FRC is aware of the considerable contribution made to the British economy by the audit profession through training a large number of graduates who, when they leave the audit firms, use the skills they have acquired in business and commerce.

The FRC notes that the education committee of IFAC<sup>5</sup> has recently issued IES 8<sup>6</sup>. IES 8 introduces the concept of an audit professional as someone who exercises significant judgement in the audit of financial statements. In the FRC’s view, the practical experience relevant to an audit professional suggested in IES 8 is greater than the current minimum requirements set by the UK professional accountancy bodies to meet the requirements of the UK Companies Act. The manner and extent to which the UK accounting profession adopts IES 8 may have an impact on the way that audit fieldwork is undertaken.

**The FRC recognises this is a complex issue – and a very important one. It has therefore agreed with the accounting bodies that a task force, ideally comprising representatives of audit firms, professional bodies and other stakeholders, should be established to consider:**

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<sup>5</sup> IFAC is the global organization for the accountancy profession. It works with its 155 members and associates in 118 countries to protect the public interest by encouraging high quality practices by the world’s accountants. IFAC members and associates, which are primarily national professional accountancy bodies, represent 2.5 million accountants employed in public practice, industry and commerce, government, and academia.

<sup>6</sup> IES 8: Competence Requirements for Audit Professionals: This International Education Standard (IES) prescribes competence requirements for audit professionals, including those working in specific environments and industries. IFAC member bodies need to establish policies and procedures that will allow members to satisfy the requirements of this IES before they take on the role of an audit professional. The responsibility for the development and assessment of the required competence is shared by IFAC member bodies, audit organisations, regulatory authorities and other third parties.

- The FRC's interpretation of IES 8
- The potential impact of IES 8 on the training of auditors and;
- The concerns expressed by companies and investor representatives.

**The task force will also consider the results of research that has been recently commissioned into the practical training of auditors.<sup>7</sup>**

- (e) The responses to the discussion paper confirm the need to review the steps that can be taken to add to the clarity and usefulness of auditors' reports within the constraints of current and likely future legislation. The Auditing Practices Board (APB) has formed a task force to consider this issue and is planning to issue a consultation paper before the end of 2007.
- (f) The responses to the discussion paper also set out a number of other possible actions or projects that could be undertaken. The FRC has not yet determined whether to take forward any of these suggestions but will consider them on their merits after having balanced the costs of any market or regulatory response with the likely benefits. If the FRC decides to take forward any of the other possible projects it will include them in its annual plan for future years and consult on them in accordance with its normal practice.

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<sup>7</sup> In July 2007, the Professional Oversight Board announced that, in conjunction with the Professional Bodies, it had commissioned research into the practical training for audit including:

- The practical training requirements of the Professional Bodies,
- How the Professional Bodies authorise and monitor firms which train students,
- Student training record requirements, and
- The views of students towards 'on the job' training and 'exam based' training.

## 4 The culture within an audit firm

In 'Promoting Audit Quality' the FRC identified the following indicators of audit firm cultures that enhance audit quality :

- Leadership of firms emphasising the importance of auditors discharging their professional responsibilities.
- Respect for the principles underlying auditing and ethical standards.
- Partner and staff development systems that promote personal characteristics essential to quality auditing.
- Not letting financial considerations drive decisions with a negative effect.
- Promotion of consultation on difficult issues and providing sufficient resources to deal with issues as they arise.
- Development of an information infrastructure to support the audit function.

and asked the following questions:

1. Are there other important factors of an audit firm's culture that are not referred to above?
2. Are there pressures that could compromise the culture of audit firms that have not been identified above?
3. Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?

- 4.1 There is a consensus amongst respondents that the culture of audit firms is very important to the quality of audits. A number of commentators noted that a number of actions have been taken by both the regulators and the audit firms themselves to formalise and fortify relevant arrangements and suggest that there is a need to evaluate fully the impact of these changes before taking further action.
- 4.2 Many audit firms who responded to the discussion paper asserted that their culture was of paramount importance to them and that the emphasis on audit quality within the auditing profession has never been higher.
- 4.3 Generally, both investors and audit firms agree that the FRC's Audit Inspection Unit<sup>8</sup> (AIU) has an important role in reviewing cultural issues. Some suggest that the AIU could comment on published statements that the firms make about their quality control arrangements, based on the

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<sup>8</sup> The Audit Inspection Unit is the part of the FRC tasked with monitoring audit quality in relation to listed companies and any other entity in whose financial condition there is a major public interest.

work undertaken during monitoring visits. Several audit firms suggest that the AIU could helpfully report publicly on the 'positives' they identified, not just the 'negatives'. Ernst & Young for example says, *"Reinforcing and encouraging good performance is a very important driver of audit quality..."*

- 4.4 However, a number of audit firms believe that 'regulatory creep' is threatening the culture they have developed to support audit quality. They believe that this manifests itself in a number of ways including:
- pressure on firms to meet changing requirements that involve more work without a corresponding increase in fees;
  - monitoring by the AIU leading to a more compliance based approach to auditing;
  - new standards that are increasingly complex and rules based, thereby directing attention away from principles; and
  - the rate of change, and the consequential need for training, causing difficulties.
- 4.5 Several audit firms note that the corporate failures of the late 1980's have led them to make significant investments in quality control, the nature and benefit of which they have tried to communicate to their clients and institutional investors. They believe that, by making their quality control processes more transparent within the market, they have been able to demonstrate their commitment to maintaining the high quality of their work.

**There is a desire from stakeholders for more information about the firms' policies and the actions that they take to embed a culture of quality within their organisations.**

- 4.6 Investors believe that an audit firm's approach to governance, in particular its 'tone from the top,' is an important influence on its culture. Whilst a number of respondents recognise that there have been positive developments in this area over recent years, they also note that there is still scope for improvement, not least, in relation to how this is communicated externally. They assert that greater transparency as to the governance and policies applied by firms to achieve audit quality will greatly assist market forces.
- 4.7 Some investors believe that the information communicated by firms about their governance and business is too generalised such that *"...it can be difficult to distinguish between substance and spin"* (Standard Life Investments).
- 4.8 Several investors believe that audit firms could further enhance their culture, as it relates to audit quality, by encouraging feedback from institutional investors about how they are perceived and to monitor trends in that feedback over time. Governance for Owners observed that *"this is ...an opportunity for [the audit firms] to get out into the market and sell their messages on how they are governed and how they ensure audit quality"*.

### **Proposed action**

The FRC hopes that audit firms will use the drivers of audit quality framework to structure annual communications about their policies and the actions they take to ensure high quality audits are performed. Such communications could form part of the 'Transparency Reports' that are already being issued by the major audit firms and which will be required by law from next year.

### **Most audit firms and professional bodies consider that the discussion paper gave inadequate weight to the fact that both firms and the vast majority of individual auditors are committed to 'doing the right thing' in the public interest.**

- 4.9 Most of the audit firms and the professional bodies observe that the discussion paper understated the importance that both firms and the vast majority of individual auditors place on 'doing the right thing' in the public interest and how an ethos of professionalism motivates them to achieve audit quality.
- 4.10 Most respondents support the key indicators of the culture of audit firms identified in the discussion paper. Some respondents suggest additional factors that could enhance a culture of quality, including the need for firms to embed a culture of quality within their appraisal systems and communications with staff.

### **Proposed action**

**The framework of drivers of audit quality (Appendix 1) takes these views into account.**

- 4.11 One respondent considers that auditors need to place more emphasis on assessing the integrity of the company being audited rather than focusing just on the truth and fairness of the financial statements. The same respondent also criticises ISQC (UK and Ireland) <sup>9</sup> and comments that it should be more closely related to ISO 9000 and require audit firms to monitor the 'continual improvement' of audit quality<sup>10</sup>.

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<sup>9</sup> International Standard on Quality Control (UK and Ireland) 1 was issued by the Auditing Practices Board in 2004. It is based on the ISQC 1 issued by the International Federation of Accountants. While the ISQC sets standards for the quality control systems that audit firms must establish, and requires internal monitoring of those systems, there is no explicit requirement for 'continual improvement' in audit quality.

<sup>10</sup> The AIU report '2005/06 Audit Quality Inspection' emphasised the need for audit firms to seek continuous improvement over time.

## 5 The skills and personal qualities of audit partners and staff

In 'Promoting Audit Quality' the FRC identified the following key drivers of audit quality:

- The skills base of partners and staff.
- The training given to audit personnel.
- The approach to appraisal of partners and staff.

and asked the following questions:

4. Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?

5. Has this paper identified the issues that could result in an inadequately trained or skilled workforce for audit - if not, what other issues are there and why are they issues?

6. Should there be a fundamental review of the qualification and training requirements for auditors?

5.1 There is widespread agreement amongst all categories of respondent that the factors identified in the discussion paper - technical skills, personal qualities and practical experience - are key drivers of audit quality. It is these factors that allow auditors to understand their client's business, undertake a rigorous audit and make high quality audit judgements.

**There is little support for a fundamental review of the examination process leading to the qualification of accountants. There is greater support for auditors receiving more 'on-the-job' training, mentoring and post-qualification technical training.**

**A number of companies and investor representatives have reservations about the way that audit fieldwork is undertaken. They consider that much of the detailed work is undertaken by relatively inexperienced staff who, in order to ensure that their work is comprehensive and consistent, are required by their firms to adhere to somewhat rigid methodologies. Audit firms support their existing approach on the basis of their investment in training and methodologies and because junior members of the team are supervised by senior staff and partners.**



- 5.2 Sixteen respondents comment on whether a fundamental review of technical training requirements is required. Of these, twelve respondents disagree that there is a need for a fundamental review, whilst four agree that such a review would strengthen confidence in audit.
- 5.3 The professional bodies do not consider a review is required. In particular, the ICAEW states that its qualification “...is subject to a process of continuous improvement.” In 2005, the ICAEW undertook a major review of its ACA qualification and introduced a new syllabus in September 2007. This review was undertaken to ensure that the new qualification was focussed on the needs of stakeholders including ensuring that:
- students have core technical skills;
  - employers can still recruit high calibre people; and that
  - the qualification has broad content and technical rigour.
- 5.4 The ICAEW does not consider that the technical content of auditing could be considered usefully in isolation. It says, “It is important for trainees to have an appreciation of commerciality and business in order to understand what is needed for effective auditing”.
- 5.5 The FRC notes that the education committee of IFAC has recently issued IES 8. IES 8 introduces the concept of an audit professional as someone who exercises significant judgement in the audit of financial statements. In the FRC’s view, the practical experience relevant to an audit professional suggested in IES 8 is greater than the current minimum requirements set by the UK professional accountancy bodies to meet the requirements of the UK Companies Act. The manner and extent to which the UK accounting profession adopts IES 8 may have an impact on the way that audit fieldwork is undertaken.
- 5.6 Several audit firms note that auditing requires knowledge in an increasingly wide range of business, accounting and legal matters. They believe that the discussion paper failed to take account of continual monitoring by the professional bodies to ensure the qualification does not lag behind the needs of the changing business environment and the needs of prospective employers.
- 5.7 Other respondents consider that there are aspects of the training syllabus that could usefully be reviewed. Grant Thornton says that there would be benefit in discussing the coverage given to topics such as auditing and basic bookkeeping. Deloitte suggests that there is a need for more development of, and training in, fraud-related skills. Two respondents want to see more teaching of the fundamentals of company law; other respondents mention the need for greater training in professional ethics and in the behavioural aspects of management.
- 5.8 While there is relatively little support for a fundamental review of the curriculum that leads to qualification as an accountant, a number of commentators say that there is a need to supplement this, especially after qualification, with specific training in auditing. The IMA states “Beyond the

*initial qualification, responsibility for ensuring individual auditors are up-to-date is left to the audit firms or the auditors themselves – we consider that it would be helpful if requirements in this area were to become more formalised”.*

- 5.9 A number of audit firms suggest that expertise could be enhanced through improved sharing of knowledge and best practice within the auditing profession. Since client confidentiality may prevent firms sharing ‘war stories’, a number of firms suggest that the FRC could assist the process by taking a central role in the collection and dissemination of case study type material.
- 5.10 The biggest area of disagreement between the audit firms and other respondents to the discussion paper relates to the staffing model used by the larger audit firms. Some comment that a staffing model that involves relatively inexperienced, unqualified, members of staff carrying out much of the audit work does not reflect the need for expertise to be applied at all stages of the audit. These commentators note that, while the complexity of business had changed considerably over the last 30 years, this has not been reflected in the approach to staffing adopted by firms.
- 5.11 Investors are concerned that if issues go unnoticed at early stages of an audit they may never reach review by a more experienced manager or partner. The Hundred Group expresses concern that there is a perception that “... *in practice much of the audit work performed can be superficial in nature if following rigid procedures and is frequently performed by inexperienced trainees. One of the difficulties facing the audit profession is that it traditionally places considerable reliance on trainees. This could be regarded as flawed as failure to identify problems in the detail may not be picked up later in the chain.*”
- 5.12 Audit firms defend their approach. They assert that the work of less experienced staff is effective because of their investment in training and methodologies and because junior members of the team are closely supervised by senior staff and partners. Indeed, they claim that the staffing model used helps the professional development of junior staff, as they are given responsibility early and are able to learn from the experience of their more senior peers. KPMG comments, “*We do not see that there is any evidence to suggest that there is a flaw in the ‘pyramid structure’ or in the training provided. Partners and managers are heavily involved in the key risk areas of an audit and staff members are adequately briefed, trained and supervised on the roles that they are assigned to*”.

#### **Proposed action**

**The FRC has agreed with the accounting bodies that a task force ideally comprising representatives of audit firms, professional bodies and other stakeholders should be established to consider the FRC’s interpretation of IES 8, the potential impact of IES 8 on the training of auditors and the concerns expressed in response to the discussion paper.**

**Several respondents observe that the current staffing model for audit is beneficial in that it results in the recruitment of a large number of graduates who, when they leave the audit firms, use their skills in business and commerce to the benefit of the British economy.**

- 5.13 Many respondents comment on the strength of the UK accounting profession and the importance of the flow of trained accountants from the audit firms to business and commerce. They are concerned that increased regulation of auditors should not reduce the attractiveness of the accounting profession to new graduates.
- 5.14 Furthermore, a number of respondents comment that the UK profession benefits from allowing graduates of all disciplines to train as auditors, so allowing talented people with a mixture of skills to enter the profession.
- 5.15 Whilst the UK profession does not currently appear to have a problem recruiting the right calibre of trainees, there is a general view that retention of the best staff after qualification continues to present a challenge. However, some investors believe that the retention situation is no worse for audit firms than for any other business.
- 5.16 Audit firms and investors disagree as to the cause of any retention problems. Audit firms believe that trainees are looking for a profession where:
- they can gain a variety of skills by working in audit and non-audit disciplines;
  - they are challenged by varied work which requires them to exercise professional judgement, rather than rigid adherence to rules;
  - they are not continually being threatened by intrusive audit regulation and concern about auditor liability; and
  - their hard work is rewarded financially.

The audit firms believe that threats to these factors are undermining their ability to retain staff.

- 5.17 Many outside the profession blame the firms' dependence on rigid procedures and audit methodologies for the poor retention rate amongst qualified staff. The main reason for the poor retention rate is that "*...audit work has been reduced to a mechanical process rather than one requiring judgement by front-line staff. We believe that too much decision-making has been removed from those who actually carry out the audit such that audit is seen as mechanical work rather than an interesting profession*" (Hermes). They assert that devolving more authority and responsibility to those actually carrying out the audit work would assist staff retention and promote quality in individual audits and across the market as a whole.
- 5.18 Some respondents comment that restrictions on firms from providing non-audit services could reduce the attractiveness of the profession to new graduates and exacerbate retention difficulties. Others, especially investors, observe that there needs to be some limitations on the services which

audit firms are allowed to provide to their audit clients, notwithstanding that audit staff benefit from the experience of working in different disciplines.

**Proposed action**

**This issue will be considered further in the course of the project on practical training discussed above.**

**Some believe that the period for the rotation of audit partners is too short.**

5.19 There is agreement that mandatory rotation of audit partners is needed to avoid 'client capture' and to ensure independence. However, some audit firms take the view that premature rotation of auditor partners creates a threat to audit quality and that the period of rotation in the UK (five years) should be aligned with the requirements of EU legislation and the IFAC Code of Ethics (seven years). The APB is currently reviewing its Ethical Standards for Auditors and plans to issue a consultation paper, including consideration of the period for partner rotation, in the autumn of 2007.

**Proposed action**

**This issue will be considered as part of the APB's review of its Ethical Standards.**

## 6 The effectiveness of the audit process

In 'Promoting Audit Quality' the FRC identified the following features of an effective audit process:

- The structure, experience and knowledge of the audit team is appropriate for the engagement and resources are sufficient to enable a considered response to issues that may arise;
- High quality technical support is available when the audit team encounters a situation it is not familiar with;
- The audit methodology is well structured and:
  - Provides a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently.
  - Provides for compliance with auditing standards without inhibiting exercise of judgement.
  - Requires appropriate audit documentation.
  - Ensures there is effective review of audit work.
- The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor; and
- Audit quality control procedures are effective, understood, applied and monitored within firms and across international networks.

and asked the following questions:

7. Are there other factors that determine whether an audit process is effective?

8. Are there threats to the effectiveness of the audit process that have not been identified before?

9. Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?

- 6.1 Participants agree that the discussion paper generally identified the correct features for an effective audit process. BDO Stoy Hayward suggests that more emphasis should be given to the importance of direct audit partner engagement with the audit client.

### **There is support for 'principles based' auditing standards and concern that international auditing standards are becoming more prescriptive.**

- 6.2 The audit firms, professional bodies, management and investors agree that there is a preference for principles based auditing standards over rules based standards and welcome the APB's

position on this. However, many respondents note the growing trend towards prescription in International Standards on Auditing (ISAs). They are concerned that such standards are changing the way in which audits are conducted.

- 6.3 Many respondents note that principles based auditing standards encourage 'thinking' auditors and are concerned by the shift towards more prescription in ISAs. The IMA considered ISAs to be "...unnecessarily detailed, prescriptive and inflexible. Thus there is a significant risk that they could result in additional costs to firms and their clients (particularly smaller entities) without any corresponding improvement in audit quality". The IMA and others are also concerned that the body<sup>11</sup> that sets ISAs is funded by the accounting professional bodies and the large accounting firms.
- 6.4 One respondent, the Electricity Pension Service, considers that, provided some flexibility and pragmatism is retained, a move away from a principles based approach would not necessarily be detrimental to the audit process, as many aspects of audit work need to be procedurally based.
- 6.5 Four audit firms and two of the professional bodies think that overly complex financial reporting and auditing rules are pushing firms towards compliance procedures and 'ticking boxes'. They argue that this trend undermines the exercise of judgement and auditors' ability to assess the overall position expressed in the financial statements.
- 6.6 A number of respondents comment that this position is reinforced by the approach of the AIU, whose reviews appeared to focus on how firms have complied with the application of standards.

#### **Proposed action**

**The FRC will continue its efforts to promote principles based standards.**

#### **The importance of the 'true and fair view' principle underlying both the preparation and the audit of financial statements is strongly supported by many respondents.**

- 6.7 Respondents agree on the importance of auditors forming an opinion on whether the financial statements provide a true and fair view and welcome the clarification provided by the new wording in Section 495 of Companies Act 2006. They note that the 'true and fair view' lies at the heart of the professional judgement of the auditor and that to move away from this basic tenet would undermine the confidence that users place on accounts. ICAS comments that the supremacy of the 'true and fair' view has been challenged in recent years and expresses concern that it may be seen by some as mere compliance with detailed accounting requirements. They think that such an approach would have a negative impact on the quality of financial reporting and auditing and should be strongly resisted.

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<sup>11</sup> ISAs are set by the International Audit and Assurance Standards Board (IAASB) which is part of the International Federation of Accountants (IFAC).

6.8 A number of respondents are also concerned as to whether auditors adopt a rigorous enough approach to the audit of amounts recorded at 'fair value' in financial statements.

**Proposed action**

**The FRC plans to update the statement it published in August 2005<sup>12</sup>, to take account of recent developments, including the Companies Act 2006.**

**There is a widely shared view that the volume of recent changes to legislation, accounting standards and aspects of audit regulation has been significant and that a period of stability is now needed.**

6.9 There is a widely shared view that the volume of recent changes to legislation, accounting standards and aspects of audit regulation had been significant. This change had been difficult for the audit firms to assimilate and there is a need for a period of stability to allow those changes to be fully understood and embedded in the firms' systems.

6.10 RSM Robson Rhodes is concerned that too rapid a pace of regulatory change is self-defeating. They observe that *"The combination of over-prescription and increasing complexity of auditing, ethical and accounting standards are placing a substantial strain on audit partners and staff..."* The result is that whilst such regulatory change is intended to improve quality, in reality it may be placing strains on the ability of audit firms to deliver it in an optimum way.

6.11 The introduction of international financial reporting standards<sup>13</sup> is seen as having presented a particular challenge to those auditing listed companies. A common view amongst respondents is that too much time is spent on ensuring that the financial accounting is right and too little checking that the financial statements fairly reflect the underlying economic condition of the business.

6.12 The relationship between new accounting requirements and new Ethical Standards for Auditors may also be causing difficulty. ICAS says that it is *"...receiving more comments from [its] members in business that their auditors cannot assist them with respect to financial reporting queries...This is considered to be unhelpful and taints the perception of a quality service"*.

**Proposed action**

**The FRC is conscious of the need to take this into account in its future work programme.**

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<sup>12</sup> "The Implications of New Accounting and Auditing Standards for the 'True and Fair View' and Auditors' Responsibilities" published 9 August 2005. (<http://www.frc.org.uk/press/pub0854.html>)

<sup>13</sup> Comprising International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) issued by the IASB.

**Many respondents are concerned that there is a lack of global consistency in the quality of audits provided. Some believe that this is exacerbated by the lack of transparency of the global firms' international network arrangements.**

- 6.13 While the quality of auditing in the UK is generally seen as being acceptable, five investors express concern at inconsistency in the quality of audits of UK owned subsidiaries based in overseas jurisdictions.
- 6.14 One investor asserts that global audit networks may not always achieve common firm-wide standards, noting that whilst global auditing networks use the same methodologies, effective application in practice depends on the skills and expertise of the local workforce.
- 6.15 These concerns of investors relating to the quality of audits of overseas subsidiaries appear to be compounded by the lack of transparency of the audit firms, particularly those that have operations based in other jurisdictions.

**Proposed action**

**The FRC will continue its efforts through IFIAR and the EGAOB to promote global consistency in audit quality. In particular, the FRC will consider this matter in giving effect to provisions in the Statutory Audit Directive on Third Country auditors.**



## 7 The reliability and usefulness of audit reporting

In 'Promoting Audit Quality' the FRC identified the following characteristics of reliable and useful audit reporting:

- An audit opinion that commands confidence; and
- Good communication with audit committees.

and asked the following questions:

**10. Are there factors that determine whether audit opinions command confidence?**

**11. Are there other reasons why users may not have confidence in the audit opinion?**

**12. Are there further steps that could be taken to reinforce the confidence in an audit opinion?**

### **A number of respondents request changes to the current form and content of the auditor's report.**

7.1 Views on the usefulness of the audit report vary considerably. Although some respondents are comfortable with the current approach, 16 respondents request changes to the current format of the auditor's report. They believe it to be overly legalistic and to contain too many caveats and provisos that limit its usefulness. Some want to see a reorganisation of the audit report so that the opinion appears earlier in the report; whilst others call for more radical changes, such as the introduction of narrative reporting to make the auditor's report more informative in areas such as estimates, judgements, sufficiency of evidence and uncertainties.

7.2 Many of the respondents comment on the recommendations made by the Audit Quality Forum (AQF) in its paper on audit reporting<sup>14</sup>. Commentators from the profession welcome the AQF paper and support continuing the debate that has been started. Deloitte, for example, comment,

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<sup>14</sup> Key recommendations made by the AQF in its paper on audit reporting are:

- Revisions to the format of the audit report so that the most relevant information is shown first and unnecessary legalistic caveats are avoided to the maximum extent possible;
- the inclusion of a positive statement in the audit report that "adequate" accounting records have been kept by the company;
- the inclusion of a positive statement in the audit report that, where it is the case, there are no matters within the annual accounts to which the auditors wish to draw attention by way of emphasis;
- the inclusion of additional company specific information such as more information about emphases of matter and material issues encountered during the audit;

*“...the APB should give consideration to the suggestions made by the AQF on this issue”.*

- 7.3 Many other commentators, most notably investors, strongly advocate implementation of many of the recommendations made by the AQF. Hermes, for example, comment *“We regard this [AQF] work as the first step towards ensuring that auditor reports are documents which shareholders regard as worth their while to read, which at present is not the case:...they are also perceived as not worth reading, because they contain no information of value”.*
- 7.4 Some institutional investors contend that investor confidence would be enhanced if auditors reported more matters of possible interest to investors – irrespective of whether the matters are disclosed elsewhere in the financial statements. The NAPF comments that *“many investors are surprised that so little is reported”* and cites, as an example of a matter that might be reported, the situation where a company’s computer system has reached the end of its operational life and the company has no plans to replace the system. It notes that *“including such an item would be fairer to investors and would spur the company into dealing with the issue”.*
- 7.5 The NAPF recognises, however, that if more entity specific information is to be included in audit reports, *“institutional investors [will] also need to show greater flexibility and openness of mind in looking at audit reports...if audit reports are to be more useful to investors they may need to show shades of grey and investors will need to learn how to regard them”.*
- 7.6 Two investors call for little or no change to the audit report because confidence in the audit report lies in the existence of the opinion itself and not in the wording of that opinion. For example, Electricity Pension Services stated, *“The current regime is largely one of “pass” (clean audit report) or “fail” (qualified audit report). This is easily understood by users...Many users never read the audit report but simply take comfort that a positive opinion has been expressed.”*

### **Proposed action**

**The APB has formed a working party, including investor representatives, to consider the content and wording of the audit report in the context of:**

- **the requirements of the Companies Act 2006;**
- **developments in audit reporting within the EU in connection with the implementation of the Statutory Audit Directive;**
- **the fact that a revised version of ISA 700 will shortly be approved by IAASB; and**
- **the detailed recommendations made by the AQF in its paper on audit reporting.**

**Several respondents comment that the reputation of the audit firm signing the report is the defining characteristic that gives users confidence in the audit opinion and that the actual form and content of the auditor's report is of relatively little significance.**

- 7.7 Eleven respondents (including four audit firms) comment that the reputation of the audit firm signing the report should be sufficient to give users confidence in the audit opinion.
- 7.8 However, two respondents observe that the lack of knowledge of smaller firms could be a barrier to entry into this market and call for smaller firms to make their skills and expertise more widely known to the market.

**Proposed action**

**No further action is proposed.**

## 8 Factors outside the control of auditors affecting audit quality

In 'Promoting Audit Quality' the FRC identified the following influences on audit quality that are outside the control of auditors:

- The approach taken by management;
- The contribution made by audit committees;
- The role of shareholders and commentators;
- The role of litigation;
- The approach of regulators; and
- The pressures caused by the accelerating reporting regime.

and asked the following questions:

13. Are there other external factors that have the potential to affect adversely audit quality?
14. Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective?
15. Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?
16. Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?
17. Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?

8.1 Most respondents consider that the introduction of audit committees has added credibility to the financial reporting process. Investors comment that they take reassurance from the fact that most members of these committees take their responsibilities seriously and seek to fulfil them to the best of their abilities.

8.2 Some respondents think that audit committees could do more to evaluate the effectiveness of the external audit<sup>15</sup>. However, others are of the view that the breadth of audit committees' current

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<sup>15</sup> The AIU is currently consulting on how best to report on the results of its monitoring activity. One element of the proposals is that the AIU would provide a separate report on each audit reviewed to the audit firm. The audit firm would then be able to share that report with the audit committee of the client. This process is likely to affect the work that audit committees currently undertake in reviewing the effectiveness of the audit.

responsibilities means that they have little time to undertake a thorough evaluation of the effectiveness of the external audit.

- 8.3 One way to address this concern might be for audit committees to seek external assistance with the evaluation of the effectiveness of the external audit from external consultants knowledgeable about audits. Others contemplate more significant changes in the relationship between audit firms and audit committees. Professor JP Percy says that there is merit in examining a model whereby the audit committee reports to shareholders on the assurances that it has obtained from external firms. In so doing, he thinks this would open up a market for constructive free-form reporting by audit firms and an expansion in the scope of work performed.

### **Investors would like to receive more narrative reporting on audit arrangements from audit committees.**

- 8.4 Audit committees adopt different approaches towards their review of the effectiveness of the external audit. Some respondents are of the view that more information should be provided by audit committees on the nature and scope of their work.
- 8.5 A number of the audit firms consider that shareholders would benefit from a summary in the annual reports of the work undertaken by audit committees in relation to the evaluation of audit effectiveness. However, others take the view that reports on audit committee activities in annual reports are already too long and that lengthening them further in this way would not be beneficial.
- 8.6 Some respondents express concern that further reporting requirements would only result in 'boilerplate' reporting which would be of little value to users.
- 8.7 Some respondents think that the FRC should provide additional guidance to audit committees on the nature and scope of their review of the effectiveness of the external audit. Those calling for more guidance want to see guidance that is practical, not prescriptive.
- 8.8 Some respondents take the view that most audit committees are comprised of members who sit on the audit committees of more than one company and are therefore well placed to judge the absolute and relative performance of auditors and audits without additional guidance.

#### **Proposed action**

**Further work in this area, if any, will be taken forward as part of the FRC's work on the Combined Code in light of the responses to the discussion paper and the final recommendations of the MPG.**

**A number of respondents want to see greater investor involvement in decisions relating to the appointment of the auditor.**

8.9 A number of respondents are concerned that shareholders do not have enough influence over the appointment of auditors. Although shareholders formally approve the appointment of the auditors, in practice management has the dominant role as it recommends a particular firm for appointment. There is concern that this leads to a potential conflict as a key element of the auditors' role is to examine aspects of management's performance. Increasing the involvement of shareholders would help ensure that there is a clearer boundary between the roles of auditor, audit committee and the management of the company.

**Proposed action**

**This issue is being considered as part of the FRC's project on competition and choice.**

**There is general support for improved communication of the reasons for auditor resignations.**

8.10 Some investors are concerned that, in the circumstances where the auditor has resigned, client confidentiality prevents the disclosure of circumstances that should properly be brought to the attention of shareholders and other third parties. However, company law<sup>16</sup> has recently been changed in this area and it would seem sensible to review the position once the new law has been effective for a period of time.

**Proposed action**

**This issue will be kept under review following amendments made to the legal regime in the Companies Act 2006, and in the light of the way the relevant provision within the Statutory Audit Directive is implemented.**

**Institutional investors continue to see auditors' exposure to liability as a very important stimulus to audit quality.**

8.11 The ABI observes that audit firms' exposure to liability continues to be viewed by institutional investors as a very important stimulus to audit quality. They note that while they support the move towards proportionate liability, they would expect any cap on audit liability that immunises auditors from the consequences of their actions to have serious implications for the quality and credibility of the audit process.

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<sup>16</sup> Sections 516 - 525 of the Companies Act 2006 are expected to become effective in April 2008.

8.12 Some investors note that the impact of litigation on the market is unclear and call for greater public transparency. Others express concern that following the Caparo<sup>17</sup> judgement, because auditor liability is directly related to audit quality, it is impossible to build a system that achieves the requisite audit quality unless a level of auditor liability that is fair and reasonable can be determined.

**Proposed action**

**Respondent's views will be passed to the working group established by the FRC to prepare guidance on the use of liability limitation agreements.**

**Some investors express concern that the concentration of audits around 31 December year-ends poses a threat to audit quality.**

8.13 A small number of respondents call for a review of the concentration of audits around 31 December year-ends. They feel that the resources of the audit firms are spread too thinly at this time of year. This concentration issue can be further exacerbated by pressure from companies on audit firms to achieve accelerated reporting deadlines.

8.14 An analysis of FTSE 100 and 250 companies' year ends (Appendix 2) shows that 187 (or 53%) of larger listed companies have a year end at, or close to, 31 December. 20% of larger listed companies have year end at, or near to, 31 March. Other than for these two 'peaks', the year ends of other listed companies are spread fairly evenly through the year.

**Proposed action**

**In light of the analysis in Appendix 2, no further action is proposed at this stage.**

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<sup>17</sup> The 1990 Caparo judgement, clarified that UK auditors do not owe a general 'duty of care' to individual current/potential shareholders, creditors, employees or other stakeholders.

## Appendix 1

### Drivers of audit quality – A Framework

Element	Indicators
The culture within the firm	<p>Emphasis given by the leadership of audit firms to:</p> <ul style="list-style-type: none"> <li>○ The importance to reputation of both the firm and individual auditors ‘doing the right thing’ in the public interest.</li> <li>○ Ensuring that partners have sufficient time to undertake each audit effectively.</li> <li>○ Providing sufficient resources to deal with difficult issues as they arise and not letting financial considerations drive actions and decisions with a negative effect on audit quality.</li> <li>○ Promoting the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgement.</li> <li>○ Fostering appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing.</li> </ul>
The skills and personal qualities of audit partners and staff	<p>Ensuring that:</p> <ul style="list-style-type: none"> <li>○ Partners and staff adhere to the principles underlying auditing and ethical standards.</li> <li>○ Partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit.</li> <li>○ Partners and managers have the necessary knowledge and experience and spend enough time on the audit, including direct audit partner engagement with the audit client.</li> <li>○ Staff performing detailed ‘on-site’ audit work have sufficient experience and are closely supervised by the partners and managers.</li> <li>○ Partners and managers provide more junior staff with ‘mentoring’ and ‘on the job’ training.</li> <li>○ Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.</li> </ul>



Element	Indicators
The effectiveness of the audit process	<p>Ensuring that:</p> <ul style="list-style-type: none"> <li>○ High quality technical support is available when the audit team encounters a situation it is not familiar with.</li> <li>○ The audit methodology and tools applied to the audit are well structured and: <ul style="list-style-type: none"> <li>▪ Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently.</li> <li>▪ Provide for compliance with auditing standards without inhibiting the exercise of judgement.</li> <li>▪ Require appropriate audit documentation.</li> <li>▪ Ensure there is effective review of audit work.</li> </ul> </li> <li>○ The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor.</li> <li>○ Audit quality control procedures are effective, understood and applied.</li> <li>○ Audit quality is monitored within firms and across international networks and appropriate remedial action is taken.</li> </ul>
The reliability and usefulness of audit reporting	<p>Ensuring that:</p> <ul style="list-style-type: none"> <li>○ Audit reports meet the needs of users of financial statements in the context of applicable law and regulations.</li> <li>○ Communications with the audit committee include discussions about: <ul style="list-style-type: none"> <li>▪ The scope of the audit.</li> <li>▪ The threats to auditor objectivity.</li> <li>▪ The key risks identified and judgements made in reaching the audit opinion.</li> <li>▪ The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.</li> </ul> </li> </ul>
Factors outside the control of auditors	<ul style="list-style-type: none"> <li>○ Good corporate governance, including an active audit committee, plays a major role in ensuring companies attach appropriate importance to corporate and financial reporting and to the audit process.</li> <li>○ Audit committees exhibit professional scepticism in their work and are robust in dealing with issues</li> </ul>

Element	Indicators
	<p>identified during the audit.</p> <ul style="list-style-type: none"> <li data-bbox="691 349 1445 517">○ Shareholders provide support to auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements.</li> <li data-bbox="691 539 1445 640">○ Reporting deadlines are not so tight that they cause auditors to over-rely on work performed before the end of the reporting period.</li> <li data-bbox="691 674 1445 743">○ Appropriate arrangements for any limitation of liability are agreed with the auditors</li> </ul>

## Appendix 2

### Analysis of FTSE 350 companies year ends

End of <sup>18</sup>	FTSE100	FTSE 250	Combined	%
January	3	10	13	4
February	3	2	5	2
March	23	48	71	20
April	1	13	14	4
May		3	3	1
June	4	13	17	5
July	1	4	5	1
August	1	2	3	1
September	8	17	25	7
October		4	4	1
November	1	2	3	1
December	55	132	187	53
<b>Total</b>	<b>100</b>	<b>250</b>	<b>350</b>	<b>100</b>

<sup>18</sup> Year ends at, or close to, the month end.

## Appendix 3

### Respondents to the discussion paper

(Excluding those who requested confidentiality)

Accountancy Firms	BDO Stoy Hayward Deloitte Ernst & Young Grant Thornton KPMG Mazars PricewaterhouseCoopers (PwC) RSM Robson Rhodes
Professional Bodies	Chartered Institute of Management Accountants (CIMA) Chartered Institute of Public Finance and Accountancy (CIPFA) Consultative Committee of Accountancy Bodies (CCAB) Institute of Chartered Accountants in England & Wales (ICAEW) Institute of Chartered Accountants in Ireland (ICAI) Institute of Chartered Accountants of Scotland (ICAS) International Federation of Accountants (IFAC) Center for Audit Quality <sup>19</sup> Global Accounting Alliance (GAA) <sup>20</sup> ICAEW, London Society
Investors	Association of British Insurers (ABI) Coal Pension Trustees Electricity Pension Services Ltd Governance for Owners Hermes Investment Management Limited (Hermes) 3i Group Plc Investment Management Association (IMA) National Association of Pension Funds (NAPF) Standard Life Investments
Corporates	Confederation of British Industry (CBI) The Hundred Group of Finance Directors
Others	Clifford Moggs Independent Regulatory Board for Auditors (South Africa) Mr D Alexander Mrs M Downes Mr I Wright National Audit Office (Malta) Office of the Revenue Commissioner (Ireland) Office of the Director of Corporate Enforcement (Ireland) Prof JP Percy Wales Audit Office

<sup>19</sup> A body formed in 2007 by the public company auditing profession in the United States.

<sup>20</sup> The GAA facilitates a co-operation between the world's leading professional accounting organisations.





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