



PROFESSIONAL OVERSIGHT BOARD

REPORT TO THE SECRETARY OF STATE FOR BUSINESS, INNOVATION AND SKILLS

YEAR TO 31 MARCH 2012

REPORT OF THE PROFESSIONAL OVERSIGHT BOARD TO THE SECRETARY OF STATE FOR BUSINESS, INNOVATION AND SKILLS

INCLUDING THE REPORT OF THE INDEPENDENT SUPERVISOR

YEAR TO 31 MARCH 2012

Presented to Parliament pursuant to sections 1231(3) and 1252(10) of, and paragraph 10(3) of Schedule 13 to, the Companies Act 2006.

The Report of the Independent Supervisor is also presented to:

- The First Minister in Scotland pursuant to section 1231(2)(b) of the Companies Act 2006;
- The First Minister and Deputy First Minister in Northern Ireland pursuant to section 1231(2)(c) of the Companies Act 2006; and,
- The First Minister for Wales pursuant to section 1231(2)(d) of the Companies Act 2006 as amended by the Government of Wales Act 2006 (Consequential Modifications, Transitional Provisions and Saving) Order 2009 (SI 2009 No 2958).

The Report of the Independent Supervisor is laid before the National Assembly for Wales pursuant to section 1231(3A) of the Companies Act 2006 as amended by the Government of Wales Act 2006 (Consequential Modifications, Transitional Provisions and Saving) Order 2009 (SI 2009 No 2958).

Ordered by the House of Commons to be printed on 17 July 2012

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This publication is available for download at www.official-documents.gov.uk.
This document is also available from our website at <http://www.frc.org.uk>.

ISBN: 9780102980301

Printed in the UK for The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office

ID: P002502430

07/12

Printed on paper containing 75% recycled fibre content minimum.

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1 INTRODUCTION

1.1 The Professional Oversight Board (“the Oversight Board”) was set up in 2004 as part of the reformed Financial Reporting Council (FRC) following the then Government’s Review of Audit Regulation. This introduced independent statutory oversight over the regulation of auditors by recognised professional bodies, marking a significant shift, from what had been essentially self-regulation, to a mixed system, in which both the Oversight Board and the professional bodies have major responsibilities.

1.2 The EU Statutory Audit Directive, agreed in 2006 and implemented in the UK in 2008, reflected many of the changes already introduced in the UK but also extended our powers and responsibilities. At present there are further proposals before the European Council and the European Parliament for major reform of audit regulation within the EU. If adopted, these would have significant implications for the UK model of regulation. We comment further on this in Chapter 5 of this report.

1.3 Our principal responsibilities are as follows:

- Statutory oversight of the audit qualification and the regulation of statutory auditors by recognised professional bodies;
- Direct inspection, by the Audit Inspection Unit, of the quality of statutory audits of public interest entities;
- Non-statutory independent oversight of the regulation of actuaries by the Actuarial Profession;
- As the Independent Supervisor of Auditors General, for the purposes of the Companies Act 2006 (the “2006 Act”);
- Non-statutory independent oversight over the regulation of accountants by the six chartered accountancy bodies.

1.4 This will be our last report to the Secretary of State on the way in which we have discharged our responsibilities. Following consultation by the FRC and the Department for Business, the FRC announced plans earlier this year to streamline its governance and structure. As a part of these changes the Oversight Board will disappear and, under legislation currently before Parliament, the powers at present delegated to us, together with some new powers, will be delegated to the FRC. The FRC will also take over the Oversight Board’s non-statutory responsibilities, in particular the

oversight of regulation of the Actuarial Profession. The changes are expected to take effect on 2 July 2012.

1.5 Since the powers of oversight of audit regulation were first delegated to the Oversight Board in 2004, we have reviewed and made recommendations to the recognised professional bodies on all significant aspects of their direct regulation of statutory auditors. Our interventions have generally been welcomed by the bodies. They have taken our findings and recommendations seriously, engaged with us closely, and in general have responded positively and constructively. This work has led over time to many incremental improvements to their systems and practices. More generally, an active programme of oversight and a greater transparency in the way we report our findings have both helped to maintain and improve the sharpness of the regulatory processes. Overall we consider that our work has had a positive effect on the quality of regulation and therefore on the quality of audit and auditors.

1.6 Similarly, the approach to audit inspection has developed over the years. In particular we make more information available about inspection results to audit committees and in public reports. And the AIU has forged closer ties to our international counterparts, which are beneficial both to us and to them.

1.7 The work currently performed by the Oversight Board will continue within the new FRC structure. Oversight remains an important part of the regulatory framework. The transfer of that responsibility to the FRC, and the new statutory powers referred to above, provide a timely opportunity to look closely at the most effective and efficient way of fulfilling that remit. As Chapter 2 shows, we continue to identify and comment on significant issues for regulation. Continuity will be provided both through those members of the Oversight Board who have been appointed to the FRC's Conduct Committee, which will have a key role in this area, and through the staff. We refer in this report to actions we propose to take in 2012/13 on the basis that we expect that the FRC will take these forward.

1.8 The rest of this report comments in more detail on how we have discharged our responsibilities in 2011/12.

1.9 Chapter 2 reports on our monitoring of the direct regulation of statutory auditors by the recognised accountancy bodies.

1.10 Chapter 3 reports on our other regulatory work, both statutory and non-statutory, in relation to auditors and accountants.

1.11 Chapter 4 reports on the direct inspection of audit firms by the Audit Inspection Unit, which is a part of the Oversight Board.

1.12 Developments in the European Union are extremely important for audit regulation and oversight in the UK and we report on this and on our close involvement in the development of the International Forum of Independent Audit Regulators in Chapter 5. The European Commission followed up its October 2010 Green Paper 'Audit Policy: Lessons from the Crisis' with the publication in November 2011 of a draft Regulation on audits of public interest entities and an amending Directive on audit regulation. The proposals, now under discussion in the European Council and the European Parliament, are wide ranging. Whilst the FRC welcomes much in the proposals, it opposes some key elements, such as the forced creation of pure audit firms and the mandatory periodic rotation of audit firms, pointing out possible adverse effects on audit quality and arguing that audit market concentration is best addressed by national competition authorities, as in the UK where there is a current Competition Commission investigation.

1.13 Of particular relevance to this report are the European Commission's proposals to restrict very substantially the role that a professional body can play in audit regulation, transferring to the independent oversight body responsibility for monitoring the work of all statutory auditors (not just those carrying out audits of public interest entities) and for all enforcement and disciplinary action against statutory auditors (not just in cases raising major public interest). We consider that the current regulatory structure in the UK is proportionate and effective and that the Commission has not made out a convincing case for such a major change.

1.14 Chapter 6 comprises the formal report of the Oversight Board in its capacity, under section 1228 of the Companies Act 2006, as the Independent Supervisor of Auditors General. The Government is expected to appoint the FRC to this role from July this year.

1.15 Chapter 7 reports on our oversight of the Actuarial Profession. The Profession is making progress in addressing most of the recommendations we made to it in May 2009. It recognises, however, that it still needs to complete a number of projects, including those involving partnering with firms. More work is also needed in developing skill sets for practising actuaries (with links to accreditation and CPD), and Actuarial Profession Standards in the field of general insurance, including in relation to peer review, to show that it has responded to all the outstanding recommendations we have made to them. We are told that it intends to have completed this work by the summer of 2013.

1.16 In the coming year we intend to assess the progress made since the 2005 Morris Review to ensure that the resultant regulatory framework governing the actuarial profession, when viewed as a whole, provides appropriate assurance as to the skills, standards and practices (supported by appropriate independent review and disciplinary processes) that are necessary if actuaries are to undertake competently the work they are employed to do.

1.17 In formal terms this report meets:

- The obligation in paragraph 10(1) of Schedule 13 to the 2006 Act to report to the Secretary of State each year on the way in which the Oversight Board has carried out its statutory responsibilities.
- The obligation under Section 1251A of the 2006 Act to provide each year a summary of the results of inspections by the Recognised Supervisory Bodies.
- The obligation under Section 1231(2) of the 2006 Act, in respect of 2011, to report at least once in each calendar year on the discharge of our responsibilities as the Independent Supervisor of Auditors General.

1.18 Following the sad death on 28 May 2011 of our Chair, Dame Barbara Mills QC, which I reported last year, I was appointed as the Chair, pending the restructuring of the FRC, and Hilary Daniels was invited to re-join the Oversight Board. For the rest of 2011/12 the Oversight Board had nine members, comprising a non-executive Chair, an Executive Director and seven other members. Given in particular that the Oversight Board will shortly cease to exist, I want to express my sincere thanks to all my fellow Board members for the considerable contribution each has made to our work, and to the staff, who have served the Oversight Board extremely well.

John Kellas CBE
Chair of the Professional Oversight Board
June 2012

Statutory Audit Regulation

- This is the final occasion that we will report on the statutory functions of the Oversight Board. The responsibility for the statutory oversight of the regulation of statutory auditors by recognised professional bodies will be delegated by the Secretary of State to the Financial Reporting Council as of 2 July 2012.
- This is the second year in which, where appropriate, we name the individual bodies to which our main recommendations apply. This more transparent approach has, understandably, made all the recognised bodies more sensitive to potential areas of criticism. The result has been a rather more formal attitude to our relationship by the recognised bodies we oversee including the involvement of legal advisers by some bodies.
- Nevertheless, we have generally continued to get good cooperation from all the bodies.
- All the recognised bodies devote substantial resources to their regulatory responsibilities. Much of the regulatory practice we have seen is of a high standard.
- Nevertheless, we consider that the bodies should pay particular attention to the following areas in order to comply fully with their statutory obligations and to improve the effectiveness of their regulation of statutory auditors and enhance audit quality:
 - We welcome recent steps by the Chartered Accountants Regulatory Board (CARB), the regulatory arm of Chartered Accountants Ireland, in seeking to meet its statutory obligation to inspect all audit firms undertaking UK audits within six years from June 2008 but still have significant concerns over its resources to do so. We will continue to monitor this situation closely.
 - In the case of the Association of International Accountants, where we have previously identified weaknesses in certain examinations, we have acknowledged some positive changes but decided that we should invite an independent expert to review its recognised professional qualification and in particular its examinations.
 - We consider that some aspects of the audit monitoring process should be modified in order to assist with improvements to audit quality.
 - There continue to be a considerable number of prior year recommendations relating to some bodies, which we have not yet been able to close. We propose to review closely the speed of response to our previous recommendations.

2 Statutory Audit Regulation

2.1 This chapter reports on our monitoring of supervisory and qualifying bodies for statutory audit in 2011/12.

MONITORING OF RECOGNISED SUPERVISORY BODIES (RSBs) AND RECOGNISED QUALIFYING BODIES (RQBs)

2.2 Audit firms that wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, a Recognised Supervisory Body (RSB). Individuals responsible for audit at registered firms must hold an audit qualification from a Recognised Qualifying Body (RQB).

2.3 The following are both RSBs and RQBs:

- Association of Chartered Certified Accountants (ACCA)
- Institute of Chartered Accountants in England and Wales (ICAEW)
- Chartered Accountants Ireland (CAI)¹
- Institute of Chartered Accountants of Scotland (ICAS)

2.4 In addition²:

- Association of Authorised Public Accountants (AAPA) is an RSB
- Association of International Accountants (AIA) is an RQB

¹ The Chartered Accountants Regulatory Board (CARB) carries out all the functions of the CAI as an RSB, in accordance with the CAI Bye-laws.

² The Chartered Institute of Public Finance and Accountancy (CIPFA) was recognised as an RQB by the then Department of Trade and Industry (DTI) in 2005, subject to conditions, but did not at that time develop fully the examinations and arrangements for practical training needed for the award of the statutory auditor qualification. CIPFA's RQB status is in abeyance and it does not at present offer students the option of training for the statutory auditor qualification. We did not therefore carry out a monitoring visit in 2011/12.

2.5 We exercised oversight primarily by:

- Documenting and understanding how each body meets all the statutory requirements for continued recognition, and making recommendations;
- Reviewing and testing the way in which each body's regulatory systems operate in practice, and making recommendations;
- Evaluating the effectiveness of specific aspects of the regulatory system.

AAPA

2.6 The AAPA, which was formed in 1978 to represent auditors individually authorised by the then DTI, was recognised as an RSB in 1991 following the Companies Act 1989. It became a subsidiary of the ACCA in 1996, since when its members³ have been supervised by the ACCA. We therefore reviewed the AAPA's RSB status as part of our review of the ACCA.

STATUTORY POWERS

2.7 Until now our powers of enforcement against an RSB or an RQB which fails to meet its statutory obligations have been limited to:

- Seeking a High Court order requiring the RQB or RSB to take specific steps to secure compliance with a statutory obligation.
- Revoking the recognition of the RSB or RQB, following due process, where it appears to us that a body has failed to meet an obligation under the Act.

2.8 Both powers are only suitable for the most serious of failures. We are pleased, therefore, that the Government has recognised the case for a more proportionate and graduated range of powers, which we consider will enhance the regulator's independence and encourage timely responses by RSBs and RQBs. The FRC, to whom responsibility for auditor oversight will be delegated, will have the following additional powers:

³ The AAPA had 57 registered auditors, as at 31 December 2011.

- To direct an RSB or RQB to take specific steps to meet its statutory obligations.
- To impose a financial penalty on an RSB or RQB where it has not met a requirement or obligation on it.

2011/12 MONITORING

2.9 We carried out a monitoring visit to five of the six RSBs and RQBs, to test how they had applied regulatory requirements in practice, in particular where there had been a significant change in the year. Most visits consisted of four to five days fieldwork at the recognised body involving one or two staff members. During our visits we also reviewed the bodies' responses to recommendations made in prior years. We last visited the AIA in March 2011 and continued to discuss issues raised with them during 2011 and 2012.

2.10 The Audit Inspection Unit (AIU), which is part of the POB, also undertook some oversight functions in relation to inspections by the monitoring units of the RSBs of smaller auditors of public interest entities. It approves the inspection methodology used to assess a firm's policies and procedures supporting audit quality and the assignment of inspectors to undertake this work; and it reviews the monitoring units' inspection reports on each firm.

2.11 We focused our 2011/12 RSB and RQB visits on the following areas:

- The processes for monitoring audit registered firms by the RSBs, and for the monitoring of continuing professional development (CPD). We reviewed the work papers and reports for a sample of on-site and desk-top reviews relating to audit monitoring carried out in 2010 and 2011. We also reviewed the CPD records of a sample of members who had been selected by their RSB to submit their CPD record with supporting evidence for review.
- The processes for student entry for examinations, marking and moderation of scripts and issue of exam results. We tested the application of these procedures in practice by reviewing (i) the question papers, model answers and marking instructions for two papers including the advanced level audit paper (ii) examiners' and moderators' reports for these papers for diets in 2010 and 2011 and (iii) the mark sheets and scripts, where available, of a sample of UK candidates sitting these two papers in 2011. We also observed a small number of committee meetings at the bodies where examiners' reports and related issues were discussed.

INFORMATION REQUIREMENTS

2.12 We ensured that we had up-to-date documentation of all the bodies' regulatory systems. All RSBs and RQBs provide an annual regulatory report, which includes statistical information on their regulatory activities during the year. **Annex 2** sets out the main elements covered in those reports. Whilst these reports in their current format provide much useful information, they say little about a body's future plans or regulatory strategy. Nor do they highlight areas where a body expects to make or implement policy changes on which we should have an opportunity to comment.

2.13 The Oversight Board recently reviewed the regulatory information currently provided by RSBs and RQBs and concluded that we should:

- Ask each body to provide us with a Regulatory Plan covering both RQB and RSB requirements;
- Give a standing instruction to each body to notify us of any significant information and events that are relevant to their RQB and RSB responsibilities, as they arise throughout the year. Initially we are leaving it to each body to determine what is significant rather than providing a detailed list of information requirements; and
- Review the information in the Regulatory Plans alongside the information in the annual regulatory reports. We consider that this will provide earlier intelligence of relevant changes, enable us to update our assessment of the risks associated with audit regulation and so inform the scope and focus of our monitoring.

PUBLIC REPORTING

2.14 The Oversight Board decided in 2010 that our public reporting would be more informative and transparent were we in appropriate cases to name the individual bodies to which significant findings and recommendations apply. This report continues that approach. However, we invite all the bodies to consider the relevance of our findings to their situation.

2.15 We also propose to look carefully at the manner and speed with which individual bodies have responded to our previous recommendations, with a view to naming individual bodies that have not responded to our recommendations promptly and where significant issues persist. This approach may also encourage the bodies to respond to our concerns in a more timely fashion.

RESULTS OF 2011/12 MONITORING

2.16 All the bodies devote substantial resources to their regulatory responsibilities. We continue to see much regulatory practice of a high standard and we encourage the bodies to share good practice, for example by holding round table discussions on aspects of regulation, such as continuing professional development. However, in a report such as this the emphasis is on aspects of regulatory activity at recognised bodies that give us specific concerns. In particular we have:

- made recommendations that seek to improve audit quality by encouraging each body to maximise the effectiveness of its audit monitoring visits and the reports to individual firms. We have some concerns that the follow up, where repeated visits suggest poor audit practice persists, is not always as effective as it should be, and intend to do further work in the coming year to see whether our concerns are justified (see paragraphs 2.20 to 2.28);
- made recommendations aimed at ensuring that examinations provide a sufficiently rigorous test of audit knowledge and of the practical application of that knowledge (see paragraphs 2.50 to 2.54); and
- made recommendations on the monitoring of CPD with a view to the bodies encouraging their members more strongly to adopt strategies or plans that are effective in maintaining their competence (see paragraphs 2.29 to 2.32).

2.17 More generally, in our private reports to the bodies, we have identified where existing systems and practices have not been applied with sufficient rigour and made recommendations for improvements to systems and practices. We have also questioned in some instances, for example in relation to testing the ability to apply theoretical knowledge, whether some bodies include all the prescribed subjects in their syllabus at a sufficiently advanced level.

2.18 We also discussed and examined the bodies' responses to recommendations made in previous reports. Overall, the bodies continue to respond positively to our recommendations. We recognise that responding to some recommendations involves a longer term project so that it is not always possible to assess whether changes made are sufficient until a year or more later. In such cases we continue to show the related recommendation as an outstanding point in our private reports to the bodies until such time as we are satisfied that the necessary changes are in place and are effective. That said, as discussed below, there are examples where progress has been slower than we would have liked.

MAIN POINTS

2.19 We give more detail below on the main points from our 2011/12 visits and the progress in response to prior year recommendations. Our work focuses on specific areas each year that have been agreed with the bodies and is done on a sample basis. Accordingly we will not necessarily be aware of all errors and weaknesses in each body's systems and procedures that may exist. Nevertheless, we have no reason to take enforcement action against any RSB or RQB at the current time or to initiate the process of withdrawing recognition. However, we need to see, in the case of Chartered Accountants Ireland, the implementation of a properly resourced project plan to address the backlog of audit monitoring visits (see paragraphs 2.34 to 2.38) and, in the case of AIA, the satisfactory resolution of our concerns about its audit qualification (see paragraph 2.53).

ISSUES IDENTIFIED AT THE RECOGNISED SUPERVISORY BODIES (RSBs)

Audit Monitoring

2.20 Each RSB must meet Companies Act requirements in respect of audit monitoring. These requirements include:

- Maintaining adequate arrangements for enabling the performance by its members of statutory audit functions to be monitored by means of inspections;
- Carrying out an inspection of each registered audit firm at least once every six years;
- Using inspectors who have appropriate education, experience of statutory audit work and adequate training in the conduct of inspections;
- Ensuring the inspection reviews one or more statutory audits; and
- Recording the main conclusions of the inspection in a report which is made available to the firm to which the inspection relates and to the body.

2.21 The overall purpose of audit monitoring visits is to ensure that a firm's audit work complies with professional standards and that the firm meets the requirements of the Audit Regulations, and in these ways to drive up the quality of auditing. The procedures and scope of the audit monitoring carried out by each body vary in detail but the main stages of the process are:

- Firms are selected to receive a visit. This may be as part of a representative sample, on the basis of risk factors previously identified or on the instructions of the relevant regulatory committee, usually to follow up a firm's progress since a previous visit.

- The visit is planned using information held by the body including the details of previous visits.
- The inspector holds an opening meeting with the firm to update his understanding of the firm's business, audit practice and procedures.
- The inspector assesses the adequacy and documentation of the firm's whole-firm policies and procedures covering areas such as independence and continuing professional development (CPD).
- The inspector reviews a sample of audit files and discusses his findings with the responsible individuals within the firm.
- The on-site visit ends with a closing meeting where the inspector discusses his findings summarised in the closing meeting notes and provides an overall assessment of the firm's audit files and procedures.

2.22 Firms must provide a response to the findings to explain the action they have taken or intend to take in response to the inspector's findings. The inspector then assesses the firm's response in the context of the evidence seen during the visit and other information in order to arrive at a grading for the visit. A grading is not simply a measure of the number and seriousness of rule breaches but also takes into account the nature of the remedial action required. A firm is usually able to deal with minor shortcomings itself. In more serious cases, or where a firm lacks the necessary skills or knowledge, the RSB may impose conditions or restrictions on its audit work, so that it can oversee the firm's progress and judge whether the required improvements have been made.

2.23 The focus of our review was to see what progress had been made regarding issues that we had raised in our previous reviews of audit monitoring. These include the need for inspectors to provide a clear trail to support the conclusions reached, to make sure that all matters identified during a monitoring visit are raised in the visit report or otherwise addressed, and to provide clear explanations of conclusions and gradings in visit reports. On the basis of the work papers we reviewed we were generally satisfied that issues raised had either been addressed to the satisfaction of the RSB reviewer, or were included in the findings or visit report. We noted in particular that the electronic documentation system introduced in 2011 by the ICAEW provided a trail that was clear to follow.

2.24 We were less satisfied that in all cases visit gradings were adequately explained or justified. This is important because visits with poor or unsatisfactory gradings are sent to a body's quality assurance committee or audit regulatory committee to consider remedial action. These committees have powers to suspend, restrict or remove a firm's audit registration. Some visit files did not clearly document why areas of non-compliance had been assessed as matters for improvement rather than breaches of auditing standards or audit regulations.

2.25 In 2010/11 we asked each body to develop a three-year action plan for raising audit quality designed to identify the issues underlying the results of monitoring and to set out the steps they would take to address them. We also asked the bodies to work together towards greater consistency in the grading systems they use. As part of this work the bodies have been trialling the process of inspectors giving a grading for each file they review as well as for the monitoring visit as a whole.

2.26 A principal purpose of audit monitoring is to help firms to take positive and prompt action to improve audit quality. Prompt follow-up of issues raised on a visit is of great importance if visits are to improve audit quality. One element is the need to provide clear and sufficiently detailed findings shortly after the visit, so that practitioners can understand and respond to the issues. Increasing the frequency of monitoring visits also encourages firms to take action on the basis that a second unsatisfactory visit is likely to lead to adverse consequences. Examples of other initiatives that appear effective include a professional training course run by ICAS and telephone monitoring by ICAEW.

2.27 We reviewed the work papers and reports for approximately 150 audit monitoring visits across ACCA, ICAEW, ICAS and CAI in 2011/12. We accompanied inspectors on five audit monitoring visits to firms registered with each of these bodies. Against this background, our main conclusions were as follows:

- Much of the audit monitoring work we reviewed was of high quality and carried out by experienced inspectors with the expert knowledge to identify weaknesses in a firm's audit work or firm-wide procedures.
- Each body has taken initiatives to improve audit quality. However, it is not yet clear that these initiatives have been successful at bringing permanent improvements.
- We consider that the responses by firms to issues included in monitoring visit reports are an important indicator of a firm's understanding and commitment to change. We found that inadequate responses were not always sufficiently questioned by the bodies.
- We have concerns whether action taken, including by regulatory committees, in response to persistent poor quality audit work is in all cases sufficient to have the required effect on audit quality. This concern is underlined by the numbers of audit monitoring visits that are graded as unsatisfactory (paragraph 2.39 below and Part B of Annex 2). This problem led to the recommendation that each body prepare a three year plan to raise audit quality (paragraph 2.25 above).

2.28 In the light of our findings, we propose to:

- Review the effectiveness of the measures taken by the bodies where a firm's work is found to be unsatisfactory on successive monitoring visits;
- Investigate whether firms whose audit work has improved as a result of external support sustain that improvement when that support is withdrawn; and
- Review the progress made by the bodies against their three year action plans for raising audit quality.

Continuing Professional Development

2.29 The Companies Act requirement is that a body must have rules and practices designed to ensure that persons eligible under its rules for appointment as a statutory auditor continue to maintain an appropriate level of competence in the conduct of statutory audits. All RSBs satisfy this requirement through their CPD scheme and monitoring of CPD. The revised International Education Standard (IES) 7 *Continuing Professional Development* also requires bodies to establish a systematic process to (a) monitor whether professional accountants meet the body's CPD requirements and (b) provide appropriate sanctions for failure to meet these requirements.

2.30 Our work on CPD was limited to a review of how the bodies monitor the compliance of their members with the CPD regulations. (This was not therefore restricted to statutory auditors and we included the actuarial profession in this work, as the issues are comparable.) They do this by requiring a sample of members to submit evidence to demonstrate compliance with the body's CPD requirements. Members who are statutory auditors are sometimes excluded from this sample because their CPD will be reviewed on a regular basis as part of an audit monitoring visit.

2.31 The bodies take different approaches to CPD – 'output' based (i.e. on learning outcomes relevant to their needs), 'input' based (i.e. number of hours of relevant CPD), or a combination of the two. This makes comparisons between the bodies more difficult. Except for some points of detail, we found that the bodies generally carry out their monitoring function properly and take regulatory action against those members who fail to co-operate. An 'output' based system has many advantages but bodies that have such a system can find it difficult to monitor compliance effectively. In particular it is difficult for those reviewing records to understand the competence requirements of the many varied roles undertaken. Typically members do not describe their job functions in any detail and staff may not have sufficient knowledge to assess whether the CPD undertaken by members in the sample is relevant to the competencies and skills that these members require to carry out their role within the firm.

2.32 We also considered certain bodies' processes for the accreditation of employers for CPD purposes. Such accreditation means that a member working for an accredited employer who complies with employer's training requirements also meets his professional body's CPD requirements. These members submit their in-house records if selected by their professional bodies for CPD review. We consider that this is an effective way of ensuring that these members meet their CPD requirements. It is important, however, that the bodies monitor accreditations regularly and are prepared to remove an accreditation where the employer fails to meet the expected standards. Neither the ICAEW nor the Institute and Faculty of Actuaries run an employer accreditation scheme for CPD.

Prior year recommendations: meeting the Statutory Audit Directive requirements on audit monitoring.

2.33 The Statutory Audit Directive (SAD), implemented in the UK through provisions in the Companies Act 2006, introduced a requirement from April 2008 that RSBs should conduct a quality assurance (QA) review of the audit work at each registered firm at least once every six years.

2.34 We have monitored the progress of all the bodies towards meeting this requirement. We are still not confident that Chartered Accountants Ireland, through the Chartered Accountants Regulatory Board (CARB), will meet its statutory obligation to inspect all audit firms undertaking audit work in the UK at least once in the six years from June 2008, without further decisive action. The position is complicated because CAI is recognised in both the UK and the Republic of Ireland. Because of later implementation of the Directive, the ROI requirement is to carry out QA reviews of each registered audit firm at least once in the six years from May 2010.

2.35 CARB's inspection team started a major review of the audits of certain financial institutions in the Irish Republic in mid-2010, which has absorbed very significant resources. CARB notified the Oversight Board in advance that this would affect its ability to meet its statutory obligations as an RSB. Our original understanding was that the review would be largely complete by the summer of 2011. However, this has taken longer than originally envisaged and will not be fully concluded until the second half of 2012.

2.36 We first queried in 2008 whether CARB was deploying sufficient resources to meet its statutory obligation and have monitored progress since. The focus on reviews of bank audits in the Republic of Ireland has added substantially to the difficulties CARB faces. We fully understand why these reviews were undertaken and the importance attributed to them, but it was inevitable that pressure would be put on the resources available to undertake the reviews of UK statutory audit work. As the 2014 deadline draws nearer, CARB will need to complete and process visits at a faster rate than it has previously achieved. By the end of 2011 CARB had only inspected 59 audit firms with UK audits out of a population of around 326 firms in the current cycle. Only three firms

with UK audits were inspected in 2011. The scale of the task facing CARB, if it is to meet its statutory obligations as an RSB, is therefore substantial. CARB will need to visit and report on some 100 firms with UK audits in 2012 and 115 in 2013.

2.37 At the time of our visit we did not consider that CARB's plans adequately addressed this problem. CARB's forecast number of visits for 2012 and 2013 in its Audit Monitoring Plan was based on a number of assumptions, including the recruitment of additional inspectors, the transfer of responsibility for the inspection of audits of Irish listed companies to the Irish Auditing and Accounting Supervisory Authority in 2013, assistance from another RSB to carry out a small number of visits, desk top reviews of firms considered to be lower risk, and a review of its monitoring function, so as to simplify and speed up the processes. We consider that these are challenging assumptions which may not be realised, or may not be realised early enough to enable CARB to catch up the large back-log of inspections within the cycle.

2.38 More recently CARB has confirmed that it has been able to recruit and train additional inspectors, that some of the inspectors engaged on the reviews of Irish financial institutions have already returned to mainstream monitoring work, and that the fieldwork for 37 inspections relevant for UK purposes has been undertaken in the first five months of this year. However, we continue to have concerns at the significant challenge faced by CARB in achieving the UK requirements and will monitor progress closely. There must also be a risk, despite CARB's continuing commitment to the quality of the inspection process, that quality will suffer in trying to meet the target.

2.39 Section B in Annex 2 gives statistics on the number of firms monitored by each RSB in the years 2009 to 2011. Annex 2 also provides information on the outcome of monitoring visits undertaken at firms outside the full scope of the AIU. Whilst the raw statistics must be interpreted with caution, they show that such monitoring visits continue to grade a high proportion of firms visited as "unsatisfactory". They also suggest that too many firms fail to address previously identified deficiencies in a timely manner. For example 28% of ACCA visits in 2011 resulted in a "D" grading, which is often given when a firm has a second or unsatisfactory visit. This underlines the need for the RSBs to follow through their three-year plans to improve audit quality (see paragraph 2.27) and for the Oversight Board to review more closely the effectiveness of the measures taken where a firm's work is found to be unsatisfactory on successive monitoring visits (see paragraph 2.28 above).

Prior year recommendations: Approval of Applications for Responsible Individual (RI) status, or for a Practising Certificate with Audit (PCAQ)

2.40 We reviewed a sample of applications for RI status or a PCAQ at each RSB. We are pleased to note in particular that the ACCA has now adopted the principles applied by the other RSBs that,

where the audit experience has been gained some time before the application for a PCAQ, the grant of the PCAQ is subject to applicants satisfying the ACCA that they continue to be competent to do audit work.

2.41 In the case of the other RSBs we found some improvement in the manner in which they considered information from applicants about their recent audit experience. Whilst the number of such applicants is small, this is an important issue and we plan to carry out a further review of applications towards the end of 2012.

ISSUES IDENTIFIED AT THE RECOGNISED QUALIFYING BODIES (RQBs)

2.42 The Companies Act 2006 states that the recognised professional qualification must be restricted to persons who have completed a course of theoretical instruction in the prescribed subjects and who have passed an examination testing:

- Theoretical knowledge of the prescribed subjects; and
- Ability to apply that knowledge in practice.

2.43 Passing the examinations should require a standard of attainment at least equivalent to that required to obtain a degree from a university or similar establishment in the United Kingdom.

2.44 RQBs offering the audit qualification must therefore have in place adequate arrangements for:

- Registration and entry for examinations;
- The processing and granting of applications for exemptions from students;
- Preparation of exam centres and invigilators;
- Transportation and scanning of examination scripts;
- Setting and marking of examinations;
- Handling of appeals and complaints from candidates and of requests for special circumstances to be considered or allowances made;
- Moderation and issue of results; and
- Making and keeping updated a detailed comparison between the topics covered in the body's syllabus and tested in the body's exams and the prescribed subjects including the extent to which the examinations test theoretical knowledge and the ability to apply that knowledge in practice.

2.45 The examination of students is thus a significant and complex part of a RQB's operations and involves numerous processes. Our review focused on each body's audit and assurance examination and the processes for question setting and moderating, marking and moderating the examination results. We also considered whether each body's syllabus, learning materials and examinations provide adequate coverage and testing of the subjects prescribed in POB regulations, including of the ability to apply theoretical knowledge in practice.

2.46 In reality most examinations test both theoretical knowledge and practical application. However, application and integration of knowledge are higher level skills than the identification or memorisation of information. Hence, the final stage examinations are substantially weighted towards the testing of practical application. In our review of final stage audit examinations we have therefore been concerned to ensure that these examinations provide a sufficiently demanding test of the practical application of audit knowledge.

2.47 We selected samples of candidates of these papers (around 100 in total) and traced the marks awarded to their scripts through the moderation and adjustments processes to the issue of the final results. In a few cases, we were able to review the student scripts, to satisfy ourselves that the standard required to pass the paper was adequate.

2.48 We found that ICAEW and ACCA had both introduced computer-assisted marking systems since the last time we had reviewed examinations in 2008/9. In essence scripts are scanned and distributed to the markers electronically with software to assist the marker. This has been a positive development. These systems apply computer assisted marking to the higher level papers where it has not previously been used. Whilst the challenges of ensuring consistency across large groups of markers remain, this provides a clear trail to show where marks have been awarded and enables an examiner to monitor the speed and consistency of each marker and to intervene quickly if required to do so.

2.49 We found that much of the work relating to examinations carried out by the bodies was of a very high standard. Nevertheless the processes connected with examinations are complex and errors do occur. At three of the RQBs we were informed of minor problems concerned with the processing of students' marks or with the wording of the question paper, though these were quickly investigated and remedial action taken.

2.50 Against this background our main findings were:

- Despite the importance of examinations, bodies still find it difficult to identify the impact of different factors on student performance e.g. type of tuition, nature of practical experience, or the extent of exemptions awarded. Although it relates

to a wider group of ACCA students than those who wish to obtain the audit qualification, we think that ACCA could do more to investigate the reasons why some students continue to fail the exams and to advise them how to improve.

- It is important that the marking process and examiner and moderator decisions are documented as clearly as possible, in part so that any appeals received can be properly resolved. In the case of CAI we consider that the marks awarded need to be more clearly documented on mark sheets so that it is clear for which points the candidate has received marks.

Standard of Examinations

2.51 During our 2008/9 RQB visits we reviewed examinations and identified areas at two RQBs where we considered that testing of some prescribed subjects, and of the ability to apply knowledge, needed strengthening.

2.52 In the case of the ACCA we carried out a further specific review in 2012. We concluded that the ACCA had amended its syllabus and learning materials for several of its papers to include certain prescribed subjects so that the requirements of the Companies Act are now met. We also reviewed the 2011 final audit papers and found that ACCA had changed the structure of the questions in the paper, so that the papers were better balanced and covered a greater variety of subjects across the syllabus. In discussion with the ACCA we have agreed that they will make further changes, so that questions in the final audit paper are based on scenarios that reflect real life situations more closely and require the student to identify the relevant information in order to obtain maximum marks.

2.53 In the case of the AIA, whilst we recognise that the body has made significant efforts to address our previous concerns relating to the standard of the Professional Level 2 Auditing paper, and to the marking scheme for that paper and others, in our view there are still significant weaknesses in its examinations. The AIA has argued that there should be a written framework through which the POB should provide interpretations of the Companies Act requirements. Although the POB is considering this, it is not a matter that the other bodies have raised and we have concerns that this could impose too rigid a framework on the approaches of the different bodies. In any event, following discussions with the AIA, we have decided to instruct an independent expert to review its examinations and related matters supporting their qualification, and to advise the FRC accordingly.

2.54 During our visits to the RQBs in 2011/12, we also reviewed progress in implementing our recommendations on the award of exemptions, intended to:

- Improve the effectiveness of the communication with universities and colleges regarding syllabus changes and other matters;
- Improve quality controls over the processing of exemption applications so that there is a lower error rate;
- Improve the comparative analysis of students' performance with particular reference to the progress of students who have been awarded exemptions and those who have not;
- Limit the time period for which exemptions are available; and
- Ensure that exemptions are not available on the basis of a lower standard of examination performance than would be required to pass the RQB's own examination.

2.55 The relevant RQBs (ICAEW, ACCA, CAI and AIA) are making changes in response to those recommendations that were relevant to them, but it is too early to assess the impact.

STATISTICAL ANNEX

2.56 **Annex 2** provides statistical information on the regulatory activities of RSBs and RQBs in respect of the following:

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

Other Regulation of Auditors and Accountants

- Our analysis of audit proposal documents indicated a much stronger emphasis by firms on audit quality. At the same time our review of fee changes following a tender process confirmed that there is significant downwards pressure on audit fees.
- Our review of reporting by auditors to audit committees of FTSE 100 companies found that the reporting was professional and that in many cases the reports were highly informative. In some cases auditors could be clearer on their views, particularly in respect of highly judgemental areas.
- Our reviews of individual complaints about professional bodies identified a small number of case-specific issues. However we saw no evidence of systemic problems with the bodies' complaints handling arrangements.
- We welcome the decision of the Office of Fair Trading to refer the audit market to the Competition Commission.
- We are starting to work with the largest audit firms to develop contingency plans, which could be activated in the event that a firm finds itself in serious difficulty.
- We have agreed with the Government to play a role in the future regulation of local public sector audit that will broadly mirror our role in the regulation of private sector statutory audit.
- The quality of transparency reports produced by the largest audit firms has continued to improve. Those of the smaller audit firms that are required to prepare them generally meet the statutory requirements but tend to provide 'boilerplate' disclosures.
- In general the accountancy bodies have acted upon the recommendations we made to them in 2010/11 on practice assurance.
- We reviewed 265 notifications of changes of auditors for "major audits" in 2011/12. The vast majority of these followed either a change in ownership of a group or part of a group of companies, or a decision to go out to competitive tender. In a small number of cases we drew the notifications to the attention of the Financial Reporting Review Panel or the Audit Inspection Unit.

3 OTHER REGULATION OF AUDITORS AND ACCOUNTANTS

3.1 This chapter comments on our statutory regulatory responsibilities for auditors, other than our statutory oversight of audit regulation by the recognised bodies (Chapter 2) and the work of the Audit Inspection Unit (Chapter 4), on other work related to audit, and on our non-statutory independent oversight over the regulation of accountants more generally by the six “chartered” accountancy bodies.

REVIEW OF AUDIT PROPOSALS AND FEES

3.2 During the year we repeated a 2009 exercise to increase our understanding of how auditors and audit committees demonstrate and assess audit quality. This exercise included a review of recent audit proposals for a selection of listed companies and interviews with some of those companies’ audit committee chairmen and/or finance directors. We carried out a related exercise to examine the effects of an audit tender process on audit fees.

3.3 The key findings were as follows:

- As in 2009, companies often find it difficult to distinguish between the Big Four.
- There appears to be a greater propensity for large companies to put their audits out to tender than in 2009. This is partly on cost grounds but is mainly a reflection of a growing emphasis on good corporate governance processes.
- Of the sample of 39 fully listed and AIM companies, the median fee change following a tender was a reduction of 18% with some reductions significantly more. This is consistent with recent anecdotal reports from audit firms.
- There was evidence of a greater focus on audit quality in proposals than was the case in 2009.
- Our interviews with companies indicated that many of the key decisions in the process were taken in practice by executive management, rather than the audit committee.
- Large listed companies are keen to have more than four audit firms from which to choose. Although a relatively small sample, those individuals we spoke to indicated that, outside the very largest companies, they were content that the mid-tier firms would conduct work to the appropriate standard, but felt that for reputational reasons they could not select a non-Big Four firm.

- Concentration in the market is likely to increase further as very few companies switch from a Big Four auditor to a mid-tier firm, whilst the reverse is more common.
- Listed companies appear increasingly disinclined to engage their auditor to carry out non-audit work, even when that work is permitted under ethical standards.

3.4 The continuing downward pressure on audit fees is a cause for concern if it brings with it a reduction in the time taken to perform the audit and/or if key audit steps are carried out by staff not yet sufficiently experienced. We will continue to monitor this. In particular the AIU is alert to any evidence from its inspections suggesting a correlation between lower audit fees and lower audit quality.

AUDIT CHOICE AND CONTINGENCY PLANNING

3.5 For a number of years the Oversight Board has taken forward on behalf of the FRC the recommendations of the Market Participants' Group (MPG) to improve choice in the audit market. The majority of the recommendations have now been implemented but there is limited evidence that this has had a significant impact on market concentration and the risks arising from that concentration.

3.6 We consider that we have used all the tools available to an audit regulator and it is now time for the matter to be considered by competition authorities, who have the power to impose regulatory solutions on market participants. We therefore welcomed the decision of the Office of Fair Trading to refer the audit market to the Competition Commission. We understand a report is due towards the end of 2012.

3.7 In the meantime, building on previous work, and following on from one of the House of Lords' recommendations, we have been working with the largest audit firms to develop contingency plans, which would be activated in the event of one of these firms finding itself in serious difficulty. This work is at a very early stage of development and is aimed at providing short-term stabilisation whilst the causes of the problems and possible solutions are investigated by the market and regulators.

REPORTING BY AUDITORS TO AUDIT COMMITTEES

3.8 The FRC has highlighted the importance for effective company stewardship of the reports by auditors to audit committees, and in particular to enable audit committees to understand the

auditors' views on significant matters, and the evidence on which they have relied in reaching their opinions. To understand current practice better, and to promote and develop good practice, we reviewed just over half the reports prepared in respect of 2010 year-ends for the then FTSE 100 companies.

3.9 Overall we found that the reporting was highly professional. We consider that those reports were particularly informative where the auditors provided clear unequivocal statements on their professional opinions, on how those opinions were reached, and on their implications for the financial statements. Less helpful in our view were those reports where the auditor provided information in general terms such as that a provision was within a "reasonable range", or that they agreed with management without further elucidation.

AUDIT FIRM GOVERNANCE CODE

3.10 The Audit Firm Governance Code was launched in July 2010 and applies initially to the eight largest UK audit firms. All eight firms have now adopted the Code.

3.11 One of the key provisions in the Code is for the appointment of independent non-executives (INEs). One of the functions of the INEs is to help ensure that firms take account of the public interest in their strategic decision-making. In January we hosted the first of what we expect to be regular roundtables with INEs from all firms. Different firms took differing approaches to the part played by INEs within their national or international governance structures. It is still too early to assess the impact of INEs on audit firm governance.

REGULATION OF LOCAL PUBLIC AUDIT

3.12 We have continued to work with the Department for Communities And Local Government (DCLG) to develop a framework for the regulation of local public sector audit following the decision to abolish the Audit Commission. The Government has announced that the draft Audit Bill, which will establish new arrangements for the audit of local bodies, will be published during the summer for pre-legislative scrutiny.

3.13 We have agreed with DCLG that we will play a part in the future regulatory architecture for the audit of local public sector entities, which will broadly mirror the existing structure for statutory regulation of audit in the private sector. We will focus our monitoring and disciplinary functions on the very largest entities, the economic well-being of which is of the greatest public interest; and we will provide oversight of one or more recognised supervisory bodies for auditors of local public sector bodies.

TRANSPARENCY REPORTING BY AUDITORS OF PUBLIC INTEREST ENTITIES

3.14 In April 2008, and in accordance with the Statutory Audit Directive, we brought into force new legal requirements on the auditors of certain public interest entities to publish annual Transparency Reports. Currently, 39 firms are required to produce Transparency Reports and the year to 31 March 2012 is the third in which most of these firms have been required to do so.

3.15 During the year we wrote to those firms whose reports did not meet the statutory requirements and advised them to remedy these failings in their next report, failing which we would refer the firm concerned to their RSB for potential disciplinary action. We will follow this up in due course.

3.16 We noted last year that the majority of reports from larger firms had improved from the previous year and that in particular there was a greater emphasis on audit quality in many of the reports. On the basis of the reports received so far this year this trend appears to have continued. Many of the larger firms use their transparency reports to discuss wider issues around regulation and risk, and we welcome this approach. We were also pleased to note the emphasis in some reports on the Audit Firm Governance Code and the role of Independent Non-Executives.

3.17 Those smaller firms' reports which we have reviewed so far meet the statutory requirements. However, the tendency is for such firms to produce reports which are virtually identical to those published in previous years. We would reiterate that firms should ensure that the information in their report remains relevant and should also where possible avoid 'boilerplate' disclosures.

3.18 Overall we consider the quality of transparency reporting in the UK to be of an acceptable standard. We continue to monitor the firms' compliance with the requirements.

COMPLAINTS TO THE PROFESSIONAL OVERSIGHT BOARD ABOUT THE INVESTIGATION BY PROFESSIONAL BODIES OF COMPLAINTS ABOUT REGISTERED AUDITORS, ACCOUNTANTS AND ACTUARIES⁴

3.19 The Oversight Board is responsible for ensuring that the Recognised Supervisory Bodies have effective arrangements in place to investigate complaints against their members and member firms or about the way in which the bodies have exercised their regulatory functions. We also, by agreement with the six "chartered" accountancy bodies and the Actuarial Profession, provide

⁴ Chapter 7 reports more generally on our oversight of actuarial regulation by the Actuarial Profession.

independent oversight of the way in which those bodies regulate their members who provide non-audit services. As part of this role we consider complaints about the way in which a professional accountancy or actuarial body has handled a complaint. It is important to emphasise that we do not act as an appeals body. Our concern on receiving a complaint is whether the relevant body has followed its procedures appropriately.

3.20 The number of complaints received by the Oversight Board fell this year for the first time in several years. However, it is difficult to draw firm conclusions given the small numbers involved. Figures for the three years to 31 March 2012 are shown below:

	2010	2011	2012
AAPA	0	0	0
ACCA	4	9	7
CIMA	0	0	1
CIPFA	0	0	0
ICAEW	5	12	6
CAI	0	0	0
ICAS	7	0	0
The Actuarial Profession	1	0	0
Totals	17	21	14

3.21 We were able to resolve some of the complaints informally. In other instances we reviewed all relevant papers held by the professional body prior to reporting our findings to the body and to the complainant.

3.22 None of the complaints we have received in the year to March 2012 involved significant procedural failings at the bodies. However, we identified a small number of issues, as well as examples of processes or systems, which might benefit from improvement and reported our views to the relevant bodies.

REVIEW OF PRACTICE ASSURANCE

3.23 We reported last year on a review of the arrangements of the professional accountancy bodies for monitoring the work of their members in respect of unregulated accountancy services.

3.24 We made a number of recommendations in our report to the bodies at that time:

- To ensure that the information that the professional bodies include on their websites more accurately reflects the monitoring they undertake of members who carry out non-regulated work;

- To suggest ways in which the bodies could make the existing reviews more effective, in order to improve the benefits that the public can gain from them; and
- To point to the need for improved follow-up procedures.

3.25 We assessed the progress the bodies have made in implementing our recommendations during 2011/12. Our follow-up involved discussing the recommendations with the relevant bodies and obtaining documented evidence of the changes made in response to our recommendations. We did not test the application of the amended procedures.

3.26 All the bodies, except CARB, have acted upon the recommendations – including in some cases tightening their procedures in areas where the recommendation was not specifically addressed to them. Two of the bodies have more or less designed new procedures based around our review; much of one of these systems had still to be implemented but was gradually being rolled out. One body's reviews are carried out on its behalf by another of the bodies.

3.27 Due to the banking problems in Ireland, CARB had diverted its resources away from monitoring reviews and therefore conducted no reviews and made no changes to its procedures for monitoring non-regulated services.

NOTIFICATIONS OF CHANGE OF AUDITORS

3.28 The 2006 Act introduced a requirement, from the Statutory Audit Directive, that both the outgoing auditor and the company must notify the "appropriate audit authority" of the reasons for the change of auditors. The Oversight Board is the audit authority for "major audits"⁵; the audit firm's RSB 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 or possible fraud) where action might be needed to protect shareholders or the public.

3.29 In the year to 31 March 2012, there were 265 notifications in respect of "major audits", as compared to 342 in 2010/11. Most cases related either to a change in the ownership of a subsidiary of a major listed company or a decision to go out to competitive tender. In a small number of cases, we drew the notifications to the attention of the Financial Reporting Review Panel or the Audit Inspection Unit.

⁵ Principally UK companies with securities listed on the Main Market or on AIM, along with their subsidiaries.

3.30 The Department for Business, Innovation and Skills consulted in 2009/10 on how it might simplify these arrangements, in view of our conclusion that the regulatory benefits were small in relation to the additional bureaucracy imposed on audit firms and companies that have an audit. We continue to support a simplification of these requirements and hope that the Government will propose changes to the legislation when there is a suitable opportunity.

KEY FACTS AND TRENDS IN THE ACCOUNTANCY PROFESSION

3.31 We published the tenth edition of Key Facts and Trends in the Accounting Profession in June 2012. This brings together in one place a range of information from the major audit firms and seven accountancy bodies including those who can register and supervise audit firms. Taken together this information illustrates the size and shape of the accountancy profession and gives the context within which the Oversight Board oversees the regulation of audit and accountancy.

Monitoring the Quality of the Auditing of Economically Significant Entities

- There has been a continued improvement in the overall inspection results for 2011/12, as indicated by a further reduction in the proportion of audits requiring significant improvements.
- Firms need to monitor the effectiveness of their actions to address issues that the AIU raises, and see that these are embedded in practice by partners and staff.
- Audit efficiency is becoming progressively more important to firms as audited entities seek to reduce fees. Firms should establish central safeguards to ensure that the extent of work performed is maintained at an appropriate level to protect audit quality.
- There are a number of areas where improvements are still required if firms are to continue to improve overall audit quality. These include:
 - The need for further action by the firms to embed the application of professional scepticism within the audit process.
 - The approach to the identification and assessment of threats to independence.
 - The involvement in the planning and execution of the work of other auditors within a group audit.

4 MONITORING THE QUALITY OF THE AUDITING OF ECONOMICALLY SIGNIFICANT ENTITIES

INTRODUCTION

4.1 The Audit Inspection Unit (AIU), which is a part of the Oversight Board, reviews the quality of the statutory audits of listed companies and other major public interest entities⁶, and of the firms' policies and procedures supporting audit quality. The Oversight Board approves the AIU's strategy and work programme and a sub-committee of the Oversight Board considers and approves AIU public and private reports on individual firms and specific audit engagements before they are issued.

4.2 This section of this report gives a summary of the AIU's 2011/12 Annual Report, which was published on 13 June 2012 and is available on the FRC website.

SCOPE AND COVERAGE OF INSPECTIONS

4.3 The AIU reviews each year the quality of approximately 100 statutory audits of listed and other major public interest entities that fall within its scope and reviews the firms' policies and procedures supporting audit quality.

4.4 Firms which audit more than ten entities within the AIU's scope are subject to annual or biennial inspections and reports. There are currently ten such firms ("the major firms") being the Big Four firms⁷, Baker Tilly UK Audit LLP, BDO LLP, Crowe Clark Whitehill LLP, Grant Thornton UK LLP, Mazars LLP and PKF (UK) LLP.

⁶ The Companies Act 2006, as amended, requires the independent inspection of auditors undertaking statutory audits of listed companies and other entities "in whose financial condition there is considered to be major public interest". This latter category is determined from time to time by the Oversight Board.

⁷ The Big Four firms comprise Deloitte LLP, Ernst & Young LLP, KPMG LLP & KPMG Audit PLC, and PricewaterhouseCoopers LLP.

4.5 AIU inspections of firms that audit ten or fewer entities within its scope are limited to a review of a sample of individual audits⁸.

4.6 In 2011/12, the AIU completed full scope inspections, comprising a review of policies and procedures supporting audit quality and of individual audits within its scope, at the Big Four firms, Baker Tilly UK Audit LLP, Crowe Clark Whitehill LLP, Mazars LLP and PKF (UK) LLP. Individual public reports summarise the findings from these inspections and are available on the FRC web-site.

4.7 Inspections were also carried out at eleven other firms which audit ten or fewer entities within the AIU's scope, in each case comprising reviews of one listed or other major public interest entity audit.

4.8 The AIU currently inspects the Big Four firms annually. These firms audit approximately 80% of the entities within scope, including over 95% of UK incorporated FTSE 350 companies. AIU inspections at the other major firms are undertaken over an extended period of approximately two years. Reports on the findings of the AIU inspections at BDO LLP and Grant Thornton UK LLP will therefore be published in 2013.

4.9 Each year the AIU selects a number of areas of particular focus. For 2011/12 these were: group audit considerations; the valuation of assets held at fair value; the impairment of assets (including goodwill and other intangibles); the assessment of going concern; revenue recognition; related parties; and the quality of reporting to audit committees. The AIU continued to focus on banks and increased its focus on building societies given the level of public interest in the sector.

4.10 The scope of AIU inspections increased following arrangements agreed with the regulatory authorities in Jersey, Guernsey and the Isle of Man ("Crown Dependencies"), to meet their obligation to ensure that audits of companies incorporated in these territories with securities that are traded on a regulated market in the European Economic Area are subject to independent inspection.

4.11 The AIU also undertook inspections at both the Audit Commission and the National Audit Office on a contractual basis and, in the case of the NAO, for the purpose of

⁸ The Companies Act 2006, as amended, permits the delegation of inspection activities to the monitoring units of the Professional Accountancy Bodies for those firms conducting ten or fewer audits within our scope. The monitoring of firm-wide procedures in relation to these firms has been delegated.

the Oversight Board's statutory role as the Independent Supervisor. The Report of the Independent Supervisor is included as Chapter 6 of this Report.

KEY MESSAGES TO AUDIT FIRMS

4.12 The AIU has seen an improvement in overall inspection results, with a further reduction in the proportion of audits requiring significant improvements. These now account for less than 10% of the audits reviewed. The proportion of audits assessed as good with limited improvements required remains consistent with previous years at around 50% of the audits reviewed.

4.13 Firms respond to issues that the AIU raises and improve their processes and procedures. Those improvements do not necessarily have immediate results and so sometimes the AIU finds itself identifying issues which firms have already taken action to address. To some extent this is inevitable, as the AIU inspects audits which were in some cases completed many months previously. Nevertheless, it is important that firms monitor the effectiveness of their actions, and that these are embedded in practice by partners and staff.

4.14 The more important matters arising from the AIU inspection activities to which firms need to pay particular attention in order to continue to improve overall audit quality are summarised below.

Focus on audit quality

4.15 Audit efficiency is becoming progressively more important to firms as audited entities seek to reduce fees. Firms should establish central safeguards to ensure that total audit hours, the determination of materiality and the extent of work performed are maintained at an appropriate level to protect overall audit quality, particularly where significant fee reductions have been agreed.

Professional scepticism

4.16 Firms have undertaken a number of good initiatives to reinforce the importance of exercising professional scepticism in the conduct of their audit work. However, changes in behaviour have not yet been fully achieved and in certain areas, such as the impairment of goodwill and other intangibles, we have yet to see any significant impact. Further action is required to embed the application of professional scepticism within the audit process.

Financial services

4.17 In inspecting the audit of loan loss provisioning by a number of banks and building societies, the AIU had concerns that there was insufficient challenge to the assumptions in, and adjustments to, models used to determine collective provisions. The AIU also continues to be concerned at the extent to which data about forbearance arrangements is available to auditors assessing the sufficiency and appropriateness of loan loss provisioning.

4.18 The AIU will continue to focus on the quality of audit work in this important sector, working closely with the Financial Services Authority ("FSA").

Impairment of goodwill and other intangibles

4.19 In addition to concerns about the level of challenge to key assumptions used in impairment testing calculations, the AIU found that audit teams did not always fully understand the accounting and reporting requirements in this area and were, therefore, not identifying errors and inconsistencies in these calculations and disclosures. Firms need to provide further training to staff to improve their understanding of the accounting and reporting requirements.

Group audit considerations

4.20 Recent changes to Auditing Standards in respect of group audits were intended to raise performance generally to the level of best practice. However, not all firms and engagement teams recognised the need for improvement. As a result a number of problems were identified, particularly in relation to the group auditor's level of involvement in the planning stage of the audit. Firms should emphasise the importance of these revised requirements and ensure that the involvement of the group auditor in the audit of a business component has a clear purpose, and that auditors are able to demonstrate how they have fulfilled the requirements of the Standards.

Auditor independence

4.21 The effective identification and assessment of threats, the application of appropriate safeguards and the proper reporting of these to audit committees are critical to maintaining auditor independence. The AIU is not able to report any improvement and firms should reconsider the adequacy of their procedures, and the training of audit staff, in this area.

Engagement quality control review

4.22 Firms have responded in different ways to improve the effectiveness of their engagement quality control reviews. The AIU will continue to focus on whether these initiatives are making a difference in practice. The AIU expects the engagement quality control reviewer to give particular attention to the extent to which appropriate professional scepticism has been exercised in key areas of judgement.

Financial statement review processes

4.23 Firms recognise the importance of pre-issuance technical reviews of financial statements as a quality control procedure which contributes to improving the overall clarity, quality and sufficiency of financial statement disclosures and provides evidence supporting the audit opinion. All major firms mandate some form of pre-issuance technical review. There are, however, differences in their review policies and procedures.

4.24 Such reviews should cover all listed entities as a minimum and be performed by appropriately experienced staff independent of the audit team. Evidence of such reviews should be retained, together with details of how significant points arising have been cleared. We expect firms to revisit their arrangements for pre-issuance reviews to ensure they are robust and in line with best practice.

KEY MESSAGES TO AUDIT COMMITTEES

4.25 Audit committees play an essential role in ensuring the quality of financial reporting. In particular, their work with auditors in planning the audit and reviewing its results contribute greatly to the quality of that audit. Highlighted below are a number of the AIU's findings which the AIU believes will assist audit committees in their oversight of the audit process and contribute to an overall improvement in audit quality.

Impact of fee reductions

4.26 A company's audit should represent value for money. Nevertheless, substantial fee reductions may lead the auditor to reduce valuable audit work and therefore compromise audit quality. The AIU is seeing evidence of audit firms making such cuts.

4.27 Where fee reductions have been offered, audit committees should scrutinise the proposed scope of the audit, including the determination of materiality, and the attention to be given to

each business component and to the significant audit risks identified. Where there are significant changes in these following a reduction in audit fees, audit committees should consider whether the overall level of work to be performed is likely to be sufficient to identify material misstatements and ensure that audit quality is not compromised.

Professional scepticism

4.28 The AIU has been and remains critical of the extent to which auditors have sometimes failed to exercise appropriate professional scepticism in relation to key judgements. Audit committees have an important role to play in supporting and encouraging a sceptical approach. In particular, audit committees should be prepared to discuss the concerns of audit teams about management's key judgements. Equally audit committees should encourage audit teams to demonstrate the extent of their challenge in relation to key judgements, even where the final audit judgement supports management's views. This might include information about the alternative approaches that were considered and why the approach adopted was considered appropriate in the circumstances.

Group audit planning

4.29 When reviewing the annual audit planning report, audit committees should consider whether this includes sufficient detail on the extent to which the group audit team has been involved in the risk assessment and determination of procedures to be performed in respect of significant components of the business.

Auditor independence

4.30 Any threat to auditor independence from the provision of non-audit services should be reported to audit committees whilst there is time to mitigate the risk. Sufficient detail should then be provided to enable an informed assessment as to whether auditor independence has been maintained. Auditors are sometimes too ready to underestimate the threats, and argue without proper consideration that current arrangements are sufficient safeguards against those threats. Audit committees are entitled to expect a good standard of independence reporting from their auditors and should seek additional information where it is not initially provided.

EFFECTIVENESS OF AUDIT QUALITY INSPECTIONS

4.31 The UK audit inspection regime is among the most transparent in the world. The AIU reports its findings clearly and believes that this transparency contributes to a continuous and sustained improvement in overall audit quality.

4.32 At the same time, because the focus of AIU reporting is on those aspects where improvement is required, AIU reports may leave the impression that there are more problems with the quality of auditing in the UK than elsewhere. However, discussions with overseas regulators confirm that the issues raised in the UK are very similar to those raised internationally and therefore this impression is incorrect.

4.33 The AIU provides written reports on reviews of individual audits, and requires written responses to the more significant of its findings. Firms are expected to take action to deal with all such findings, and the AIU generally sees improvements in audit quality when it carries out follow-up reviews in subsequent years. Nevertheless, there are some areas where further progress is required. A number of these are highlighted above. Often these require a change in culture and attitude before the required improvement in behaviour can be achieved. The AIU will ensure that these areas continue to be reviewed in future years so that further improvements in practice continue to be made.

4.34 One change being introduced as part of the FRC reforms is to give the FRC an additional power: to determine sanctions against audit firms where the AIU concludes, following an inspection, that firms have not complied with the requirements for carrying out statutory audits.

4.35 The AIU is engaged in a number of other activities that contribute, directly and indirectly, to the overall quality of auditing. It:

- Provides feedback from its inspections to UK and international standard setters;
- Participates in a number of international forums, including the International Forum of Independent Audit Regulators;
- Works where appropriate with other parts of the FRC on regulatory issues, in particular with the Financial Reporting Review Panel and the Accountancy and Actuarial Disciplinary Board;
- Has developed a closer working relationship with the Financial Services Authority; and
- Undertakes other inspection activities, including those in the public sector and more recently for the Crown Dependency regulatory authorities.

4.36 The AIU attaches considerable importance to the effectiveness of its inspection approach and the quality and clarity of its reporting. The feedback it receives, particularly from audit committee chairs, is a valuable input to this process of continuous improvement.

International Regulatory Responsibilities

- The international aspects of our work, both within the EU and more widely, are increasingly important.
- Whilst we welcome much in the European Commission's proposals on audit, we strongly oppose some key elements, for example for pure audit firms and mandatory rotation of audit firms.
- We see no good case for removing most of the current regulatory responsibilities of professional bodies for audit, as the European Commission proposes, and in particular to require the independent regulator to monitor and discipline all statutory auditors.
- We consider that the current requirements in the Statutory Audit Directive on the regulation of third country auditors are disproportionate and impracticable and wish to see them simplified.
- Nevertheless, we continue to work closely with the Commission and other Member States to try to apply the existing requirements in practice and are consulting further on how to carry out inspections of certain third country auditors, recognising that this is difficult to achieve in many cases.
- Oversight Board staff have continued to play a leading role in the activities of the International Forum of Independent Audit Regulators (IFIAR) and its working groups.
- The Executive Director has continued in the role of the Chair of IFIAR; his term runs for the two year period to April 2013.
- IFIAR's principal objectives are to share knowledge and experience of independent regulation and promote collaboration in regulatory activity.

5 INTERNATIONAL REGULATORY RESPONSIBILITIES

5.1 It is important that the UK has a strong voice, both in the EU and more widely, in the international debate on the future of auditing and audit regulation, and in developing regulatory cooperation across boundaries, at a time when what happens at the international level is of increasing importance. The Oversight Board has continued to support the wider FRC international effort in particular through close involvement in the work of both the European Group of Auditor Oversight Bodies (EAOB) and the International Forum of Independent Audit Regulators (IFIAR).

EUROPEAN COMMISSION PROPOSALS ON THE REGULATION OF AUDITORS

5.2 Developments in the European Union are extremely important for audit regulation and oversight in the UK. The European Commission followed up its October 2010 Green Paper 'Audit Policy: Lessons from the Crisis' with the publication in November 2011 of a draft Regulation on audits of public interest entities and an amending Directive on audit regulation.

5.3 The proposals, now under discussion in the European Council and the European Parliament, are wide ranging. If adopted as proposed by the Commission, they would involve substantial change to the structure of the audit market, including the mandatory rotation of auditors of public interest entities, much greater restrictions on the provision of non-audit services by the auditor to the audit client, and the creation in some circumstances of pure audit firms. Whilst the FRC supports much in the proposals, particularly where directed at improving audit quality, auditor reporting and the coordination of oversight across the EU, it opposes key elements, pointing out possible adverse effects on audit quality. In particular, the FRC is opposed to the forced creation of pure audit firms, arguing that audit market concentration is best addressed by national competition authorities (as in the UK where there is a current Competition Commission investigation) and favouring periodic re-tendering on a 'comply or explain' basis rather than the mandatory rotation of audit firms, as proposed.

5.4 Other elements of the European Commission's proposals would impact very directly on the role of the Oversight Board. In particular the Commission wants to restrict very substantially the role that a professional body can play in audit regulation, placing on the independent oversight body responsibility for monitoring the work of all statutory auditors (not just those carrying out audits of public interest entities) and for all enforcement and disciplinary action against statutory auditors (not just in cases raising major public interest). We do not consider that the Commission has made out a convincing case for such a major change and consider that the existing

arrangements, at least in a UK context, are fit for purpose.

EUROPEAN GROUP OF AUDITOR OVERSIGHT BODIES (EGAOB)

5.5 The EGAOB was set up at the end of 2005 to advise the European Commission on statutory audit matters, in particular on the detailed implementation of the Statutory Audit Directive, and to provide a forum within which the new auditor oversight bodies in Europe could coordinate their activities and develop cooperation. That initial phase is largely complete and the European Commission has proposed that there should be an enhanced role on audit regulation at European level for the European Securities and Markets Authority⁹ (ESMA). We are not opposed to some enhancement in principle but the precise responsibilities need further consideration and there must be a well-defined role within ESMA for auditor oversight bodies, who are best informed on current practice and retain the national responsibilities for audit regulation.

EUROPEAN COOPERATION ON AUDIT INSPECTION

5.6 The emergence of Europe-wide firms such as KPMG Europe LLP and Ernst & Young Europe LLP, has required the Audit Inspection Unit (AIU) to work closely with other regulators. To respond to these developments, the AIU plays a leading role in a college of regulators, which was established to facilitate the sharing of information and efficient inspection processes across these European firms. The AIU is also closely engaged in the work of the European Audit Inspection Group, which comprises independent audit regulators from within Europe and shares findings and good inspection practice.

REGULATION OF THIRD COUNTRY AUDITORS

5.7 The Statutory Audit Directive (SAD) sets specific requirements for the regulation of the auditors (“third country auditors”) of companies from outside the EU that issue securities traded on EU regulated markets. The Oversight Board has responsibility for setting and applying the detailed requirements within a statutory framework. The issue is important for the UK because of the number of issuers from third countries that have issued securities on the UK markets.

⁹ ESMA is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.

5.8 Our objective, working with the European Commission and other Member States, is to reach a situation as quickly as possible where countries with well-developed and broadly equivalent systems of audit regulation largely rely on one another's work, with appropriate exchanges of information. There has been progress on this with the coming into force of measures that recognise a number of third countries as "equivalent", and provide for a further transitional period for a further group of third countries. We continue to work closely with the European Commission and other members of the EGAOB to move ahead with a further stage of this process to greater mutual reliance of regulatory systems.

5.9 We are also undertaking a further round of consultation on how to carry out reviews of third country audits and audit firms from around the world in a way that is effective but does not impose disproportionate costs and regulatory burdens. This is difficult to achieve under the current EU requirements. At the same time as working out how best to apply the existing requirements of the SAD, we are proposing that the European Commission takes the opportunity of other Directive changes to simplify the relevant Articles, which in our view are likely to yield only modest benefits for European investors for considerable regulatory cost.

INTERNATIONAL FORUM OF INDEPENDENT AUDIT REGULATORS (IFIAR)

5.10 We have continued to play a leading role in the activities of IFIAR, which is chaired by the POB Executive Director, whose term runs for the two year period to April 2013.

5.11 IFIAR's objectives are to:

- (i) Share knowledge of the audit market environment and practical experience of independent audit regulatory activity;
- (ii) Promote collaboration in regulatory activity; and
- (iii) Provide a focus for contracts with other international organisations which have an interest in audit quality.

5.12 We are involved in all of IFIAR's working groups which are as follows:

➤ **Investor Working Group**

Responsible for organising IFIAR's dialogue with investor representatives.

➤ **Global Public Policy Committee (GPPC) Working Group**

Responsible for organising IFIAR's regular dialogue with the member firms of the GPPC, which include the six largest international audit networks (BDO, Deloitte

Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG and PricewaterhouseCoopers).

Topics discussed in recent meetings with GPPC representatives included the role of the auditor, auditor communications, audit committees and the firms' processes surrounding sovereign debt. The members also discussed a report from the IFIAR GPPC working group on the actions that the networks have taken with regard to frequently-occurring issues, in particular professional scepticism, group audits, engagement quality control review, and revenue recognition. These discussions allow the findings of national independent inspection programmes to be raised with global firms' management.

➤ **Standards Coordination Working Group**

Responsible for establishing a forum for IFIAR Members to share views and concerns, in particular feedback from members' inspection programmes, about pronouncements from the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA), with a view to helping members consider and, where appropriate, incorporate points from other members in their submissions to the IAASB or IESBA.

➤ **Inspection Workshop Working Group**

Responsible for organising the annual Inspection Workshop, which has been very successful in developing and disseminating best practice in independent audit inspection around the world.

➤ **International Cooperation Working Group**

Responsible for identifying ways in which IFIAR Members can cooperate more closely and share information relating to audit firm inspections and audit engagements.

5.13 IFIAR held two plenary sessions during the year, the highlights of which were:

- Discussions between IFIAR members about recent national developments, including inspection findings. Some IFIAR members presented their recently published reports. At the firm level, examples of findings (which are not dissimilar to those of the AIU) included concerns about:

- engagement Quality Control Reviews;
 - the firms' own internal inspection processes; and
 - the firms' incentive and remuneration structures.
- Other inspection findings at the engagement level in these reports included deficiencies in:
- The exercise of professional scepticism;
 - The audit of fair values;
 - Group audits;
 - Auditing of disclosures;
 - Quality of audit evidence;
 - The use of auditors' experts; and
 - The provision of non-audit services and other threats to auditor independence.
- Some members noted concerns that audit fee pressure resulting from the on-going challenging market conditions may have a negative impact on audit quality.
- Discussions between IFIAR members on audit policy topics including the sovereign debt crisis, the role of the auditor, the auditor's reporting model, enhancing auditor independence, objectivity and professional scepticism, and improving audit transparency.
- IFIAR agreed upon a set of Core Principles for Independent Audit Regulators. The Core Principles are intended to promote the common goal shared by IFIAR members to serve the public interest and enhance investor protection by improving audit quality globally, including through independent inspections of auditors and/or audit firms. The Core Principles cover the following areas: (i) the structure of audit oversight, (ii) the operations of audit regulators and (iii) principles for inspection processes.

Report of the Independent Supervisor of Auditors General

- Auditors General are eligible to conduct statutory audits under the 2006 Act, subject to oversight and monitoring in respect of those audits by the Oversight Board, in its role as the Independent Supervisor.
- At present only the Comptroller and Auditor General (C&AG) undertakes statutory audits. To date all these audits have been of companies within the public sector and undertaken by the National Audit Office (NAO).
- The AIU reviewed two of the 32 Companies Act audits undertaken by the NAO in respect of financial periods ending on 31 March 2011. The issues raised were of less significance than those identified in the previous year.
- Whilst progress has been made in addressing prior year firm-wide inspection findings, we expect further action to address outstanding matters.
- We consider, on the basis of the AIU findings, and subject to the NAO's action plan, that the NAO has policies and procedures in place that are generally appropriate to its Companies Act statutory audits.

6 REPORT OF THE INDEPENDENT SUPERVISOR OF AUDITORS GENERAL

INTRODUCTION

6.1 The Comptroller and Auditor General (C&AG) and the other Auditors General are eligible for appointment as the statutory auditors of companies under the 2006 Act, subject to meeting certain conditions.

6.2 One of the conditions in the 2006 Act is that Auditors General who wish to audit such companies are subject to oversight and monitoring in respect of that audit work by the “Independent Supervisor”. The Independent Supervisor Appointment Order 2007 (SI 2007/3534), which came into force on 6 April 2008, appoints the Professional Oversight Board as the “Independent Supervisor”. To date only the C&AG has indicated that he wishes to undertake statutory audits under the Act. Relevant staff in the National Audit Office (NAO) completed the third year of such audits in respect of accounts for financial years that ended on 31 March 2011 and the Audit Inspection Unit (AIU) monitored this work on behalf of the Independent Supervisor.

6.3 Section 1228 of the 2006 Act requires that the Independent Supervisor report on the discharge of his responsibilities at least once in each calendar year to the Secretary of State, the First Minister of Scotland, the First Minister and the Deputy First Minister in Northern Ireland, and to the First Minister for Wales.

6.4 As noted in the introduction, this is the last report of the Professional Oversight Board as the Independent Supervisor. The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc.) Order 2012, expected to come into force on 2 July 2012, amongst other things appoints the Financial Reporting Council as the Independent Supervisor. This is part of the wider reform of the Financial Reporting Council under which the Oversight Board will no longer exist.

SUPERVISION ARRANGEMENTS

6.5 Section 1229 of the 2006 Act requires that the Independent Supervisor establish arrangements for:

- determining the ethical and technical standards to be applied by an Auditor General in their statutory Companies Act audit work;
- monitoring the performance of statutory Companies Act audits carried out by an Auditor General; and
- investigating and taking disciplinary action in relation to any matter arising from the performance of a statutory audit by an Auditor General.

6.6 The responsibilities of the Independent Supervisor do not extend to the other work of the C&AG.

REPORTING REQUIREMENTS

6.7 We report below in accordance with the requirements of Article 4(a) to (e) and Article 5 of the Independent Supervisor Appointment Order 2007.

(a) Discharge of Supervision Function

6.8 Our Memorandum of Understanding (MOU) requires that the C&AG and relevant NAO staff follow technical and ethical standards prescribed by the Oversight Board when conducting statutory audits and sets out the investigation and disciplinary procedures that would apply were there a need to discipline the C&AG in his capacity as a statutory auditor. The relevant standards are those set by the FRC for auditors generally. We would enter into similar arrangements with other Auditors General as necessary.

6.9 As part of the supervision arrangements, the AIU annually reviews some of the statutory audits undertaken by the C&AG.

6.10 We continue to meet periodically with senior staff responsible for the audit practice of the NAO on behalf of the C&AG. We have familiarised ourselves with the NAO procedures to discharge these responsibilities and keep abreast of any changes.

(b) Compliance by Auditors General with duties under 2006 Act

6.11 As noted above, to date only the C&AG has undertaken statutory audits, all of which have been of companies within the public sector.

6.12 The AIU inspection in 2011/12 of the C&AG's statutory audit work comprised:

- Updating its understanding of the firm-wide procedures that applied to these audits; and

- Reviewing the performance of two of the 32 statutory audits carried out by NAO staff in respect of financial periods ending on 31 March 2011.

6.13 Whilst progress has been made in addressing the AIU's prior year inspection findings there are a limited number of areas where further action is required.

6.14 In respect of the individual audits reviewed, which were not complex, the concerns the AIU identified were of less significance than in the prior year. Consistent with prior years, these related to the audit of the balance sheet and going concern.

6.15 In last year's report the AIU suggested that, in the light of its findings, further support was required in the conduct of Companies Act audits. In particular, it noted that, if the number and complexity of these audits were to increase, additional and appropriately experienced resources would be required to ensure that they are undertaken to an acceptable standard. In the year under review, the NAO appointed an additional Responsible Individual to undertake Companies Act audit work, and we understand that a further Responsible Individual has subsequently been appointed.

6.16 On the basis of the findings in the AIU's report, and subject to the NAO's action plan, in our view the NAO has policies and procedures in place that are generally appropriate to the conduct of its Companies Act statutory audits.

6.17 We found no evidence that any Auditor General was in breach of duties under the 2006 Act.

(c) Notification by Auditors General under Section 1232 of the 2006 Act

6.18 No Auditor General was required to notify the Independent Supervisor of any other information under Section 1232 of the 2006 Act.

(d) Independent Supervisor's Enforcement Activity

6.19 We issued no enforcement notices and made no applications for compliance orders in 2011.

(e) Account of Activities relating to the Freedom of Information Act

6.20 We received no requests for information under the Freedom of Information Act in our role as the Independent Supervisor.

(f) Article 5: Financial Information

6.21 Article 5 of the Independent Supervisor Appointment Order 2007 requires that the Independent Supervisor prepare and publish financial information of its expenditure in such manner as it sees fit at least once in each calendar year.

6.22 In the financial year 2011/12 the core operating costs of the Oversight Board were £1.2 million. We estimate that less than 5% of those costs related to our role as the Independent Supervisor. The costs of reviewing firm wide procedures and inspecting statutory audits undertaken by the NAO were £90,000.

Oversight of the Actuarial Profession

Following the Morris Review of the Actuarial Profession, the Oversight Board took responsibility in 2006 for independent oversight of the UK Actuarial Profession under a Memorandum of Understanding between the FRC and the Institute & Faculty of Actuaries (the Profession).

The Actuarial Profession has the primary responsibility for the regulation of its members acting in their professional capacity. The Profession has agreed to respond to our recommendations, either by implementing them within a reasonable period or by giving reasons for not doing so, on the basis that those reasons will be published.

The public interest agenda for our oversight of the Profession was set in 2009 when we published our conclusions and recommendations from a wide-ranging review of monitoring and scrutiny of actuarial work, which we undertook in consultation with the Profession, the FSA and the Pensions Regulator.

During 2011-12, we encouraged the Profession to prioritise and report on its activities under three headings, as follows:

- *Ethics and professionalism of actuaries* – the Profession has significantly improved and updated its materials on whistle-blowing and conflicts of interest, particularly in pensions, although it still needs to review some of its other materials including the Actuaries' Code.
- *Technical skills of actuaries* – the Profession has supported the introduction of the Technical Actuarial Standards (TASs) through targeted seminars for existing practitioners as well as changes to its examinations; reviewed how it sets examination papers and marks scripts, to differentiate better between those who demonstrate the required knowledge and competence and those who do not; and improved the transparency of its qualification by making examiners' reports more consistent and informative in content.
- *Working environment for actuaries* – the Profession has increased its engagement with employers of actuaries and developed a new partnership agreement with firms to promote an actuarial quality mark. We can see merits in these proposals although we consider that there needs to be effective verification, if they are to be seen to have value.

We have encouraged the Profession not just to respond to our recommendations, but itself to consider the public interest outcomes it is looking to achieve in regulating its members, and the quality of its regulatory processes for achieving them. The Profession published a new overall strategy in June 2011, and a draft regulatory strategy framework, which it finalised in April 2012.

With the Board for Actuarial Standards, we commissioned a survey of actuarial quality and reviewed statements of compliance with the TASs. We also produced tailored questions for specific users of actuarial work.

7 Oversight of the Actuarial Profession

INTRODUCTION

7.1 The Actuarial Profession is relatively small, but actuaries are particularly influential in advising insurers, pension schemes and other financial institutions that require long-term planning and modelling of financial risk. The Institute and Faculty of Actuaries regulates its members as the Actuarial Profession. We oversee the Profession by virtue of an agreement in 2006 between the FRC and the Profession following the Morris Review in March 2005. We monitor developments, assessing those issues that could adversely affect public confidence in actuaries and, where appropriate, undertake more detailed research and make recommendations to the Profession and to other relevant bodies.

PRIORITIES FOR THE ACTUARIAL PROFESSION

7.2 The recent agenda for our oversight of the Profession was largely set in 2009 when we published our conclusions and recommendations from a wide-ranging review of monitoring and scrutiny of actuarial work, which we undertook in consultation with the Profession, the FSA and the Pensions Regulator.

7.3 The FRC's Actuarial Quality Framework (AQF) identifies six factors (or drivers) and associated indicators that promote high quality actuarial work:

- reliability and usefulness of actuarial methods
- communication of actuarial information and advice
- ethics and professionalism of actuaries
- technical skills of actuaries
- working environment for actuaries
- other factors outside the control of actuaries

7.4 The FRC's Board for Actuarial Standards (BAS) has issued technical actuarial standards (TASs) to support the first two drivers (actuarial methods and communication), which are also supported by the Profession through its education and training. We have encouraged the Profession to focus its responses to our recommendations under three of the four remaining headings (ethics and professionalism, technical skills, and working environment). We have sought to promote other positive factors in conjunction with other regulators and user groups.

7.5 After a slow start, the Profession has made significant progress during 2011-12 towards meeting our expectations in response to most of the challenging recommendations we made in May 2009. It recognises, however, that it still needs to complete a number of projects to show that it has responded in full to all the outstanding recommendations, and has said that it intends to have completed this work by the summer of 2013.

PROMOTING THE PUBLIC INTEREST

7.6 The Profession has responded positively to our recommendations and has agreed to report against the drivers and indicators in the AQF. However, we have also encouraged the Profession not just to respond to our recommendations, but itself to consider the public interest outcomes it is looking to achieve in regulating its members, and the quality of its regulatory processes for achieving them.

7.7 The Profession published a new overall strategy in June 2011, and a new draft regulatory strategy framework, which it finalised in April 2012. The latter emphasises:

- an integrated approach to regulation across the Profession's functions and activities;
- strong leadership and an increasingly professional executive function, ensuring effective regulatory policy-making and direction; and
- a more confident relationship with the FRC, responding to our recommendations and challenges but taking responsibility for developing its own regulatory solutions.

7.8 The Profession is supporting its new regulatory strategy with additional resources, overseen by a Professional Regulation Executive Committee (PREC) with a lay chairman. The Profession has also adopted a more open approach to consultation on its proposals, involving external stakeholders and publishing feedback statements to explain its regulatory decisions.

7.9 We welcome the Profession's development and publication of a regulatory strategy, its enhanced executive function and resources which have assisted its progress this year, and its greater openness to external stakeholders in its regulatory decision-making. The Profession has accepted an invitation to attend the FRC's Actuarial User Committee as a regular observer and to submit significant regulatory proposals to the Committee for comments and feedback.

7.10 In discussions with the Profession as it has developed its new regulatory strategy framework, we urged the Profession to address the following concerns:

- The need for greater objectivity and transparency. FRC oversight is described in the strategy as supporting both the reality and the perception of objective transparency through external scrutiny. However, the Profession itself also needs to embrace these qualities in the way it regulates its members in the public interest.
- The dangers in overstating any equation of the public interest with members' interests. The regulatory strategy is right to argue that members' interests are promoted by pursuing the public interest, but the Profession needs to guard against an inversion of this argument whereby the public interest is interpreted by reference to its own members' interests.
- The danger in the Profession asserting a regulatory philosophy of 'assumed trust' in its members, if this means failing to monitor and challenge the activities of its members and the quality of their work.
- The importance of assessing outcomes against the AQF. The Profession acknowledges this, but does not itself incorporate the AQF or its indicators into the regulatory strategy or its assessment of what successful implementation will look like. For example, there is only limited reference to the working environment for actuaries, and the role of actuarial firms and users of actuarial work in promoting the quality of actuarial work.

7.11 The Profession has responded to our concerns in its final published regulatory strategy. However, much will depend on how the Profession seeks to address its public interest objectives under the new strategy, and responds to external challenges and the priorities we have identified.

ETHICS AND PROFESSIONALISM OF ACTUARIES

7.12 We consider that, after relatively slow progress in 2009-11, the Profession has significantly enhanced its promotion of ethics and professionalism of actuaries during 2011-12, although as the Profession itself recognises there is still more to do.

7.13 We have encouraged the Profession to build on its recent more outcome-focused Actuaries' Code by developing a comprehensive set of standards, guidance and education. The Profession has

found this challenging, and we have encouraged it to set realistic expectations and milestones for this work, with adequate resources and processes for ensuring that it delivers high quality regulation, and supports awareness and compliance with the TASs.

7.14 During 2011-12, the Profession has:

- issued two guides on whistle-blowing: one for actuaries and one for their employers (published in April 2011).
- developed new requirements on conflicts of interest for pensions actuaries, as well as guides for actuaries and pension trustees (published in June 2012).
- developed new ethical and conduct standards for life insurance to coincide with the implementation of the TASs (published in September 2011).
- supplemented its new standards and guides with on-line training and a new Professional Support Service (introduced in April 2012).
- commenced a review of the Actuaries' Code and started working on new or revised standards for general insurance and funeral plans.

7.15 We have provided significant input and feedback to the Profession on these developments, and we are pleased that the Profession has implemented substantive responses to the important recommendations from us and the Morris Review on whistle-blowing and, following two major consultations, the difficult area of conflicts of interest in pensions. We understand why – in view of the responses received to its consultation – the Profession eventually decided to introduce a 'rebuttable presumption' against dual appointments for pension scheme actuaries rather than an outright ban on advising both the trustees and the employers, as originally proposed. We have worked with the Profession to ensure that the constraints on any rebuttal (which should be rare) are effective, and that actuaries are more strongly encouraged to recognise the existence of conflicts.

7.16 We hope that the Profession's new requirements will be adopted much earlier than its July 2013 deadline and we will monitor the situation closely with the Profession and the Pensions Regulator to ensure that the requirements are both effective and proportionate, and that any relevant lessons are incorporated into the review of the Actuaries' Code. We have also encouraged the Profession to look to the actuaries' working environment and the users of their work to support members' professional requirements, and we welcome the guides for pension trustees and employers, which the Profession has developed or is developing in these important areas.

7.17 We consider the Profession should develop a new ethical and conduct standard for general insurance, following the introduction of the Insurance TAS and withdrawal of Guidance Note 12: *General insurance business: actuarial reports*. We regard the standards for life insurance as too narrowly focused on the actuarial function and with-profits actuary roles, which are already heavily regulated

by the FSA. We would also like to see a more fundamental review of the Profession's compliance review requirements following the introduction of the TASs, and we are pleased that the Profession is now reviewing these on a cross-practice basis.

7.18 We have encouraged the Profession to develop more on-line training and assessment to support compliance with the TASs and the Profession's own requirements. We share the Profession's disappointment that the previous Interpretation Service was relatively underused, and we hope that the new Professional Support Service will be more effective. We have encouraged the Profession to share and publicise significant anonymised responses to such requests, in order to promote better compliance and publicise its support arrangements.

7.19 During 2012-13, we will continue to monitor the Profession's progress as it develops its ethical and conduct standards, including its review of the Actuaries' Code, and to review the impact of the new standards introduced by the Profession and the FRC. We will work with the Profession and other regulators to learn lessons from our respective monitoring and disciplinary work, and we will review the impact of the TASs on the work of actuaries who support the audit of actuarial information, which is a crucial but often overlooked area of actuarial work.

TECHNICAL SKILLS OF ACTUARIES

7.20 We consider that the Profession has significantly updated its promotion of the technical skills of actuaries during 2011/12 and improved the transparency of its examinations.

7.21 In previous years, we have encouraged the Profession to clarify the expected skills of practising actuaries, and establish a framework for developing, maintaining and confirming their professional competence, including awareness and understanding of the new technical actuarial standards (TASs), issued by the BAS.

7.22 During 2011-12, the Profession has:

- supported the introduction of the TASs through targeted seminars for existing practitioners as well as some changes to its examinations;
- reviewed how it sets examination papers and marks scripts, to differentiate better between those who demonstrate the required knowledge and competence and those who do not;
- improved the transparency of its qualification by making examiners' reports more consistent and informative in content; and

- begun work on a new accreditation scheme which, if agreed, will apply more widely within the profession.

7.23 This year we undertook a comparative review of the CPD monitoring arrangements maintained by the Profession and the professional accountancy bodies. We found that the Profession's arrangements were very effective in identifying formal non-compliance and encouraging a high level of professional development by its members. However, what was less clear was whether the CPD being undertaken was sufficient to maintain members' expected level of competence.

7.24 We have suggested that, in clarifying the expected skills of practising actuaries, the Profession should seek to focus in the first instance on specific roles such as pension scheme actuaries, the actuarial function and with-profits actuary, syndicate actuaries, and actuaries supporting audit work. We consider it should draw on the expectations that are already explicit in its examinations and its practising certificate criteria, as well as evidence from the on-line information about CPD undertaken and its CPD courses and from consulting clients and employers about the skills they expect in practice. The Profession says it intends to introduce more outcome-based CPD materials for actuaries. However, if the Profession continues to make slow progress, we may need to provide further input or undertake our own review.

WORKING ENVIRONMENT FOR ACTUARIES

7.25 The Profession is developing proposals for enhancing the working environment for actuaries as a driver of actuarial quality and supporting and confirming its members' compliance with their individual responsibilities. Much will depend, however, on its implementation and the uptake by firms, and the arrangements to confirm that appropriate procedures are in place.

7.26 The Profession is not at this stage proposing to expand the scope of practising certificates, and is instead developing a new 'accreditation' framework with proposals for regulation of students, the possible introduction of a new intermediate qualification of actuarial analyst, and specialist and generalist classifications for accreditation of practising actuaries. We see some merits in this approach, although we expect the Profession to ensure that the requirements for those in positions of actuarial influence, including those responsible for consulting advice, are no less rigorous than those for actuaries with a practising certificate.

7.27 The Profession does not actively monitor its members' work, primarily because most actuarial work tends to be undertaken for regulated entities, such as insurers and pension schemes, which have their own statutory regulators, and increasing requirements for independent review by auditors and for judgements to be taken by governing bodies. The Profession only regulates

individual members and not actuarial firms.

7.28 Following our review of monitoring and scrutiny of actuarial work in 2007-9, we concluded that the Profession's primary strategy should be to support the existing regulatory and market mechanisms for monitoring and scrutiny of actuarial work, and it should only itself undertake independent monitoring if other measures proved inadequate. However, given the reliance which is placed on consulting actuaries to have proper quality controls over their work, we recommended that the Profession should (i) consider extending its practising certificate arrangements to cover all consulting actuaries, and (ii) seek to place greater regulatory reliance on the quality assurance arrangements maintained by firms, including:

- a senior actuary to provide professional leadership within the actuary's firm;
- arrangements for handling conflicts of interest and confidential information;
- controls on competence and quality control, such as checks on individual actuaries' work;
- management of customer relationships, including terms of reference, complaints handling and compensation for shortcomings; and
- arrangements to support communications with regulators and whistle-blowing.

7.29 During 2011-12, the Profession has:

- increased its engagement with employers of actuaries and drafted a new partnership agreement with firms to promote an actuarial quality mark;
- implemented new practising certificate arrangements for existing practising certificate holders from 1 January 2012, incorporating a requirement for applicants for certificates to be supported by another practising actuary;
- implemented revised compliance review arrangements for pensions with effect from April 2011 and started a review of peer review arrangements more generally; and
- developed or started developing guides for employers of actuaries on whistle-blowing and conflicts of interest (see ethics and professionalism of actuaries).

7.30 During 2012-13, we will continue to monitor the Profession's progress in developing its proposals for accreditation, CPD and partnering with firms. We recognise that the Profession wishes to work with its members and with employers of actuaries to help achieve its regulatory objectives, and we expect it to take a clear public interest perspective in deciding upon criteria for actuarial quality marking and accreditation.

INCENTIVE EXERCISES

7.31 In recent years pension scheme members have increasingly been offered incentives to take their pension in a different form. As financial pressures on trustees and scheme sponsors grow, many pension scheme members are being offered an 'enhanced' transfer value to a personal pension, or an option to exchange a lower index-linked pension for a higher pension without indexation. These members can be faced with very difficult decisions in a complex area which is of significant importance to their financial future. It is therefore important that incentivised exercises are carried out professionally and that members receive the information they need so they can make an informed decision.

7.32 The FRC has, with various other bodies, taken steps to improve the regulatory framework for incentivised exercises. We supported a DWP-sponsored industry working group which has produced a Code of Practice for those involved in these exercises, and the BAS is consulting on bringing the actuarial work in these exercises into the scope of the TASs.

7.33 The Profession has also contributed to these initiatives, provided additional training and written to its members to update them on the public interest issues involved. We have encouraged the Profession to acknowledge the significant part many actuaries take in these exercises, whether advising scheme sponsors or trustees, and highlight their obligations under the Actuaries' Code to speak up if they have concerns, to recognise and address any conflicts of interest, and to take steps to ensure that communications with which they are associated are accurate and not misleading, and contain sufficient information to enable scheme members to put incentive offers in proper context.

COMPLIANCE STATEMENT REVIEW AND USER UPDATES

7.34 We and the BAS have carried out a review of compliance statements prepared by actuaries as required by the Technical Actuarial Standard on Reporting Actuarial Information (TAS R). The purpose of the review was to gain an understanding of how actuaries are implementing the requirement and to determine how useful the statements are to the users of actuarial information. We have made clear our view that compliance statements should generally be short, should confirm that the work as well as the report complies with the relevant TASs, and should not be omitted on grounds of materiality.

Compliance Statement Review

The main findings of this review were as follows:

- Almost all reports contain a compliance statement.
- Users expressed a preference for short statements and most statements were short.
- Some practitioners' statements confirm that the report is compliant with the TASs but do not refer to the underlying work.
- A few practitioners say they have on occasions failed to provide a statement on the grounds of materiality.
- Both users and practitioners acknowledge that users expect the work carried out by an actuary to comply with relevant professional standards.
- Some practitioners consider that compliance statements are not useful to the users.
- Users generally consider compliance statements are useful and some rely on them.
- Views differ as to whether it is more useful to confirm compliance with "all relevant standards" or list the TASs.

7.35 We have updated the FRC's questions for users of actuarial work to ask their actuaries. In November 2011 we issued tailored sets of questions on specific topics designed for three groups of users of actuarial work: insurance directors, pension scheme trustees and pension scheme sponsors.

INTERNATIONAL ASPECTS

7.36 We have continued to monitor developments in Europe and beyond, given their impact on the principles and practices adopted in the UK, in conjunction with BAS colleagues. FRC staff have met officials from the European Insurance and Occupational Pensions Authority and the Groupe Consultatif Actuariel Européen, and attended committee meetings on education and professionalism at the International Actuarial Association.

7.37 To enhance our influencing of international developments, we have established a UK forum on international actuarial standards with representatives of the Profession, other regulators, Government and industry, which meets twice a year and as required in response to significant initiatives.

Measuring the impact of regulation

We have commissioned regular surveys of confidence in actuarial information and the actuarial profession.

Taken together with the individual comments of those interviewed, this gives some indication of the impact our oversight activities and the implementation of the TASs have had on actuarial quality.

Confidence in the competence and integrity of the actuarial profession remains high, further strengthened by an increasing proportion of those asked who say that they are very confident.

A high proportion of those surveyed said that technical standards were either extremely or very important. However, a significant proportion still considers that actuarial information is presented in a more complex way than is strictly necessary.

Confidence of:		Insurance directors	Pension trustees	Actuaries
Relevance of actuarial information	2008	71%	88%	76%
	2010	92%	78%	88%
	2012	86%	98%	92%
Reliability of actuarial information	2008	71%	93%	72%
	2010	89%	80%	96%
	2012	92%	96%	98%
Clarity of actuarial information	2008	57%	86%	56%
	2010	69%	70%	82%
	2012	69%	88%	90%
Integrity of the actuarial profession	2008	100%	100%	92%
	2010	97%	96%	94%
	2012	97%	98%	98%
Competence of the actuarial profession	2008	100%	95%	84%
	2010	86%	91%	96%
	2012	95%	94%	98%

ANNEX 1

STATUTORY BASIS FOR THE POWERS AND RESPONSIBILITIES OF THE PROFESSIONAL OVERSIGHT BOARD

In February 2008, Parliament approved a Delegation Order made by the Secretary of State for Business, Innovation and Skills under Sections 504, 1252 and 1253 of the 2006 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 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 (see paragraphs 3.28 to 3.30 above).
- The Oversight Board has a specific obligation to set statutory requirements on auditors of public interest entities to prepare and publish annual transparency reports (see paragraphs 3.14 to 3.18 above).
- 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 Government has delegated the responsibility for setting and administering the detailed requirements on third country auditors to the Oversight Board (see paragraphs 5.7 to 5.9 above).

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 (see Chapter 6 above).

ANNEX 2

STATISTICAL ANNEX: REGULATORY ACTIVITIES OF RECOGNISED SUPERVISORY AND QUALIFYING BODIES

A) Audit Registration

	ACCA	ICAEW	CAI	ICAS
Number of audit firms				
As at 31.12.11	2,281	3,865	995	235
As at 31.12.10	2,278	3,958	986	235
As at 31.12.09	2,503	4,113	985	242
Number of Office locations, as at 31.12.11				
1	1,994	2,379	911	174
2-3	276	1,313	78	44
4-10	11	156	6	16
10+	0	17	0	1
Number of Office locations, as at 31.12.10				
1	2,023	2,525	907	176
2-3	247	1,265	73	43
4-10	7	151	6	15
10+	1	17	0	1
Number of Office locations, as at 31.12.09				
1	2,247	2,789	903	181
2-3	246	1,189	76	45
4-10	9	116	6	15
10+	1	19	0	1

	ACCA	ICAEW	CAI	ICAS
Number of Principals, as at 31.12.11				
1	1,398	1,716	604	88
2-6	858	1,878	367	127
7-10	18	154	12	12
11-50	7	99	9	7
50+	0	18	3	1
Number of Principals, as at 31.12.10				
1	1,409	1,804	619	85
2-6	833	1,881	346	129
7-10	29	160	10	13
11-50	7	96	9	7
50+	0	17	2	1
Number of Principals, as at 31.12.09				
1	1,631	1,945	621	88
2-6	839	1,897	343	132
7-10	26	154	12	15
11-50	7	99	7	6
50+	0	18	2	1
Number of new applications¹⁰				
Yr to 31.12.11	142	235	73	10
Yr to 31.12.10	132	270	49	44
Yr to 31.12.09	100	218	30	8

¹⁰ New applications include those firms changing status, for example from a partnership to an LLP.

	ACCA	ICAEW	CAI	ICAS
Number of applications refused¹¹				
Year to 31.12.11	2	0	1	0
Year to 31.12.10	0	1	3	0
Year to 31.12.09	0	1	6	0

Some bodies have experienced an increase in the number of new audit registrations. In the case of CAI the increase in 2011 compared with 2010 is largely due to firms applying to register as a limited liability partnership. However, the number of new registrations across all the bodies has been more than matched by firms withdrawing from the audit market leading to a small decrease in the number of registered firms.

The long term trend of a decline in the number of registered audit firms is largely the result of increases in the audit threshold, resulting in a lower number of entities requiring an audit and of higher costs so that some firms have found that there is no longer a good business case for retaining their audit registration. The impact of higher audit exemption thresholds is that some firms find that they no longer hold any audit appointments. However, some firms with no audit clients retain their audit registration so that they continue to be eligible to undertake a range of assurance type work, which under the relevant legislation may only be carried out by registered auditors.

B) Audit Monitoring

Since 1st January 2005, the monitoring of firms has been undertaken by each RSB separately. The Audit Inspection Unit (AIU) inspects the auditors of listed and other major public interest entities (see Section 3).

The Statutory Audit Directive (SAD) (effective April 2008 in respect of audit firms registered to undertake audits in the UK) introduced a requirement that the RSBs should monitor the activities undertaken by audit firms at least once every six years.

¹¹ All applications that are refused must be considered by the registration/ licensing committee

	ACCA	ICAEW	CAI	ICAS
Number of firms monitored				
Actual 2011	373	716	22	56
Target 2011	Not available	710	None set	50
Actual 2010	357	755	97	50
Target 2010	Not Available	750	None set	50
Actual 2009	425	757	102	51
Target 2009	Not Available	750	None set	50
Actual firms monitored as a % of audit registrants				
2011	16.4%	18.6%	2.2%	23.8%
2010	15.7%	19.1%	9.8%	21.3%
2009	17.0%	18.4%	10.4%	21.1%

With the exception of CAI, we consider that the bodies are carrying out a sufficient number of monitoring visits each year, have sufficient staff resources in place and the necessary administrative arrangements in place to provide a realistic expectation that they will meet the requirements of the SAD. We consider that it important that RSBs avoid getting far behind in progress towards meeting the six year cycle, as it is then difficult, costly and inefficient to catch up. The position of CAI is more complex and is discussed in paragraphs 2.34 to 2.38 above.

	ACCA	ICAEW	CAI	ICAS
Reason for monitoring visits				
2011				
Number of firms monitored following a request by the registration/ licensing committee	46	29	3	16
Number of firms with public interest entities visited without AIU ¹² involvement	0	49	0	0
Number of firms with public interest entities visited with AIU involvement	0	0	0	1

¹² AIU = Audit Inspection Unit

	ACCA	ICAEW	CAI	ICAS
Number of firms specifically selected due to heightened risk (including early follow ups)	42	59	19	39
Number of firms randomly selected	285	579	0	0
2010				
Number of firms monitored following a request by the registration/ licensing committee	17	11	5	17
Number of firms with public interest entities visited without AIU involvement	0	59	3	0
Number of firms specifically selected due to heightened risk (including early follow ups)	41	68	87	33
Number of firms randomly selected	299	617	2	0
2009				
Number of firms monitored following a request by the registration/ licensing committee	32	22	5	7
Number of firms with public interest entities visited without AIU involvement	0	46	2	1
Number of firms specifically selected due to heightened risk (including early follow ups)	36	65	84	43
Number of firms randomly selected	357	624	11	0

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. The RSBs are currently undertaking a joint project with the aim of achieving a more consistent use of gradings across all the bodies. As part of this project inspectors will give a grading to each file they review as well as an overall grading for the visit as a whole. This project is in its early stages and we look forward to considering its conclusions in due course. The tables below are based on the current different gradings, as explained after each table.

The monitoring results for any one year are not typically directly comparable with the results of previous years. This is because the mix of firms selected in each year is likely to vary, as between firms selected as higher risk, randomly selected and firms selected to meet the six year cycle.

Particular care is needed also in interpreting the percentage of "D" outcomes at each body, especially given that the sample of firms inspected in any year is unlikely to be random but will

almost certainly include a disproportionate number of weaker firms selected because of higher risk. However, the percentages of visits undertaken in 2011 with “D” outcomes is little changed from the outcome of visits undertaken in 2010.

It should also be noted that the visits with A and B outcomes may include a number of visits to audit registered firms that currently have no audit clients.

The tables below show the gradings for the four bodies for visits conducted from 2009-2011 together with brief explanatory comments from the bodies where available.

ACCA	2011	2010	2009
Number of A & B outcomes	208	223	238
% of A & B outcomes compared to all visits conducted	56	62	56
Number of C+ outcomes	47	38	64
% of C+ outcomes compared to all visits conducted	12	11	15
Number of C- outcomes	14	9	21
% of C- outcomes compared to all visits conducted	4	3	5
Number of D outcomes	104	87	102
% of D outcomes compared to all visits conducted	28	24	24

ACCA grades visits to firms A-D. Those firms that are graded 'A' are judged to comply with all aspects of the Global Practising Regulations (GPRs), Code of Ethics and Conduct (CEC) and relevant auditing standards. Those firms rated 'B' are judged to comply with the GPRs, CEC and auditing standards in all material respects so that any deficiencies found in audit work are minor and unlikely to have compromised the audit opinion issued. Firms are graded 'C+' or 'C-' by the ACCA if their quality controls over audit work are either weak or not consistently effective so that the audit work is unsatisfactory at a single visit and improvements are required. The 'C-' grade indicates that there may be a systemic problem or that the improvements required are significant. When a firm has a second or subsequent unsatisfactory visit and there are no mitigating factors, the firm will be referred to a regulatory assessor or the Admissions and Licensing Committee (ALC) and the visit graded a 'D'. In addition, where there are serious breaches of other regulations, such as a firm's failure to meet the eligibility requirements for audit registration or to comply with a previous ruling of a regulatory assessor, then the matter will be referred to Governance - Professional Conduct for potential disciplinary action. The gradings of a visit are not based solely on the standard of audit work. For example, the outcome could be deemed unsatisfactory due to a breach of client money rules or Continuing Professional Development regulations.

ACCA has explained that the number of firms monitored in 2011 was slightly higher than in 2010 because there was a full complement of staff carrying out visits during the year. 14% of the monitoring was of firms with no audits clients (2010: 31%) some of which was carried out using a desk-top questionnaire. In the absence of serious non-compliance such visits are generally awarded a satisfactory outcome which substantially improves the overall percentages. Overall 56% of visits in 2011 had satisfactory outcomes compared with 62% in 2010 and ACCA has explained that this decrease is largely attributable to the reduction in the number of firms monitored in 2011 that did not hold audit appointments.

ICAEW	2011	2010	2009
Number of A & B outcomes	385	486	494
% of A & B outcomes compared to all visits conducted	54	64	65
Number of C outcomes	149	132	140
% of C outcomes compared to all visits conducted	21	17	19
Number of D outcomes	71	80	94
% of D outcomes compared to all visits conducted	10	11	12
Number of N outcomes	111	57	29
% of N outcomes compared to all visits conducted	15	8	4

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

The ICAEW classes 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 follow-up action is required. 'B' rated visits are those with evidence of non-compliance with the Audit Regulations, but where the Quality Assurance Directorate (QAD) is confident that the firm's responses, as set out in the closing meeting notes, adequately address all the issues and that no follow up action is required. A 'C' rated report records instances of non-compliance with the Audit Regulations where the QAD considers that there is 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 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 and a detailed report to ARC is prepared by the QAD. Reports rated 'D' are sub-divided into four sub-ratings (D1 – D4) with D1 reserved for the most serious situations where QAD recommends that the firm's audit registration should be withdrawn. An 'N' visit grading is used for any circumstances that cannot be

rated in accordance with the criteria set out above, for example, when a firm wishes to continue with registration but has no audit clients and no audit work has been reviewed or the firm has applied to withdraw from registration and QAD proposes acceptance.

ICAEW has commented that the percentage visit gradings in 2011 remain broadly consistent with 2010.

Chartered Accountants Ireland¹³	2011¹⁴	2010	2009
Number of A & B outcomes	13	21	22
% of A & B outcomes compared to all visits conducted	37	21	24
Number of C outcomes	9	40	38
% of C outcomes compared to all visits conducted	26	39	42
Number of D outcomes	13	41	29
% of D outcomes compared to all visits conducted	37	40	32

The CAI considers all visits graded A to C as good or satisfactory and hence a 'pass'. Reports graded 'A' are where no instances of non-compliance have been recorded. Grade 'B' indicates that the firm has the ability and commitment to address the issues identified during the visit. Where reports are graded 'C', firms are required to give undertakings in writing covering the actions they must take and some further follow-up action may be required. There is a considerable difference between a report graded a 'C' and one graded a 'D'. Reports graded a 'D' have significant issues and will always require follow-up action. Those reports will always be considered by the Head of Quality Assurance and by the Quality Assurance Committee (QAC).

CAI has commented that there are no significant movements in the visit statistics with 63% of visits (60% in 2010) achieving good or satisfactory results (outcomes A, B and C). However all visits carried out in 2011 were selected either because the firm was considered higher risk (19 visits) or at the request of the Quality Assurance Committee (3 visits) and a comparison with outcomes in previous years may not be particularly meaningful.

¹³ The Chartered Accountants Regulatory Board (CARB) carries out all the monitoring functions of the CAI, in accordance with the CAI Bye-laws.

¹⁴ Although there were 22 audit monitoring visits completed by CARB during 2011, the Quality Assurance Committee considered the outcome of 35 visits included some undertaken in 2010.

ICAS	2011	2010	2009
Number of A & B outcomes	27	30	33
% of A & B outcomes compared to all visits conducted	48	60	65
Number of C outcomes	21	17	13
% of C outcomes compared to all visits conducted	37	34	25
Number of D outcomes	8	3	5
% of D outcomes compared to all visits conducted	15	6	10

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 addressed adequately 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. At the start of 2010 the 'C' grading was split into 'C1' and 'C2' gradings with 'C1' being the most serious. This is used where the issues are considered to be pervasive, whereas 'C2' gradings are used where findings are specific to particular individuals or files and do not indicate systemic problems. Of the 21 C gradings in 2011, 15 were the less serious C2 grading. A 'D' rating is given when the standard of compliance is such that the Audit Registration Committee (ARC) needs to consider appropriate follow-up action, such as imposition of conditions and restrictions or withdrawal of registration.

ICAS has commented that overall the outcomes from the 2011 visits are not directly comparable with the outcomes in previous years because the individual firms visited in each year will be different. Nevertheless ICAS has identified a number of themes that it believes have resulted in a greater number of firms having to comply with conditions imposed by the ARC in 2011. These themes include matters such as ineffective CPD, over-reliance on accounts production work and ineffective cold file reviews.

C) *Complaints about Auditors*

	ACCA	ICAEW	CAI ¹⁵	ICAS
Number of new cases¹⁶				
2011	31	85	36	8
2010	24	95	20	2
2009	27	93	17	10
Number of cases passed to the AADB¹⁷				
2011	0	2	0	0
2010	0	3	0	0
2009	0	0	1	2
Number of cases passed to committee¹⁸				
2011	3	71	12	6
2010	8	66	20	2
2009	5	53	7	6
Number of complaints¹⁹ closed in the year				
2011	43	89	6	3
2010	24	89	13	1
2009	25	76	6	6

¹⁵ The Chartered Accountants Regulatory Board (CARB) is responsible for handling complaints about all members of the CAI, including audit-related complaints, in accordance with the CAI Bye-laws.

¹⁶ Audit-related complaints only

¹⁷ Cases relating to audit work only

¹⁸ 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 Committee, Disciplinary Committee and Appeal Committee for the CAI and D) the Investigation and Professional Conduct Enforcement Committee at ICAS.

¹⁹ Audit-related complaints only

Average time taken to close a complaint				
	ACCA	ICAEW	CAI	ICAS
2011	10.3 months	11 months	4.6 months	For cases closed by IPCEC ²⁰ = 5.0 months. For cases closed by Secretariat = 5.6 months.
2010	7.8 months	10 months	9 months	For cases closed by IPCEC = 3.9 months. No audit cases were closed by the Secretariat during the year.
2009	9.4 months	11 months	6 months	For cases closed by IPCEC= 3.8 months. For cases closed by Secretariat = 1.5 months.

The figures of CAI complaints for 2009 and 2011 are for audit-related complaints only. The figures for 2010 include complaints against Registered Auditors regardless of the nature of the complaint.

ICAS has explained that the number of new audit-related complaints increased to 8 from 2 in 2010 which had been its lowest level for over five years. ACCA and ICAEW have not identified any particular reasons for the movements in their complaints statistics.

²⁰ Investigation and Professional Conduct Enforcement Committee

D) Student Registration

	ACCA ²¹	ICAEW	CAI	ICAS	AIA ²²
Number of new students					
2011	16,080	5,951	1,404	1,000	15
2010	19,597	5,652	1,205	820	3
2009	19,265	4,854	1,432	740	8
Total number of students					
2011	89,220	19,073	6,361	3,024	155
2010	90,044	17,653	5,771	3,004	151
2009	93,864	16,517	6,171	3,119	143
Number of students who became members					
2011	3,880	3,118	1,064	804	0
2010	4,071	3,290	1,332	768	0
2009	3,583	3,418	1,093	863	0
Number of members who became audit qualified					
2011	106	25,730	800	980	0
2010	98	1,020	979	29	0
2009	111	2,180	998	27	0

All the bodies, other than ACCA, have seen an increase in the number of new students registering to train as accountants. The number of students enrolling with ACCA has been affected by the introduction of more flexible registration processes. The overall number of ACCA students registering is on a par with previous years but the removal of a December deadline allowed students the opportunity to register for their exams in January 2012.

²¹ ACCA figures are for students in UK and ROI only

²² AIA figures are for students in UK and ROI only

The high numbers of members awarded the audit qualification in 2011 by the ICAEW and ICAS, as compared to previous years, requires explanation. The ICAEW figures include 740 students admitted to membership who were granted the audit qualification upon application. Additionally, ICAEW made a retrospective award of the Audit Qualification to 24,990 members whose records already logged with the ICAEW showed that they had met the Companies Act requirements but had not previously applied. The ICAS figure includes 27 members who were granted the audit qualification upon application. A further 953 members were granted the audit qualification on the basis of an award to all those members who qualified in 2009 and 2010 who had met eligibility requirements..

It is important to note that holding the audit qualification is a necessary but not a sufficient condition to be eligible to sign an audit opinion on behalf of the registered audit firm. In the case of CAI, ICAEW and ICAS, the firm must additionally apply for the individual to be granted “Responsible Individual” status, which involves an assessment of the individual’s current competence to be responsible for statutory audit work.

ACCA has a different system and grants its practising certificate with audit only to eligible members who apply.

E) Registered Training Offices in UK and Ireland

	ACCA ²³	ICAEW	CAI	ICAS	AIA ²⁴
Number of registered training offices					
2011	4,283 ²⁵	3,572	834	175	0
2010	4,622	3,322	837	167	23
2009	4,822	3,115	828	168	20

²³ UK only.

²⁴ The registration of training offices by AIA is subject to processing of final details and final approval.

²⁵ 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.

	ACCA ²³	ICAEW	CAI	ICAS	AIA ²⁴
Number with students training for the audit qualification					
2011	3,208 ²⁶	877	409	N/A	0
2010	3,371	1,059	460	N/A	0
2009	3,606	1,122	578	N/A	0
Number of new applications					
2011	N/A	246	53	15	0
2010	N/A	267	61	9	3
2009	N/A	239	74	12	20
Number of applications refused					
2011	N/A	3	0	0	0
2010	N/A	0	0	0	0
2009	N/A	1	0	1	0
Number of registrations withdrawn					
2011	515	0	50	8	0
2010	376	0	0	10	0
2009	73	2	0	29	0
Number of approved training offices visited²⁷					
2011	756	596	130	42	0
2010	1,052	522	161	34	0
2009	768	433	180	41	0

²⁶ ACCA figures are of offices registered to provide training for the audit qualification. Not all these offices will have students in training.

²⁷ This includes both authorisation visits to firms seeking registration for the first time and review visits to firms that are already registered.

	ACCA ²³	ICAEW	CAI	ICAS	AIA ²⁴
Number of approved training offices visited as a % of the total					
2011	17.7%	16.7%	15.6%	24.0%	0%
2010	22.8%	15.7%	19.2%	20.4%	0%
2009	15.9%	13.9%	21.7%	24.4%	0%

ICAS has explained that it continues to encourage firms to consider becoming an authorised group rather than authorising single offices as this facilitates the movement of students within an organisation.

ACCA has recorded a small decrease in the number of registered training offices including those offices registered to provide training for the audit qualification. This is due to a higher number of firms withdrawing from registration primarily because of changes in recruitment patterns since initial registration and of office mergers and closures and offices that have ceased to train ACCA trainees and members.

CAI has commented that the number of visits to approved training offices and efforts to promote training for students with business rather than public practice employers were both scaled back in 2011 due to resource constraints.

The increase in the number of ICAEW registered training offices may be due to the recession causing student redundancies and resulting in the need for students to seek new employers. The increase in the number of training offices visited is due to the introduction of a three year rather than a five year visit cycle which aims to ensure that training offices that are actively training students are monitored more closely.

Although AIA has arrangements in place for approving training offices for students seeking the audit qualification, it has not yet completed the approval of any such training offices. It is not expected to do so until these students have reached a more advanced stage of their studies and need to consider where they will obtain their practical training in audit.

ANNEX 3

PROFESSIONAL OVERSIGHT BOARD

1 APRIL 2011 TO 31 MARCH 2012

Chair

The late Dame Barbara Mills DBE QC (to 28 May 2011) Director of the Serious Fraud Office from 1990 to 1992. Director of Public Prosecutions and Head of Crown Prosecution Service from 1992 to 1997.

John Kellas, CBE (from 8 June 2011) Chair of the International Auditing and Assurance Standards Board, 2004 – 2008. Previously, the senior UK technical partner of KPMG.

Members

Lillian Boyle A lawyer and a Chartered Insurer. A former President of the Chartered Insurance Institute and Chair of the CII Audit Committee. Formerly Managing Director of Scottish Provident International. Currently sits on a variety of boards including investment and financial services companies.

Anthony Carus Consulting Actuary and Director, Royal Liver Assurance Limited. Formerly Appointed Actuary, NFU Mutual Life Insurance Society.

Iain Cheyne, CBE Solicitor. Formerly Managing Director of International Banking, Lloyds Bank and financial adviser to the Aga Khan.

Hilary Daniels (from 21 June 2011) Board Member and Chair of Audit Committee, Olympic Lottery Distributor. Independent Member of the Professional Standards Board of the Institute of Legal Executives. Formerly Chief Executive, West Norfolk Primary Care Trust. Past President, CIPFA.

Rudolf Ferscha Lawyer, banker and investor. Held a range of senior management positions, including Chief Executive of a major European derivatives exchange and with the Goldman Sachs Group.

Paul George Director of Auditing, FRC, and Director, Professional Oversight Board

Mick McAteer Non-executive FSA Board Member. Formerly Principal Policy Adviser for Which? Member of European Consultative Panels for banking and insurance regulators.

Diane Walters Qualified accountant. Combines lecturing at Heriot-Watt University with a portfolio of teaching and examining posts with professional accountancy bodies.

Secretary

John Grewe



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ISBN 978-0-10-298030-1



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