



## PROFESSIONAL OVERSIGHT BOARD

### REPORT TO THE SECRETARY OF STATE FOR BUSINESS, ENTERPRISE & REGULATORY REFORM

YEAR TO 31 MARCH 2008



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Year to 31 March 2008

Presented to Parliament pursuant to section 1252(10) of, and paragraph 10(3) of Schedule 13 to, the Companies Act 2006.

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## ANNEX 3

### PROFESSIONAL OVERSIGHT BOARD

1 April 2007 to 31 March 2008

#### Chair

##### Sir John Bourn KCB

Sir John was Comptroller and Auditor General of the United Kingdom until he retired at the end of January 2008.

#### Members

##### Richard Barfield

A director of a number of investment trusts and adviser on investment matters to two pension funds. Formerly Chief Investment Manager of Standard Life in Edinburgh.

##### Tim Barker

Senior Independent Director of Drax Group plc and of Electrocomponents plc. Formerly Vice Chairman of Dresdner Kleinwort Benson and of Kleinwort Benson Group plc

##### Anthony Carus

Consulting Actuary in private practice and Director, Royal Liver Assurance Limited. Formerly Appointed Actuary, NFU Mutual Life

##### David Crowther

Formerly a senior partner of PricewaterhouseCoopers LLP, responsible for quality assurance and risk management. Non Executive Director of TT Electronics plc, the Financial Ombudsman Service and the Treasury Solicitor's Department.

##### Hilary Daniels

Board Member and Chair of Audit Committee, Olympic Lottery Distributor; Independent Member of the Professional Standards Board of the Institute of Legal Executives (ILEX); a member of the Actuarial Stakeholder Interests Working Group. Past President CIPFA and formerly Chief Executive, West Norfolk Primary Care Trust.

not trained students for a considerable period. If such an office recruits a new trainee, an early visit will be scheduled to ensure all procedures are up to date and suitable support networks are available.

## Chair's Foreword

I am pleased to send you the fourth annual report on the work of the Professional Oversight Board for the year to 31 March 2008. This is the third full year in which the Board has exercised statutory responsibilities for the oversight of audit regulation since it was established in 2004 as part of an expanded Financial Reporting Council.

Our responsibilities flow principally from three recommendations made in the Government's Review of audit regulation in 2003: that an Oversight Board should take responsibility for the statutory oversight of audit regulation; that an Audit Inspection Unit as part of the Oversight Board should be responsible for monitoring the quality of audits of those entities which have the greatest impact on financial and economic stability; and that the Oversight Board should have a wider non-statutory oversight role over the regulatory activities of the principal accountancy bodies in relation to their members generally.

Oversight of the regulation of the actuarial profession was added to our responsibilities in April 2006, following the Morris Review of the Actuarial Profession. That aspect of our work gathered pace in 2007/8. In January 2008, we published a follow-up report on its implementation of the recommendations made to it by the Morris Review. Whilst the actuarial profession continued to embed the Morris reforms, we had concerns at the lack of progress in some areas, such as the development of its ethical code. Our main projects have been working with stakeholders to review the arrangements for the monitoring and scrutiny of actuarial work and to develop and promote an understanding of the drivers of actuarial quality. We report briefly on this work in Chapter 5.

In 2007, we consulted on a new approach to reporting by the AIU. We published the results of that consultation in December 2007 in a feedback document "*Reporting on Audit Quality Monitoring - Implementing a New Approach*". A key change to the reporting was that the AIU would no longer publish one annual report on generic themes and findings but would publish high-level public reports on those individual audit firms where the AIU had undertaken a full scope inspection. The content of these reports would reflect the findings set out in the private reports to the respective audit registration committees. This change took effect for the 2007/8 inspection cycle and marks an important development in increasing the transparency of the AIU's work.

Another significant change in reporting was the introduction of new style reports on individual audits reviewed by the AIU, for all reviews of individual audits, which commenced after 1 January 2008. While these reports are addressed to the relevant audit engagement partner, our expectation is that they will be provided to the relevant client's audit committee. This is also another important contribution to the transparency of reporting on the work of the UK's audit profession.

I am pleased to note that, while we continue to find areas for improvement, the quality of auditing in the UK is fundamentally sound. The summarised findings of our inspection activity are set out in section 4.

Our work in 2007/8 was not conducted in isolation from the financial turmoil, which started in 2007 and has deepened through 2008. The Board and its staff were actively involved in the development of the FRC's guidance, aimed at audit committees, on the risks to corporate reporting arising from the credit crisis. We tailored staff training to assist our audit inspectors to carry out their work in an informed way. In the autumn of 2007, as part of our routine audit monitoring, we considered the largest audit firms' preparations for the December 2007 audits. The outcome of this work is summarised in section 4.

Inevitably, the work of auditors is coming under increasing scrutiny and in particular that the judgements made in the course of their work are firmly based. Our monitoring of major audits for financial years ended in December 2007 started in April 2008, after the completion of the current inspection cycle, and the results of this will be published in 2009.

There have been other significant changes to our work and responsibilities since our previous report, reflecting in particular the coming into force in April 2008 of changes to audit regulation in the Companies Act 2006. As a part of this, the Board became subject to the Freedom of Information Act in respect of our statutory duties. Ahead of that, we consulted on and published a publication scheme, which was also approved by the Information Commissioner.

For the most part, the Companies Act changes, which are of most relevance to our remit, were necessary to give effect to the Statutory Audit Directive. We worked closely with your officials through 2007/08 on the legislative and other arrangements necessary to give effect to them. These include the regulation of the auditors of certain companies from outside the European Union that issue securities, and a new statutory requirement on some UK audit

*Progress:*

A number of the RQBS have amended their procedures and documentation in relation to approval and monitoring visits. The revised forms include additional space and questions, which seek further information and clarification to support the decision for initial approval or continued approval. All of the RQBs have highlighted to staff the need to ensure that any conclusions are clear

#### **C4 Availability of audit work**

The reduction in the number of statutory audits following the substantial increases in the audit threshold in recent years raised questions about the amount and variety of audit work available in some approved training offices. We recommended that the RQBs assessed the variety and amount of audit work available for students as part of their approval and monitoring of training offices. Where there was a concern that students might not receive sufficient experience the body should ensure that the student was aware of this and should monitor the training office closely.

*Progress:*

The bodies concerned have changed their procedures so that upon approval or continued authorisation of a training office the reviewer identifies whether there will be sufficient audit experience available for trainees. Where this is judged not to be the case this is flagged on the system and discussed with the trainee. The decline in the amount and variety of audit work available for trainees in smaller practices is an issue for all RQBs, and was identified as part of a more recent review of Practical Training (see Section 2).

#### **C5 Training offices with no students**

We noted that a number of training offices approved by the RQBs were not at present training students. Whilst the RQBs continued to review these offices as part of the cyclical reviews of all training offices, such offices were usually assessed as low risk and their status as a training office continued. We considered that all the bodies should have procedures in place so that such offices were automatically treated as of higher risk once they took on students, and were then subject to an early review to confirm their suitability as a training office.

*Progress:*

All RQBs now have procedures in place to identify those authorised training offices not currently training students. Some RQBs have introduced a block on a training office that has



*Progress:*

The bodies have implemented additional checks to ensure that student training records correctly reflect the experience gained. Due to the timing of implementing these changes, we will continue to monitor this in the future to ensure that students are only admitted to membership and awarded the recognised professional qualification when they have achieved the required amounts of experience.

### *Examinations*

#### **C2 Testing candidates' ability to apply theoretical knowledge**

The final audit examination papers are designed to take the weight of testing a candidate's ability to apply theoretical knowledge in practice, a specific Companies Act requirement. Since candidates with little or no practical experience may take the paper, we had concerns whether it could provide both an adequate test of a candidate's ability to apply audit knowledge in practice and an appropriate test for students with no audit experience. We therefore asked the relevant bodies to explain how they considered their papers could provide both an appropriate test and be taken successfully by those with little or no practical audit experience.

*Progress:*

We remain concerned whether the final audit examination at a number of RQBs adequately tests a candidate's ability to apply audit knowledge in practice. We are aware that one of the RQBs provides guidance to students stating that it is highly desirable to have gained some practical experience before attempting the paper. However, we are planning to undertake a fuller review of examinations at all RQBs in 2008/09 including an assessment as to whether the examinations meet the requirements of the 2006 Act

### *Approval and Monitoring of Training Offices*

#### **C3 Justification of initial approval or continued approval of training offices**

A number of the RQBs did not record adequately why specific conclusions had been reached or what follow up points needed to be addressed following an approval or monitoring visit to a training office. Reviewers should provide a clear explanation of the conclusions from such visits. In some cases, the forms used for recording needed to be amended.

firms to publish annual transparency reports. These changes have also deepened the need to work closely with the European Commission and other oversight bodies in the EU to try to ensure that regulatory requirements set at EU level prove workable and are proportionate to the regulatory need. Our work through the European Group of Auditor Oversight Bodies will continue to develop, not least as the largest audit firms look to a greater integration of their activities across the EU and beyond.

The Companies Act 2006 also gives the Oversight Board new responsibilities for the oversight of Auditors General, in relation to their new power to act as statutory auditors under company law. We put in place during the year the necessary regulatory arrangements ahead of the coming into force of the relevant part of the 2006 Act on 6 April 2008.

Monitoring the effectiveness of the regulation by recognised bodies of statutory auditors is another core function. We changed the format of inspection visits for 2007/08 to focus for each body on key areas of risk or where there had been significant change in the systems. I am pleased to say that our overall conclusion is that the recognised bodies take their regulatory responsibilities extremely seriously and that much of the regulatory practice we have seen is of a high standard. That said, the more detailed comments in Section 2 highlight those aspects of regulatory activity that are less strong or where there is room for improvement.

We have again worked in collaboration with other parts of the FRC on key projects relating to our wider responsibilities. In particular, the Board worked closely with the FRC on *Choice in the UK Audit Market*, and with the Auditing Practices Board to develop the *Audit Quality Framework*, published in February 2008.

Finally, I want to record my thanks to all the members of the Board and to the staff, whose wide and varied knowledge and experience has underpinned our effectiveness over the last four years. Above all the Board owes a debt of gratitude to Sir John Bourn, whom I succeeded as Chair on 1 October 2008, and who led the Board from the beginning with such a sure guiding hand.

**Dame Barbara Mills DBE QC**  
**Chair**  
**Professional Oversight Board**  
**December 2008**

*Progress:*

The RSBs agreed to ensure that registered audit firms with no audit clients notify them if they accept any audit appointments. The RSB will then schedule a monitoring visit to ensure that the firm has appropriate procedures in place and that the individuals are sufficiently competent to undertake the work. In addition, the bodies agreed to identify those individuals who indicate a change in their audit clients from zero within their annual return.

*Continuous professional development (CPD)*

**B6 CPD monitoring**

One of the RSBs did not have a system for monitoring compliance with their CPD requirements other than as a part of audit monitoring visits, though they were planning to introduce such a system. We discussed this with the body concerned and emphasised the need to ensure that appropriate procedures were in place.

*Progress:*

The body has now designed a process to review CPD records for a sample of all members, not only those in practice. We will review the new process during our 2008/9 monitoring cycle and highlight any improvements if necessary. More generally, as all of the RSBs have changed their requirements for CPD and designed new CPD programmes recently, we have planned a round table meeting to discuss the implementations of the new schemes and share ideas in relation to the challenges they face.

**C) Issues Identified at Recognised Qualifying Bodies**

*Student registration and progression*

**C1 Review of training records**

We identified weaknesses at a number of the RQB in their processes for reviewing training records. In particular, whilst we did not review statistically significant samples, we found examples where records had been completed retrospectively, details recorded incorrectly and where the student had provided inaccurate information. We have emphasised to the relevant bodies the importance of reviewing training records comprehensively and ensuring that they do not admit individuals to membership or award the recognised professional qualification when it is not appropriate to do so.

*Progress:*

The body has now re-stated its procedures with regard to unsatisfactory outcomes to first visits, making clear that a significant failure to carry out audits to a satisfactory standard will lead to a referral to the registration committee.

The body in question has now defined criteria against which an unsatisfactory outcome to a first visit could lead to referral of the findings to the Committee. The body has stated that it would refer firms at a first visit where little or no attempt has been made to carry out an audit in compliance with auditing standards. We have reiterated the need to alert the Committee to all instances of poor quality audit work so that appropriate conditions and restrictions can be imposed to protect the public. We will continue to monitor this in the future.

#### *Audit Monitoring*

#### **B4 Justification of the results of monitoring visits**

We concluded that not all RSBs record sufficient explanation for decisions made and conclusions reached following a monitoring visit to a firm. It is important that clear and adequate explanations are recorded, so that other staff and committee members reading the reports can understand fully the reasoning behind the conclusions.

*Progress:*

Whilst the RSBs have reminded reviewers of the need to ensure that conclusions are adequately explained, we have continued to find examples where the explanation provided is not adequate or as clear as it could be. We will continue to review the bodies' progress in relation to this recommendation during future RSB visits.

#### **B5 Registered auditors who have no audit clients**

We discussed with the RSBs the arrangements for monitoring firms who hold registered auditor status but do not have any audit clients. Some of the bodies decided to review these firms using desktop monitoring rather than a visit. Whilst we have no difficulty in principle with this approach, we considered that it was important that the body be notified were the firm to be subsequently appointed as an auditor. This would give the RSB the opportunity to arrange an early follow up visit to review the competency of staff and the procedures and systems to confirm these are adequate to undertake statutory audit work.

## **One – Introduction**

1.1 The Professional Oversight Board contributes to the Financial Reporting Council's (FRC) aim of promoting confidence in corporate reporting and governance by:

- Independent oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies
- Monitoring of the quality of the auditing function in relation to economically significant entities
- Independent oversight of the regulation of the accountancy profession by the professional accountancy bodies
- Independent non-statutory oversight of the regulation of the actuarial profession by the professional bodies

1.2 In February 2008, Parliament approved a Delegation Order made by the Secretary of State for Business, Enterprise and Regulatory Reform under sections 504, 1252 and 1253 of the Companies Act 2006 (the Act). This replaced a previous Order made in 2005 which delegated to the Oversight Board the Secretary of State's statutory functions for the oversight of the regulation of audit in the United Kingdom. In most respects, the powers and responsibilities delegated by the new Order are equivalent to those previously delegated. However, there are a number of additional functions, in particular:

- The Oversight Board is designated as the appropriate authority for the receipt of notices under sections 522 and 523 of the 2006 Act (notices of auditors ceasing to hold office) in respect of major audits.
- The Board has a specific obligation to set statutory requirements on auditors of public interest entities to prepare and publish annual transparency reports.
- The 2006 Act sets out a legal framework for the registration and regulation of auditors of issuers from outside the European Economic Area that have issued securities admitted to trading on UK regulated markets. This reflects requirements in the Statutory Audit Directive. The responsibility for setting and administering the detailed requirements on third country auditors is delegated to the Oversight Board.

1.3 Under a separate Order, made under section 1228 of the 2006 Act, the Secretary of State has appointed the Oversight Board as the Independent Supervisor of Auditors General. Section 1226 of the 2006 Act provides that Auditors General are eligible for appointment as a statutory auditor where certain conditions are met, and in particular that the performance of each Auditor General's functions as a statutory auditor is subject to supervision by the Independent Supervisor.

1.4 This report meets the obligations in paragraph 10(1) of Schedule 13 to the 2006 Act to report each year to the Secretary of State on the way in which the Board has carried out its statutory responsibilities. This report focuses on the statutory part of our work but also comments briefly on our non-statutory work.

1.5 Section 2 sets out the way in which we have exercised oversight over those accountancy bodies recognised to qualify statutory auditors in the UK and to exercise direct supervision over statutory auditors.

1.6 Section 3 reports on our other work related to our statutory responsibilities.

1.7 Section 4 reports on the work of the Audit Inspection Unit in monitoring the auditors and audits of listed and other entities in which there is a major public interest.

1.8 Section 5 reports briefly on our non-statutory work.

1.9 Section 6 comments on our Work Programme for 2008/09, which is an integral part of the FRC's overall Plan and Budget.

*Progress:*

The relevant body has changed its procedures to ensure that, where there is any doubt as to control by audit qualified individuals, it writes to the firm asking for confirmation that it meets the statutory requirements; where this is not received the body will move to take action not to grant or not to continue audit registration.

*Registration Committees for Audit*

**B2 Relationship with the Audit Inspection Unit**

Two of the RSBs have audit registration committees who receive reports from the Audit Inspection Unit (AIU). We attended committee meetings where the AIU presented their findings on the larger UK audit firms. We concluded that it would be helpful if the registration committees considered together the AIU report and the relevant monitoring unit's report on the same firm. Where this was not possible, we concluded that it was important that both the AIU and the relevant monitoring department were involved in the discussions of the other party's report. We also recommended that audit registration committees should not confirm the firm's registration status until both reports had been reviewed.

*Progress:*

All reports produced by the AIU and the relevant monitoring units were considered at the same time during 2007/8 and confirmation of continuation of audit registration was only confirmed when both reports had been discussed. Where one report was available a considerable period before the other, then the audit registration committee might look at one report first, but subsequently both reports would be considered together to highlight any differences in findings and ensure that both outcomes are reflected in any decisions.

**B3 Referral of firms to the registration committee following a monitoring visit**

One body's current procedures meant that a firm was not referred to the registration committee following their first monitoring visit, even where the review highlighted significant shortcomings in the quality of audit work performed. We recommended that where the overall conclusion is unsatisfactory the firm should be referred to the registration committee.

*Progress:*

We have noted that the flow of information between the regulatory departments at all RSBs and RQBs has improved and that decisions are more likely to be made with all the appropriate information available.

#### **A4 Approving audit registration and training offices**

We noted a number of instances where some RSBs had granted audit registration and some RQBs had approved training offices prior to the receipt of all relevant information. We made clear to the relevant bodies that in general audit registration and training firm authorisation should not be given prior to receipt of all relevant and necessary information and confirmations. Where in exceptional circumstances the RSB or RQB considers that there are strong reasons to approve the firm before it has provided all the information, the body should make clear that audit registration or training office approval are subject to specific actions, and should follow this up in a timely manner.

*Progress:*

The relevant bodies have implemented changes to their procedures to ensure that firms are not granted audit registration or approved training office status without all documentation and relevant information being received.

### **B) Issues identified at Recognised Supervisory Bodies**

#### *Audit Registration*

##### **B1 Ownership requirements for registered audit firms**

One RSB did not request sufficient information from partnerships to determine that the firm met the ownership requirements of the Companies Act 1989. We told the RSB to develop the appropriate systems to check that existing registered partnerships met the statutory requirements and recommended that they amend the application form for registered auditor status to make it easier to assess future applications. Under the existing statutory requirements, RSBs must have appropriate mechanisms in place to ensure compliance at any point in time.

## **Two – Independent oversight of the Recognised Supervisory and Qualifying Bodies**

2.1 The Oversight Board has statutory powers for the recognition, de-recognition and regular monitoring of supervisory and qualifying bodies for audit in the UK. Audit firms who wish to be appointed as a company auditor in the UK must be registered with, and subject to supervision by, a recognised supervisory body (RSB). Individuals responsible for audit at registered firms must hold an audit qualification from a recognised qualifying body (RQB).

2.2 The following are both RSBs and RQBs:

- Association of Chartered Certified Accountants (ACCA)
- Institute of Chartered Accountants in England and Wales (ICAEW)
- Institute of Chartered Accountants in Ireland (ICAI)
- Institute of Chartered Accountants of Scotland (ICAS)

In addition:

- Association of Authorised Public Accountants (AAPA) is an RSB
- Association of International Accountants (AIA) is an RQB
- Chartered Institute of Public Finance and Accountancy (CIPFA) is an RQB

### **RSB and RQB monitoring**

2.3 We exercise oversight over the regulatory activities of the RSBs and RQBs in three ways;

- Documenting and understanding each body's regulatory systems, in particular to satisfy ourselves that each body meets all the statutory requirements which are conditions of continued recognition;
- Reviewing and testing on an annual basis the way in which each body's regulatory systems are applied in practice and making recommendations for change;

- Evaluating periodically the effectiveness of a specific aspect of the regulatory system such as the handling of complaints, disciplinary arrangements, monitoring of audit firms, audit registration procedures, moderation of examinations, syllabus coverage, examination standards, training requirements and monitoring of approved training practices.

2.4 We visited each RSB and RQB in 2007/08. For all the bodies except CIPFA we have updated our documentation of the regulatory systems and, with the exception of CIPFA and the AIA, we have tested the application in practice in particular where a recognised body has made changes to its regulatory systems.

2.5 CIPFA was recognised as an RQB in July 2005 but has not yet launched a recognised audit qualification.

2.6 The AIA has the necessary regulatory systems in place in relation to its RQB recognition. These include the examinations, arrangements for approving training offices and the practical training of students. However, whilst it has trained students for the audit qualification in the past, and has around 300 students in training for its accountancy qualification, there are no students training at present for the audit qualification. We were not able therefore to test the way in which systems such as student registration and the recording of training records worked in practice in relation to audit.

2.7 We changed the format of our RSB and RQB visits for 2007/08 to focus for each body on key areas of risk or on significant changes in the systems. There were therefore differences in the regulatory activities reviewed at each of the bodies.

2.8 We address our key recommendations in this report to all the bodies, where we judge it is appropriate that all should consider the relevance of the findings to their situation. We also send each body a private report outlining findings and recommendations flowing directly from our work at that body.

2.9 Our overall conclusion continues to be that the way in which audit regulation operates in practice shows that the bodies take their regulatory responsibilities extremely seriously and that they have the necessary requirements and procedures in place. Much of the regulatory practice we have seen is of a high standard. That said, external scrutiny is likely to identify aspects which are less strong or where there is room for improvement. Much of our work, and our private reports to the bodies, therefore address potential

resources to handle complaints engaged a team of temporary investigations officers to reduce the backlog.

We will continue to monitor the level of resources available at all of the bodies.

### **A2 Length of service of Committee members**

Some of the RSBs and RQBs do not have procedures for the rotation of committee members. Whilst we acknowledge the considerable value, which the experience and expertise of committee members brings, we consider that it is necessary to strike a balance between the experienced members who have served for a considerable length of time and newer members who are able to bring new ideas and a fresh perspective to the Committee. We recommended that the bodies concerned considered amending their constitutions to limit the number of terms that members can serve on a Committee.

#### *Progress:*

The bodies concerned have undertaken a review of the necessary Committees and introduced appropriate rotation procedures. The bodies are phasing in these changes to ensure that too much experience is not lost in a short period. That is sensible. One of the bodies has conducted a comprehensive review of all governance matters and has implemented a number of changes in various areas to improve their internal procedures for Committees, including the rotation of committee members and monitoring of Committee objectives.

### **A3 Interface between internal regulatory departments**

We recommended that the interface between regulatory departments at a number of the RSBs and RQBs should be strengthened. We noted examples where firms were continuing to act as registered auditors and train students when it may not have been appropriate for them to do so, for example where the firm was no longer audit registered or, in relation to, training students or where the firm was judged unsatisfactory following an audit monitoring review. Had the relevant information been shared between the relevant regulatory functions, the body would have been better able to take an informed decision and appropriate action to protect the public.

## ANNEX 2

### RESPONSES TO RECOMMENDATIONS 2006/07

During our 2007/8 annual compliance visits at the RSBs and RQBs we reviewed the bodies' progress in implementing our prior year recommendations. We summarise below details of the action taken to date and any proposed plans to address the issues raised.

The majority of the work we reviewed during our RSB and RQB visits was undertaken prior to the finalisation of the prior year recommendations. We therefore discussed the action plans and progress of implementation with appropriate staff. Where possible we reviewed how changes, which had been made, were working in practice.

#### A) General issues relating to RSBs and RQBs

##### A1 Resources for regulatory functions

Whilst the RSBs and RQBs had sufficient resources to carry out their functions effectively and efficiently in most areas of their audit regulatory functions, we had concerns at two bodies at the level of resources available for specific regulatory functions. One body in our opinion did not have adequate resources either for monitoring audit firms or for the approval and monitoring of training offices. We had concerns at a second body about the adequacy of their resources for handling complaints efficiently. These concerns did not reflect a lack of will on the part of the bodies to provide the necessary resources but rather specific difficulties in recruiting experienced staff for certain functions. Where we considered that this could cause significant problems, we asked the bodies to explain how they intended to overcome the difficulties to ensure that they could continue to meet the requirements of the Companies Act.

##### *Progress:*

Our concerns in relation to resources for monitoring audit firms have been largely addressed by the deployment of additional resources and the development of realistic plans, though there is a continuing need to keep the level of resources under review. As noted, we also raised concerns in respect of available resources that one body had for the approval and monitoring of training offices. Following discussions with staff and a review of the number of visits undertaken in 2007/8, we consider that our concerns were unfounded. The body was able to double the number of firms visited in the prior year. The body with inadequate

improvements in the bodies' systems and practices, identify where those systems and practices have not been applied fully, or question whether the way in which the requirements have been interpreted fully meets Companies Act' requirements.

2.10 As part of our oversight of the regulatory activities of both RSBs and RQBs, the bodies provide an annual regulatory report, which includes statistical information on their regulatory activities during the year. **Annex 1** sets out the main elements covered in those reports. We comment on important points arising in paragraphs 2.27 to 2.29 below.

#### Response to prior year recommendations

2.11 During our review visits, we also discussed and examined the bodies' responses to recommendations made in previous reports. We are pleased to note the positive steps that the bodies have taken in response to the recommendations made in previous years. In some cases it is still too early to see the effect of changes on regulatory practice. In a small number of cases, where we consider that the response to our recommendations has been inadequate, we have emphasised to the relevant body the importance we attach to the recommendation and the thinking behind it.

**Annex 2** comments on the responses by the bodies to the principal recommendations made last year.

2.12 We summarise below the main points from our visits according to the regulatory area to which they relate.

#### Issues identified at the Recognised Supervisory Bodies (RSBs)

##### Complaints and Discipline: The Accountancy and Actuarial Discipline Board (AADB) Scheme

##### *Referral of cases to the AADB*

2.13 RSBs are required to participate in independent arrangements for the investigation and disciplining of auditors in cases raising significant public interest issues. In practice, the bodies meet this requirement by membership of the Scheme operated by the Accountancy and Actuarial Discipline Board (AADB). An important difference between the AADB scheme and the predecessor Joint Disciplinary Scheme (JDS) is that the AADB can initiate a case or

take over a case from a participating body without waiting for a referral. Thus, the AADB Scheme provides two distinct routes to launch a formal investigation:

- a case can be referred by a participating body under paragraph 6(2) of the Scheme;
- the AADB can initiate a case following consultation under paragraph 6(8) of the Scheme.

2.14 There are differences of view between the participating bodies and the AADB on the way in which the Scheme should work in practice. The bodies consider that the powers to initiate or call in a case under paragraph 6(8) should only be used in exceptional circumstances, in particular when a participating body fails to refer a case in the face of compelling evidence that the matter needs investigation by the AADB. In our view, what has happened in a number of cases is that the AADB initiates the consultation process with the participating bodies, as provided for in paragraph 6(8), and the participating body responds, following its own initial investigation, by referring the case to the AADB under paragraph 6(2). In our view, this mixing of the two routes leads to confusion as to the respective roles of the AADB and the participating bodies, and is not in accordance with the way in which the Scheme was established. We have therefore recommended that the two routes to initiating an AADB investigation should be kept separate and that the participating bodies should respond to initial consultations by the AADB on individual cases accordingly. We also recommended that there should be discussion between the participating bodies and the AADB with a view to better cooperation to ensure that the Scheme works efficiently and effectively. We are pleased to note recent progress.

***Signing audit reports without appropriate authority***

2.15 A number of complaints received by the RSBs reveal audit reports that have been signed by individuals who are not “Responsible Individuals” (RI) and therefore not entitled to sign audit reports on behalf of a firm. Such individuals tend to argue that they were not aware of the need for RI status and that they considered that it was sufficient to hold a practising certificate. We consider that part of the reason for this is that the bodies do not in all cases make it sufficiently clear to their members, or do not reinforce the message often enough, that holding a practising certificate does not on its own confer the right to accept audit appointments or to sign an audit report. We have therefore recommended that the bodies should consider the way in which they communicate with their members on this point. This is important to protect the public and to maintain confidence in statutory audit.

	ACCA	ICAEW	ICAI	ICAS	AIA <sup>19</sup>
<b>Number of approved training offices visited as a % of the total</b>					
2007	13.0%	5.6%	19.1%	24.7%	0
2006	15.0%	6.5%	7.8%	30.6%	-
2005	14.2%	11.5%	3.1%	21.1%	-

The number of registered training offices in the UK has continued to grow for most of the bodies over the past 3 years. One explanation is that the increase in demand for Chartered Accountants and Chartered Certified Accountants has increased the demand for authorised training firms. The bodies have seen an increase in the demand for training offices outside public practice in the UK and internationally.



## E) Registered Training Offices in UK and Ireland

	ACCA	ICAEW	ICAI	ICAS	AIA <sup>19</sup>
<b>Number of registered training offices</b>					
2007	4,794	2,938	722	174	0
2006	4,663	2,595	681	160	-
2005	4,518	2,503	713	199	-
<b>Number with students in training</b>					
2007	N/A	1,493	467	N/A	0
2006	N/A	1,383	454	144	-
2005	N/A	1,423	443	N/A	-
<b>Number with students training for the audit qualification</b>					
2007	3,777 <sup>20</sup>	1,298	N/A	N/A	0
2006	3,772	1,383	N/A	N/A	-
2005	3,786	1,423	N/A	N/A	-
<b>Number of new applications</b>					
2007	N/A	176	40	25	0
2006	N/A	312	33	15	-
2005	N/A	142	36	11	-
<b>Number of applications refused</b>					
2007	N/A	4	N/A	0	0
2006	N/A	56	N/A	0	-
2005	N/A	98	N/A	0	-
<b>Number of registrations withdrawn</b>					
2007	76	1	N/A	11	0
2006	143	4	N/A	11	-
2005	158	3	N/A	5	-
<b>Number of approved training offices visited</b>					
2007	623	164	138	43	0
2006	701	168	53	49	-
2005	643	289	22	42	-

<sup>19</sup> Information for AIA not requested prior to 2007.

<sup>20</sup> The ACCA figures appear high in comparison to the number of ACCA audit registered firms as many of ACCA's training offices are audit registered with another RSB; ACCA also registers each location of a firm as a separate training office.

2.16 We also recognise that there are a small number of cases where individuals who are not members of any recognised body nevertheless hold themselves out as a statutory auditor and sign audit reports. Given these wider concerns, we propose to work with the RSBs in the coming months to establish whether this is a significant problem and to explore ways of improving protection for the public.

### Audit Monitoring

#### *Meeting the requirements of the Statutory Audit Directive*

2.17 The Statutory Audit Directive introduces an obligation on RSBs to monitor the quality of audits undertaken by statutory auditors at least once every six years. Provisions in the Act to give effect to this came into force in April 2008, replacing a more general requirement that RSBs have effective processes and procedures to monitor statutory auditors. Some RSBs have already increased the number of monitoring visits to audit firms to bring their monitoring frequencies into line with the Directive at an early stage.

**Annex 1** includes data on the number of firms each RSB visited during the years ended 31<sup>st</sup> December 2005, 2006 and 2007.

2.18 We welcome the RSBs' commitment to meet the new requirements on audit monitoring and to provide additional resources as necessary. Nevertheless, in our view this could prove challenging for some bodies. In particular, we have stressed that it is important that the overall monitoring cycle is not met at the expense of more frequent visits to audit firms that pose the highest risks. The RSBs must therefore continue to monitor their own position closely, to ensure that they have a realistic plan in place and that there are adequate resources. We will continue to monitor this as part of our compliance reviews.

### Continuing Professional Development (CPD)

2.19 All the RSBs have introduced new CPD schemes recently and are finding similar issues. We held a round table discussion of all the RSBs towards the end of 2008 to share good practice and to seek ways forward in response to common issues. We comment below on two of the issues arising from our visits to the bodies.

### **CPD Enforcement – Non submission of CPD annual returns**

2.20 Each RSB requires members to complete an annual return to confirm their compliance with CPD requirements. A small minority of members fail to submit their annual CPD return in spite of repeated follow up requests. Whilst we recognise that bodies should not take immediate disciplinary action against members who are slow to submit their returns, we have made clear that members who fail to submit their annual return on a repeat basis should be referred to the Professional Conduct Department for possible disciplinary action.

### **CPD Enforcement – Non submission of evidence of CPD**

2.21 To ensure that members comply with CPD requirements each body selects a sample of members each year to submit evidence of compliance. Not all individuals provide the necessary information to support their annual declaration in spite of considerable chasing. We consider that those who have confirmed their compliance with the CPD regulations but then fail to provide evidence to support this in spite of repeated chasing should be referred to the Professional Conduct Department and appropriate action should be taken. All the bodies should consider carefully how they follow up such cases.

## **Issues identified at the Recognised Qualifying Bodies (RQBs)**

### **Examinations**

#### **Meeting the Companies Act requirements**

2.22 The Companies Act 2006 requires that a recognised audit qualification must test both theoretical knowledge of the prescribed subjects and the ability to apply that knowledge in practice. We raised some concerns last year as to whether all the bodies provided adequate testing of candidates' ability to apply theoretical knowledge in practice, given in particular that in some cases it was not necessary to have gained practical experience prior to sitting final examinations. Whilst in most respects we are now satisfied on this point, we have asked some of the bodies to review further how they meet the requirement that the qualification must be restricted to persons who have passed an examination testing the ability to apply theoretical knowledge in practice and to put proposals to us.

### **D) Student Registration<sup>17</sup>**

	ACCA	ICAEW	ICAI	ICAS	AIA <sup>18</sup>
<b>Number of new students</b>					
2007	20,052	5,057	1,758	1,140	58
2006	21,395	4,639	1,497	1,188	-
2005	19,981	4,075	1,201	1,020	-
<b>Total number of students</b>					
2007	90,653	15,422	5,126	3,460	286
2006	85,296	11,680	4,525	3,154	-
2005	79,513	10,364	3,880	2,636	-
<b>Number of students who became members</b>					
2007	3,891	2,459	971	657	2
2006	3,356	2,604	884	511	-
2005	3,111	2,554	890	687	-
<b>Number of members who became audit qualified</b>					
2007	161	225	104	41	0
2006	165	197	80	25	-
2005	171	172	79	42	-

The number of new students at all bodies rose in 2007. This can be explained in part by an increase in demand for qualified accountants in response to the rise in regulatory requirements.

The proportion of students who become members is considerably lower for the ACCA and AIA than for the other bodies, where the number of students who become members is similar to the related student intake. The ACCA have explained that fewer students are becoming members, as a greater proportion than at other bodies fail to complete all the examinations successfully.

The table also shows the number of members that became audit qualified. The number of members who become audit qualified is low compared to the number of students passing the examinations and becoming members.

<sup>17</sup> UK and Republic of Ireland figures, except for the ICAEW which are on a worldwide basis

<sup>18</sup> Information for AIA not requested prior to 2007.

	ACCA	ICAEW	ICAI	ICAS
2006	8.6 months	20 months	11 months	For cases closed by Investigation & Professional Conduct Enforcement Committee = 188 days
2005	5 months	17 months	Not available	For cases closed by the Investigations committee = 80 days

ICAI is the only body that saw a fall in the number of audit related complaints in 2007 compared to prior years.

The ICAEW explained that the increased average time to handle complaints in part reflected the fact that a number of the older cases particularly those allocated to staff who left in 2005 were closed.

2.23 More generally, a number of the RQBs have made significant changes to their syllabuses in the past few years. We are therefore undertaking a wider review of these as part of our 2008/09 work to ensure suitable coverage and testing of the prescribed subjects.

#### **Award of the Recognised Professional Qualification for audit**

2.24 The Companies Act 2006 sets minimum requirements for the practical training that an individual must have undertaken in order to hold the recognised professional qualification. A part of that practical experience must be in UK statutory audit work. Our review at one of the bodies raised doubts as to whether this requirement was met in all cases where the individual trained outside the United Kingdom. We asked the body in question to review its requirements and its procedures for verifying the training records of individuals based outside the UK and to report to us. In particular, we asked that they review a sample of individuals who trained outside of the UK and have been awarded the recognised professional qualification. This has now been done and we have agreed revised procedures with the body.

2.25 More generally, we continue to come across instances at a number of the bodies where we consider that the recognised professional qualification has been awarded but it is unclear to us how the required practical experience has been obtained. We reiterate therefore that it is important that the bodies have robust procedures for reviewing the records of experience submitted and in particular, for satisfying themselves that this includes sufficient experience of UK statutory audit.

#### **Training Records**

2.26 We also continue to come across instances in our reviews where training records have been signed off by individuals without the appropriate authority, and where this is not challenged by the body. We have made clear to the bodies that they must have the necessary procedures and practices in place to minimise the risk (i) that training records are submitted that have not been properly authorised and (ii) that, where such records are submitted, that appropriate action is taken.

## Statistical Annex

2.27 **Annex 1** provides statistical information on the regulatory activities of recognised supervisory and qualifying bodies in respect of:

- audit firms registered with the supervisory bodies
- audit monitoring visits by the supervisory bodies
- complaints to recognised bodies about statutory auditors
- student registration
- registered training offices

### Number of Registered Audit Firms

2.28 All the RSBs, with the exception of the ICAI, report a significant gradual fall over recent years in the number of registered UK audit firms. This is primarily a result of the large increases in the threshold for mandatory statutory audit in the UK. The ICAI figure reflects the different position in the Republic of Ireland, where a major change in audit thresholds is much more recent. It is likely, however, that there will be a similar significant reduction in the number of ICAI registered audit firms over the next few years.

### The results of Audit Monitoring

2.29 Considerable care is needed in interpreting the results of audit monitoring shown in Annex 1, as reflected in the grading of visits by inspectors. Most importantly, the sample of firms visited is not purely random but is likely to include a disproportionate number of higher risk firms. Moreover, the gradings have somewhat different meanings at different bodies and it would be wrong to compare one body against another on the basis of this information. Nevertheless, we note with some concern that the percentages of firms visited that receive either a C or a D grade – in simple terms, firms at which there were significant issues of poor quality audit work and/or of non compliance with requirements, requiring some follow up action – remain high. Whilst these statistics support the view that the monitoring unit at each body takes its role extremely seriously, they also invite questions as to the root causes underlying the figures. This is not simply a question of one year's statistics – this is a recurring pattern. Our concerns are reinforced by our separate work with the accountancy bodies on the poor quality of accounts filed at Companies House, including accounts that have been audited. We think that it is important therefore to get beneath the

## C) Complaints about Auditors

	ACCA	ICAEW	ICAI	ICAS
<b>Number of new cases<sup>13</sup></b>				
2007	15	106	78	8
2006	10	78	113	4
2005	13	65	84	4
<b>Number of cases passed to the AIDB<sup>14</sup></b>				
2007	0	0	0	0
2006	1	2	1	0
2005	0	1	0	0
<b>Number of cases passed to committee<sup>15</sup></b>				
2007	4	70	37	6
2006	4	57	27	2
2005	9	43	18	4
<b>Number of complaints<sup>16</sup> closed in the year</b>				
2007	7	86	92	4
2006	16	81	87	2
2005	13	69	66	0
<b>Average time taken to close a complaint</b>				
2007	6.4 months	12 months	9.8 months	For cases closed by Investigation & Professional Conduct Enforcement Committee = 45 days; cases closed by Secretariat = 42.5 days

<sup>13</sup> Cases relate to audit related complaints only

<sup>14</sup> AIDB suggest an emphasis on the exclusion of referrals i.e. 'taken on' rather than 'passed to'

<sup>15</sup> Cases passed to the committee relate to: A) the disciplinary committee for the ACCA B) Cases considered by the Investigations committee and referred to the disciplinary committee for the ICAEW C) the Complaints, Disciplinary and Appeals committee for the ICAI and D) the Investigation committee at ICAS.

<sup>16</sup> Audit related complaints only

and 'D' reports. Considerable care is therefore needed in drawing conclusions based on either the overall spread of outcomes of visits or on comparisons of outcomes year on year.

#### ICAS

	2007	2006	2005
Number of A & B outcomes	21	33	35
% of A & B outcomes compared to all visits conducted	51	50	56
Number of C outcomes	14	21	17
% of C outcomes compared to all visits conducted	34	30	27
Number of D outcomes	6	15	11
% of D outcomes compared to all visits conducted	15	20	17

An 'A' rating indicates there are no issues to deal with. A 'B' rating indicates there are some regulatory issues but that these have been adequately addressed by the firm's closing meeting responses and no further action is required. 'C' gradings indicate that there are regulatory issues and there is a need for the firm to show that planned changes have occurred by submitting further information. A 'D' rating is given when the standard of compliance is such that the Audit Registration Committee needs to consider appropriate follow up action, such as imposition of conditions and restrictions or withdrawal of registration.

Due to planned resource issues in 2007, ICAS reduced the target number of visits. ICAS noted that it was difficult to compare the gradings year on year as different firms were visited in order to meet the requirements of the Statutory Audit Directive.

ICAS suggest that a possible explanation for the reduction in A and B rated visits in 2006 and 2007 as compared with 2005 is that firms have encountered teething issues using the International Standards on Auditing.

statistics to understand the issues fully and consider what needs to be done so that this does not simply continue from year to year. Therefore, as part of our work this year, we are asking the bodies to analyse more closely, what lies behind these statistics and we shall examine the results of audit monitoring of smaller audit firms.

#### Practical Training Project

2.30 The Oversight Board has recently published its report on the practical training of auditors. This review was conducted because of the concerns arising from the changing market structure for audit in the UK and concerns raised during our previous RQB annual compliance visits. This report focuses on the policies, systems and practice governing the practical training of auditors.

2.31 Prior to the Companies Act 1989, all qualified members were deemed to be qualified auditors. Since then, to become a qualified auditor (i.e. be eligible to sign an audit opinion), a qualified accountant must have passed a recognised examination and obtained a prescribed level of experience in company audit or similar work. In practice, until recently, the qualification was only awarded on application, such applications generally being made when an accountant wished to sign audit opinions.

2.32 During our annual monitoring visits to the bodies, we identified that each body adopts a different approach to the practical training requirements of the Act. Therefore, the objective of our review was to assess each RQB's procedures with respect to practical training and to recommend areas for further improvement.

2.33 Our review included all aspects of practical training including the approval and monitoring of training firms, student training records requirements, and the completion and monitoring of student training records. To ensure that we fully understood all viewpoints we and the bodies jointly commissioned a research team from the University of Glamorgan to conduct two surveys of students and mentors. At the specific request of the bodies, the views of firms were not sought.

2.34 Our work draws seven conclusions, which divide into two broad categories, profession wide issues and operational issues;

Profession wide issues:

- Availability of audit work in small audit firms. As the audit threshold rises and the number of companies requiring audits falls, smaller firms are finding it increasingly difficult to retain a critical mass of audit clients to provide trainees and audit staff with sufficient audit experience to achieve the audit qualification and to maintain competence once qualified;
- Audit firm ownership rules. The Act requires that firms registered to conduct audits be controlled by audit-qualified individuals. A decline in the number of qualified auditors may make succession in smaller firms more difficult;
- Retention of trained auditors in larger firms. The research team found that trainees in the larger firms who have plenty of audit experience often favour a different long-term career path. Historically, larger firms have recruited trained auditors from smaller firms to fill any gaps arising from their own trainees following a different career path. With a restricted supply of trained auditors within smaller firms, this is likely to prove more difficult.

2.35 Operational issues:

- Mentoring arrangements for trainees. Mentoring plays, an important role in ensuring trainees receive appropriate support and training. There is evidence from the research team that mentoring could be improved;
- Practical training records. The research team found evidence that both trainees and mentors considered that the records were not always a true reflection of the work done;
- Interaction between examinations and practical experience. The research evidence shows that the integration of practical training and examination preparation best aids the development of trainees. Where these are not interlinked, examinations tend to be seen as bearing little relevance to in-house training and practical experience.
- Operating procedures within the professional bodies. These were found to be generally strong. However, there were instances where staff did not follow the body's own procedures.

confident, that the firm's proposed actions set out in the closing meeting notes adequately address all the issues. In addition QAD believe that the firm has the ability to take action within the stated timescale and that they have the commitment to take the agreed action. A 'C' rated report records instances of non compliance with the audit regulations where the QAD considers that there is a need for follow-up action, due to some doubt about the actions proposed or the firm's competence, resources or commitment, but that there is no need for the Audit Registration Committee (ARC) to impose any further conditions or restrictions. 'D' rated visits record cases of non-compliance with the audit regulations that need to be referred to the ARC for possible further action.

The proportion of D-graded visits substantially decreased in 2005, as approximately one third of the visits undertaken during 2005 were to firms who had never been visited before, as they were lower risk compared to the two previous years. The ICAEW explained that differences are likely to arise year on year as the population visited will be different.

ICAI

	2007	2006	2005
Number of A & B outcomes	10	7	15
% of A & B outcomes compared to all visits conducted	24	23	27
Number of C outcomes	17	10	28
% of C outcomes compared to all visits conducted	40	32	51
Number of D outcomes	15	14	12
% of D outcomes compared to all visits conducted	36	45	22

The ICAI consider all visits graded A to C as a 'pass'. There is a considerable difference between a report graded a 'C' and one graded a 'D'. A grade C is given where a number of issues have arisen on a visit but the firm has appropriate action plans to address the issues, and there is generally no follow up action required. In contrast, those reports graded a 'D' have significant issues and will always require follow up action.

It is important to emphasise that the visits are not randomly selected and that firms with identified risks are disproportionately targeted. For example in 2007, the ICAI visited a large number of firms who had not previously had a monitoring visit, which resulted in more 'C'

ACCA grades visits A-D. Those that are graded 'A' are judged to be satisfactory and comply with all material aspects of the Global Practising Regulations (GPRs) and Code of Ethics and Conduct (CEC). Those visits rated B are deemed to be acceptable and any deficiencies found in audit work are minor and unlikely to have compromised the audit opinion issued. Visits are graded 'C' by the ACCA if the audit work is unsatisfactory at a single visit and improvements are required. When a firm has a second unsatisfactory visit and there are no mitigating factors, the firm will be referred to the Regulatory Assessor/ Admissions and Licensing Committee (ALC) and the visit graded a 'D'. In addition, where there are serious breaches of other regulations then the matter will be referred to the Professional Conduct Department and the visit graded a 'D'. The gradings of a visit are not based solely on the standard of audit work; the outcome could be deemed unsatisfactory due to the breach of client money rules or CPD regulations.

In 2007, 48 visits were carried out on the order of the ALC. Of these, 33 firms were found to have improved their procedures so that their compliance with auditing standards was satisfactory. 15 firms remained unsatisfactory and were referred back to the ALC for further action.

#### ICAEW

	2007	2006	2005
Number of A & B outcomes	582	457	630
% of A & B outcomes compared to all visits conducted	60	64	73
Number of C outcomes	283	188	194
% of C outcomes compared to all visits conducted	29	27	22
Number of D outcomes	110	64	44
% of D outcomes compared to all visits conducted	11	9	5

The above figures represent those reports finished in the year and reported to the Audit Registration Committee (ARC).

The ICAEW class all visits graded A-C as satisfactory. Visits graded 'A' are those where there are no instances of non-compliance with the Institute's audit regulations and no regulatory action is required. 'B' rated visits are those with evidence of non-compliance with the audit regulations of the Institute, but where the Quality Assurance Directorate (QAD) is

2.36 The bodies have confirmed that they recognise the profession-wide concerns raised by our work and have agreed to work with the Oversight Board to address the issues and in particular the concerns as to the structure of the audit market. The outcome of our discussions with them will be shared with the firms. The issue of the retention of trained audit staff in larger firms may resolve itself in the current economic climate. We do not propose therefore to address this at the current time but to keep a watch on the market.

2.37 The bodies will address the operational issues individually and we will pursue progress on these with each of the bodies in 18 months.

### Three – Other Statutory Responsibilities

#### Contributing to the wider activities of the FRC

3.1 The Oversight Board has contributed to a number of FRC wide initiatives in the area of auditing in support of our statutory responsibilities. In particular, we have contributed to the FRC's project on competition and choice in the audit market and, with the Auditing Practices Board (APB), developed an audit quality framework.

#### Competition and Choice

3.2 The objectives of the FRC's project on competition and choice in the audit market are increased choice of auditor for public interest entities, reduced risk of an existing firm leaving the market without good reason, and reduced costs of uncertainty and disruption in the event of a firm leaving the market.

#### Audit Quality

3.3 High quality audits and improving the quality of audits are fundamental to what the Oversight Board does. However, audit quality is a much used but poorly defined term. In particular, it is difficult for the users of audited accounts and the users of audit services to differentiate between the good, the indifferent and the poor audit. We took forward with the APB the work started in 2006 to promote awareness amongst the providers and users of audit services of the key drivers the drivers of audit quality. This led, following extensive consultation, to the publication in February 2008 of a short booklet, *The Audit Quality Framework*, designed to assist all stakeholders, but in particular audit committees, companies and auditors, to recognise the critical elements underlying high quality audits. However, we recognise that the indicators of audit quality may change over time and we will therefore with the APB review the Framework periodically in the light of feedback and of our experience from audit monitoring.

#### Cooperation with other international regulators

3.4 Given the global nature of capital markets, of major companies and of the firms who audit them, our objectives are more easily achieved with strong international cooperation. We seek to achieve this through the following initiatives:

	ACCA	ICAEW	ICAI	ICAS
Number of firms with public interest entities visited without AIU involvement	0	39	5	0
Number of firms specifically selected due to heightened risk	70	742 <sup>12</sup>	37	59
Number of firms randomly selected	345	84	9	3

#### Gradings

The grading process and definition of grades vary for each body. It is therefore not appropriate to use the gradings to compare audit quality between firms registered with the different bodies. Particular care is also needed in interpreting the percentage of "D" outcomes at each body, given in particular that the sample of firms inspected in any year is unlikely to be a random but will almost certainly include a disproportionate number of weaker firms.

The tables below show the gradings for the four bodies for visits conducted from 2005-2007.

#### ACCA

	2007	2006	2005
Number of A & B outcomes	159	182	271
% of A & B outcomes compared to all visits conducted	56	49	59
Number of C+ outcomes	65	64	63
% of C+ outcomes compared to all visits conducted	23	17	14
Number of C- outcomes	20	33	60
% of C- outcomes compared to all visits conducted	7	9	6
Number of D outcomes	41	92	98
% of D outcomes compared to all visits conducted	14	25	21

<sup>12</sup> Within the ICAEW figure of firms selected due to heightened risk, 281 firms were included, as they had not been visited in the previous six years.



	ACCA	ICAEW	ICAI	ICAS
<b>Reason for monitoring visits</b>				
<b>2007</b>				
Number of firms monitored following a request by the registration/ licensing committee	48	21	6	0
Number of firms with public interest entities visited without AIU <sup>10</sup> involvement	0	29	3	0
Number of firms specifically selected due to heightened risk	35	681	21	38
Number of firms randomly selected	202	244	12	0
<b>2006</b>				
Number of firms monitored following a request by the registration/ licensing committee	37	42	9	1
Number of firms with public interest entities visited without AIU <sup>11</sup> involvement	0	35	2	1
Number of firms specifically selected due to heightened risk	74	240	6	65
Number of firms randomly selected	260	396	16	1
<b>2005</b>				
Number of firms monitored following a request by the registration/ licensing committee	47	40	4	1

<sup>10</sup> AIU = Audit Inspection Unit

<sup>11</sup> AIU = Audit Inspection Unit

- participation in the European Group of Auditor Oversight Bodies and its related sub-committees, whose role is to advise the European Commission on audit regulatory matters and which provides a platform for cooperation between regulators in Member States;
- ad hoc bilateral discussions with other regulators. There is considerable growth in the establishment of independent oversight and inspection bodies, many of whom seek to learn from the UK's experience;
- participation in IFIAR (the International Forum of Independent Audit Regulators) which aims to share knowledge of the audit market environment and practical experience of independent audit regulatory activity, to promote collaboration in regulatory activity, and to provide a focus for contact with other international organisations which have an interest in audit quality

### Implementing the Statutory Audit Directive

3.5 Part 42 of the Companies Act 2006 makes significant changes to the Oversight Board's statutory powers and responsibilities, principally as part of implementing the Statutory Audit Directive. We report below on how we are taking forward these new responsibilities..

3.6 The main changes, which came into force on 6 April 2008, are to:

- strengthen the requirements supervisory bodies must meet to maintain their recognition;
- provide a framework for the regulation of auditors from outside the European Union of companies that issue securities admitted to trading on regulated markets in the UK; and
- set a new statutory requirement on some UK auditors of public interest entities to publish annual transparency reports.

3.7 The Act also places new responsibilities on the Oversight Board for the oversight of Auditors General, in relation to their new power to act as statutory auditors under company law.

3.8 Putting in place the detailed measures necessary to bring this package of changes into force required close coordination between the Oversight Board and the Department for Business, Enterprise and Regulatory Reform, given that on some aspects implementation is the responsibility of the Oversight Board under delegated powers.

3.9 We consulted on three POB instruments in 2007/08, which formed an integral part of the implementation scheme for the Statutory Audit Directive. These all took effect on 6 April 2008.

**Statutory Auditors (Transparency) Instrument**

This sets the detailed requirements for the transparency reports, which the auditors of public interest entities are required to prepare and publish each year. Whilst a number of audit firms already publish transparency reports on a voluntary basis, the first such statutory reports are required following the end of the audit firm’s first financial year starting after 6 April 2008. We are looking to the relevant audit firms to meet the spirit as well as the letter of the legal requirements, and in particular, to take the opportunity to explain in a straightforward way how they ensure consistent high quality audits.

**Statutory Auditors (Registration) Instrument**

The Statutory Audit Directive sets more detailed requirements than hitherto as to the information on audit firms that must be available on the public register. This instrument sets requirements in line with those in the Audit Directive.

**Statutory Auditors (Examination) Instrument**

This Instrument prescribes the subjects on which a candidate must be tested as part of gaining the audit qualification.

**Independent Supervisor of Auditors General**

3.10 The 2006 Act provides that for the first time the Comptroller & Auditor General (C&AG) and the other Auditors General (AGs) are eligible for appointment as statutory auditors. The purpose is to allow AGs to audit public sector companies and other public sector entities that require a statutory audit. The Secretary of State appointed the Oversight Board as the Independent Supervisor of AG.

3.11 The 2006 Act requires the Independent Supervisor to discharge the supervision duty by entering into arrangements in relation to the following:

- the ethical and technical standards to be applied by an AG in statutory audit work;
- monitoring the performance of statutory audits carried out by an AG;

**B) Audit Monitoring**

Following recognition in 1991, the recognised supervisory bodies started monitoring their member firms. The three territorial Institutes formed a single Joint Monitoring Unit (JMU) and the ACCA set up a separate monitoring department. From 1st January 2005, the JMU was disbanded and the monitoring of firms was undertaken by each Institute independently. The ICAEW’s Quality Assurance Directorate assists the ICAI on visits to larger firms.

The Audit Inspection Unit (AIU) inspects the auditors of listed and other major public interest entities (see Section 3)

The population of firms monitored each year will be different and the number of firms monitored is not necessarily sufficient to compare the data year on year. The Statutory Audit Directive (effective April 2008 in the UK) introduced a requirement that RSBs should monitor the activities undertaken by all audit firms at least once every six years. Whilst the Directive was not in force during 2007, a number of the RSBs increased the number of firms they monitored to bring practice into line with the Directive at an early stage.

	ACCA	ICAEW	ICAI	ICAS
<b>Number of firms monitored</b>				
Actual 2007	285	975	42	41
Target 2007	Not Available	920	50	40
Actual 2006	371	713	33	69
Target 2006	Not Available	875	50	50
Actual 2005	462	905	55	63
Target 2005	Not available	900	50	50
<b>Actual firms monitored as a % of audit registrants</b>				
2007	10.6%	21.5%	4.2%	15.4%
2006	13.5%	15.2%	3.2%	23.0%
2005	15.6%	17.4%	5.3%	18.4%

	ACCA	ICAEW <sup>7</sup>	ICAI	ICAS
<b>Number of Principals, as at 31.12.06</b>				
1	1,954	2,481	666	127
2-6	753	2,115	339	148
7-10	28	146	12	17
11-50	6	105	10	7
50+	0	12	1	1
<b>Number of Principals, as at 31.12.05</b>				
1	2,170	2,822	679	166
2-6	771	2,111	682	157
7-10	21	147	12	12
11-50	6	99	9	7
50+	0	14	3	1
<b>Number of new applications<sup>8</sup></b>				
Yr to 31.12.07	77	272	41	19
Yr to 31.12.06	89	258	35	14
Yr to 31.12.05	125	290	35	7
<b>Number of applications refused<sup>9</sup></b>				
Yr to 31.12.07	0	0	0	0
Yr to 31.12.06	0	0	0	0
Yr to 31.12.05	0	0	0	0

<sup>8</sup> New applications, other than for ACCA, include those firms changing status, for example from a partnership to an LLP

<sup>9</sup> All applications that are refused must be considered by the registration/ licensing committee

- the investigation and disciplinary arrangements in relation to any matter arising from the performance by an AG of a statutory audit.

3.12 The Auditors General are not members of any professional accountancy body, and are therefore not bound by the technical and ethical standards of the bodies. We have therefore entered into a memorandum of understanding, initially with the National Audit Office, which requires the C&AG and relevant staff to follow prescribed standards. As a part of these arrangements, we have also designed disciplinary procedures which would come into force were there a requirement to discipline the C&AG or AGs in their capacity as statutory auditors.

3.13 To date, only the C&AG has expressed a wish to undertake statutory audits. We would enter into similar arrangements with other Auditors General as necessary.

3.14 The monitoring of the work of Auditors General will be undertaken by the AIU on behalf of the Oversight Board. The AIU is currently formulating the scope of the work they will carry out.

3.15 We understand that the National Audit Office is discussing undertaking statutory audits with a number of companies. We expect that the first such audits will be in respect of the financial year ending 31 March 2009. The AIU would therefore conduct its first reviews under these new arrangements in late 2009/early 2010.

### Freedom of Information Act

3.16 The Oversight Board became subject to the Freedom of Information Act (FOIA) in respect of its statutory duties on 6 April 2008.

3.17 In accordance with the requirements of the FOIA, we drafted a publication scheme, which, after consultation with our stakeholders, has been approved by the Information Commissioner and is now available on the Oversight Board website. This scheme provides guidance to the public on what information we will provide generally and how to make requests for information.

3.18 We received four requests for information between March and September 2008: two requests for hard copies of documents available on our website, a request for an analysis of complaints received by the Oversight Board and a request, the nature of which was and remains unclear.

## Notifications of change of auditor

3.19 The 2006 Act introduced a new requirement, in force from April 2008, that both the outgoing auditor and the company must notify the “appropriate audit authority” of the reasons for the change of auditors. The Professional Oversight Board is the audit authority for “major audits”; the recognised supervisory body of the audit firm is the audit authority in all other cases. The intention is to alert regulatory bodies more directly to situations where the reasons for a change of auditor might point to underlying issues, such as weaknesses in a company’s accounts, where action might be needed.

3.20 In the six months since April, there were 126 notifications to us of changes of auditor in respect of “major audits”. In three such cases, we judged that the notifications should be drawn to the attention of the Financial Reporting Review Panel and the Audit Inspection Unit.

## Complaints to the Professional Oversight Board about registered auditors, accountants and actuaries

3.21 In 2008 the Oversight Board published its policy on the handling of complaints it receives about the way in which a recognised body has handled a complaint about a registered auditor, accountant or actuary.

3.22 The Oversight Board has a statutory responsibility under company law to ensure that those accountancy bodies recognised to supervise auditors and audit firms have effective arrangements in place to investigate complaints against their members and member firms or about the way, they have exercised their regulatory functions.

3.23 By agreement with the six “chartered” accountancy bodies, and the Institute and Faculty of Actuaries, the Oversight Board also exercises independent oversight of the way those bodies exercise their regulatory functions in relation to their members more generally.

3.24 The Oversight Board will consider complaints that raise concerns about the way in which a professional accountancy or actuarial body has handled a complaint. However, the professional bodies are responsible for their own regulatory processes and the Oversight Board will not consider the merits of an individual case or second guess the conclusions reached by the professional body under its own processes.

## ANNEX 1

### STATISTICAL ANNEX: REGULATORY ACTIVITIES OF RECOGNISED SUPERVISORY AND QUALIFYING BODIES

#### A) Audit Registration

	ACCA	ICAEW <sup>7</sup>	ICAI	ICAS
<b>Number of audit firms</b>				
As at 31.12.07	2,697	4,526	1,006	266
As at 31.12.06	2,741	4,817	1,028	300
As at 31.12.05	2,968	5,193	1,044	343
<b>Number of Office locations, as at 31.12.07</b>				
1	2,417	3,297	929	212
2-3	267	1,107	72	41
4-10	11	107	5	11
10+	2	15	0	2
<b>Number of Office locations, as at 31.12.06</b>				
1	2,454	3,660	958	238
2-3	275	1,039	66	48
4-10	10	103	4	12
10+	2	15	0	2
<b>Number of Office locations, as at 31.12.05</b>				
1	2,656	4,126	975	278
2-3	299	947	64	50
4-10	12	103	5	13
10+	1	17	0	2
<b>Number of Principals, as at 31.12.07</b>				
1	1,894	2,265	654	109
2-6	770	1,986	329	132
7-10	25	156	13	17
11-50	8	106	9	7
50+	0	13	1	1

<sup>7</sup> The ICAEW figures are for those firms that were to be registered as at 1 January the following year.

of interest, as well as the profession's proposals for reform in the areas of continuing professional development, practising certificates and discipline. We continue to encourage the profession to focus on the quality and intended outcomes of its regulatory processes, including in the area of education and training requirements for the main actuarial qualifications.

6.17 We will also follow up the two major consultations that were issued in May 2008:

- *Monitoring and scrutiny in actuarial work*, an Oversight Board discussion paper responding to a recommendation to the FRC by the Morris Review of the Actuarial Profession – as a result of which we intend to develop draft recommendations to the Profession;
- *Promoting actuarial quality*, an FRC discussion paper which we developed in conjunction with the Board for Actuarial Standards. We intend to issue an Actuarial Quality Framework, as a means of improving the assessment and understanding of actuarial quality, and communicating with our stakeholders about the quality of actuarial work.

## Resources

6.18 In 2007/08 the operating costs of the Professional Oversight Board (excluding the Audit Inspection Unit) were £1.3 million, excluding support services provided centrally. The average monthly number of staff in post was 7. For 2008/09, the equivalent budgeted figures are £1.5 million and 9 staff.

6.19 The costs of the Audit Inspection Unit are accounted for separately. The cost for 2007/08 was £2.1 million with an average of 17 staff, against a budget of £2.8 million. The AIU is planning to operate with 18 staff in 2008/09 on a budget of £2.5 million

3.25 An analysis of the complaints received by the Oversight Board in each of the three years to 31 March 2008 is shown below.

Complaints made to the Oversight Board					
Year end 31 March					
	2006	2007	2008	Audit	Non audit
AAPA	0	0	0	0	0
ACCA	1	4	1	1	5
CIMA	1	1	0	*1	1
CIPFA	0	0	0	0	0
ICAEW	4	3	3	5	5
ICAI	0	0	0	0	0
ICAS	2	1	2	2	3
Institute of Actuaries	0	0	0	0	0
Faculty of Actuaries	0	0	0	0	0
<b>Totals</b>	<b>8</b>	<b>9</b>	<b>6</b>	<b>9</b>	<b>14</b>

\* Complaint regarding a CIMA member who had signed an audit opinion

## Four – Monitoring the Quality of the Auditing of Economically Significant Entities

### Introduction

4.1 The AIU's inspections of the major audit firms, on which it reports publicly, comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year by the Oversight Board.

4.2 The AIU review firms' policies and procedures in the following areas:

- Leadership, strategy and communications
- Performance evaluation, promotions and remuneration
- Other human resource matters
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Independence and ethics
- Audit methodology

4.3 The AIU's reviews of individual audits place emphasis on the appropriateness of significant audit judgements exercised in reaching the audit opinion, as well as the sufficiency and appropriateness of the audit evidence obtained.

4.4 The AIU's inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the auditing standards and ethical and quality control standards for auditors issued by the FRC's Auditing Practices Board (APB)<sup>1</sup> and other relevant requirements under the ICAEW's Audit Regulations<sup>2</sup>. The standards referred to in the AIU's reports for 2007/8 are those effective at the time of the AIU's inspection or, in relation to its review of individual audits, those effective at the time the relevant audit was

<sup>1</sup> International Standards on Auditing (UK and Ireland), APB Ethical Standards and International Standard on Quality Control (UK and Ireland) I.

<sup>2</sup> The Audit Regulations are issued jointly by The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

### Wider oversight of regulation of the accountancy profession

6.12 Our efforts in 2008/09 will continue principally to support wider FRC initiatives on audit and accountancy, in particular:

- taking forward, and where appropriate putting into effect, the recommendations in the Market Participants' Group Final Report on Choice in the UK Audit Market, which aim to enhance the efficiency of the market for audit and to mitigate the risks associated with a major firm leaving the market; and
- keeping under review the Audit Quality Framework, and the way in which it is being used in practice.

6.13 We are also continuing to work with the accountancy bodies to follow up our previous project work, in particular on the quality of the accounts of small and medium sized enterprises and the role of accountants in supporting the needs of the SME community.

### International Priorities

6.14 Following the implementation by most Member States of the requirements of the Statutory Audit Directive, a priority in 2008/09 is to deepen cooperation across the EU on audit regulation, through the European Group of Auditor Oversight Bodies. This is increasingly necessary not simply as a result of the Directive's provisions but also as the major audit firms look to increase the level of their internal integration across their international networks.

6.15 We also continue to support the FRC in promoting international regulatory cooperation through participation in the International Forum of Independent Audit Regulators.

### Oversight of the actuarial profession

6.16 For 2008/09 we continue to monitor the regulatory activities of the actuarial profession as well as developments that could adversely affect public confidence in actuaries. Priority areas include the profession's development of a revised set of ethical and conduct standards, including a new Actuaries' Code and standards for dealing with conflicts

maintain appropriate competence, in the light of higher audit exemption thresholds and increasing complexity.

6.8 As noted above, the coming into force of the Companies Act 2006 brings with it additional statutory responsibilities for 2008/09. From April 2008 we have taken on responsibility for the registration and regulation of auditors of third country issuers of securities listed in the UK; we have started to receive and to assess statutory notifications of changes of auditor; and we have taken on the role of the Independent Supervisor of Auditors General, in respect of their new ability to undertake statutory audit work.

#### **Monitoring the quality of major audits**

6.9 For 2008/09 the Audit Inspection Unit will carry out full scope inspections, involving reviews of both firm-wide procedures and a sample of individual audits, of eight of the nine firms currently subject to such inspections (including the six largest firms). One of these eight firms has not previously been subject to a full scope AIU inspection. The AIU will assess the progress made by the seven other firms against the action plans agreed with them following their previous inspection. It will pay particular attention to monitoring how the firms have responded to the challenges arising from the financial crisis at both a firm-wide and individual engagement level. The AIU will also review a sample of public interest audits at selected smaller firms undertaking audits within the scope of independent inspection.

6.10 The AIU is committed to a process of continuous improvement in the light of feedback from the firms subject to inspection and others on how the process might be improved. As part of that commitment, the AIU has further refined its systems, work programmes and quality control procedures for the 2008/09 inspections to promote ongoing improvement in the quality of its work.

6.11 2008/9 is the first year for which the more transparent reporting arrangements for the AIU agreed by the Board following consultation with stakeholders are fully in force. As well as publishing reports on all full scope inspections of audit firms carried out, the AIU is issuing reports on individual audits reviewed during 2008/9, which the relevant audit firms will be able to share with their clients.

undertaken. (The APB issued revised Ethical Standards in April 2008, which are effective for audits of financial statements for periods commencing on or after 6 April 2008.)

4.5 The AIU seeks to identify areas in which improvements are, in their view, required to safeguard audit quality, including matters relating to compliance with regulatory requirements, and to agree an action plan with the firm designed to achieve these improvements. The AIU also assesses the extent to which the firm has addressed the findings and recommendations arising from the previous AIU inspection.

4.6 The AIU provides the Audit Registration Committee of the relevant professional accountancy body in the UK, who register firms to conduct audit work, with a report on each major firm containing a number of findings in relation to how the firm can improve audit quality, together with an overall recommendation on whether the firm's audit registration should be continued. These reports provide the basis for the AIU's public report on each firm. In addition, the AIU reports separately to the Audit Registration Committees on its findings from reviews of audits at smaller firms.

4.7 The AIU's inspections are not designed to, nor would it be possible to, identify all weaknesses, which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by the AIU for review and cannot be relied upon for this purpose.

4.8 The AIU does not carry out a detailed technical review of the audited financial statements in reviewing individual audits. The AIU's focus in relation to financial reporting issues is on the appropriateness of audit judgements exercised and any underlying deficiencies in the firm's audit work and quality control procedures. Accounting and disclosure issues identified are therefore raised with firms in an audit context rather than a financial reporting context. Audit judgements on financial reporting issues are, however, challenged by the AIU, where appropriate, as an integral part of its work.

4.9 If the AIU identifies a significant concern during the course of a review of an individual audit as to whether an accounting treatment adopted and/or disclosures provided comply with the applicable accounting framework, it may draw the matter to the attention of the FRC's Financial Reporting Review Panel (FRRP). Such matters are then considered in accordance with the FRRP's Operating Procedures. In 2007/8, the AIU drew the FRRP's attention to matters arising in relation to the financial statements of three entities whose audits it had reviewed.

4.10 Similarly, if during the course of its inspections the AIU identifies a significant concern as to the conduct of an individual or firm it may draw the matter to the attention of the FRC's Accountancy and Actuarial Discipline Board (AADB). In 2007/8, the AIU drew no such matters to the attention of the AADB.

4.11 The monitoring units of the professional accountancy bodies in the UK are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within the scope of audit regulation in the UK. We report on the Board's oversight of the monitoring activities of the professional bodies within Section 2 above.

#### *Coverage of Inspections*

4.12 During 2007/8, the AIU undertook full scope inspection visits, comprising a review of firm-wide procedures and individual audits within its scope, at seven of the nine firms which audit more than ten entities within the scope of the AIU (BDO Stoy Hayward LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and KPMG Audit Plc, PKF (UK) LLP, and PricewaterhouseCoopers LLP), all of which are registered by the ICAEW. Full scope inspections at the other two firms, Baker Tilly UK Audit LLP and Howarth Clark Whitehill LLP, which were not visited in 2007/8, will form part of the AIU's inspection programme for 2008/9.

4.13 The AIU also carried out inspection visits at nine smaller firms. For these firms, the AIU's work comprised reviews of one or more of the small number of listed or other major public interest entities audited by them.

4.14 Staff from the US Public Company Accounting Oversight Board participated in certain aspects of the AIU's 2007/08 inspections of PricewaterhouseCoopers LLP and Deloitte & Touche LLP, by agreement with the firms concerned. All matters raised in the AIU public reports, however, are based solely on work carried out by the AIU.

4.15 At the request of the Audit Commission, the AIU also undertook an inspection visit comprising a review of its firm-wide procedures and five individual audits. This inspection visit was undertaken on a contractual basis as entities audited by the Audit Commission are outside the scope of audit regulation. The Audit Commission has provided a high-level summary of the review findings in its Audit Practice Annual Quality Report.

## **Six – Work Programme 2008/09**

6.1 The Board's work programme for the year to 31 March 2009 reflects our four responsibilities – statutory independent oversight of the UK system of audit regulation, independent monitoring of the quality of the audits of major public interest entities, broader non-statutory oversight of the regulation of the accountancy profession, and oversight of the regulation of the actuarial profession.

6.2 The work programme is an integral part of the Financial Reporting Council's Plan and Budget for 2008/09. We draw out the major themes below.

#### **Statutory oversight of the regulation of the auditing profession**

6.3 We have now exercised statutory oversight of audit regulation by the recognised qualifying and supervisory bodies for four years. For 2008/09 our monitoring of the effectiveness of the bodies' compliance with the requirements of the Companies Act again focuses on specific aspects of their regulatory activity, though, in contrast to the monitoring activity we undertook during 2007/8, we will focus on the same themes at each of the bodies.

6.4 Our focus for monitoring recognised supervisory bodies is on the competence of the audit firms and individuals involved in audits, particularly in smaller firms. We are reviewing the bodies' processes in respect of audit monitoring and continuous professional development to ensure these are sufficient to support the competence of those entitled by law to offer this service to the public,

6.5 As regards the recognised qualifying bodies, we are carrying out a review of examinations at all RQBs. Our visits over the past three years have highlighted concerns at several RQBs in relation to their examinations and exemptions policies, as set out in Section 2. Furthermore, a number of the RQBs have recently made significant changes to their syllabuses. We are conducting this review to confirm the RQBs' compliance with the Companies Act requirements for examinations.

6.6 We continue to review the progress the bodies have made in response to our previous recommendations.

6.7 We will also develop proposals with the professional bodies to address the key issues raised in our project on the practical training of auditors, in particular how auditors gain and



to improve the quality of accounts filed at Companies House with the involvement of their members.

5.7 We also published the fifth edition of *Key Facts and Trends in the Accounting Profession*, which provides in one place key information on the major accounting firms and a number of the professional bodies whose members provide accounting and related services.

### Oversight of the actuarial profession

5.8 2007/8 was a busy year for our oversight of the actuarial profession. In January 2008, we published a follow-up report on its implementation of the recommendations made to it by the Morris Review. We found that the profession continued to embed the Morris reforms, but were concerned about lack of progress in some areas, such as the development of its ethical code. We called on it to focus on the quality and intended outcomes of its regulation of its members.

5.9 The profession's proposed development of a new principles-based ethical code was welcomed by us in our first report on its implementation of the Morris recommendations. However, we were not satisfied that the draft Actuaries' Code on which it consulted in 2007 was adequate, as we made clear in a public letter to the profession in December 2007. We have since been in further discussions with the profession about our concerns, and we expect it to consult on a revised version in early 2009, at which time we will publish a further assessment.

5.10 To develop and share our understanding of the drivers of actuarial quality and associated threats with the profession and users of their work, we worked with the Board for Actuarial Standards to produce a discussion paper on *Promoting actuarial quality*, which the FRC issued in May 2008. We also published a discussion paper on *Monitoring and scrutiny of actuarial work*, which reported on the work we had undertaken in conjunction with the profession and other regulators in response to a Morris recommendation made to the FRC. We found enhanced independent scrutiny of actuarial work but limited monitoring of compliance with actuarial standards, and sought views on a number of strategies and options, which we might recommend to the profession.

Our findings and proposals have been well received (both by users of actuarial work and the profession), and we will take both projects forward through the development of an Actuarial Quality Framework and specific recommendations on monitoring and scrutiny of actuarial work.

### Analysis of audits reviewed by the AIU

4.16 In the year to 31 March 2008 the AIU completed the review of 90 audits undertaken by audit firms (compared to 103 in 2006/7), as set out by firm type in the following table.

Firm type	File reviews 2007/8	File reviews 2006/7
Big four firms	60	67
Other larger firms	20	25
Smaller firms	10	11
<b>Total</b>	<b>90<sup>3</sup></b>	<b>103</b>

### Overview of findings

4.17 The AIU considers the quality of auditing in the UK to be fundamentally sound. The AIU public reports indicate that the senior management of the seven major firms are committed to audit quality and have quality control procedures in place, which are appropriate to their size and the nature of their client base. The reports confirm that in each case the AIU has recommended to the relevant Audit Registration Committee that the firm's registration to conduct audit work be continued. The AIU believes that its inspection process is both rigorous and challenging for firms and that the progress achieved by the firms in addressing the findings from its inspections in previous years has contributed significantly to an improvement in the overall quality of audit work in the UK.

4.18 In relation to its reviews of individual audits undertaken by the seven major firms, the AIU considered the audit work generally to have been performed to a good or acceptable standard. However, the AIU's review of individual audits at each firm identified certain areas in relation to which further improvements need to be made by the firms.

4.19 A small proportion of the audits reviewed at the seven major firms were considered by the AIU to require significant improvement in certain areas. Only three of these audits related to entities which were listed on a regulated market<sup>4</sup> and none related to FTSE100

<sup>3</sup> Includes three file reviews commenced in 2006/7 and completed in 2007/8. The equivalent figure for 2006/7 was 11.

<sup>4</sup> Within the meaning of Part VI of the Financial Services and Markets Act 2000.

entities. The proportion of audits requiring significant improvement was, however, higher at the smaller firms.

4.20 While the AIU's public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review by the AIU, which, in turn, reflects the firm's client base. An issue reported in relation to a particular firm might also apply to other firms. Only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

4.21 Key findings arising from its inspection work in 2007/8 that the AIU wishes to highlight are set out below.

#### *Audit evidence and related judgements*

4.22 A key aspect of the AIU's work is the review of significant audit judgements, including the acceptability of accounting treatments adopted, the reasonableness of assumptions used in accounting estimates and judgements relating to the nature and extent of the audit work performed and the adequacy of the audit evidence obtained. While the AIU was generally satisfied with the basis on which significant audit judgements were made, the public reports all comment specifically on issues arising in this area. The areas in which issues arose included the appropriateness of audit judgements relating to valuations, impairment and provisioning; the basis on which reliance was placed by the auditors on the work of third parties; and the adequacy of the audit evidence obtained in relation to material stock balances.

4.23 The AIU continues to believe that the thought processes underlying significant audit judgements need to be properly evidenced at the time and that failure to do so increases the risk of them being incomplete or misguided and of inappropriate audit judgements being made as a result. Firms need to continue their efforts to achieve improvements in this key area, which, in the AIU's view, is central to the principles-based approach to auditing in the UK.

## **Five – Non Statutory Work**

### **Introduction**

5.1 While this report focuses on how the Oversight Board has discharged its statutory responsibilities, it is important to recognise the Board's wider responsibilities.

5.2 The Oversight Board has a responsibility to oversee the regulation of accountants and actuaries by the professional accounting and actuarial bodies.

5.3 The Oversight Board discharges this responsibility through monitoring the regulatory activities of the accountancy and actuarial professional bodies in relation to their members, assessing those issues that could adversely affect public confidence in accountants and actuaries and, where appropriate, undertaking more detailed research and making recommendations to the professional bodies or recommend the development of new standards. This is typically delivered through project activity.

### **Oversight of the accounting profession**

5.4 Based on our assessment of the risks and the extent of our new statutory responsibilities, we launched no new projects in 2007/08 in relation to the oversight of the accounting profession. However, we continued to monitor progress on how the professional bodies had responded to our previous recommendations. In particular, we published in December 2007 an update on progress made by the professional accountancy bodies in implementing our recommendations made in March 2006 following our review of how accountants support the needs of small and medium-sized companies and their stakeholders.

5.5 The update acknowledged the progress made by the bodies and set out in particular the further work needed to explain the extent and relevance of the involvement of professional accountants in non-audited accounts, including the development of a cross-profession report for non-audited accounts. Such a report would explain the effort taken by professional accountants as a matter of course to provide competent professional services and to ensure that accounts are of high quality.

5.6 We are continuing to monitor progress in 2008/9 on all recommendations but in particular on the development of a cross profession report and the efforts made by the bodies

4.38 While the Ethical Standards do not explicitly address this issue, in the AIU's view the underlying principles of the Standards indicate that such KAPs should be treated in the same way as other audit partners responsible for key audit decisions or judgements and that they should not be rewarded for selling non-audit services to the audit clients concerned.

*Direct assistance from internal audit staff*

4.39 The AIU identified that some firms have policies and practices, which permit the use of staff from a client's internal audit department to perform external audit procedures directly for the audit team.

4.40 While Standards permit firms to place appropriate reliance on the work of clients' internal audit functions, they do not specifically address the use of internal audit staff to provide direct assistance to the external auditors in this way. In the AIU's view, the practice of including staff from clients' internal audit departments in external audit teams may be inconsistent with the underlying principles of the Ethical Standards because it is not possible for such staff to be independent of their employers. The AIU considers that firms should review the appropriateness of this practice and what safeguards should be applied to address the threats to their independence arising.

*Risk assessment*

4.24 Auditing Standards require the identification and assessment of the risks of the financial statements being materially misstated; including those risks, which require special audit consideration (such risks are termed "significant risks"). A proper assessment of the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

4.25 The AIU raised issues relating to the identification of significant risks at most firms, concerning either the appropriateness of the firm's guidance or the application of that guidance on individual audits. The AIU also raised issues at a number of firms relating to the evaluation of the design and implementation of related internal controls.

4.26 While the AIU noted that improvements had been achieved in this area at a number of firms, it considers that there is scope for further improvement at all firms to ensure that the requirements of Auditing Standards relating to risk assessment procedures are fully complied with.

*Analytical review*

4.27 The AIU continues to identify weaknesses at most firms in the use of analytical procedures to obtain audit evidence. In the majority of cases, the issues identified by the AIU related to a failure to set appropriate expectations and/or thresholds for investigation of variances from those expectations, together with insufficient corroboration by the audit teams of explanations obtained. In a number of audits, the AIU concluded that there were significant weaknesses in analytical procedures performed to obtain audit evidence.

4.28 The AIU notes that most firms have appropriate guidance on how to undertake analytical review procedures and that this has been recently enhanced at some firms. The issue primarily relates to the application of the firms' procedures and supporting guidance in practice. The AIU considers this to be an area where continued efforts to achieve improvements are required.

*Reporting to those charged with governance*

4.29 Appropriate communication with audit committees or other relevant governance bodies contributes to the quality of an audit and assists both parties in discharging their responsibilities effectively. Generally the AIU considered the quality of reporting to audit

committees by firms to be of a good standard. However, the AIU has observed that where the corporate governance arrangements, particularly the role of the audit committee, is less formalised this can adversely affect the quality of communications with those charged with governance.

#### *Audit challenges arising from the "credit crunch"*

4.30 The AIU undertook an assessment during 2007/8 of how the seven major firms were responding at a firm-wide level to the audit challenges arising from the "credit crunch". The public reports contain a brief commentary on how each firm responded. Overall, the AIU considered that the firms responded appropriately and on a timely basis to the significant challenges arising. However, the AIU's assessment of these responses was, in most cases, made prior to 31 December 2007 in order to assess their likely impact on audits relating to this major reporting date. It therefore did not address audit challenges associated with the more recent turmoil in the financial markets or how the firms responded at an individual audit engagement level.

#### *Ethical Standards*

4.31 While the AIU identified very few clear breaches of the specific requirements of the Ethical Standards at the seven major firms, it identified certain areas where the underlying principles of the Ethical Standards were, in its view, not being fully observed by some of the firms. A number of examples are set out below.

4.32 The number of issues relating to independence requirements under the Ethical Standards, which the AIU identified at smaller firms, was higher. The AIU partly attributes this to a lack of familiarity on the part of some smaller firms with the additional requirements under the Ethical Standards for listed entities. Independence issues identified by the AIU at smaller firms included long association with the audit client, involvement in the preparation of the client's financial statements and fee dependency.

#### *Long association with audit clients*

4.33 Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. This reflects the need to avoid auditor independence being compromised by the familiarity threat arising from a

long period of service in a senior role. For listed company audits, the audit engagement partner is required to rotate after having served for a maximum period of five years and "key audit partners"<sup>5</sup> (KAPs) are required to rotate after seven years.

4.34 The AIU has previously commented on the adequacy of firms' systems for monitoring compliance with the specific rotation requirements for audit engagement partners and KAPs. While the AIU considers that there is still work to be done in some cases to improve the completeness and integrity of rotation databases, the AIU was generally satisfied with the progress the firms have made in this area.

4.35 The AIU noted that there has generally been an increase in the number of partners identified as KAPs, although there is some variation in practice between the firms particularly in relation to specialist partners involved in major listed group audits. The change in the definition of a KAP (now referred to as "a key partner involved in the audit"<sup>6</sup> under the revised Ethical Standards issued in April 2008 should, in the AIU's view, provide firms with a catalyst to review their identification of KAPs on major listed group audits.

4.36 The AIU has previously commented on the issue of long involvement on large group audits by the audit engagement partner. Such long involvement, which will have been in varying capacities and often continuous, may not be precluded by the Ethical Standards but nonetheless gives rise to familiarity threats. In the AIU's view, firms continue to give insufficient consideration to the independence threats arising and, as a consequence, have often not applied appropriate additional safeguards to mitigate them. While the AIU believes that the new definition of a "key partner involved in the audit" under the revised Ethical Standards should help to address this issue, it considers that firms nevertheless need to look beyond the specific requirements under the Ethical Standards and to take a more principles-based approach in assessing the threats arising from such long involvement.

#### *Rewarding KAPs for selling non-audit services to audit clients*

4.37 The AIU identified that some firms permit senior specialist personnel from outside the audit function who are involved in audits, including those identified as KAPs on those audits, to be rewarded for selling non-audit services or for their performance to be evaluated based on their success in selling non-audit services.

<sup>5</sup> Partners other than the audit engagement partner who are responsible for key audit decisions or judgements.

<sup>6</sup> The definition has been extended to include partners who are responsible for the audit of material subsidiaries, in accordance with the requirements of the EU Statutory Audit Directive, and to make it clear that it covers non-audit professionals, such as tax partners, who are responsible for key audit decisions or judgements.