

## **STATUTORY AUDIT SERVICES**

### **Law and Regulation working paper**

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The Competition Commission has excluded from this working paper information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [X]. [Some numbers have been replaced by a range. These are shown in square brackets.] [Non-sensitive wording is also indicated in square brackets.]

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- B: Reports and Reviews leading up to the current Code
- C: Code Provisions for Audit Committee and Auditors—extracts
- D: Audit Choice Market Participants Report, October 2007: list of recommendations

# Law and Regulation applicable to the provision of Statutory Audit services

## 1. Introduction

1.1 This working paper sets out the CC's current understanding of the law and regulation applicable to the provision of statutory audit services in the UK. In five substantive sections it sets out:

- (a) the duties of companies and their directors to provide financial reports and accounts;
- (b) the statutory and common law regarding the provision of statutory audit services;
- (c) the regulation applicable to the contents and quality of a statutory audit;
- (d) the institutions relevant to and tasked with the enforcement of the standards applicable to audit quality and to auditor quality and independence;
- (e) the role of audit committees; and
- (f) the role of shareholders with regard to audits.

## 2. The duties of companies and their directors to provide financial reports

2.1 Auditors audit the annual accounts that company directors produce. The general duties that the directors owe to the company are specified in the Companies Act 2006 (the Act).<sup>1</sup> These are based on (and replace) common law rules and equitable principles as they apply to directors and are to be interpreted and applied in the same way as those rules and principles.<sup>2</sup> These general duties include a duty to promote the success of the company<sup>3</sup> and the duty to exercise reasonable care, skill and diligence.<sup>4</sup>

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<sup>1</sup> Sections 171–177 of the Act.

<sup>2</sup> Section 170(3) & (4) of the Act.

<sup>3</sup> Section 172 of the Act.

<sup>4</sup> Section 174 of the Act.

- 2.2 Companies have a duty to keep accounting records which disclose with reasonable accuracy at any time the financial position of the company at that time.<sup>5</sup> These records must contain entries of all sums of money received and expended by the company, a record of the assets and liabilities of the company and statements of any stock held by the company at the end of each financial year.<sup>6</sup> The accounts must also be sufficient to enable the directors to ensure that any accounts required to be prepared comply with the requirements of the Act and, where applicable, of Article 4 of the IAS Regulation.<sup>7</sup>
- 2.3 A company's annual accounts must be approved by the board of directors and signed on behalf of the board by a director.<sup>8</sup> Any director who approved annual accounts, knowing that they did not comply with the requirements of the Act and, where applicable, of Article 4 of the IAS Regulation, or being reckless as to whether they complied, and who failed to take reasonable steps to secure compliance or prevent the accounts from being approved, commits a criminal offence, punishable by a fine.<sup>9</sup>
- 2.4 The directors of a company have a duty to prepare a director's report for each financial year.<sup>10</sup> Unless a company is exempt from the requirement for the accounts to be audited, the directors' report for each financial year must include a statement as to disclosure to auditors. This statement must be to the effect that, in the case of each of the persons who were directors at the time the report was approved, so far as each was aware, there was no relevant audit information of which the company's auditor was unaware; and each had taken all the steps that ought to have been taken as a director in order to become aware of any relevant audit information and to

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<sup>5</sup> Section 386(2)(b) of the Act.

<sup>6</sup> Section 386(3) of the Act.

<sup>7</sup> Section 386(2)(c) of the Act. The IAS Regulation is EC Regulation No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

<sup>8</sup> Section 414 of the Act.

<sup>9</sup> Section 414 (4) & (5) of the Act.

<sup>10</sup> Section 415(1) of the Act.

establish that the company's auditor was aware of that information.<sup>11</sup> This would include making such enquiries of fellow directors and of the auditors, and such other steps as was required by the duty to exercise reasonable care, skill and diligence.<sup>12</sup>

2.5 A director who makes such a disclosure statement in a report falsely, or recklessly as to whether it was false, and failed to take steps to prevent the report from being approved, commits a criminal offence, punishable by imprisonment, or a fine, or both.<sup>13</sup>

2.6 The directors of a company (including an unregistered company) must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company, or (in the case of group accounts) of the undertakings included in the consolidation as a whole, so far as concerns members of the company.<sup>14</sup> See further paragraphs 3.50 to 3.53 for discussion of the meaning of 'true and fair'.

### **3. Statutory and common law regarding the provision of statutory audit services**

3.1 This section describes: (a) the statutory framework; (b) the statutory audit; (c) who may conduct a statutory audit; (d) the duties of companies as regards statutory audits; (e) the functions of a statutory auditor; (f) the duties and (g) liabilities of a statutory auditor; and (h) the meaning of 'true and fair' with regard to audit.

#### ***The statutory framework***

3.2 The statutory provisions relating to company audits were consolidated in the Act. Part 15 of the Act (Accounts and reports—sections 380 to 474) sets out the

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<sup>11</sup> Section 418(2) of the Act.

<sup>12</sup> Section 418(4) of the Act.

<sup>13</sup> Section 419(3) and (4) of the Act.

<sup>14</sup> Section 393 of the Act.

requirements as to accounts and reports in relation to each financial year of a company, and Part 16 of the Act (Audit—sections 475 to 539) provides for the auditing of those annual accounts.

3.3 In particular, Part 16 of the Act provides for the statutory audit of companies (both registered and unregistered<sup>15</sup>) and of limited liability partnerships.<sup>16</sup> Statutory auditors may be appointed under other legislation but the general provisions of Part 16 of the Act are applied, with modifications, to such audits.

3.4 Part 42 of the Act (Statutory auditors—sections 1209 to 1264) specifies who may be appointed as a statutory auditor and how statutory audits are to be carried out. It gives effect to EU requirements for the approval and registration of persons that carry out statutory audits<sup>17</sup> which have replaced arrangements in the 8<sup>th</sup> Company Law Directive of 1984<sup>18</sup> (now repealed).

### ***The statutory audit***

3.5 A statutory audit is defined by the Act by reference to the person appointed as auditor, but there are also provisions specifying the functions of a statutory auditor and matters which must be included in a statutory audit report.

3.6 The Act defines a statutory audit<sup>19</sup> as an audit conducted by a person appointed as a statutory auditor, that is to say an audit conducted by a person appointed by a company,<sup>20</sup> a limited liability partnership, a building society,<sup>21</sup> a friendly society,<sup>22</sup> a

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<sup>15</sup> In the case of unregistered companies, Part 16 of the Act is modified by the Unregistered Companies Regulations 2009 (SI 2009/2436).

<sup>16</sup> In the case of limited liability partnerships, Part 16 of the Act is modified by the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911).

<sup>17</sup> Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts.

<sup>18</sup> Council Directive 84/253/EC (8<sup>th</sup> Company Law Directive—now repealed).

<sup>19</sup> Section 1210(1) of the Act.

<sup>20</sup> Under section 485 (private companies) or section. 489 (public companies) of the Act.

<sup>21</sup> Under section 77 of, or Schedule 11 to, the Building Societies Act 1986.

<sup>22</sup> By an insurer, that is a friendly society under section 72 of, or Schedule 14 to, the Friendly Societies Act 1992.

Lloyd's syndicate,<sup>23</sup> an insurance undertaking<sup>24</sup> or a bank.<sup>25</sup> The provisions of Part 16 of the Act apply (in some cases with modifications) to all such financial audits. Our market investigation relates to company financial audits, as our terms of reference have limited the scope of 'statutory audit' by defining the expression 'statutory audit services' as meaning company audits carried out under Part 16 of the Act.<sup>26</sup>

### ***The duties of companies as regards audits***

3.7 Companies and limited liability partnerships have a duty to commission statutory audits each financial year,<sup>27</sup> unless they are exempted<sup>28</sup> and the members have not exercised their right to require an audit, notwithstanding such exemption.<sup>29</sup> This requirement extends both to registered and unregistered companies.<sup>30</sup> The appointment of an auditor is usually made formally by the shareholders by ordinary resolution in the general meeting.

3.8 The obligations placed on statutory auditors by Part 42 of the Act (eligibility for appointment as statutory auditor etc) apply both to auditors appointed by companies and limited liability partnerships under Part 16 of the Act, and to statutory auditors appointed under other legislative provisions.<sup>31</sup>

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<sup>23</sup> Appointed as auditor for the purposes of regulation 5 of the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008 (SI 2008/1950) or to report on the 'aggregate accounts' within the meaning of those regulations: see section 1210(1)(e) of the Act.

<sup>24</sup> For the purposes of the Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008 (SI 2008/565): see section 1210(1)(f) of the Act.

<sup>25</sup> For the purposes of the Bank Accounts Directive (Miscellaneous Banks) Regulations 2008 (SI 2008/567): see section 1210(1)(g) of the Act.

<sup>26</sup> 'For the purposes of this reference, statutory audit services means an audit conducted by a person appointed as auditor under Part 16 of the Companies Act 2006.' Terms of reference, paragraph 3.

<sup>27</sup> Under section 475 of the Act, as modified in the case of limited liability partnerships by article 33 of the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911). Until 6 April 2008, the duty was on an auditor to audit the accounts, not on the company.

<sup>28</sup> Small companies and dormant companies are exempted under sections 477 and 480 respectively of the Act. Non-profit-making companies subject to public sector audit are exempted by section 475(1)(b) of the Act.

<sup>29</sup> Under section 476 of the Act. Notification that an audit is required must be given by members representing not less than 10 per cent in nominal value of the company's issued share capital or any class of it, or not less than 10 per cent in number of the members of a company which has no share capital.

<sup>30</sup> The obligation on unregistered companies arises from the Unregistered Companies Regulations 2009 (SI 2009/2436).

<sup>31</sup> Section 2010(1) of the Act.

- 3.9 An auditor must be appointed for each financial year of the company, unless the directors reasonably resolve otherwise, on the ground that audited accounts are unlikely to be required.<sup>32</sup> If a company fails to make an appointment, it must notify the Secretary of State, and the Secretary of State may appoint a person to fill the vacancy.<sup>33</sup>
- 3.10 The appointment must be made, in the case of a public company, each year, before the end of the accounts meeting of the company at which the annual accounts and reports for the previous financial year are laid.<sup>34</sup> In the case of a private company, the appointment must be made within 28 days of the accounts for the previous year being circulated to members.<sup>35</sup>
- 3.11 An auditor of a public company holds office as auditor only for one year (ie until the conclusion of the next accounts meeting following appointment) unless the auditor is reappointed.<sup>36</sup> An appointment must be made for each financial year.<sup>37</sup>
- 3.12 By contrast, an auditor of a private company will be deemed to be reappointed each year unless: (a) the appointment was made by the directors (not the members); (b) the company's articles require an actual reappointment; (c) enough members<sup>38</sup> have given notice to the company under section 488; (d) there has been a resolution that the auditor should not be reappointed; or (e) the directors decide that they do not need auditors for the following year.

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<sup>32</sup> Section 485(1) of the Act—private companies; section 489(1) of the Act—public companies.

<sup>33</sup> Section 486(1) of the Act—private companies; section 490(10) of the Act—public companies.

<sup>34</sup> Section 489 of the Act.

<sup>35</sup> Section 485 of the Act.

<sup>36</sup> Section 491(1)(b) of the Act.

<sup>37</sup> Usually at the accounts meeting, section 489(2) of the Act.

<sup>38</sup> ie 5 per cent or whatever lower figure is specified in the company's articles.

- 3.13 The remuneration of an auditor, who has been appointed by the directors of a company, is fixed by the directors, and that of an auditor appointed by the members of a company is fixed by the members, by ordinary resolution.<sup>39</sup>
- 3.14 Small<sup>40</sup> and medium-sized<sup>41</sup> companies must disclose in a note to the annual accounts the fee paid to their auditors for the audit itself. Large companies (ie companies which are not small or medium-sized) must disclose both the audit fee and all other fees receivable by the auditors for services supplied by them and their associates to the company, its subsidiaries (with some exceptions) and associated pension schemes.<sup>42</sup> Consolidated group accounts of large companies must disclose the types of services and the fees paid for them, as if the group were a single company (in which case the individual companies do not need also to disclose them).<sup>43</sup>
- 3.15 If a company has made a liability limitation agreement with its auditors,<sup>44</sup> it must disclose, in a note to the accounts, the principal terms and the date of the approval resolution (or of the resolution waiving the need for approval, in the case of a private company) passed by the company's members.
- 3.16 An auditor may resign from office by depositing a written notice to that effect at the company's registered office. The notice must be accompanied by a statement of any circumstances connected with the resignation which the auditor considers should be brought to the attention of the members or creditors of the company, or (where

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<sup>39</sup> Section 492 of the Act.

<sup>40</sup> Section 382 of the Act provides that a company is small if it satisfies two or more of the following requirements: (1) Turnover—not more than £6.5 million; (2) Balance sheet total—not more than £3.26 million; (3) Number of employees—not more than 50.

<sup>41</sup> Section 465 of the Act provides that a company is medium-sized if it satisfies two or more of the following requirements: (1) Turnover—not more than £25.9 million; (2) Balance sheet total—not more than £12.9 million; (3) Number of employees—not more than 250.

<sup>42</sup> Under the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489) as amended by SI 2011/2198.

<sup>43</sup> *ibid*, regulation 7.

<sup>44</sup> In principle, an auditor has unlimited liability, but under sections 532–538 of the Act, auditors are able to limit liability by contract with the company to an amount that is 'fair and reasonable in all the circumstances'. A separate agreement will be required for each year's audit, and each one must be approved by the company's shareholders.

relevant and permitted) a statement that there are no such circumstances, and the notice of resignation is not valid unless this has been done.<sup>45</sup>

- 3.17 Section 519 of the Act requires that an auditor who ceases to hold office must deposit a statement at the company's registered office explaining the relevant circumstances. This requirement applies also to an auditor who does not seek reappointment. The auditor must make a statement of any circumstances connected with this decision that the auditor considers should be brought to the attention of the members or creditors of the company, or a statement that there are no such circumstances.

### ***Who may conduct a statutory audit***

- 3.18 An individual or firm<sup>46</sup> is eligible to be appointed as a statutory auditor if the individual or firm is a 'fit and proper person',<sup>47</sup> who is a member of a recognized supervisory body and is eligible for appointment under the rules of that body.<sup>48</sup> The Secretary of State was previously responsible for the oversight of statutory audits, but from September 2005<sup>49</sup> the Professional Oversight Board (POB), part of the Financial Reporting Council Limited (FRC), carries out these functions as regards the public oversight of statutory audits required by the Audit Directive.<sup>50</sup>
- 3.19 It is an offence for a person, who is ineligible to be appointed as a statutory auditor, to act as statutory auditor.<sup>51</sup> It is also an offence for a person to act as statutory auditor if that person lacks the necessary independence, by being an officer, partner

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<sup>45</sup> Section 516 of the Act.

<sup>46</sup> For these purposes, 'firm' means any entity, whether or not a legal person, which is not an individual, and includes a body corporate, a corporation sole and a partnership or other unincorporated association: section 1261(1) of the Act.

<sup>47</sup> Paragraph 8 of Schedule 10 to the Act.

<sup>48</sup> Individuals who have retained Companies Act 1967 authorization, but are not otherwise eligible for appointment, may only audit an unquoted company (section 1222 of the Act). In the cases to which the Act section 1222 applies (individuals retaining only Companies Act 1967 authorization).

<sup>49</sup> By the Companies Act 1989 (Delegation) Order 2005 (SI 2005/2337), later replaced by the Statutory Auditors (Delegation of Functions etc) Order 2008 (SI 2008/496).

<sup>50</sup> Directive 2006/43 EC.

<sup>51</sup> Under section 1213 of the Act.

or employee of the audited person, or an officer, partner or employee of an associated undertaking of the audited person.<sup>52</sup> If, while conducting a statutory audit, a person becomes ineligible or becomes prohibited by reason of lack of independence, that person must resign their office as auditor with immediate effect.

- 3.20 Where a partnership is appointed as statutory auditor, then unless a contrary intention appears, it is the partnership, not the partners, which is appointed. If the partnership ceases, and if the members of the successor partnership are substantially the same as those of the former partnership, and the partnership or person succeeds to the whole, or substantially the whole, of the business of the former partnership, the appointment will be treated as extending to the successor partnership or person.<sup>53</sup>
- 3.21 The Act requires that a register is kept of persons eligible for appointment as statutory auditor. The register is maintained by ICAS on behalf of the RSBs in accordance with requirements set by the Professional Oversight Board.
- 3.22 The Auditing Practices Board (see paragraph 5.3) requires that in general, in the case of listed companies, the audit firm must establish policies and procedures to ensure that: (a) no one acts as audit engagement partner for more than five years; and (b) anyone who has acted as the audit engagement partner for a particular audited entity for a period of five years must not subsequently participate in the audit engagement until a further period of five years has elapsed.
- 3.23 Shareholders may dismiss an auditor at any time by ordinary resolution at a general meeting, so long as special notice of the resolution has been given both to the share-

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<sup>52</sup> Under section 1215 of the Act.

<sup>53</sup> Section 1216 of the Act.

holders and to the auditor. The auditor can make representations in writing to the company which must be copied to the members (unless there is no time to do so).<sup>54</sup>

- 3.24 If a company removes an auditor from office by resolution, it must give notice to the registrar of companies and it is an offence committed by the company, and every officer who is in default, to fail to do so.<sup>55</sup>
- 3.25 An auditor may resign by depositing written notice with the company which includes a written statement of the circumstances connected with the auditor ceasing to hold office, unless the auditor considers that there are no such circumstances that need to be brought to the attention of members or of creditors of the company, in which case the auditor must deposit a statement to this effect.<sup>56</sup>
- 3.26 If an auditor of a quoted company ceases for any reason to hold office, a statement of the circumstances connected with ceasing to hold office must be deposited by the auditor at the company's registered office.<sup>57</sup> The company must send a copy of the auditor's statement within 14 days to the persons who are entitled to be sent accounts,<sup>58</sup> and the auditor must send a copy of its statement to the registrar of companies within 21 days of deposit.<sup>59</sup>

### ***The functions of a statutory auditor***

- 3.27 The two main functions of a statutory auditor are: (a) to make a report to the company members on all the annual accounts of the company identifying the financial reporting framework and the auditing standards that have been applied and,

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<sup>54</sup> Sections 510 & 511 of the Act. Section 510 of the Act is applied with modification to LLPs as from 1 October 2008 by the Limited Liability Partnerships (Accounts and Audit)(Application of Companies Act 2006) Regulations 2008 (SI 2008/1911, regulations 2(1), (7) and 43.

<sup>55</sup> Section 512 of the Act.

<sup>56</sup> Section 519 of the Act.

<sup>57</sup> Section 519 of the Act.

<sup>58</sup> Section 520 of the Act.

<sup>59</sup> Section 521 of the Act.

in particular, stating whether the annual accounts give a true and fair view of the state of affairs of the company at the end of the financial year, and of the profit or loss of the company for the financial year. Where the auditor is a firm, then the audit report must be signed and dated by the senior statutory auditor on behalf of the audit firm.

3.28 An auditor has a general right of information for the purpose of preparing this report. This includes a right of access to the company's books, accounts and vouchers and a right to require any officer or employee of the company to provide such information or explanation as the auditor thinks necessary.<sup>60</sup>

3.29 Where a parent company has a subsidiary that is not incorporated in the UK, the auditor of the parent company may require it to obtain information or explanation for the purposes of the audit from any officer, employee or auditor of the subsidiary, any person holding or accountable for any of the subsidiary's books, accounts or vouchers, and any person who had such a position or was so accountable at the relevant time.<sup>61</sup>

3.30 It is an offence for a person knowingly or recklessly to make a statement (oral or written) of information required for the purposes of an audit that is misleading, false or deceptive in a material particular.<sup>62</sup> It is also an offence to fail to comply with a requirement to provide information for the purposes of an audit without delay, unless it was not reasonably practicable to provide the required information or explanation.<sup>63</sup>

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<sup>60</sup> Section 499 of the Act.

<sup>61</sup> Section 500 of the Act.

<sup>62</sup> Section 501(1) of the Act.

<sup>63</sup> Section 501(3) of the Act.

- 3.31 An auditor is entitled to receive all notices of general meetings, and to attend and be heard at any general meeting of the company.<sup>64</sup>
- 3.32 The auditor must make a report on all the annual accounts of the company and this report must be laid before the company in general meeting (in the case of a public company) or sent out to members (in the case of a private company).
- 3.33 The report must be either qualified or unqualified. 'Qualified'<sup>65</sup> means that the report or statement does not state the auditor's unqualified opinion that the accounts have been properly prepared in accordance with this Act or, in the case of an undertaking not required to prepare accounts in accordance with this Act, under any corresponding legislation under which it is required to prepare accounts. The report must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.
- 3.34 The auditor's report must state the name of the auditor and be signed and dated. From 6 April 2008, where the auditor is a firm, the report must be signed by the senior statutory auditor in their own name, for and on behalf of the auditor.<sup>66</sup> The name of the auditor, and of the senior statutory auditor who signed the report, must be stated in every copy of the report that is published or made available for public inspection,<sup>67</sup> unless the company: (a) considers on reasonable grounds that this would create a serious risk that the auditor, or senior auditor, or any other person would be subject to violence or intimidation; (b) has resolved that the name should not be stated; and (c) has given notice of the resolution to the Secretary of State.<sup>68</sup>

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<sup>64</sup> Section 502 of the Act.

<sup>65</sup> Section 539 of the Act.

<sup>66</sup> Section 503 of the Act.

<sup>67</sup> Section 505 of the Act.

<sup>68</sup> Section 506 of the Act.

- 3.35 The senior statutory auditor is the individual identified by the firm as senior statutory auditor in relation to the audit in accordance with Chapter 2 of Part 42 (sections 1212 to 1225) of the Act<sup>69</sup> and the term ‘senior statutory auditor’ has the same meaning as the term ‘engagement partner’ when used in the International Standards in Auditing (UK and Ireland) (ISAs) issued by the FRC.<sup>70</sup>
- 3.36 The senior statutory auditor is not, by reason of having signed the report or of being identified as senior statutory auditor, subject to any civil liability to which they would not otherwise be liable.<sup>71</sup>
- 3.37 If the auditor is of the opinion: (a) that adequate accounting records have not been kept; or (b) that the company’s individual accounts are not in agreement with the accounting records and returns; or (c) in the case of a quoted company, that the auditable part of its directors’ remuneration report is not in agreement with the accounting records and returns, then that fact must be stated in the report.<sup>72</sup>
- 3.38 If the auditor is of the opinion that the accounts are not in agreement with the records, or if the auditor fails to obtain the information and explanations needed for the audit, this must be stated in the report.<sup>73</sup> The auditor must also state if the requirements<sup>74</sup> as to disclosure in the accounts of directors’ benefits, remuneration, pensions and compensation for loss of office are not complied with, or requirements<sup>75</sup> are not complied with as to information concerning the auditable part of the directors’ remuneration.

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<sup>69</sup> Section 504(2) of the Act.

<sup>70</sup> Bulletin 2008/6 of the Auditing Practices Board—The ‘Senior Statutory Auditor’ under the UK Companies Act 2006.

<sup>71</sup> Section 504(3) of the Act.

<sup>72</sup> Section 498(2) of the Act.

<sup>73</sup> Section 498 of the Act.

<sup>74</sup> Under section 412 of the Act.

<sup>75</sup> Under section 421 of the Act.

- 3.39 The auditor must state clearly in the report: (a) whether in its opinion the annual accounts give a true and fair view of affairs as at the end of the financial year of the company; (b) whether in its opinion the accounts have been properly prepared in accordance with the relevant financial reporting framework, the requirements of the Act and, where applicable, Article 4 of the International Accounting Standards Regulation; (c) whether the report is unqualified or qualified; and (d) whether there are any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.<sup>76</sup>
- 3.40 In addition, an auditor must state in the report whether, in its opinion, the information given in the directors' report for that financial year is consistent with the accounts.<sup>77</sup> If the company is a quoted company, the auditor must also state in the report whether, in its opinion, the auditable part of the directors' remuneration report has been properly prepared in accordance with the Act.<sup>78</sup>
- 3.41 Where the company prepares a separate corporate governance statement in respect of a financial year, the auditor must state in the report whether, in its opinion, the information given in the statement in compliance with the rules on information about internal control and risk management systems in relation to financial reporting processes, and about share capital structures,<sup>79</sup> is consistent with the accounts.

### ***The duties of a statutory auditor***

- 3.42 The Act provides that duties of an auditor are to carry out investigations and form an opinion as to: (a) whether adequate accounting records have been kept by the company, and returns adequate for their audit have been received from branches not

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<sup>76</sup> Section 495 of the Act.

<sup>77</sup> Section 496.

<sup>78</sup> Section 497.

<sup>79</sup> Rules 7.2.5 & 7.2.6 in the *Disclosure Rules and Transparency Rules sourcebook*, issued by the Financial Services Authority (FSA).

visited by the auditor; (b) whether the company's individual accounts are in agreement with the accounting records and returns; and (c) in the case of a quoted company, whether the auditable part of the company's directors' remuneration report is in agreement with the accounting records and returns.<sup>80</sup>

3.43 Case law makes clear that the auditor's primary duty is to give the true financial position of the company. In doing so, the auditor must do more than check the arithmetical accuracy of the balance sheet. Lord Denning said:

What is the proper function of an auditor? It is said that he is bound only to verify the sum, the arithmetical conclusion, by reference to the books and all necessary vouching material and oral explanations, and that it is no part of his function to inquire ... I think this is too narrow a view. An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. ... His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly, he must come to it with an inquiring mind—not suspicious of dishonesty, I agree—but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.<sup>81</sup>

3.44 According to Legatt LJ, the auditor must conduct the audit in such a way as to make it probable that material misstatements in financial documents will be detected:

The primary responsibility for safeguarding a company's assets and preventing errors and defalcations rests with the directors. But material irregularities, and *a fortiori* fraud, will normally be brought to light by

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<sup>80</sup> Section 498(1).

<sup>81</sup> *Fomento (Sterling Area) Limited v Selsdon Fountain Pen Co Ltd* [1958] 1 WLR 45 (HL), p61.

sound audit procedures, one of which is the practice of pointing out weaknesses in internal controls. An auditor's task is so to conduct the audit as to make it probable that material misstatements in financial documents will be detected. Detection did not occur here, and there therefore is a case for C&LS to answer.<sup>82</sup>

### ***The liabilities of a statutory auditor***

- 3.45 Schedule 10 to the Act requires a supervisory body: (a) to have rules and practices designed to ensure that statutory audit work is conducted properly and with integrity; (b) rules and practices as to the technical standards to be applied in statutory audit work, and the manner in which those standards are to be applied in practice; and (c) that persons appointed as statutory auditors of public interest entities (see paragraph 5.36) report to the entity's audit committee (if it has one) at least once in each calendar year during which they hold office. Schedule 10 also requires a supervisory body to monitor and enforce compliance with its rules.
- 3.46 Schedule 10 also provides that a supervisory body must have adequate rules or arrangements designed to ensure that statutory auditors take such steps as may reasonably be expected of them to secure that they are able to meet claims against them arising out of statutory audit work. The Act provides that this may be achieved by professional indemnity insurance or other appropriate arrangements.
- 3.47 Auditors owe a duty to the company that has engaged them to exercise reasonable skill and care in carrying out their duties as auditors. Auditors are therefore at risk of claims for damages for breach. The scope of this duty was described by Lord Hoffman:

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<sup>82</sup> *Barings plc v Coopers & Lybrand* [1997] 1 BCLC 427, CA.

A plaintiff who sues for breach of a duty imposed by the law (whether in contract or tort or under statute) must do more than prove that the defendant has failed to comply. He must show that a duty was owed to him and that it was a duty in respect of the kind of loss which he has suffered. Both of these requirements are illustrated by *Caparo* ... The auditor's failure to use reasonable care in auditing the company's statutory accounts was a breach of their duty of care. But they were not liable to an outside take-over bidder because the duty was not owed to him. Nor were they liable to shareholders who had bought more shares in reliance on the accounts because, although they were owed a duty of care, it was in their capacity as members of the company and not in the capacity (which they shared with everyone else) of potential buyers of its shares. Accordingly, the duty which they were owed was not in respect of loss which they might suffer by buying its shares ...<sup>83</sup>

3.48 So in the case of a claim in tort against an auditor the claimant must prove: (a) that the relationship between the auditor and the claimant was capable of giving rise to a duty of care; (b) that the loss flowing from the auditor's breach of that duty was caused by the auditor's negligent report, and was foreseeable; (c) that, at the time the auditor undertook those services, the auditor had in contemplation that it would be relied on by the claimant for the purpose of a particular transaction or class of transaction; and (iv) that the claimant, in fact, relied on the auditor's report when embarking on such transaction which resulted in the loss for which compensation is claimed.

3.49 Lord Phillips of Worth Matravers summarised the overall position as follows:

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<sup>83</sup> *South Australia Asset Management Corp v York Montague Ltd* [1996] 3 All ER 365, [1997] AC 191 per Lord Hoffman at 211, cited in *Barings plc (in liq) & anor v Coopers & Lybrand (firm) & ors (No 1)*; *Barings Futures (Singapore) Pte Ltd (in liq) v Mattar & ors (No 1)* [2002] 2 BCLC 364 at 366.

The leading authority is *Caparo Industries Plc v Dickman* [1990] 2 AC 603. The duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant Auditing Standards. The duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the company in the interests of its shareholders. No duty is owed directly to the individual shareholders. This is because the shareholders' interests are protected by the duty owed to the company. No duty is owed to creditors—*Al Saudi Banque v Clarke Pixley* [1990] Ch 313. The Auditing Standards require auditors who have reason to suspect that the directors of a company are behaving fraudulently to draw this to the attention of the proper authority.<sup>84</sup>

### **'True and fair'**

3.50 The obligation on the auditor to report whether the accounts in its opinion give a true and fair view of the state of the company's affairs apply:

- in the case of an individual balance sheet, to the state of affairs of the company as at the end of the financial year;
- in the case of an individual profit and loss account, to the profit or loss of the company for the financial year; and
- in the case of group accounts, to the state of affairs as at the end of the financial year, and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

3.51 There is no statutory definition of the phrase 'true and fair' and none of the decided 'auditor' cases appears to have attempted to define what is meant by 'true and fair'.

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<sup>84</sup> *Moore Stephens (a firm) v Stone Rolls Limited (in liquidation)* [2009] 1 AC 1391.

However, the same phrase is also relevant for tax law. In a leading case before the House of Lords, Lord Hoffman said:

Although the requirement that the initial computation shall give a true and fair view involves the application of a legal standard, the courts are guided as to its content by the expert opinions of accountants as to what the best current accounting practice requires. The experts will in turn be guided by authoritative statements of accounting practice issued or adopted by the Accounting Standards Board.<sup>85</sup>

Further detail on the Accounting Standards Board is provided in paragraph 5.2 of this paper. The FRC has a webpage which provides further materials on the meaning of 'true and fair'.<sup>86</sup>

3.52 Subsequently, in the Commercial Court, Andrew Smith J said:

the expression 'true and fair view' has become established and accepted and given statutory force as a standard for preparing financial statements, and must be understood and given effect in light of generally accepted accounting practices, which are reflected in Financial Reporting Standards.<sup>87</sup>

3.53 It therefore appears in practice that the phrase equates to being computed in accordance with the relevant accounting principles. The FRC, through the Accounting Standards Board, develops and publishes principles by which accounting standards can be established, and to provide a framework within which accounting issues can be resolved.<sup>88</sup>

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<sup>85</sup> *Revenue and Customs Commrs v William Grant & Sons Distillers Ltd* [2007] UKHL 15, paragraph 2.

<sup>86</sup> <http://www.frc.org.uk/about/trueandfair.cfm>.

<sup>87</sup> *Macquarie Internationale Investments Ltd v Glencore UK Ltd* [2009] EWHC 2267 (Comm), paragraph 162.

<sup>88</sup> See [www.frc.org.uk/asb/about/aims.cfm](http://www.frc.org.uk/asb/about/aims.cfm).

3.54 The following section describes how these legal standards have been developed and made concrete in practice by the auditing profession.

#### **4. The definition and regulation of audit quality**

##### ***Definition***

4.1 The auditor's report has to cover three matters. It must state whether, in the auditor's opinion, the annual accounts: (a) give a true and fair of the state of affairs of the company and the profit and loss account; (b) have been properly prepared; and (c) have been prepared in accordance with the Act.

4.2 De Angelo<sup>89</sup> defined audit quality as: 'the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system and (b) report the breach'. Point (a) relates to the quality of the investigation that the auditor undertakes while point (b) relates to independence in terms of the auditor acting on the results of the investigation. 'Market assessed' relates to the perception of audit customers and other users of published audit reports.

4.3 The FRC has stated<sup>90</sup> that audit quality is difficult to define and that there is no agreed definition of audit quality that can be used as a standard against which actual performance can be assessed. The FRC's Audit Inspection Unit (AIU) has set out what it considers necessary to complete a quality audit in its public report on audit inspections, published in 2005:

Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgments. ... A quality audit [also] involves appropriate and complete reporting by the

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<sup>89</sup> DeAngelo, L E (1981) 'Auditor size and audit quality', *Journal of Accounting and Economics*, 3(3): 93–199.

<sup>90</sup> Submission to the House of Lords Economic Affairs Committee: *Auditors: Market Concentration and their Role*, September 2010, paragraph 2.2:

[www.frc.org.uk/documents/pagemanager/frc/spotlight/Submission%20to%20HLEAC%20September%202010.pdf](http://www.frc.org.uk/documents/pagemanager/frc/spotlight/Submission%20to%20HLEAC%20September%202010.pdf).

auditors which enables the Audit Committee and the Board properly to discharge their responsibilities.<sup>91</sup>

- 4.4 Accordingly, it appears to match the two criteria proposed by De Angelo of investigation and reporting.
- 4.5 The FRC published an *Audit Quality Framework* in February 2008.<sup>92</sup> It aimed to assist companies in evaluating audit proposals, audit committees in undertaking annual assessments of the effectiveness of external audits, all stakeholders in evaluating the policies and actions taken by audit firms to ensure that high-quality audits are performed, and regulators when undertaking and reporting on the monitoring of the audit profession.
- 4.6 The Audit Quality Framework was intended to complement existing regulations and guidelines and listed the following drivers of audit quality:
- (a) the culture within an audit firm;
  - (b) the skills and personal qualities of audit partners and staff;
  - (c) the effectiveness of the audit process;
  - (d) the reliability and usefulness of audit reporting; and
  - (e) factors outside the control of auditors affecting audit quality. These relate to corporate governance, audit committees, shareholders, reporting deadlines, appropriate limitation of liability, and regulatory environment.
- 4.7 Following De Angelo's and the AIU's classification, the remainder of this section:
- (a) describes standards regarding audit investigation; and
  - (b) sets out the requirements of auditor independence.

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<sup>91</sup> Audit Inspection Unit, 2004/5 Audit quality inspections, Public report June 2005:

[www.frc.org.uk/images/uploaded/documents/Web%20optimized%20AIU%20Public%20Report%20200405.pdf](http://www.frc.org.uk/images/uploaded/documents/Web%20optimized%20AIU%20Public%20Report%20200405.pdf).

<sup>92</sup> [www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web1.pdf](http://www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web1.pdf).

## **Standards regarding audit investigation**

4.8 In order to reduce uncertainty regarding what amounts to a high-quality audit, the APB publishes International Standards on Auditing (UK and Ireland) (ISAs (UK and Ireland)) which deal with technical issues in an audit of financial statements (see further Section 5). There are over 30 ISAs under the following broad headings: respective responsibilities; audit planning; internal control; audit evidence; using work of other experts; audit conclusions and audit report; specialized areas. They provide detail on particular procedures. For example:

- (a) ISA 220 'Quality control for an audit of financial statements'<sup>93</sup> outlines the requirements including leadership responsibilities and documentation.
- (b) ISA 500 'Audit evidence'<sup>94</sup> outlines what is sufficient appropriate audit evidence, and selecting items for testing to obtain audit evidence.
- (c) ISA 600 'Special Considerations—Audits of group financial statements (including the work of component auditors)'<sup>95</sup> states that, with regard to group audits where the audit firm (carrying out the group audit) has to rely on the work of another audit firm (carrying out some of the component audits), the group audit firm is responsible for the group audit and should carry out sufficient work and obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

4.9 The APB also publishes Practice Notes which contain guidance on the application of certain ISAs (UK and the Republic of Ireland) to the audit of certain entities or situations (eg banks, building societies, complex financial instruments, charities etc). See further paragraph 5.14 and following.

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<sup>93</sup> [http://frc.org.uk/images/uploaded/documents/ISA%20\(UK%20and%20Ireland\)%20220%20\(Feb%202012\).pdf](http://frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20220%20(Feb%202012).pdf).

<sup>94</sup> [http://frc.org.uk/images/uploaded/documents/ISA%20\(UK%20and%20Ireland\)%20500%20\(Feb%202012\).pdf](http://frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20500%20(Feb%202012).pdf).

<sup>95</sup> [http://frc.org.uk/images/uploaded/documents/ISA%20\(UK%20and%20Ireland\)%20600%20\(Feb%202012\).pdf](http://frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20600%20(Feb%202012).pdf).

## ***Auditor 'independence'***

4.10 Regulation requires auditor 'independence' to ensure that auditors report objectively on their findings. This subsection covers:

(a) the APB and the UK framework for ensuring auditor independence.

It then considers the ethical standards surrounding auditor independence and examples of safeguards for specific circumstances, including:

(b) the rules on non-audit services that firms can provide for audit clients;

(c) the rules concerning the ownership of audit firms by qualified auditors;

(d) rules concerning personal independence (arising from financial interests such as loans or shareholdings or personal or business relationships); and

(e) rules on audit partner rotation.

### *The APB and the UK framework for ensuring auditor independence*

4.11 The UK framework for auditor independence is issued by the APB. There are five APB Ethical Standards in total concerned with the integrity, objectivity and independence of auditors. These standards apply to all audits of financial statements and there are additional provisions regarding audits of listed companies. The Standards contain requirements and guidance. They take a principles-based approach which involves examining if there are threats and (if found), putting in place safeguards to eliminate or reduce the threats to an acceptable level. This is described in more detail from paragraph 4.14.

4.12 'Ethical Standard 1: integrity, objectivity, and independence' (ES1)<sup>96</sup> describes the importance of integrity, objectivity and independence for an auditor; ways of complying with ethical standards (policies and procedures, leadership, ethics partner); identification and assessment of threats and safeguards; and engagement quality control review.

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<sup>96</sup> [www.frc.org.uk/images/uploaded/documents/ES%201%20revised%201210%20updated%201211.pdf](http://www.frc.org.uk/images/uploaded/documents/ES%201%20revised%201210%20updated%201211.pdf).

4.13 The ICAEW also provides regulations and guidance as to an auditor's obligations in its updated version of its Audit Regulations and Guidance (published December 2011; effective 1 January 2012).<sup>97</sup> Firms registered with the ICAEW must comply with the Audit Regulations and Guidance.

*Threats to independence*

4.14 ES1 sets out the principal types of threats to the auditor's objectivity and independence:

- (a) self-interest threat;
- (b) self-review threat;
- (c) management threat;
- (d) advocacy threat;
- (e) familiarity (or trust) threat; and
- (f) intimidation threat.

4.15 The ICAEW's Regulations and Guidance<sup>98</sup> list the following situations as some of those that might threaten firm's independence, as they have the potential to affect an auditor's obligations:

- (a) undue financial dependence on an audit client;
- (b) personal or family relationships;
- (c) beneficial or other interests in shares or other investments in an audit client;
- (d) beneficial interest in a trust that has investments in an audit client;
- (e) involvement as a trustee in an audit client;
- (f) loans to or from an audit client;
- (g) participation in the business affairs of an audit client; and
- (h) voting on audit appointments.

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<sup>97</sup> ICAEW Audit Regulations and Guidance, January 2012: [www.icaew.com/en/members/regulations-standards-and-guidance/audit/audit-regulations-and-guidance](http://www.icaew.com/en/members/regulations-standards-and-guidance/audit/audit-regulations-and-guidance).

<sup>98</sup> ICAEW Audit Regulations and Guidance, January 2012: [www.icaew.com/en/members/regulations-standards-and-guidance/audit/audit-regulations-and-guidance](http://www.icaew.com/en/members/regulations-standards-and-guidance/audit/audit-regulations-and-guidance).

### *Safeguards for independence*

- 4.16 If the audit engagement partner identifies threats to the auditor's objectivity, including any perceived loss of independence, the partner must identify and assess the effectiveness of safeguards in order to eliminate the threats or reduce them to an acceptable level. Where the audit engagement partner chooses to reduce rather than eliminate a threat to objectivity and independence, the partner must recognize that this judgement may not be shared by users of the financial statements and may be required to justify the decision (ES1).
- 4.17 In circumstances where it is not possible to eliminate the threats or reduce them to an acceptable level, the auditor must either not accept or withdraw from the audit engagement (ES1).
- 4.18 As set out in paragraph 4.10 (and following the notation there), the remainder of this section considers (b) the rules on non-audit services that firms can provide for audited entities, (c) the rules concerning the ownership of audit firms by qualified auditors, (d) rules concerning personal independence (arising from financial interests such as loans or shareholdings or personal or business relationships with clients), (e) rules on audit partner rotation.

### *Rules on non-audit services for audited entities*

- 4.19 Ethical Standard 5<sup>99</sup> (ES5) sets out requirements and guidance on specific circumstances arising from the provision of non-audit services by audit firms to entities audited by them. There are widespread restrictions but not a total ban on non-audit services.

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<sup>99</sup> APB Ethical Standard 5 (Revised): Non-Audit Services Provided to Audited Entities:  
<http://frc.org.uk/images/uploaded/documents/ES%205%20revised%201210%20updated%201211.pdf>.

4.20 ES5 distinguishes between ‘audit service’, ‘audit related service’ and ‘other non-audit service’. Audit-related service refers to work which is done on financial information and/or controls, which is integrated with the work performed during the audit and by the audit team, and on the same terms and conditions as the audit but is not done to enable the auditor to provide an audit opinion. Other non-audit service refers to any other service provided by the auditor to the audited entity. The list of audit-related services contained in ES5 is in [Annex A](#).

4.21 Any threats to auditor independence from audit-related services are considered to be insignificant under ES5, as the work involved is closely related to the work performed in the audit.

4.22 The threats from self-interest, self-review, management, and advocacy (of the threats listed in paragraph 4.14, these four are discussed in ES5) that may arise with regard to the provision of non-audit services, and the possible safeguards, are considered below.

*Self-interest threat*

4.23 According to ES5, the ‘self-interest threat’ addresses the situation where substantial fees for an audit firm are regularly generated from the provision of non-audit services and where the fees for non-audit services are greater than the annual audit fees. In this situation the audit partner must assess the possibility of a perceived loss of independence. Having made the assessment, the audit partner will either determine that the threats to independence are at an acceptable level, or reduce them to an acceptable level by putting in place acceptable safeguards (eg separate engagement teams), and inform the people charged with governance (presumably the audit committee, among others).

- 4.24 Under ES5, in the case of listed companies, where the non-audit fees are expected to be greater than the annual audit fees, the audit partner must provide details to the ethics partner of the audit firm and discuss the matter.
- 4.25 The situation is more complex in the case of contingent fees. An audit firm must not accept a non-audit service engagement on a contingent fee basis where: (a) the fee is material to the audit firm, or that part of the firm by reference to which the audit partner's profit share is calculated; or (b) the outcome of the service (and therefore the fee) is dependent on a future or contemporary audit judgement relating to a material matter in the financial statements of an audited entity (Ethical Standard 4: Fees, remuneration and evaluation policies, litigation, gifts and hospitality (ES4)).<sup>100</sup>

*Self-review threat*

- 4.26 According to ES5, a self-review threat exists where the results of a non-audit service performed by the audit firm are reflected in the accounts included or disclosed in the financial statements. A threat to objectivity or independence arises because, in the course of the audit, the auditor may need to re-evaluate the work it has performed in the non-audit service; the auditor is less likely to assess the work of its own staff objectively.
- 4.27 There are certain non-audit services discussed in ES5 which may never be carried out by the audit firm, for example:
- (a) an audit firm cannot carry out accounting services to an audited entity that is a listed company, or to an audited entity where those accounting services would involve the audit firm undertaking part of the role of the management; and
  - (b) an audit firm cannot undertake internal audit services to an audited entity where it is reasonably foreseeable that the auditor would place reliance on the internal

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<sup>100</sup> [www.frc.org.uk/images/uploaded/documents/ES%204%20revised%202010.pdf](http://www.frc.org.uk/images/uploaded/documents/ES%204%20revised%202010.pdf).

audit work performed by the audit firm, or that the audit firm would undertake part of the role of management.

*Management threat*

- 4.28 According to ES5, a management threat exists when the audit firm undertakes work that involves making judgements and taking decisions which are properly the responsibility of management. ES1 prohibits partners and employees of the audit firm from taking decisions on behalf of the management of the audited entity.
- 4.29 A threat to objectivity and independence arises if the auditor becomes closely aligned with the views and interests of management (which may erode the distinction between the audited entity and the audit firm) which in turn may impair the auditor's ability to apply a proper degree of professional scepticism.

*Advocacy threat*

- 4.30 According to ES5, an advocacy threat exists when the audit firm undertakes work which involves acting as an advocate for an audited entity and supporting a position taken by management in an adversarial context. This is because the auditor could become too closely aligned with the audited entity and it then may be difficult for the auditor to take an impartial view during the audit.

*Safeguards*

- 4.31 Under ES5, if a threat is identified and safeguards can be applied that would be effective to eliminate the threat or reduce it to an acceptable level, then the non-audit service may be provided. Where no safeguards are applied, the audit firm must not provide the non-audit service, or must withdraw from the audit engagement.

- 4.32 Safeguards may include separate teams; or review by the audit firm engagement quality control review partner determining that the audit judgements, if any, relating to the non-audit service are sufficient and that the conclusions of the audit team are appropriate.

*Rules concerning the ownership of audit firms by qualified auditors*

- 4.33 Schedule 10, Part 2, of the Act contains the rules governing ownership of audit firms which differ depending on whether the firm is a partnership or a 'body corporate'. These are also in the ICAEW Audit Regulations and Guidance.

- 4.34 The ownership, control and management rules set out below mean that it may currently be more difficult than otherwise for audit firms to access external capital to fund expansion.

*Ownership*

- 4.35 If the firm is a partnership, the partners must be chartered accountants or registered auditors.<sup>101</sup> If the firm is a body corporate, there are no restrictions on who may be a shareholder.

*Control*

- 4.36 If the firm is a partnership, and where the partners have equal voting rights, then at least a majority of the partners must be qualified individuals, registered auditors or combination of both. In any other case at least a majority of the voting rights must be held by qualified individuals, registered auditors or combination of both.

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<sup>101</sup> That is, a member of the ICAEW, ICAS and/or the ICAI, or a member of the ACCA.

4.37 If the firm is a body corporate, then (in contrast to the requirement for ownership (see paragraph 4.35)) the majority of shareholders' voting rights must be held by qualified individuals, registered auditors or combination of both.

#### *Management*

4.38 If the firm is a partnership, and where the policies are set and implemented by a management committee, board or other body, then at least a majority of the voting rights in that body must be held by qualified individuals, registered auditors or a combination of both.

4.39 If the firm is a body corporate, then at least the majority of voting rights in the board of directors, committee or other management body must be held by qualified individuals, registered auditors or a combination of both. In addition, each director must be a chartered accountant or registered auditor.<sup>102</sup>

#### *Conflicts of interest*

4.40 ES2 includes provisions on specific circumstances arising out of financial, business, employment and personal relationships in the audited entity. The general principle is that the auditor must make an assessment as to the threat to the auditor's objectivity and independence, and put in place safeguards where necessary. There are some situations where the threat is such that no safeguards can eliminate them to an acceptable level. ES4 includes provisions on fees, which are discussed from paragraph 4.54 onwards.

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<sup>102</sup> That is, a member of the ICAEW, ICAS and/or the ICAI, or a member of the ACCA.

### *Financial interests*

- 4.41 Financial interest is defined in the Ethical Standards<sup>103</sup> as an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such an interest.
- 4.42 The audit firm, any partner in the audit firm, a person in a position to influence the conduct and outcome of the audit or an immediate family member must not hold: any direct financial interest in the audited entity; any indirect financial interest where the investment is material to the audit firm or individual; or any indirect financial interest where the person holding it has both the ability to influence the investment decisions of the intermediary and actual knowledge of the existence of the underlying investment in the audited entity.
- 4.43 ES2 states that the threats to objectivity and independence are such that no safeguards can reduce them to an acceptable level. Disposals of the relevant financial interests must be made as soon as possible.
- 4.44 There are specific regulations on loans and guarantees. Audit firms, persons in a position to influence the conduct and outcome of the audit and immediate family members must not make a loan to, or guarantee the borrowings of, an audited entity unless this represents a deposit made with a bank or similar deposit-taking institution in the ordinary course of business. There are similar regulations relating to loans from an audited entity.
- 4.45 The guidance in ES2 states that loans by a bank or similar institution (for example, mortgage, overdraft, car loan) to a person in a position to influence the outcome of the audit do not create an unacceptable threat to objectivity and independence,

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<sup>103</sup> APB Ethical Standards Glossary of Terms: <http://frc.org.uk/images/uploaded/documents/Glossary%20ES%20revised%202010.pdf>.

unless the loans are in arrears by a significant amount, in which case this creates an intimidation threat which is unacceptable.

#### *Business relationships*

- 4.46 Unless in the ordinary course of business, audit firms, persons in a position to influence the conduct and outcome of the audit and immediate family members must not enter into a business relationship (meaning two parties having a common commercial interest) with the audited entity. Where a business relationship has been entered into that is not permitted, it must be terminated. Safeguards may need to be adopted until the relationship is terminated, for example a restriction on a member of staff working on the audit team.
- 4.47 Where a close family member to one of the influencers noted above enters into a business relationship with the audited entity, that individual must report the matter to the audit engagement partner and/or the ethics partner to take appropriate action.

#### *Employment relationships*

- 4.48 There are restrictions on who can undertake audit work. An audit firm cannot employ or admit to its partnership a person who is also employed by the audited entity.

#### *Staff loan assignments*

- 4.49 An audit firm must not agree to loan a member of staff to an audited entity unless (a) the agreement is for a short period of time and does not involve staff or partners performing non-audit services which are not permitted under ES5 (for example, accounting services) and (b) the audited entity agrees that the individual concerned will not hold a management position.

- 4.50 Where a partner or member of staff returns to the audit firm, that individual must not be given any role on the audit involving any function or activity that he or she performed during the assignment.

*Partners and team members joining an audited entity or audited entity joining audit firm*

- 4.51 Where a former partner in the audit firm joins an audited entity, the audit firm must take action to ensure that no significant connections remain between the firm and the individual (for example, all capital balances and financial interests settled). Where a partner leaves the audit firm and is appointed director or to a key management position within the audited entity, having acted as audit engagement partner or similar, the firm must resign as auditor, and cannot be reappointed for another two years. Where a former member of the audit team (other than partner) joins the audited entity, the audit team must consider whether the composition of the audit team is appropriate.
- 4.52 Where a former director or employee of the audited entity, who was in a position to exert significant influence over the preparation of the financial statements, joins the audit firm, that person must not be assigned to a position in which they are able to influence the conduct and outcome of the audit for two years.

*Family and personal relationships*

- 4.53 There are requirements for an audit firm to have policies and procedures in place to safeguard against the threat to objectivity or perceived loss of independence arising from family and personal relationships.

*Fees*

- 4.54 The audit engagement partner must ensure that audit fees are not influenced or determined by the provision of non-audit services to the audited entity.

- 4.55 An audit must not be undertaken on a contingent fee basis, and an audit firm must not undertake an engagement to provide non-audit services to an audit audited entity on a contingent fee basis where the contingent fee is: material to the firm; or where the outcome of the non-audit services (and therefore the amount of the fee) is dependent on a future or contemporary audit judgement relating to a material matter in the financial statements of the audited entity.
- 4.56 There are specific provisions where the total fees for both audit and non-audit fees receivable from a listed company by the audit firm will regularly exceed 10 per cent of the annual fee income of the audit firm (or 15 per cent for non-listed companies). The firm must not act as auditor and must either resign or not stand for reappointment, as appropriate. Where the proportion is between 5 and 10 per cent for a listed company (or between 10 and 15 per cent for non-listed companies), the audit engagement partner must consider appropriate safeguards to eliminate or reduce the threat to the auditor's objectivity and independence.

#### *Auditor rotation*

- 4.57 The requirement for audit partner rotation is in the APB's Ethical Standard 3 (revised) 'Long Association with the Audit Engagement' (ES3).<sup>104</sup>
- 4.58 There is a general provision that an audit firm should have policies and procedures to monitor the length of time that audit engagement partners and key partners and staff in senior positions (including those from other disciplines) work on the engagement team. Where they have a long association with the audit, the firm should assess the threats to objectivity and independence.

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<sup>104</sup> ES3: <http://frc.org.uk/images/uploaded/documents/Glossary%20ES%20revised%202010.pdf>.

- 4.59 There is no specific requirement for audit firms of non-listed companies to rotate an audit engagement partner, but there is guidance that after holding the role for a continuous period of ten years, careful consideration is given as to whether there is a loss of perceived objectivity and independence.
- 4.60 There are additional provisions related to the audits of listed companies:
- (a) No one shall act as an audit engagement partner for a particular company for more than five years, and anyone who has been audit engagement partner for a particular company should not participate in that audit engagement for another five years.
  - (b) No one shall act as the engagement quality control reviewer for a particular company for longer than seven years, and the audit engagement partner shall review the safeguards in place to address the threats to the auditor's objectivity and independence where partners and senior staff have been involved in the audit for more than seven years.

### ***Other issues relating to audit quality***

#### *Transparency reporting*

- 4.61 The FRC has stated that transparency reporting by major audit firms has a significant role to play in encouraging audit quality:<sup>105</sup>
- (a) by helping investors and potential buyers of audit services to understand the strengths of a particular audit firm. There are similarities to the workings of the the UK Corporate Governance Code (see paragraphs 6.8 to 6.11) in that relatively weak or inadequate disclosures by a firm can be seen as adding a risk factor to the use of that firm; and

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<sup>105</sup> <http://www.frc.org.uk/images/uploaded/documents/POB%20trans%20consdocument%20final.pdf>, Professional Oversight Board: *Transparency Reporting by Auditors of Public Interest Entities. A consultation document on the implementation of article 40 of the 8<sup>th</sup> Company Law Directive on the statutory audit of annual accounts*, July 2006.

(b) clear public information on the firm's processes and practices for quality control, for ensuring independence, for partner remuneration, on their governance and network arrangements provides a clear incentive to staff to deliver what the firm has said it would.

4.62 Until recently, most audit firms published very limited information about themselves. Most were structured as partnerships, with no statutory requirement for external reporting. Two factors changed this, at least for the largest firms:

(a) Following the Limited Liability Partnerships Act 2000, all the largest firms adopted the LLP form, which requires accounts and reports much as for a limited liability company.

(b) Following the Enron scandal, the Government concluded in January 2003 that there was a legitimate public interest in the public availability of information on those firms which audit public interest entities and 13 out of the 20 largest audit firms gave a voluntary undertaking to meet these proposals. Most major firms incorporated 'transparency' information as part of their annual report and accounts prepared as an LLP, although they did not identify specific information separately as a 'transparency report'.

4.63 In March 2009, the Consultancy Committee of Accountancy Bodies (CCAB) published a Voluntary Code of Practice on Disclosure of Audit Profitability, which applied in respect of accounting periods beginning on or after 6 April 2009. This was as a result of Recommendation 2 of the final report of the Market Participants Group established by the FRC in October 2006, which was published in October 2007. Recommendation 2 stated 'Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis'. The FRC invited the CCAB to develop guidance to audit firms on the voluntary disclosure of this information. The Code of Practice applied to any UK audit firm that is a 'major

firm' as determined by the POB (this includes all UK incorporated companies with listed securities, among others—see paragraph 5.36 onward).

- 4.64 The Statutory Audit Directive, agreed in 2006, introduced a mandatory requirement for annual transparency reporting by auditors of UK companies with securities admitted to trading on a UK regulated market. In the UK, this was given effect through the Statutory Auditors (Transparency) Instrument 2008, published by the POB following consultation, and applied to any relevant audit firm from 2008. Reports became mandatory in 2010.
- 4.65 Firms must disclose the following, within three months of the firm's financial year end:
- (a) description of the legal structure and ownership of the transparency reporting auditor;
  - (b) where the transparency reporting auditor belongs to a network, a description of the network and the legal and structural arrangements of the network;
  - (c) a description of the governance of the transparency reporting auditor;
  - (d) a description of the internal quality control system of the transparency reporting auditor and a statement by the administrative or management body on the effectiveness of its functioning;
  - (e) a statement of when the last monitoring of the performance by the transparency reporting auditor of statutory audit functions took place;
  - (f) a list of public interest entities in respect of which an audit report has been made by the transparency reporting auditor in the financial year of the auditor;
  - (g) a description of the transparency reporting auditor's independence procedures and practices including a confirmation that an internal review of independence practices has been conducted;
  - (h) a statement on the policies and practices of the transparency reporting auditor designed to ensure that persons eligible for appointment as a statutory auditor

continue to maintain their theoretical knowledge, professional skills and values at a sufficiently high level;

- (i) financial information for the financial year of the transparency reporting auditor to which the report relates, including showing the importance of the transparency reporting auditor's statutory audit work; and
- (j) information about the basis for remuneration of partners.

### *Confidentiality*

- 4.66 Conflicts of interest arising from having confidential information about a client's competitors are dealt with in the ICAEW Code of Ethics.<sup>106</sup> An auditor must respect the confidentiality of information acquired from one client and not disclose the information to another party unless there is a legal or professional right or duty to do so, or use the information for the personal advantage of the auditor or third parties.
- 4.67 Following the description of the applicable law and the regulation governing the quality of audits and independence of auditors, we turn to the institutions tasked with enforcing that regulation.

## **5. Regulatory bodies and mechanisms**

- 5.1 This section describes the institutional architecture that has been established to ensure the quality of audits and the appropriate conduct of auditors. In particular it:
- (a) briefly describes the history of the institutional framework, and then describes the current role, function and interaction of:
  - (b) the FRC;
  - (c) the professional accounting bodies, and their role as Recognised Qualifying Bodies (RQBs) and Recognised Supervisory Bodies (RSBs);
  - (d) the FSA;

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<sup>106</sup> <http://www.icaew.com/en/technical/ethics/icaew-code-of-ethics/icaew-code-of-ethics>.

- (e) international bodies and legislation; and
- (f) other relevant bodies.

### ***Brief history of the institutional framework***

- 5.2 The FRC was originally set up in the early 1990s as a private sector body tasked with promoting high-quality financial reporting. It consisted of two bodies, the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP), which respectively set UK accounting standards and reviewed listed companies' compliance with those standards.
- 5.3 Formed in 2000, the Accountancy Foundation provided independent and non-statutory oversight of the regulation of the six chartered accountancy bodies of the Consultative Committee of Accountancy Bodies (CCAB) (see paragraph 5.106 onwards). The Accountancy Foundation's remit extended to the way the professional bodies conducted their audit supervision role, although the statutory responsibility to ensure adequate technical and other standards for auditors was with the professional bodies. The Accountancy Foundation had four subsidiary bodies: the Review Board, the APB, the Ethics Standards Board, and the Investigation and Discipline Board.
- 5.4 Following the major auditing failures in the USA at Enron and WorldCom, the Government concluded in January 2003<sup>107</sup> that there should be a strengthening of the regulatory framework for corporate governance, auditing and financial reporting, and recommended that the FRC take on formal responsibilities for audit and accountancy regulation.
- 5.5 The Companies (Audit, Inspection and Community Enterprise) Act 2004 provided the legislative basis for the regulatory structure relating to audit. As a part of this, from

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<sup>107</sup> *Review of the Regulatory Regime of the Accountancy Profession* ('the Swift Review'): [www.bis.gov.uk/files/file20417.pdf](http://www.bis.gov.uk/files/file20417.pdf).

September 2005 the Government gave the FRC the responsibilities and powers to oversee and monitor the system of audit regulation that the Government had previously exercised directly.

- 5.6 More recently the Companies Act 2006 and the Statutory Auditors and Third Country Auditors Regulations 2007<sup>108</sup> made further changes to the statutory framework, in particular to give full effect in the UK to the requirements of the Statutory Audit Directive (2006/43/EC).

### ***The FRC***

- 5.7 The FRC is the UK's independent regulator responsible for promoting high-quality corporate governance and reporting to foster investment. It has statutory and non-statutory responsibilities. It is funded mainly by a levy from public companies and accountancy professional bodies, and a small amount from BIS and a levy from public sector organizations.<sup>109</sup>
- 5.8 The FRC board has 16 board members and is composed of the Chair, a non-executive Deputy Chair, the Chief Executive, seven non-executive directors and the Chairs of the FRC's six operating bodies.
- 5.9 The FRC's regulatory responsibilities in relation to audit and to the accountancy profession are exercised through its operating bodies. The FRC structure, shown in Figure 1, comprises a board managing seven individual operating bodies supported by the FRC's professional staff, namely:

(a) ASB;

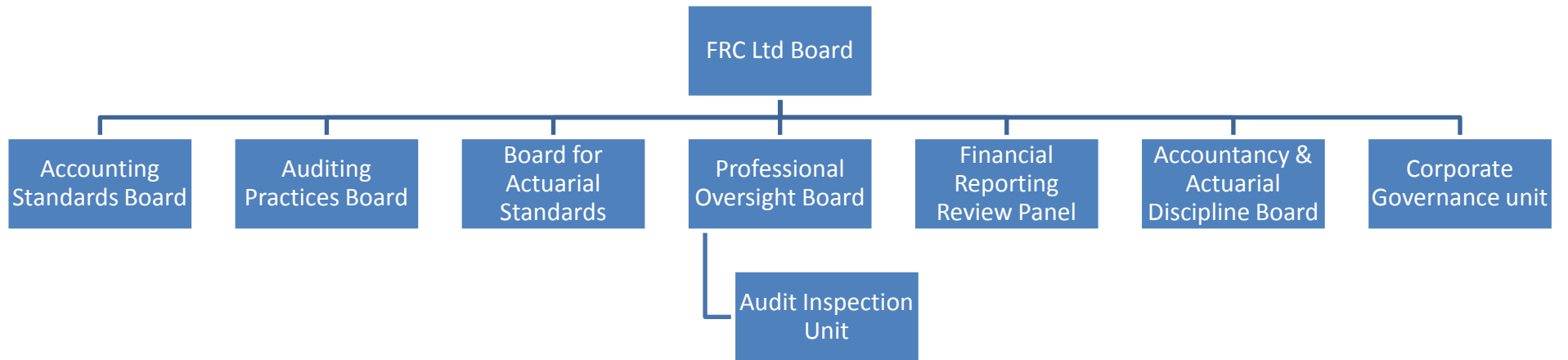
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<sup>108</sup> SI 2007 No 3494 [www.legislation.gov.uk/uksi/2007/3494/pdfs/uksi\\_20073494\\_en.pdf](http://www.legislation.gov.uk/uksi/2007/3494/pdfs/uksi_20073494_en.pdf).

<sup>109</sup> For 2011/12 the funding requirement is £12 million for accounting, auditing and corporate governance; audit inspection costs are £3 million (met by the RSBs with which the audit firms are registered); and accountancy disciplinary case costs are £4 million (met by the accountancy professional bodies to which the individuals or firms which are subject to each case belong within the terms of a formal case-costs agreement).

- (b) APB;
- (c) Board for Actuarial Standards (BAS);
- (d) Professional Oversight Board (POB), including the AIU;
- (e) FRRP;
- (f) Accounting and Actuarial Discipline Board (AADB); and
- (g) Corporate Governance Unit.

FIGURE 1  
FRC current structure



Source: FRC.

5.10 The four operating bodies directly relevant to this investigation are the APB, POB, AIU and AADB. They are discussed first. The contribution of two other operating bodies (ASB and FRRP) to the regulatory framework for audit is less important to our inquiry though still relevant. The Board for Actuarial Standards is not relevant to audit and is not discussed in this paper.

5.11 The functions and objectives of these six operating bodies are described below.

### **APB**

5.12 The APB was originally established in 1991 by the principal accountancy bodies. It was given greater independence from the professional bodies in April 2002 and became part of the reformed FRC in 2004. The APB's aims to set high-quality standards and guidance, both for what it terms 'assurance services' (ie 'external audit and other activities undertaken by accountants that result in reports or other output that is published, required by law or otherwise relied on in the operation of the financial markets') and for the independence, objectivity and integrity of external auditors and the providers of assurance services.<sup>110</sup>

5.13 To achieve these aims, the APB:

- (a) establishes auditing standards which set out the basic principles and essential procedures with which external auditors in the UK and Republic of Ireland are required to comply;
- (b) issues guidance on the application of auditing standards in particular circumstances and industries and on new and emerging issues;
- (c) establishes ethical standards in relation to independence, objectivity and integrity of external auditors and the providers of assurance services;

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<sup>110</sup> [www.frc.org.uk/apb/about/aims.cfm](http://www.frc.org.uk/apb/about/aims.cfm).

- (d) takes an appropriate role in the development of statutes, regulations and accounting standards which affect the conduct of auditing and assurance services, both domestically and internationally;
- (e) contributes to efforts to advance public understanding of the roles and responsibilities of external auditors and the providers of assurance services including the sponsorship of research; and
- (f) works with the International Auditing and Assurance Standards Board (IAASB) to encourage the development of high-quality International Standards on Auditing (ISAs) and their adoption in the UK.

5.14 This next section describes auditing standards to provide background to the APB's activities. Next, the APB's publications (including those relating to auditing standards) are described, followed by its structure, sanctions and interaction with other bodies.

#### *Auditing standards: ISAs and ISAs (UK and Ireland)*

5.15 Auditing standards are professional standards or requirements for the performance of an audit of financial statements. New standards were issued by the International Federation of Accountants (IFAC) through the IAASB (see paragraphs 5.102 onwards) and were adopted in the UK in October 2009 as ISAs (UK and Ireland), and apply to audits of financial statements for periods ending on or after 15 December 2010. Where necessary, the APB has augmented the international standards with a small number of additions to address specific UK and Irish legal and regulatory requirements.

5.16 As noted in paragraph 4.8, there are over 30 ISAs under the following broad headings: respective responsibilities (of the auditor and audit client); audit planning; internal control; audit evidence; using work of other experts; audit conclusions and audit report; and specialized areas.

## *Publications*

5.17 The APB publishes a variety of documents including mandatory standards and practice notes and bulletins which are guidance only. In relation to statutory audit, the APB has issued:

- (a) International Standards on Auditing (UK and Ireland).
- (b) International Standards on Quality Control (UK and Ireland). These are quality control standards.
- (c) The Auditors' Code. This is a framework of fundamental principles which encapsulate the concepts that govern the conduct of audits and underlie the APB's ethical and auditing standards.<sup>111</sup>
- (d) APB Ethical Standards for auditors, and ISAs (UK and Ireland). These contain the objectives and requirements in planning and performing every audit, and are engagement standards.<sup>112</sup>
- (e) Practice Notes and Bulletins. These are guidance, not requirements.

## *Structure of APB*

5.18 The APB comprises 15 members, of whom 40 per cent are individuals who are 'responsible individuals' (ie persons who are eligible for appointment as an auditor under the Act). The remaining 60 per cent are intended to have some degree of independence. These individuals must be accountants but must not be office holders of any accountancy body, nor involved in the governance of any accountancy body, nor partners of auditing firms. There are also three non-voting observers.

5.19 The APB has a number of sub-committees in order to assist the APB in considering particular perspectives on auditing practice, including an SME Audit Sub-committee and a Client Assets Sub-committee.

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<sup>111</sup> The Auditor's Code has the following headings: accountability; integrity; objectivity and independence; competence; rigour; judgement; clear, complete and effective communication; association; and providing value.

<sup>112</sup> The APB's Ethical Standards are described in great detail in Audit 43 'Audit Quality Regulation'.

5.20 The APB also has a technical advisory group (TAG) which is a group of audit practitioners which is charged with reviewing draft APB documents for technical accuracy and practicality prior to submission to the APB for approval, and to comment more generally on the APB's work programme and to highlight issues where standards and/or guidance are required. Any audit firm can nominate a member of TAG, so in theory each firm could nominate its own member.

### *Sanctions*

5.21 The APB itself does not have any powers to discipline auditors. Apparent failures by auditors to comply with APB standards may be investigated by the relevant accountancy body. Auditors who do not comply with auditing standards when performing audits make themselves liable to regulatory action which may include the withdrawal of registration and hence of eligibility to perform audits.

### *Interaction with other bodies*

#### *International*

5.22 The APB's 2009/10 published report describes the increasing demand for auditing standards to be set on an international basis, and it states that it has spent a good deal of its time in influencing the work of the IAASB and the International Ethics Board for Accountants (IESBA) (see paragraph 5.102 onwards).

#### *RSBs*

5.23 Each RSB is required to have technical arrangements in place for the effective monitoring and enforcement of the standards, through their rules and practices. Under section 1212 of the Act, a person must be registered with an RSB in order to be eligible for appointment as an auditor, so compliance with these standards is important.

5.24 RSBs are discussed from paragraph 5.83 onwards.

### ***Professional Oversight Board***

5.25 The Professional Oversight Board (POB) was set up in 2004 as part of the reformed FRC to provide independent statutory oversight over the regulation of auditors by recognized professional bodies. This marked a shift from what had been essentially self-regulation to a mixed system, in which both the POB and the professional bodies have major responsibilities. The POB has a maximum of 13 members.

5.26 The POB provides independent oversight of the regulation of the auditing, accountancy and actuarial<sup>113</sup> professions by the relevant recognized professional bodies. It monitors the quality of audit through the AIU, and also has independent supervision of the Auditor General (head of the National Audit Office (NAO)) in respect of the NAO's function as statutory auditors.

5.27 The POB has statutory powers delegated to it by the Government under the Companies Act 2006 for the recognition, supervision and de-recognition of the professional accountancy bodies responsible for supervising the work of auditors or offering an audit qualification (the RSBs and RQB's respectively—see paragraph 5.83 onwards).

5.28 It also has non-statutory powers in its oversight of the accountancy profession, based on an agreement with the members of the six chartered accountancy bodies reached in 2004.<sup>114</sup>

5.29 To achieve its aims:

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<sup>113</sup> The regulation of the actuarial profession by the POB is not relevant to this investigation so is not discussed further.

<sup>114</sup> The POB published the ninth edition of *Key Facts and Trends in the Accounting Profession* in June 2011. This brings together in one place a range of information from the major audit firms and seven accountancy bodies including those who can register and supervise audit firms.

(a) In relation to audit, the POB authorizes professional accountancy bodies to act as supervisory bodies and/or to offer a recognized professional qualification. As part of this activity, the POB assesses whether the recognized supervisory and qualifying bodies comply with all the statutory requirements for recognition set out in the Act and whether the RSBs comply with the independent standard setting, monitoring and disciplinary arrangements which the legislation provides for. It also reviews the transparency reports made by each audit firm which audits public interest entities (see paragraph 5.36).

(b) In relation to accountancy, it reviews the regulatory activities of the professional accountancy bodies in relation to their members, including: education; training; continuing professional development; standards; ethical matters (except those which are the responsibility of the APB); professional conduct and discipline; registration and monitoring, including making recommendations on how these activities might be improved; and producing ad-hoc reports (although it does not appear to have published any since 2008).

### *Interaction with other bodies*

#### *RSBs and RQBs*

5.30 RSBs and RQBs are discussed from paragraph 5.83 onwards. The POB's oversight of the regulatory activities of the RSBs is carried out in three ways, by:

- (a) documenting and understanding each body's regulatory system including information on how it complies with relevant legislation;
- (b) annual compliance testing of the operation of each body's regulatory systems;  
and
- (c) periodic evaluation of the effectiveness of a specific aspect of the regulatory system, ie complaints and discipline procedures, audit monitoring visits, audit registration procedures etc.

### *Interaction with the US Public Company Accounting Oversight Board*

- 5.31 The Public Company Accounting Oversight Board (PCAOB) and the POB signed an agreement in January 2011 recognizing the need to cooperate and share information in matters relating to the oversight of auditors subject to the regulatory jurisdictions of both the PCAOB and the POB, including joint inspections.<sup>115</sup>

### *Sanctions*

- 5.32 The POB has stated that its powers of enforcement, where a body fails to meet its statutory obligations, are limited:

We can seek a High Court order requiring an RQB or RSB to take specific steps to secure compliance, where there has been a failure to meet a statutory obligation.

We can revoke the recognition of an RSB or RQB, following due process, where it appears to us that a body has failed to meet an obligation under the Act.

Both powers are essentially nuclear options, and therefore suitable only for the most serious of failures. We consider that there is a case for more proportionate powers to enable us to exercise our oversight more effectively and the FRC is considering with the Department for Business, Innovation and Skills how this could be achieved.<sup>116</sup>

### *AIU*

- 5.33 The AIU is part of the POB. It examines a sample of audits of listed companies and other major public interest entities as part of a rolling inspection programme. The overall objective of its work is to monitor and promote improvements in the quality of auditing.

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<sup>115</sup> [www.frc.org.uk/images/uploaded/documents/PCAOB-POB%20Statement%20of%20Protocol%20FINAL1.pdf](http://www.frc.org.uk/images/uploaded/documents/PCAOB-POB%20Statement%20of%20Protocol%20FINAL1.pdf).

<sup>116</sup> *Professional Oversight Board's Report to the Secretary of State for Business, Innovation and Skills*, year to 31 March 2011, published 21 July 2011.

5.34 The AIU was set up in 2004 following the Government's "post Enron" review which recommended enhancing the monitoring of the audits of listed and other major public interest entities through a new independent inspection unit reporting to a professional oversight board within an independent regulator.

#### *Scope and coverage*

5.35 The scope of the AIU's work covers the audits of all UK incorporated companies 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'. The AIU reviews both the firm-wide procedures of the major audit firms and a sample of individual audit engagements.

5.36 The POB is responsible for determining which audited entities fall within the 'major public interest' category and therefore within the remit of the AIU. The POB published a list of such entities in March 2011 for the 2011/12 inspections. In addition to all UK incorporated companies with listed securities, the main categories are AIM quoted companies with a market capitalization in excess of £50 million, UK unquoted companies with group turnover in excess of £500 million, and UK banks and building societies not captured in the above categories.

5.37 Firms other than the four largest audit firms undertaking a significant number of audits (deemed to be more than ten) are within the scope of the AIU as 'Other Major Firms' (of which there are currently six: BDO, Baker Tilly, Crowe Clark Whitehill, Grant Thornton, Mazars, and PKF). The four largest audit firms, together with the Other Major Firms, are subject to full scope AIU inspections including a review of their firm-wide procedures. For all other firms which have one or more audits falling within the AIU's scope ('Smaller Firms') the AIU's work focuses on the review of one or more of these audits. The firm-wide procedures of Smaller Firms are reviewed by

the monitoring unit of the professional body with which the firm is registered. The AIU inspects around 100 audits annually.

5.38 In order to ensure that the principal focus of independent inspection is on those audit firms and individual audits where the level of public interest is highest, while the four largest firms are inspected on an annual basis, the Other Major Firms are now subject to an inspection in which the work is phased over a period of approximately two years. The scope and frequency of inspections of Smaller Firms is more restricted, and takes into account the inspection work undertaken at those firms by the monitoring units of the professional bodies.

5.39 The audit registration committees of the professional accounting bodies receive formal reports from the AIU on its monitoring work, with the POB overseeing the action taken by them in response to the AIU's recommendations.

5.40 The monitoring units of the professional bodies are responsible for the monitoring of other audits within the scope of audit regulation in the UK (but outside the scope of independent inspection by the AIU) and are also responsible for the registration of firms to conduct audit work.

#### *Monitoring approach*

5.41 The AIU monitors compliance with what is essentially the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's APB and other requirements under the audit regulations issued by the relevant professional accounting bodies.

5.42 As such, the AIU's approach is intended to be challenging for the firms.<sup>117</sup> Reviews of individual engagements and the firm's policies and procedures cover the firm's compliance with the requirements of relevant standards and other aspects of the regulatory framework. Reviews of individual engagements place emphasis on the appropriateness of key audit judgements made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained.<sup>118</sup>

5.43 The AIU's approach focuses on audit judgements as well as on processes, and is based on the following characteristics:

- (a) focus on the quality of auditing: each year the AIU selects areas of particular focus. For 2010/11 these were limited to: the fair value measurement of assets and liabilities; the impairment of assets; revenue recognition and fraud risks; segmental reporting; and the evaluation of going concern;
- (b) thorough, robust and challenging approach to inspection visits;
- (c) wide-ranging views of firm-wide procedures, including an assessment of how the culture within firms impacts on audit quality: for example, 'tone at the top' and international communications; independence and ethics; and client risk assessment and acceptance/continuance;
- (d) risk-based selection of individual audits for review, using a risk model covering listed and AIM listed entities;
- (e) in-depth reviews of individual audits, addressing identified areas of risk and including critical assessment of key audit judgements made in reaching the audit opinion; and
- (f) an assessment of the quality of communications with the Audit Committee.<sup>119</sup>

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<sup>117</sup> [www.frc.org.uk/images/uploaded/documents/AIU%20Annual%20Report%202010-11.pdf](http://www.frc.org.uk/images/uploaded/documents/AIU%20Annual%20Report%202010-11.pdf). Audit Inspection Unit Annual Report 2010/11, July 2011.

<sup>118</sup> <http://frc.org.uk/pob/audit/>.

<sup>119</sup> <http://frc.org.uk/pob/audit/>.

## *Reporting*

5.44 The AIU produces various different reports, both private and public.

### *Private reports*

- *Reports to the professional accounting bodies*

5.45 For issues arising from the review of individual audit engagements, and those arising from the review of audit firm-wide procedures, the AIU produces a formal private report to the Audit Registration Committee (ARC) of the professional accounting body with which the audit firm is registered (the ICAEW in the case of the Big Four firms, and the ICAEW or the ICAS for the Other Major Firms). The AIU discusses these reports at senior level within the audit firms before they are finalized. The ARC considers whether audit registration should be continued for the audit firm following each inspection undertaken.

- *Reports to the audit firms*

5.46 The AIU produces confidential reports on individual audit engagements reviewed by the AIU which are sent to the relevant audit firms, addressed to the relevant audit engagement partner or director. The FRC has stated that the audit firms are expected to provide copies of these reports to the directors of the audit clients concerned.

5.47 The AIU categorizes issues arising from its review into: assessing and responding to risk; audit evidence and related judgements; quality control and independence; communicating with the Audit Committee/board; and audit finalization.

### *Public reports*

- 5.48 The AIU publishes individual reports on the inspections of Major Firms and an overall report on the inspections of Smaller Firms, as well as an annual report with an overview of activities.
- 5.49 In the individual report for each major firm and the overall report for the smaller firms, the AIU bands each audit into one of three categories considering a variety of factors:<sup>120</sup>
- (a) good with limited improvements required;
  - (b) acceptable but with improvements required; and
  - (c) significant improvements required.
- 5.50 ‘Requiring significant improvement’ means ‘the AIU had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of audit judgements in one or more key audit area, or the implications of concerns relating to other areas are considered to be individually or collectively significant’. The AIU notes that this type of assessment does not necessarily imply that an inappropriate audit opinion was issued. Out of a total of 55 audits reviewed by the AIU in relation to the four largest firms in 2010/11, five were deemed to require significant improvement.<sup>121</sup> There were 27 audits reviews undertaken by the AIU in relation to the mid-tier firms and smaller firms between 2009 and 2011 and seven were deemed to require significant improvement.<sup>122</sup>
- 5.51 The AIU has stated<sup>123</sup> that the purpose of the review is to identify areas where improvements are needed to safeguard audit quality and/or to comply with regulatory

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<sup>120</sup> Sufficiency of audit evidence; Quality of audit evidence; Appropriateness or otherwise of audit judgements; Evidencing of thought processes underlying audit judgements; Existence and extent of concerns in other areas.

<sup>121</sup> Deloitte: 1 out of 13; EY: 1 out of 13; KPMG: 2 out of 14; PwC: 1 out of 15.

<sup>122</sup> BDO: 1 out of 8; Grant Thornton: 2 out of 10; smaller firms: 4 out of 9.

<sup>123</sup> AIU Annual Report 2010-2011, published 19 July 2011:

[www.frc.org.uk/images/uploaded/documents/AIU%20Annual%20Report%202010-11.pdf](http://www.frc.org.uk/images/uploaded/documents/AIU%20Annual%20Report%202010-11.pdf).

requirements and, following this, to agree an action plan with the firm designed to achieve those improvements, for example amendments to the firm's procedures. Accordingly, the reports place greater emphasis on the weaknesses found rather than areas of strength: it is not a balanced scorecard approach. The reports also assess the extent to which the firm has addressed findings from the last AIU inspection.

- 5.52 The AIU may also make recommendations to the recognized supervisory bodies for appropriate regulatory action; and where appropriate refer matters to the AADB and the FRRP.

### **AADB**

- 5.53 The AADB's aim is to investigate the conduct of members or member firms of the professional accountancy bodies to determine whether or not there has been any misconduct by an accountant or accountancy firm (the Accountancy Scheme). This could involve non-audit work as well as audit or actuarial work done by an accountant or accountancy firm. It also takes disciplinary action in public interest cases (matters which raise or appear to raise important issues affecting the public interest). Misconduct means any act which falls short of the standards reasonably expected of a member or member firm.<sup>124</sup> The AADB has 11 members.

- 5.54 In the first instance, complaints about accountants or accountancy firms may be made to the accountancy body of which the accountant or the firm is a member. Matters which raise serious issues affecting the public interest will be referred to the AADB by the accountants' professional bodies. The AADB will then decide whether to investigate the matter. If it decides that a matter should be investigated, it will be referred to the Executive Counsel (who is an individual lawyer).

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<sup>124</sup> <http://frc.org.uk/aadb/about/>.

- 5.55 The AADB may also decide of its own accord to investigate a matter without it having been referred to it by one of the accountants' professional bodies.
- 5.56 The Executive Counsel will conduct an investigation and decide whether or not any accountant or accountancy firm or actuary should be subject to disciplinary proceedings. In making this decision, the Executive Counsel acts independently. The Executive Counsel has wide information-gathering powers to require the accountancy bodies, firms and accountants to provide information and documents, and give evidence to a tribunal.
- 5.57 If disciplinary proceedings are to be commenced, the Executive Counsel will file a complaint with the AADB and the Convenor for the AADB will appoint an independent disciplinary tribunal to hear the case, which normally sits in public.
- 5.58 If the tribunal upholds a complaint, it can impose a wide range of sanctions including an unlimited fine, exclusion from membership of a professional body covered by one of the schemes and withdrawal of practising certificates or licences. It can also order the accountant or accountancy firm to pay all or part of the costs of the investigation and the hearing.<sup>125</sup>
- 5.59 If the tribunal dismisses a complaint, it can order the AADB to pay legal costs. The tribunal does not have the power to order compensation to be paid.

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<sup>125</sup> Two recent examples: (a) an AADB hearing in March 2010 held that the former financial controller (a member of the ICAEW) of iSoft plc was excluded as a member of the ICAEW for at least eight years and ordered to pay costs of £250,000 to the AADB, after accepting that he had provided false and misleading information to iSoft plc's former auditors in relation to a contract; and (b) an AADB hearing in January 2012 held that PwC, as auditor to JP Morgan Securities Limited, was severely reprimanded by the AADB and fined a record amount of £1.4 million as well as the AADB's costs in investigating and prosecuting the case. The AADB complaint was in relation to PwC's role in reporting to the FSA on its client's compliance with the FSA's Client Money Rules which govern the segregation and protection of client money.

5.60 The AADB is currently investigating 18 cases, dating back to 2005 in the case of the MG Rover/Deloitte case.<sup>126</sup> The three most recent cases involve Healthcare Locums plc (audited by BDO), Aero Inventory plc (audited by Deloitte) and Connaught plc (audited by PwC). The scope of each of these investigations relates to the overall preparation, approval and audit of the financial statements for various years. In some (less recent) cases the scope of the investigation was limited to particular audit matters, for example commissions paid, revenue recognition, or goodwill, or work done supporting reports to the FSA on compliance with client assets.

### **ASB**

5.61 The aim of the ASB is to establish and improve standards of financial accounting and reporting. It took over the task of setting accounting standards from the Accounting Standards Committee (ASC) in 1990. It develops principles to establish standards and provides a framework within which others can exercise judgement in resolving accounting issues. It issues new accounting standards,<sup>127</sup> amends existing ones in response to evolving business practices, new economic developments and deficiencies identified in current practice, and addresses urgent issues through the Urgent Issues Task Force (UITF).<sup>128</sup>

5.62 Membership of the ASB is limited to a maximum of 11, of whom two (the Chairman and the Technical Director) are full-time members and the remainder are part-time members.

5.63 UK listed companies now have to follow international financial reporting standards, which are published by the International Accounting Standards Board (IASB), which

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<sup>126</sup> MG Rover went into administration in 2005, and subsequent investigations criticized the five executives who oversaw the company's collapse, four of whom were disqualified from serving as company directors. In February 2012 the AADB announced that it was going to review Deloitte's conduct as auditors and advisers to various companies in the MG Rover Group sale. Both the AADB and Deloitte confirmed that the inquiry was into the 'transactions' overseen by Deloitte, not the audit work.

<sup>127</sup> Not to be confused with International Standards on Auditing (ISAs).

<sup>128</sup> <http://frc.org.uk/asb/about/>.

now appears to have a greater role than the ASB, although the ASB also collaborates with accounting standard-setters from other countries and the IASB both in order to influence the development of international standards and in order to ensure that its standards are developed with due regard to international developments.

### *Accounting standards*

5.64 In order for financial statements to aid comprehension and allow comparability for users who rely on them for investment and other decision-making purposes, there must be effectiveness and consistency in the way items are treated in financial statements. Without such treatment, it would be impossible to use them to compare business performance. The prescribed approaches designed to provide effective and consistent treatment are called 'accounting standards', and apply to all companies and other kinds of entities which prepare accounts that are intended to give a true and fair view. These set out:

- (a) the accounting treatments permissible for any individual event or transaction; and
- (b) disclosure requirements: these state the permissible layouts (called formats) for the balance sheet and profit and loss account items, and the level of detail required.

### *International Financial Reporting Standards*

5.65 There are a variety of accounting standards in current use. For the purpose of this inquiry, International Financial Reporting Standards (IFRS) (previously called International Accounting Standards) are the most significant accounting standards. These are set by the International Accounting Standards Board, and have been compulsory for listed companies in the EU since 2005. IFRS have largely been adopted into UK Financial Reporting Standards. Some FRS, such as the three on financial instruments, copy the IFRS/ISAs directly, but FRS and IFRS are still separate standards. There is a transitional period. Accounting standards developed

by the ASB are contained in FRS. Early versions of FRSs are for public consultation and are called Financial Reporting Exposure Drafts (FREDs).<sup>129</sup> Soon after it started its activities, the ASB adopted the standards previously issued by the ASC (the 'Statements of Standard Accounting Practice' (or SSAPs)), so that they also fall within the legal definition of accounting standards. Whilst some of the SSAPs have been superseded by FRSs, some remain in force. Rules for compliance are also embodied in Urgent Issues Task Force Statements (UITFSs).

### *SORPs*

- 5.66 Statements of Recommended Practice (SORPs) are recommendations on accounting practices for specialized industries or sectors. They supplement accounting standards. They are not issued by the ASB but by industry or sectoral bodies recognized for the purpose by the ASB.<sup>130</sup> A SORP should aim to reduce areas of difference of accounting treatments within the industry or sector by recommending a preferred accounting treatment. As such, they are not standards but recommendations.

### *Urgent Issues Task Force*

- 5.67 The ASB has a number of committees to assist it in carrying out its functions, including the Urgent Issues Task Force (UITF). The main role of the UITF is to assist the ASB in areas where an accounting standard or provision of the Act exists, but where unsatisfactory or conflicting interpretations have developed or seem likely to develop. Its consensus pronouncements are issued as UITF Abstracts, which the ASB expects be regarded as accepted practice in the area in question, and part of the corpus of practices forming the basis for what determines a true and fair view.

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<sup>129</sup> The ASB published FREDs 46 to 48 on 30 January 2012 for public consultation into the future of financial reporting and a fundamental overhaul of UK and ROI financial reporting standards. These proposals recommend replacing all FRSs, SSAPs and UITFs with a single FRS, introducing a reduced disclosure framework for certain entities, and changing the financial reporting requirements for smaller entities.

<sup>130</sup> The British Bankers' Association, the Finance and Leasing Association, the Oil Industry Accounting Committee, the Pensions Research Accountants Group and the Charity Commission are examples of industry or sectoral bodies recognized by the ASB to issue SORPs.

Consequently a UITF Abstract may be taken into consideration by the FRRP in deciding whether a company's financial statements call for review.

## ***FRRP***

5.68 The FRRP was set up in 1990 as part of the FRC. The FRRP aims to ensure that the provision of financial information by public and large private companies complies with relevant accounting requirements, namely the requirements of the Act and applicable accounting standards. Since April 2006, the FRRP also reviews directors' reports.<sup>131</sup> As such, it does not have a direct impact on audit firms but as it deals with company management it has an impact on how it prepares its accounts. The FRRP has 44 members.

5.69 As set out above, directors prepare accounts and auditors audit and report on them. The FRRP does not duplicate this process, rather it aims to ensure that financial information is presented in a fair, balanced and comprehensive manner as required by the Act. Directors are responsible for the accuracy of the accounts and for their judgements. It is the role of the FRRP to enquire into cases where it appears that the rules have not been followed: 'where it appears to the Panel [FRRP] that there is, or may be, a question whether accounts comply with the requirements of this Act'.<sup>132</sup>

### *Scope and powers*

5.70 The FRRP can enquire into the accounts of public and large private companies: public limited companies (PLCs) (except PLCs that are subsidiaries in a small or medium-sized group), companies within a group headed by a PLC, and any company

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<sup>131</sup> This therefore includes both interim and final accounts, but not press releases, trading statements etc.

<sup>132</sup> Companies Act: Chapter 4 'annual accounts'.

not qualifying as small or medium-sized<sup>133</sup> or any company within a group which does not qualify as small or medium-sized.<sup>134</sup>

- 5.71 The FRRP does not offer advice on the application of accounting standards or the accounting requirements of the Act.
- 5.72 The FRRP's powers are restricted to seeking the correction of defective accounts. Likely outcomes include the FRRP issuing a press notice setting out its conclusions in a case, the reasons for those conclusions, and the corrective action that has been agreed with the company. In other cases, the FRRP may accept corrective action by a company without the issue of a press notice. Where appropriate, the FRRP can refer its findings to other relevant bodies, such as the FSA, the AADB or a professional institute.

### *Monitoring*

- 5.73 The FRRP develops and operates a programme of review of annual accounts based on risk assessment, and selects accounts for review in a number of ways. Each year priority sectors are announced. In December 2011, the panel announced that commercial property, retail and support services would be sectors of focus for 2012/13. The areas of focus for 2011/12 were commercial property, insurance, support services and travel. In all cases the selection is based on the FRRP's assessment of the risk of non-compliance and the risk of significant consequences if there is non-compliance. The FRRP:
- (a) discusses with the FSA and the FRRP's Standing Advisory Group which sectors of the economy are under strain or likely to give rise to difficult accounting issues;
  - (b) chooses a number of sectors and reviews a selection of accounts in each;

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<sup>133</sup> As defined by section 382 of the Act.

<sup>134</sup> As defined by section 466 of the Act.

- (c) has developed its own risk model to identify cases where accounting problems are more likely, eg cases of poor corporate governance;
- (d) looks at specific topical accounting issues; and
- (e) responds to complaints from the public, the press and the City.

5.74 Where there may be a case to answer, the FRRP appoints a group to conduct the inquiry. The group puts its concerns to the directors in correspondence and at meetings. The FRRP encourages directors to consult their auditors, to involve their audit committee and to take any other advice they may need. The process is informal but is intended to combine efficiency with fairness. The process needs to be quick, as defective accounts could mislead the public. The group aims to reach agreement with the directors of the company by persuasion. If the group is satisfied by the company's explanations, the case is closed and the fact that an enquiry was made remains confidential. Where the directors agree to take remedial action the FRRP issues a press notice, but does not comment on or discuss its conclusions further.

5.75 The FRRP can ask directors to explain apparent departures from the requirements. If the FRRP is not satisfied by the directors' explanations it aims to persuade the directors to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their accounts and replace them with revised accounts that correct the matters in error. Depending on the circumstances, the FRRP may accept another form of remedial action, for example correction of the comparative figures in the next set of annual financial statements.<sup>135</sup> Failing voluntary correction, the FRRP can exercise its powers to secure the necessary revision of the accounts through a court order.<sup>136</sup> The FRRP maintains a legal costs fund of £2 million for this purpose.

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<sup>135</sup> A recent case involved Rio Tinto Plc—the FRRP issued a press release on 15 March 2011 into the consideration of the contents of its 2009 accounts, around whether some of the company's operations referred to in the 2008 business review ought to have been included in the 2009 review in order to comply with the Act's requirement for a balanced analysis. Following discussion with the directors, Rio Tinto published its 2010 report and accounts and included more information about environmental matters, social and community issues and related reputational risk.

<sup>136</sup> To date the FRRP has succeeded in resolving all cases brought to its attention without having to apply for a court order.

Also, if the case concerns accounts issued under the UK Listing Rules, the FRRP may report to the FSA.

### *Interaction with other bodies*

5.76 Under the Act, the FRRP is entitled to share information with other bodies which would otherwise be confidential, including the Secretary of State for Business, Enterprise and Regulatory Reform, the Treasury, the Bank of England, FSA and HMRC.

### *Other issues relating to the FRC*

#### *FRC and choice: Market Participants' Group*

5.77 The FRC created the Market Participants' Group (MPG) in October 2006 in order to provide advice to the FRC on possible actions that market participants (ie companies, investors and audit firms) would take to mitigate the risks arising from the characteristics of the market for audit services to public interest entities in the UK. The MPG issued 15 recommendations in October 2007, intended to allow the audit market to work more efficiently and, in the medium to long term, to increase audit choice in the UK.<sup>137</sup> Among these were recommendations (which are listed in full in [Annex A](#)) that audit committees explain their choice of auditor; that shareholders take a greater interest in audit selection; and that the FRC promote understanding of audit quality. It was hoped that greater transparency and shareholder engagement would lead to more choice in the audit market.

5.78 Since publication of the recommendations, the FRC has made five progress reports (the last was in June 2010) on the implementation of the recommendations. The fourth progress report explained that the majority of the MPG recommendations had been implemented and that the FRC's role was now to monitor the effectiveness of

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<sup>137</sup> Final report of Audit Choice Market Participants Group published: [www.frc.org.uk/press/pub1420.html](http://www.frc.org.uk/press/pub1420.html).

that implementation. However, by the time of the fifth progress report, although 14 of the 15 implementations had been implemented, the FRC found limited evidence that the recommendations had had a significant impact on market concentration and the risks arising from that concentration. Many of the recommendations were guidance only and could not be enforced: for example, more than half of listed companies surveyed by the FRC ignored guidance that audit committees should provide information on frequency of audit tenders and on tenure of incumbent auditor.<sup>138</sup>

### *Reform*

- 5.79 The FRC published a consultation document in October 2011<sup>139</sup> on the reform of the FRC which was aimed at cementing the FRC's independence, increasing effectiveness and focusing its activities on capital markets.
- 5.80 The consultation proposed reinforcing the FRC's independence by providing it with:
- (a) the power to require an RSB to impose sanctions on an audit firm and/or individual auditor in respect of poor quality work; and
  - (b) the ability to make its own rules for disciplinary arrangements in relation to accountants, without needing to obtain the agreement of the accountancy professional bodies.
- 5.81 The consultation also proposed replacing the FRC's existing seven operating bodies with two board committees—one focusing on Codes and Standards, the other on Conduct.

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<sup>138</sup> [www.frc.org.uk/images/uploaded/documents/Choice%20in%20the%20UK%20Audit%20Market%20Fifth%20Progress%20Report.pdf](http://www.frc.org.uk/images/uploaded/documents/Choice%20in%20the%20UK%20Audit%20Market%20Fifth%20Progress%20Report.pdf).

<sup>139</sup> [www.frc.org.uk/press/pub2653.html](http://www.frc.org.uk/press/pub2653.html).

5.82 Although the legal changes to the FRC's powers do not come into force until July 2012, the FRC Reform project has already undergone a 'soft launch' and in many respects the new structure is already in place.

### ***The Professional Accounting Bodies***

5.83 Accountancy as such is not subject to statutory regulation in the UK and there are a large number of private bodies that represent and regulate groups of accountants. Of these the best known are the six bodies which have a Royal Charter:

- (a) Association of Chartered Certified Accountants (ACCA);
- (b) the Chartered Institute of Management Accountants (CIMA);
- (c) the Chartered Institute of Public Finance and Accountability (CIPFA);<sup>140</sup>
- (d) the Institute of Chartered Accountants in England and Wales (ICAEW);
- (e) the Institute of Chartered Accountants in Ireland (CAI); and
- (f) the Institute of Chartered Accountants of Scotland (ICAS).

5.84 As at 31 December 2010 there were just over 300,000 members across these bodies in the UK and the Republic of Ireland, with nearly half (115,000) being members of the ICAEW.

5.85 Audit firms who wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, an RSB. Individuals responsible for audit at registered firms must hold an audit qualification from an RQB.<sup>141</sup>

5.86 RQBs and RSBs are recognised by and monitored subject to oversight by the POB (see paragraph 5.30 above).

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<sup>140</sup> There are very few CIPFA and CIMA members employed in public practice at 1 and 3 per cent of each institute's membership respectively.

<sup>141</sup> The Statutory Auditors (Registration) Instrument 2008 (POB 02/2008) and The Statutory Auditors (Examinations) Instrument 2008 (POB 03/2008). The powers were delegated to the POB under Article 3(1)(a) of the Statutory Auditors (Delegation of Functions etc) Order 2008 ('the Order') made under sections 504(4)(1)(b)(ii), 1252(1), (4)(a), (5) and (8) and 1253(4) of, and paragraphs 7(3), 11(2) and 3(a) of, Schedule 13 to the Act.

## *RQBs*

5.87 RQBs award the qualifications necessary to undertake audit work, as an entry requirement. There are five RQBs<sup>142</sup> comprising four chartered bodies (ACCA, ICAEW, CAI, and ICAS and the Association of International Accountants. RQBs must have rules and arrangements in place to register students and track their progress, administer examinations and ensure that appropriate training is given to students in an approved environment.

## *RSBs*

5.88 There are four principal RSBs. These are: the ACCA; the ICAEW; the CAI; and the ICAS. In addition the Association of Authorised Public Accountants is an RSB but it is now a subsidiary of the ACCA and for all practical purposes its small number of members is regulated by the ACCA.

5.89 RSBs must have procedures in place to register and de-register statutory auditors and supervise work undertaken by these individuals and firms, and to this end they carry out four main tasks: audit registration; audit monitoring; arrangements for the investigation of complaints; and procedures to ensure that those eligible for appointment as statutory auditor continue to maintain an appropriate level of competence (continuous professional development, or CPD).

5.90 Under the procedures followed by ICAEW, ICAS and CAI, an individual who wishes to undertake audit work must (a) hold an audit qualification and (b) be approved as a Responsible Individual (RI). An RI is an individual who takes responsibility for carrying out an audit on behalf of a registered audit firm and may be a principal (ie partner) or an employee of the registered audit firm. An RI cannot accept an audit

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<sup>142</sup> CIPFA was recognized as an RQB by the then Department of Trade and Industry (DTI) in 2005, subject to conditions, but did not at that time develop fully the examinations and arrangements for practical training needed for the award of the statutory auditor qualification. CIPFA agreed to hold its RQB status in abeyance until 2012.

appointment unless the firm in which the individual works is also a registered audit firm. An RI must be approved by the relevant professional body and the audit firm's audit compliance principal must vouch for their integrity, fit and proper status and competence. The ACCA has similar procedures but instead of accredited individuals as RIs it grants them a practising certificate with audit.

- 5.91 Statutory Audit Directive (effective from April 2008 in the UK) introduced a requirement that the RSBs should monitor the activities undertaken by audit firms at least once every six years. This replaced the less prescriptive requirements in the 1989 Companies Act that RSBs had procedures in place to monitor their registrants, with the RSB left to decide the frequency.

### *The ICAEW*

- 5.92 The ICAEW is described here in more detail as it has the most auditors compared with the other RSBs. As at 31 December 2010 there were 7,457 registered audit firms, of which 3,958 were registered through the ICAEW, and approximately 58 per cent of the total fee income of audit firms registered with the ICAEW was attributable to the Big Four.
- 5.93 To be admitted to membership of the ICAEW, applicants must generally complete 450 days of relevant work experience (training) and pass a series of examinations. The work experience lasts between three and five years and must be with an employer or employers approved by the institute for training.
- 5.94 The ICAEW describes itself as a professional membership organization, supporting over 136,000 chartered accountants around the world; through its technical knowledge, skills and expertise, it provides insight and leadership to the global accountancy and finance profession. The ICAEW states that it provides its 'members

with knowledge and guidance based on the highest ethical and technical standards' and that it 'shapes opinion, understanding and delivery to ensure the highest standards in business and in the public interest'.

5.95 The ICAEW's board has overall responsibility for ICAEW's planning and budgeting process and the development of policy, and is supported by four boards that oversee the main areas of ICAEW activity: professional standards, learning and professional development, member services and technical strategy.

5.96 The objectives in its Royal Charter are to:

- (a) advance the theory and practice of accountancy, finance, business and commerce;
- (b) recruit, educate and train a body of members skilled in accountancy and finance;
- (c) preserve at all times the professional independence of accountants;
- (d) maintain high standards of practice and professional conduct by all members;
- and
- (e) advance the profession of accountancy.

### ***The FSA***

5.97 The FSA is the independent organization responsible for regulating financial services in the UK. Under the Financial Services and Markets Act 2000 it has four statutory objectives: market confidence, financial stability, consumer protection, and the reduction of financial crime.

5.98 Although statutory audit does not come directly under the scope of regulation by the FSA, confidence in published accounts (as well as high-quality reporting in respect of client assets) is important to the FSA's objectives of market confidence, financial stability and consumer protection. In addition, other activities carried out by account-

ancy firms, such as arranging deals in investments or advising on investments, may come under the scope of regulation by the FSA.

### *Interaction with FRC*

5.99 In January 2011, the FSA and FRC agreed a new memorandum of understanding to enable a greater degree of cooperation and information exchange between the two regulators. It follows the publication of a joint discussion paper on the audit of financial institutions published in June 2010, entitled 'Enhancing the auditor's approach to prudential regulation',<sup>143</sup> which considered ways of enhancing auditors' contribution to regulation, in particular following the financial crisis of 2008.

5.100 The purpose of this June 2010 paper was to stimulate debate on how the FSA can best use audit and auditors to meet its statutory objectives. In particular, the paper examined how the FSA, the FRC and auditors can best work together to enhance how auditors can contribute to prudential regulation in the future.

### ***International bodies and legislation***

#### *Sarbanes-Oxley*

5.101 As part of the US federal law Sarbanes-Oxley Act of 2002 (commonly called 'Sarbox' or 'SOX')<sup>144</sup> is a US federal law the Securities and Exchange Commission (SEC) issued very strict requirements regarding auditor independence, setting new or enhanced standards for all US public company boards, management and accountancy firms. It applies to many of the largest UK companies as they are listed in the USA. The bill was enacted as a reaction to a number of major corporate and accounting scandals including Enron and Worldcom. It created a new, quasi-public agency, the PCAOB, charged with overseeing, regulating, inspecting and disciplining

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<sup>143</sup> [www.frc.org.uk/images/uploaded/documents/FSA%20FRC%20Discussion%20paper1.pdf](http://www.frc.org.uk/images/uploaded/documents/FSA%20FRC%20Discussion%20paper1.pdf).

<sup>144</sup> Also known as the 'Public Company Accounting Reform and Investor Protection Act' and 'Corporate and Auditing Accountability and Responsibility Act'.

accountancy firms in their roles as auditors of public companies. The Sarbanes-Oxley Act also covered issues such as auditor independence, corporate governance, internal control assessment and enhanced financial disclosure. This is a prescriptive rules-based approach compared with the UK's principles-based approach (see paragraph [6.6] onwards).

### *IFAC*

5.102 The IFAC is a worldwide body with the central objective of harmonizing the accountancy profession. It concentrates in particular on the production of ethical guidelines and auditing standards. The UK is represented on IFAC's board and its various committees.

### *IAASB*

5.103 The IAASB is a subsidiary of the IFAC. It is an independent standard-setting body which sets standards for auditing, quality control, review, other assurance and related services, by facilitating the convergence of international and national standards. It develops and issues (among other publications) ISAs.

### *IESBA*

5.104 The IESBA is a subsidiary of the IFAC. It is a body which sets standards for professional accountants and facilitates the convergence of international and national ethical standards, including auditor independence requirements, through a code of ethics.

### *IASB*

5.105 The IASB is an independent accounting standard setter based in London and is responsible for developing IFRS and promoting the use and application of those standards. Its parent is the IFRS Foundation. The IASB has 15 members each with

one vote, who are each experts with a mix of experience of standard setting, preparing and using accounts, and academic work. It is privately funded mostly by banks and other companies which use or have an interest in promoting international standards.

### ***Other relevant bodies***

#### ***CCAB***

5.106 The CCAB was founded in 1974 by the six UK accountancy bodies formed by royal charter (ACCA, CIMA, CIPFA, ICAEW, CAI, and ICAS) and is an umbrella group for the major British professional accounting bodies. CIMA left the CCAB in March 2011, leaving the remaining five accountancy bodies.

5.107 The CCAB provides a forum whereby its member bodies can meet and act collectively on behalf of the accountancy profession in the UK to promote the public interest on matters within the sphere of the profession and its members.

5.108 The combined membership of the five bodies amounts to 236,000 professional accountants in the UK and the Republic of Ireland (334,000 worldwide). The CCAB has four strategic objectives:<sup>145</sup>

(a) Current and Emerging Issues: to provide a forum for considering current and emerging issues and agreeing joint approaches to the FRC, government and other authorities, both national and international, on behalf of the UK profession and, in particular, where significant public interest issues are at stake.

(b) Maintaining Identity: to maintain and develop CCAB's identity as the collective voice of the UK profession.

(c) Representing views to international standard setters, regulators and other bodies: to provide a mechanism for influencing the global profession by representing the

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<sup>145</sup> [www.ccab.org.uk/objectives.php](http://www.ccab.org.uk/objectives.php).

views of the UK profession to international standard setters, regulators and other bodies, including the making of nominations to international organizations.

(d) Joint Approaches: to facilitate joint project-based thought leadership, technical work and research on behalf of the UK profession, where this enhances the 'collective voice' and adds value for the bodies.

5.109 CCAB does not undertake any education or training activities; these are matters for the individual professional bodies.

#### *Interaction with other bodies*

5.110 The CCAB Ethics Group coordinates activities between the member bodies relating to ethical guidance and liaises with relevant FRC standard setting and oversight boards, in respect of ethical issues. This includes discussions with the APB regarding auditor independence issues, application of the IFAC requirement to apply independence requirements to assurance engagements, and the implementation of the new IFAC code of ethics. The CCAB has also issued ethical dilemma case studies for professional accountants in business and professional accountants working as non-executive directors.

## **6. The role of audit committees**

### ***Legal provisions***

6.1 The Act<sup>146</sup> defines 'audit committee' as meaning a body which performs the functions referred to in Article 41.2 of the Audit Directive<sup>147</sup> or equivalent functions.

6.2 Article 41.2 of the Audit Directive requires every public interest entity to have an audit committee, which has at least four functions:

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<sup>146</sup> Schedule 10, paragraph 10B of the Act (inserted by Statutory Auditors and Third Country Auditors Regulations 2007 SI 2007/3494, regulation 21).

<sup>147</sup> Directive 2006/43/EC.

- (a) to monitor the financial reporting process;
- (b) to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- (c) to monitor the statutory audit of the annual and consolidated accounts; and
- (d) to review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

6.3 The Company Reporting Directive<sup>148</sup> requires companies whose securities are traded on a regulated market to include a corporate governance statement in their annual report.

6.4 As the UK already had self-regulatory arrangements for audit committees in the Combined Code on Corporate Governance (from 2010 revised and renamed *The UK Corporate Governance Code*) these EU requirements were given effect by amending Part 6 of the Financial Services and Markets Act 2000 to allow the FSA to make rules as to 'any Community obligation relating to the corporate governance of issuers'.<sup>149</sup>

6.5 Accordingly, the arrangements for audit committees are treated as being part of corporate governance and transparency matters, and the requirements of EU Directives have been given effect under the Financial Markets and Securities Act as issuer matters, not as company matters, and are not treated as 'company law provisions' for the purposes of the Act.<sup>150</sup>

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<sup>148</sup> Directive 2006/46/EC.

<sup>149</sup> Section 1269 of the Act inserts a new section 89O into Part 6 of the Financial Services and Markets Act 2000. The Secretary of State is also given a regulation-making power, similar to that of FSA, by section 1273 of the Act.

<sup>150</sup> Section 2 of the Act limits the 'company law provisions of the Act' to the provisions of Parts 1 to 39 and those in Parts 45 to 47. The sections relevant to audit committees are in Part 42 of the Act.

## ***Development of corporate governance provisions relating to audit committees***

- 6.6 Audit Committees were first proposed by the Cadbury Report on corporate governance in 1992.<sup>151</sup> Since 1994, the London Stock Exchange Listing Rules have required companies that do not have an audit committee to explain to the stock market why they do not have one.
- 6.7 In 1998, the Hampel report reviewed and revised the Cadbury and Greenbury reports.<sup>152</sup> It proposed principles of good governance rather than explicit rules, in order to reduce the regulatory burden on companies and avoid 'box ticking' so as to be flexible enough to be applicable to all companies.
- 6.8 In 1998, the Combined Code on Corporate Governance was created to consolidate the principles and recommendations of the Cadbury, Greenbury and Hampel reports. Compliance with the Code was not mandatory, but the Code was appended to the London Stock Exchange Listing Rules.
- 6.9 In 2003, the Smith report<sup>153</sup> developed and codified the role of audit committees. It recommended that:
- (a) audit committees should include at least three members, all of them to be independent non-executive directors, and at least one of them to have significant, recent and relevant financial experience, with suitable training to be provided to all of them; and
  - (b) that the role of the audit committee should be:
    - to monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements;

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<sup>151</sup> *Financial Aspects of Corporate Governance* (December 1992). The report recommended that companies should establish an Audit Committee, comprising at least three non-executives.

<sup>152</sup> The Greenbury report (1995) led to a *Code of Best Practice on Directors' Remuneration*.

<sup>153</sup> The Smith report: *Audit committees: Combined Code guidance* (2003).

- to review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board in relation to the external auditor's appointment; and in the event of the board's rejecting the recommendation, the committee and the board should explain their respective positions in the annual report;
- to monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements; and
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

6.10 These recommendations were incorporated into the Combined Code in 2003, which also required that the audit committee should be provided with sufficient resources, that its activities should be reported in a separate section of the directors' report (within the annual report) and that the chairman of the committee should be present to answer questions at the AGM.

6.11 In 2010, following a review by the FRC,<sup>154</sup> the code was renamed The UK Corporate Governance Code (the Code). The Code requires that the company's statutory auditor must make a report to the audit committee that includes:

(a) a statement in writing confirming the person's independence from the public interest entity;

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<sup>154</sup> 2009 Review of the Combined Code.

- (b) a description of any services provided by the person to the public interest entity other than in his capacity as statutory auditor;
- (c) a description of any significant threats to the person's independence;
- (d) an explanation of the steps taken by the person to safeguard his independence from those threats;
- (e) a description of any material weaknesses arising from the statutory audit in the public interest entity's internal control in relation to the preparation of accounts; and
- (f) any other significant matters arising from the statutory audit.

6.12 Further detail on the evolution of UK corporate governance is contained in [Annex B](#).

## **7. The role of shareholders with regard to audits**

### ***Rights in the Companies Act 2006***

7.1 Part 16 of the Act gives shareholders the right to 'hire and fire' the company's auditor; to receive the audit report; to require the company to publish on its website a statement setting out matters relating to the audit or circumstances connected with the auditor ceasing to hold office; and to authorize a liability limitation agreement with the auditor.

7.2 The shareholders have the right to appoint an auditor by ordinary resolution at an accounts meeting<sup>155</sup> and to determine the auditor's remuneration, or decide the method by which it should be determined.<sup>156</sup> The directors can appoint the company's first auditor (or the first after a period of audit exemption), and can fill a casual vacancy, in which case the directors fix the auditor's remuneration.

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<sup>155</sup> Section 489(4) of the Act.

<sup>156</sup> Section 492(1) of the Act.

- 7.3 The shareholders have the right at any time to dismiss the company's auditor by ordinary resolution,<sup>157</sup> so long as special notice is given and any representations made by the auditor are sent to every member of the company who has notice of the meeting.<sup>158</sup>
- 7.4 The shareholders have the right to receive the auditor's report on whether, in the auditor's opinion, the accounts have been properly prepared and constitute a true and fair view of the state of the company's affairs, and whether the report is unqualified or qualified.<sup>159</sup> The report must include an introduction identifying the annual accounts and the financial reporting framework that has been applied in their preparation and a description of the scope of the audit, identifying the auditing standards that have been applied.
- 7.5 The members of a quoted company have the right to require the company to publish on a website a statement setting out concerns relating to the audit, or any circumstances connected with an auditor of the company ceasing to hold office, that the members propose to raise at the next accounts meeting of the company. This right is conditional on the request being made by members representing at least 5 per cent of the total voting rights, or by at least 100 members who have a relevant right to vote and hold shares in the company on which there has been paid up an average sum per member of at least £100.
- 7.6 The members of the company have the right to authorize by resolution in a general meeting a liability limitation agreement which limits the liability owed to the company

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<sup>157</sup> Section 410 of the Act.

<sup>158</sup> Section 411 of the Act.

<sup>159</sup> Section 495 of the Act.

by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the course of the audit.<sup>160</sup>

### ***The Stewardship Code***

7.7 The Stewardship Code was published in July 2010 by the FRC. The FRC has stated that it aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities by setting out good practice on engagement with investee companies to which the FRC believes institutional investors should aspire. It appears relevant to the audit investigation to the extent that institutional investors have a right to vote on the appointment of auditors.

7.8 The Stewardship Code is a set of principles and guidelines. Its principal aim is to make shareholders be active and engage in corporate governance in the interests of their beneficiaries. It is addressed in the first instance to firms which manage assets on behalf of institutional shareholders (such as pension funds, insurance companies, and investment trusts), but the FRC has stated that the responsibility for monitoring company performance does not rest with fund managers alone, and thus encourages other institutional investors to disclose their level of compliance with the Stewardship Code.

7.9 The FRC sees the Stewardship Code as complementary to the Code (see paragraph 6.11) and, like the Code, should be applied on a 'comply or explain' basis. This means that it does not require compliance with the principles, but if fund managers and institutional investors do not comply with any of the principles set out, they must

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<sup>160</sup> Section 536 of the Act.

explain why they have not done so. The information is also sent to the FRC. There are seven principles of the Stewardship Code.<sup>161</sup>

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<sup>161</sup> 1. publicly disclose their policy on how they will discharge their stewardship responsibilities; 2. have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed; 3. monitor their investee companies; 4. establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value; 5. be willing to act collectively with other investors where appropriate; 6. have a clear policy on voting and disclosure of voting activity; 7. report periodically on their stewardship and voting activities.

**Audit related services contained in Ethical Standard 5**

Audit-related services are:

- reporting required by law or regulation to be provided by the auditor;
- reviews of interim financial information;
- reporting on regulatory returns;
- reporting to a regulator on client assets;
- reporting on government grants;
- reporting on internal financial controls when required by law or regulation; and
- extended audit work that is authorized by those charged with governance performed on financial information<sup>162</sup> and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions.

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<sup>162</sup> This does not include accounting services.

## Reports and Reviews leading up to the current Code

### **1992—Cadbury Report**

1. The Cadbury Report<sup>163</sup> was published in 1992 and was a response to major corporate scandals associated with corporate governance failures in the UK in the late 1980s/ early 1990s: Polly Peck, BCCI and Maxwell. The report covered financial, auditing and corporate governance matters, and made three basic recommendations:
  - (a) The CEO and chairman of companies should be separated.
  - (b) Boards should have at least three non-executive directors, two of whom should have no financial or personal ties to directors.
  - (c) Each board should have an audit committee composed of non-executive directors.
  
2. In 1994, these recommendations were appended to the Listing Rules of the London Stock Exchange. It was stipulated that companies need not comply with the rules, but had to explain to the stock market why not if they did not. This is still the case—what the Code refers to as ‘comply or explain’.

### **1995—Greenbury Report**

3. Following public anger over executive pay, particularly in the then recently privatized public utilities, the Greenbury Report<sup>164</sup> recommended some further changes to the existing principles in the Cadbury Report:
  - (a) Each board should have a remuneration committee composed without executive directors, but possibly the chairman.
  - (b) Directors should have long-term performance-related pay, which should be disclosed in the accounts and contracts renewable each year.

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<sup>163</sup> *Financial Aspects of Corporate Governance*, December 1992: [www.ecgi.org/codes/documents/cadbury.pdf](http://www.ecgi.org/codes/documents/cadbury.pdf).

<sup>164</sup> *Directors’ Remuneration, Report of the Study Group*: [www.ecgi.org/codes/code.php?code\\_id=131](http://www.ecgi.org/codes/code.php?code_id=131).

### **1998—Hampel Report**

4. In 1998 the Hampel Report,<sup>165</sup> intended to be a progress review three years after the Greenbury Report, suggested that all the Cadbury and Greenbury principles be consolidated into a 'Combined Code'. It added:
- (a) The Chairman of the board should be seen as the 'leader' of the non-executive directors.
  - (b) Institutional investors should consider voting with the shares they held at meetings, though rejected compulsory voting.
  - (c) All kinds of remuneration including pensions should be disclosed.

### **1999—Turnbull Report**

5. The Turnbull Report<sup>166</sup> was published one year after the Hampel Report, and recommended that directors be responsible for financial and auditing controls.

### **2001—Myners Report**

6. The Myners Report<sup>167</sup> was published to HM Treasury in March 2001 (and a review in 2003<sup>168</sup>) on the role of institutional investors.

### **2009—Walker Review**

7. The Walker Review<sup>169</sup> was published in 2009 shortly after collapse of Northern Rock and financial crisis, focusing on the banking industry, but also with recommendations for all companies.

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<sup>165</sup> *Review of Corporate Governance since Cadbury*: [www.ecgi.org/codes/documents/hampel.pdf](http://www.ecgi.org/codes/documents/hampel.pdf).

<sup>166</sup> *Internal Control: Guidance for Directors on the Combined Code*.

<sup>167</sup> *Institutional Investment in the United Kingdom: A Review*: [http://archive.treasury.gov.uk/pdf/2001/myners\\_report.pdf](http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf).

<sup>168</sup> *Myners principles for institutional investment decision-making: review of progress*: [www.hm-treasury.gov.uk/d/myners\\_principles\\_web.pdf](http://www.hm-treasury.gov.uk/d/myners_principles_web.pdf).

<sup>169</sup> *A review of corporate governance in UK banks and other financial industry entities: Final recommendations*: [http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker\\_review\\_261109.pdf](http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf).

## Code Provisions for Audit Committee and Auditors—extracts

### Main Principle

**The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.**

### Code Provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and

- removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
  - to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditor. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

**Audit Choice Market Participants Report, October 2007:  
list of recommendations**

1. The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.
2. Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.
3. In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.
4. Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.
5. The FRC should continue its efforts to promote understanding of audit quality and the firms and the FRC should promote greater transparency of the capabilities of individual firms.
6. The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.
7. The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.

8. The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.
9. When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.
10. Investor groups, corporate representatives, auditors and the FRC should promote good practices for shareholder engagement on auditor appointments and re-appointments.
11. Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.
12. The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.
13. Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.
14. Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.
15. Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.