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Our ref: pb/cs

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Sent by email only

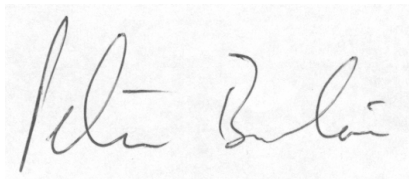
Dear Ms Trickett

Reporting on Audit Quality Monitoring – a consultation document

The Institute of Chartered Accountants in England & Wales is pleased to respond to your request for comments on 'Reporting on Audit Quality Monitoring'.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely



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Reporting on Audit Quality Monitoring

Memorandum of comment submitted in September 2006 by the Institute of Chartered Accountants in England & Wales, in response to the Financial Reporting Council's consultation paper 'Reporting on Audit Quality Monitoring', published in June 2006.

INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales (the 'Institute') welcomes the opportunity to comment on the consultation paper 'Reporting on Audit Quality Monitoring' published by the Financial Reporting Council (FRC).
2. The Institute of Chartered Accountants in England & Wales is the largest professional accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.
4. We are also a Recognised Supervisory Body under the Companies Act 1989 and register and monitor nearly 5,000 audit firms, including the vast majority of firms that will potentially be affected by the proposals in the consultation paper.

EXECUTIVE SUMMARY

5. We are not persuaded that there should be a change to the current method of reporting. It has barely had time to become established and prove itself. The consequences of extended public reporting could be the reverse of what is intended, ie there could be a lessening of audit quality. Firms could become much less open with the AIU (and the ARC) to the detriment of the whole process, which could become overly legally based. Auditing standards may become highly prescriptive as both the reviewed and the reviewers seek to support their views and actions. This would be to the detriment of audit quality as judgement is removed from the process. It would also be a move away from the principles-based framework which has been pioneered by the UK's audit and accountancy profession and this Institute in particular.
6. We would suggest that alternative forms of public reporting are kept under review, and considered again when the current arrangements have been applied to all the types of firms that are subject to AIU monitoring for a period of time and a comprehensive evidence base on audit quality assembled.
7. However before individual reporting could take place, in our view there needs to be a generally accepted definition of audit quality, the drivers of it and how these can be measured. Also, we believe that a firm should be able to make comments within the report so that it can explain, if it wishes, why it may not be taking forward some of the AIU's recommendations.
8. We are also concerned that the consultation paper underplays the role of the Institute as a Recognised Supervisory Body and the Audit Registration

Committee (ARC) through which the Institute discharges its regulatory functions. It is only the Institute, acting through the ARC, which can take action against registered audit firms, even if that action is based on a report from the AIU.

9. Finally, we do not believe that individual file reviews should be made available to the audit committees of companies. This was not the original purpose of the review arrangements and we believe it could lead to significant legal challenges against the AIU and individual firms if companies sought redress against some apparent deficiency in the reports.

GENERAL OBSERATIONS

10. Before we respond to the consultation questions in detail, we would like to make a few general observations that have a direct bearing on the consultation.

Reporting process

11. We note that the current 'private' reporting process adopted by the AIU is the same as that of the Institute in its role as a Recognised Supervisory Body (RSB). Thus detailed issues on the individual audit file reviews are discussed with the firm. A report is then written, drawing on the individual file reviews, for the ARC to consider, and so determine if any action, of a regulatory or disciplinary nature, is needed. We welcome the AIU's adoption of this approach which allows some matters to be resolved expeditiously.
12. The ARC receives a report from the AIU and the Institute's own monitoring visit, the Quality Assurance Directorate (QAD). The ARC can publish any of its orders or decisions, but at the moment this is only done in respect of the withdrawal of registration or a regulatory penalty (effectively a disciplinary sanction).
13. Other orders or decisions are not published as the Institute and the ARC are of the view that this could cause mis-understanding amongst the audit firm's clients. The subject matter of many of the ARC's decisions is frequently technical in nature but the underlying decision is not that registration should be withdrawn. The ARC is concerned that the greater publicity suggested in the consultation paper could be counter-productive in terms of raising public understanding of audit quality. That this could be the case is clear, in the ARC's view, given the type of press comment that has followed the publication of the AIU's reports to date.
14. The AIU may, as does the QAD, make direct suggestions to firms for improvement to their systems, but it is only the ARC that can require the firm to take action, with the ultimate threat of deregistration. Recommendations from the AIU to a firm are just that. The firm may accept those recommendations as contributing to improved audit quality and change its procedures, but if it is satisfied with the work that it is doing and this complies with the audit regulations or standards it would not have to.

The UK's needs

15. A key point to bear in mind is that the Institute, acting through the ARC, is the registering body and only it can make decisions about the continued audit registration of a firm, and that only the Institute can make firms change their procedures, etc. This is a key difference to the international comparisons made in the consultation document. Although born out of the same concerns arising from corporate failures such as Enron, the UK's reaction to these was much more measured than in the USA and Canada. The main reason for this was because the UK already had an audit supervisory system in place. That this was operating well and acting in the public interest was made clear in the Swift Report. The changes that brought about the creation of the AIU were to increase further public confidence in the audit supervision arrangements but not to alter them radically.
16. Thus the UK model is different to the USA/Canada models in a number of respects. Under the USA arrangements and in Canada, the relevant audit firms are registered by the body that is responsible for the monitoring. In the USA this is the Public Company Accountancy Oversight Board (PCAOB) and in Canada the Canadian Public Accountability Board (CPAB). So it is these bodies which are the direct supervisors of the firms and they have the power to stop a firm acting as auditor to certain types of clients.
17. In the UK the AIU has no such powers and indeed, as part of the oversight arrangements, for it to have such powers would probably not be in accordance with the revised 8th Directive. It may make such a recommendation to the ARC, but it is the ARC, after receiving comments from the particular firm, as natural justice would dictate (and indeed as is provided for in the Companies Act 1989 and the Companies Bill, that our procedures must be fair, reasonable and allow adequate provisions for appeals) that makes the final decision. We assume that there is no intention to bypass these statutory provisions.
18. Comparisons with foreign jurisdictions may be useful, but such comparisons need to be treated with caution as they are the product of a different framework and are also in the early stages of development.

Conclusion

19. Our conclusion is that only if the current system of reporting is shown as not working, which in our view has not been demonstrated, is a change required. If there is a consensus that there should be change, then our view is that the only option that would be an improvement on the current system is some form of individual reporting on each of the 'big 4' and 'other significant' firms. There would also need to be a report on the other (approximately 50) firms that are currently in the AIU's remit and the third country auditors (auditors from outside the UK who audit a company that is listed on the London stock exchange) where we assume that the AIU will have a role.
20. However, in our view, before individual reporting could take place, but also as a means of improving the current reporting process, there needs to be a generally

accepted view on what constitutes audit quality, what the drivers of it are and how these can be measured to show that improvements are taking place. If individual reporting is introduced at some point in the future, we also believe that a firm should be able to make comments within the report so that it can explain, if it wishes, why it may not be taking forward some of the AIU's recommendations. Allowing such comments may prevent the concerns over the timeliness of reporting being hindered by long discussions about the validity of issues raised. Each 'side' will have to be much clearer on the reasons for suggested action or inaction and this should in itself help with the quality of audit work and its reporting.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

To which of the arguments set out in Part 5, for and against extending public reporting of AIU inspection findings, do you attach most weight and why? Are there other important arguments which we have not captured?

21. The consultation paper raises many of the expected advantages and disadvantages of extended public reporting. One point to bear in mind is that the current form of public reporting has only been in place for two years in respect of the 'big 4' and one year for the 'other significant' firms. There has yet to be any public reporting on the approximately 50 or so other audit firms that are within the AIU's scope. It is unclear that the current form of reporting, which must have similar, if not the same, advantages and disadvantages as extended reporting, has yet had time to prove itself. Thus a disadvantage not mentioned is changing to another system while the current one is unproven.

Drivers of audit quality

22. The first stated advantage of extended public reporting is the greater transparency that will result. There is no further discussion of what this transparency concerns but it is assumed to be greater transparency on the quality of audit work.
23. For there to be greater transparency, there needs to be in place a number of generally accepted views on:
- the purpose of the report;
 - what the report is measuring; and
 - the criteria to make those measurements.
24. It is assumed that the purpose of the report is to report on audit quality with the aim of increasing public confidence in the audit process and the quality of it. It is not clear that public reporting per se increases audit quality. It is generally accepted that audit quality has improved over what it was in the past, and there is probably an expectation that it will continue to rise. However, past increases in audit quality took place without any public reporting of the type now undertaken, so there were clearly other drivers acting. We could speculate on what these are, but they would include increased regulation, an increased specification of what an audit should be (as set out in auditing standards

although this itself does raise concerns about the removal of the auditor's judgement from the audit process) and, last but not least, investment by firms in innovative audit procedures as they have sought to differentiate their version of an audit from those of other firms. We do not see that these drivers are any less effective now than in the past.

25. If the report is measuring audit quality, then there has to be an agreed definition of what audit quality is. The 2005/06 report of the AIU on audit inspections devotes just half a page to a definition of audit quality. The Institute's Audit and Assurance Faculty has pioneered work in this area, especially with the creation of the Audit Quality Forum. It is currently working on material to feed into the FRC's audit quality project. Without a definition of quality, and an agreed understanding of the drivers of audit quality, it is difficult to see how public report can achieve the aims of reporting on quality and how this is evolving, so as to maintain and increase public confidence.
26. Once the drivers of audit quality are agreed, there has to be some way of measuring these, so a report can be written that can give a much better representation of the state of audit quality. Part of any discussion about measurement needs to distinguish between the concepts of 'best' practice and 'generally accepted' or 'good' practice. Auditing and accounting standards are frequently referred to as generally accepted standards. They are not meant to be the best, but represent a set of standards on which there is general agreement that applying these will achieve an appropriate outcome. There is thus headroom for some to aspire to a better practice and even something that may be recognised as best practice. It is the gradual raising of the generally accepted level that leads to rising standards.
27. We have already mentioned that the quality of audit work (even without a clear definition of what that quality is) is generally perceived to have risen over the years, without the need for public reporting. We do not think that the threat of public reporting, 'name and shame', is a driver for increasing audit quality and it would be wrong to describe this as an incentive. There are already considerable 'professional' incentives for a firm to improve its work.
28. Any firm, when presented with suggestions for improvement, will take those suggestions seriously. If the 'recommendations' are to remedy identified failures to comply with the audit regulations or standards, we would expect the firm to speedily rectify such matters, and regulatory action could be taken if needed. If they are recommendations for improvements to the auditor's processes, we are back to the definition of audit quality. While gradual change in the level of what is good is almost inevitable, there has to be an incentive for early adoption of changes to audit work that exceeds the current level of a good audit. One such incentive would be if a public report indicated that a firm was operating beyond the level of 'good'. That would be a clear indication to audit committees and investors that a firm was exceeding expectations. Public reporting is then an incentive to the other firms to move forward and so the overall level of a 'good' audit increases.

29. It is to some extent a statement of the obvious that there can never be a perfect audit. There is always some part of an audit that can be improved. Making these points is probably relatively easy for a reviewer coming along after the audit is completed and who is not operating in the time pressured atmosphere of meeting a company's reporting deadline for the stock exchange, which arguably are sometimes too short. Thus there are always likely to be recommendations but there needs to be a balance in the report of the scale of those recommendations against the position that the firm is already operating at. Otherwise it will seem that a firm is always in need of improvement. Without a positive comment on what the firm is doing well, a report will always be unbalanced and not properly reflect the quality of the firm's audit work.
30. Some of the arguments given for not extending the scope of reporting are similar to those given as advantages for an extension. We agree that the whole process will become more defensive, but that is to some extent an issue of process. If the AIU cannot substantiate its position, then it should expect the firms to challenge what it puts forward. However this process will lead in our view, as suggested in the paper, to a more compliance driven inspection and a 'tick' box approach to audits. The AIU are likely to call for greater specification in auditing standards so as to make its work easier and firms may also welcome this as a means of more easily proving that the work they have done is adequate and compliant. This will drive out of the audit process the key element of judgement and potentially cause the very problem that we are seeking to avoid, a decrease in audit quality.
31. It is our view that any report should be made within a framework that has a description of what quality is and a means of measuring it. It should also give due credit to the strengths of the firms. A key feature of any public report would be to note the monetary value of all the work that firms undertake to raise standards. This would include the cost of training, internal quality review work and research into advancing the quality and application of its audit work. If reporting was to be on an individual basis, there should also be the possibility of the firms making a formal comment on the report.

Public confidence – audit committees and investors

32. The concept of public confidence, as mentioned above, also needs further consideration. An audit report is by law a report to the shareholders on the stewardship of their company by the directors. It is not designed for investors who may wish to invest in that company or for those who wish to supply the company with goods and services. These are useful by-products of an audit report but the Government, in the current Companies Bill, has not sought to change the primary purpose of the audit report.
33. The next stated advantage concerns support for audit committees and we have already made some general comments on the utility of public reports to assist those who appoint auditors. The introductory section of the consultation paper mentions that the Public Oversight Board (POB) is to give further consideration to what information should be made available to audit committees and all that is being sought in this consultation paper are comments to assist the POB in its

further work. It therefore seems that any decision reached about public reporting on the basis of this consultation paper will anticipate any conclusion that the further research may reach. This does not seem an appropriate manner in which to proceed.

34. If the audit inspection report is to be used in this way, then the audit committee will need to consider reports on the other audit firms that could replace the current auditor. Also if the audit committee has to make an annual decision on the company's auditor, then it needs annual reports on the audit firms. It seems to us that this would create a very extensive and expensive system and not at all what was originally envisaged.
35. As a further consideration there are the requirements in the EU's statutory audit directive for a 'transparency' report from the auditors of public interest entities, which are mainly listed companies. This requires a firm to give details about itself on its website, including a description of its quality control procedures and a statement by the firm's governing body on the effectiveness of those procedures. These requirements will have to be enacted into UK law and these should also be considered in the context of assisting audit committees. It seems to us that there is nothing to prevent an audit committee questioning the firm about the outcome of the AIU's review. This is the approach taken by the CPAB, which has already considered the provision of review reports to audit committees and concluded that they should not be provided.
36. The third advantage listed in the consultation documents is to help investors, by which we assume is meant the current shareholders, reach a view on using a non-big 4 firm as auditor. This is a variation on providing information to the audit committee. Investors, as well as the audit committees, would presumably want detailed information on the specialisms of the firm, which is not provided in current AIU reporting. Also, although the investors will vote on the appointment of the auditor, this is a proposal from the company. It is unclear to us that the investors have a great deal of input into the initial selection process.
37. The Oxera report on competitiveness in the UK audit market noted a disconnect between the views of the audit committees about the type of auditor that the investors would want and views of the investors themselves. Indeed the report suggested that some investors see the selection of auditor as a minor matter compared to other corporate governance issues. Thus if investors do not see the auditor selection as an issue, it is unclear how this would be changed by providing them with more information. Both audit committees and investors are likely to be concerned by the benefits that choosing a particular auditor can bring in the sense of the provision of other services, geographical spread of offices in relation to the company's operations etc. To some extent it is assumed that the product, an audit report, will be as needed, ie there is little consideration of the underlying quality of the report. Indeed, the needs of the investors may be better served by more comprehensive reporting or the release to them of reports that the auditor makes directly to the audit committee.
38. Central to the consideration of assisting the audit committee and investors may be the issue that the current form of reporting, including the reporting to the

audit firm and the regulatory body, does not deal with their needs. The reports tend to concentrate on issues identified with little reporting on the strengths of the firm. This raises a key issue for extended reporting on an individual basis. If it is to be of greater use to a wider range of audiences, there has to be a consequent increase in the level of detail included in the report, including a view on the quality of the firm's current audit work and an opportunity in that report for the auditor to express any differences of opinion. Auditing standards are principles-based. This means they do not lay down a mass of detailed rules to be followed blindly. They have to be applied with the exercise of judgment to specific situations. This means that inevitably there will be differences of opinion about how some of the principles are applied. That the AIU may have one view does not make it the only or correct view.

39. Our view is therefore that it would not be appropriate to provide audit committees with any more information than is in the public domain. The review process was designed for a specific purpose and adding to its objectives in this way is likely to lead to confusion and increased costs.

Impact on firms

40. The final advantage given in the consultation document is that extended reporting allows for the differentiation between firms. That is an advantage for a particular type of reporting, ie on individual firms. It is not necessarily an advantage for the overall issue of extended reporting. There is only a difficulty with the current form of reporting if it is considered that it is insufficient to maintain public confidence in the quality of audit in the UK. Whether this is the case is unclear. It is probably the case that the 'public interest' and 'public confidence' can never be satisfied by whatever the current arrangements are. There is always a call for an increase in some aspect but incremental increases have to be balanced against the incremental cost.
41. One of the disadvantages mentioned is the impact on the commercial position of companies if an AIU report casts doubt on an auditor. There is clearly a danger that this would be the case and even more so if the individual file findings were published. There would be a very real danger of economic harm to a company because a firm was considered to have conducted an inadequate audit, even though there was nothing wrong with accounts or the audit had been conducted to an acceptable level but improvements could be made. In our view this would lead to litigation, which could draw in the AIU and cause its work to be examined. This outcome does not seem to have been considered in the consultation paper.
42. That this could be an outcome is even clearer in the case of the small firms that have yet to become fully within the AIU's remit. For these firms, with perhaps a single public interest client, it will be the case that any criticism of the firm is a criticism of the audit of that company. This is likely to act to drive these smaller firms out of the market and further increase the concentration of audit work.
43. There is also something of a contradiction in the comment in the paper that firms will be more motivated to deal with recommendations if this avoids public

comment than the automatic publication of a report. If a report does show that recommendations are being taken up then there is public confirmation that quality is improving. Of greater concern to the firms in our view is the possibility of action by their regulatory body on the basis that they have not honoured commitments to make improvements.

44. There is also the impact on the firm if a public report on an audit firm is misunderstood, which we believe will be the case. It should be remembered that in the Enron case, the audit firm of Andersen did not necessarily fail because of any reported or proven failure, but because it lost the confidence of its clients. Public reporting brings with it large responsibilities in the context of maintaining public confidence in the auditors and audited. There would have to be a clear distinction between an individual issue and a matter that was of a more systemic nature

Timeliness and content of reports

45. We note the issues of timeliness of reporting. This is caused by a concern that greater work will be needed to make the reports legally water-tight. In our view the reports should be sufficiently robust already. If they are not, we would question the approach. There has to be a difference between dealing with something which is wrong, and persuading a firm that it should exceed the generally accepted level of a good audit. However, as before, we are concerned that this will lead to a greater drive to set out more prescriptive auditing standards and a 'tick-box' approach to auditing, which is mentioned as an argument against extending the level of public reporting.
46. The point about the simultaneous issue of reports is mentioned as a reason for a further delay in timely reporting. Given the number of firms that the AIU will eventually be reporting on, in our view it would be impossible for all the reports to be published at the same time. The only alternative would be to complete the work but not make any report until all the reports were ready. The entire process is then dependent on the speed of finalising the last report and we do not think that this is acceptable. If a parallel is taken with company reporting, companies report at different times and this does not seem to cause a problem for companies operating in the same sector.
47. It is noted that future reports will tend to become anodyne and of little value. Is that not the certain outcome of any system of public reporting where both parties have, at the end of the day, the same objective, that audit work should be of high quality? We have yet to find a firm that has an objective to produce low quality audit work. This all comes back to one of our earlier points. If there are no clear criteria for what constitutes a good audit, then any reporting does not have a suitable framework to operate in and it will become anodyne.
48. By including details of individual firms in the reports, even though firms are not named, raises all manner of concerns that are not there if the report was anonymous. It seems that the only way to satisfy those concerns is for a report on each firm, but as noted in the paper, this raises other issues. If such an individual report is made, the style of reporting has to change dramatically. The

reports that are presented to the Institute's ARC are lengthy and are likely to be misunderstood and misrepresented if they were in the public domain. Also, as noted above, if individual reporting is considered, there will be still be a need for a private report to the registration committee. Nor can we see the point of publishing what will look like a string of errors without putting them into context. It will always be the case in the best run firm that there will be instances of human error. Firms will obviously strive to reduce the chance of this happening, but when they do they also need to be put into context.

49. The Institute is the regulatory body of most of the firms that are subject to review by the AIU. It is to the Institute's Audit Registration Committee that the AIU makes its reports so that the Committee can consider if it needs to take any action. This could be to reinforce the recommendations of the AIU or take other action if properly agreed recommendations that the firm has undertaken to deal with have not been properly carried out. For that process to work, the Committee needs timely and detailed information. That seems in danger if the reporting process is elongated and the reports do not contain sufficient detail because of the subsequent need to publish that report. Thus if there was to be public reporting it would seem that there would still be a need for a private report to the Committee. This may include, for example, issues that the firm had brought to the attention of the AIU in a spirit of openness and it would seem unfair if the firm was held in an unfavourable light because of this.
50. We do not think that the consultation paper has considered sufficiently some of the legal ramifications of individual reporting. A report in the public domain, made by a body that is in existence because of a requirement of law, carries some weight. If that report is on an individual firm, and is critical, then there is the possibility of legal challenge against the firm, possibly from an audit client of the firm or an investor in that audit client, based on material in the report. In addition, because of commentary in the public report, information that is held on the AIU's files may be sought to support legal actions. We are not convinced that individual reporting on firms will lead to the advantages claimed for it.

Conclusion

51. In our view, the only reason to have reporting of the outcome of AIU inspections is to show that audit work is conducted conscientiously and to an appropriate level of quality. There is a strong argument to say that the current reporting process does that. If a firm fell below the standard then regulatory action, by the regulatory body, should be taken. Any publicity would be of that action.
52. The consultation paper covers a number of key advantages and disadvantages which we have considered above. In our view there is a grave danger that the outcome of increased public reporting could be a diminution in the very aspect that the reporting is trying to increase – audit quality. There is likely to be a tendency to produce more and more prescriptive auditing standards to make it easier for the firms to defend their work and the AIU to 'prove' poor quality work. This in our view will lead to reduced innovation in audit work and a reduction in audit quality.

Question 2

Which of the options set out at para. 6.1 below do you favour, and why? In particular, do you share our view, set out at para 6.2 below, that the nature of weaknesses at a named firm should be disclosed only after the firm, in the opinion of the Oversight Board, has failed to respond positively and promptly to recommendations made to them by the AIU?

53. Turning to the reporting options in the consultation paper our first observation is that there is no need for the AIU to comment on the non co-operation of an individual firm. If the AIU cannot persuade a firm of its legitimate right to see certain information or the firm has otherwise failed to co-operate, then the AIU's first course of action should be to raise the matter with the relevant RSB, after informing the firm that this is what it intends to do. It would then be for the RSB to take appropriate action, which if need be could lead to de-registration.
54. Some of the options also refer to a firm making insufficient progress with implementing the AIU's recommendations. We think that this needs careful consideration. If a firm is not complying with an audit regulation or standard, then there should be a referral of the matter to the regulatory body. It can then take action to require the firm to make the necessary change. However, a recommendation is just that. While it is hoped that the recommendations would lead to a higher quality of audit, if the firm was already operating at a generally accepted level of quality, we cannot see that it can be forced to do more. Therefore any reporting on progress with adopting recommendations has to be on the assumption that the firm has accepted the validity of the recommendation. Hence our reluctance for reporting methods that are based on 'name and shame'. If a firm fails to carry out a recommendation that it has agreed to on a timely basis, then that is another matter which may bring the integrity of the firm into doubt.
55. Each reporting option is an escalation on the one before it, although as the paper mentions, the options are not necessarily mutually exclusive. From the discussion above, you will see that our initial view is that potentially public reporting on firms has already gone too far. We are also concerned that the current system is yet to settle down and has not had enough time to prove itself. In so far as the current public reporting is seen as not achieving what the reader may expect, ie a conclusion on the audit quality of firms, we believe that this can be dealt with in the current report by giving a clearer conclusion on the quality of firms' work.
56. We do not favour the release of detailed file reviews, either into the public domain or to audit committees. In our view this will make the whole process incredibly defensive and will lead to legal challenges that will jeopardise the process.
57. If reports were to be made on individual firms, then in our view they would have to reach a conclusion on the quality of the individual firm's audit work. But you will note our earlier concerns that there is not a generally understood and accepted definition of what is quality in the context of audit work. In so far as a report makes recommendations for further improving the quality of firms audit

work, then the report should include comment from the firm on how this will be achieved. We also think that if the AIU makes a recommendation that the firm does not agree with, this should also be in the report, with the firm's reasons why. Not to allow comments from firms in the report would not, in our view, be reasonable and accord with natural justice. The Companies Act 1989 and the Companies Bill requires our procedures to be fair and reasonable and we cannot see why this should not also apply to the AIU.

58. We also think that if there is reporting on individual firms then there would be a call from firms for an immediate revisit and report to show that issues raised had been dealt with. This has obvious practical problems but may need to occur if a firm's reputation is in question.
59. Our concern with increased reporting is not so much the concerns over an increase in time to report and that reports will become anodyne (which we consider will happen anyway) but that pressures from the reviewer and the reviewed will lead to audits becoming much more rules based and checklist driven. This in our view is not a desired outcome. It could have far reaching consequences for the profession on such diverse matters as the recruitment of suitable candidates.
60. A further point that needs consideration is the style of reporting for those firms who the AIU has not really visited yet, those that have very few public interest clients, and third country auditors. The latter are not yet subject to monitoring, but will be the auditors of non-EU companies with a listing on the London Stock Exchange. Since the objective is to review the quality of the auditing of listed companies, then presumably these non-EU auditors will also need reporting on.
61. For both these groups we cannot see that individual reports will be a viable option and that a combined report, as currently for the larger firms, will be necessary. Otherwise the resource issues could become significant and identification of clients that much easier. If a combined report is produced for these firms, but individual reports for the larger firms, it then becomes an issue as to where the dividing line is between the two groups.
62. Based on the considerations above, our view is that we should continue with the current method of reporting (ie option A) but try to make it more balanced to reflect the actual quality of audit work that is undertaken. However, in our view this can only be achieved if there is agreement on what audit quality is and how it is achieved.

Question 3

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

63. It is not clear if option F, which is an escalation on option E, would name the individual clients. Nor is it clear if option H, where individual audit reviews are to be published, will give the names of the respective companies. However, we

do not think that the information on individual companies should be published or provided to the audit committees. There are many situations where a director sits on more than one board and, with the greatest respect to such individuals, it is very likely that the private report to an audit committee will very quickly find its way into the public domain.

64. We note that the AIU does not even supply copies of the findings on individual audits to the Audit Registration Committee, on the grounds of confidentiality. Yet here is a proposal to provide these findings to the companies themselves.
65. There are also many entities within the wider AIU scope of public interest who do not have audit committees, and who may not even know that their auditor is subject to this system of review. Providing reports to these on the competence or otherwise of their auditors would lead, in our view, to a total misunderstanding of what was going on, and detailed requests to the AIU to explain the significance of matters noted in the report.
66. Our view is that a report on an individual audit will lead to disputes with auditors and possible legal actions if a company believes it did not get a 'quality' audit. The review of the audit is not a reperformance and there are still limitations on what the review can say about all aspects of the conduct of the audit. The fastest review cycle that the AIU is operating is three years for the largest listed companies. Thus an adverse, or apparently adverse, report could be published on a firm's client in the first year of the cycle and other clients may have to wait for three years before they can be reassured that their audit is not deficient. This clearly will create great uncertainty and the possible consequences of such uncertainties are not lightly ignored.
67. The question of what information may be useful for audit committees is under consideration by the FRC. It has also just launched a consultation on what the 'transparency' reports required under the revised 8th Directive on auditors should contain. Both pieces of work should be allowed to proceed first. If there is a public report on the individual audit firms, this should provide the audit committees with sufficient information to assist in discharging their responsibilities.
68. While it may be superficially attractive to provide copies of the individual file findings to audit committees, we do not regard this as an appropriate use of the review system.

Question 4

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

69. The benefits identified in annex A are some of the items noted in paragraph 5.2 of the consultation paper and the rest of the items in that paragraph are equally assumed to be benefits. The benefits are essentially qualitative in nature and we note that no attempt has been made to assign monetary values to these. While we appreciate the obvious difficulties in making such an assessment, it does make it difficult to assess the overall impact of these proposals.

70. Equally the analysis of additional costs is, we appreciate, difficult. However, the figures seem to us as essentially arbitrary, with each option increasing the costs by 5%. No account is taken of the increased costs in the firms which we would also expect to be considerable and they may be able to provide data on this, based on the current experience of working with the AIU.
71. These costs will fall on the firms, who may be able to pass them, together with their internal costs, onto the clients that are subject to the reviews. Those firms with fewer public interest clients may find it difficult to pass the costs on. This could have the unintended consequence of driving firms out of this particular audit market, so creating an even greater concentration in the provision of audit services.
72. The extension of reporting to the smaller firms and third country auditors will cause additional costs. While these costs would be paid by those audit firms, it brings into question whether the AIU will have the physical resource to undertake this work, even if it has a source of funding.
73. There is a further question over whether this extended reporting should extend to all audit firms. While they may not be of such great public interest, there will be some public interest in them, however localised, but reporting in the same way on these firms, approximately 5,000 for this Institute, will greatly increase the costs of audit regulation and lead to a further shrinkage in the number of audit registered firms.