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**PROFESSIONAL OVERSIGHT BOARD**

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

**YEAR TO 31 MARCH 2011**

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# **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 2011**

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).

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# 1 INTRODUCTION

- 1.1 The Professional Oversight Board was set up in 2004 as part of the reformed Financial Reporting Council (FRC). This followed the then Government's Review of Audit Regulation in 2003, in the light of the major auditing failures in the US at Enron and WorldCom. 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, subsequently reflected many of the changes already introduced in the UK. Our 2004 statutory powers and responsibilities were extended in 2008, as part of the UK's full implementation of the Statutory Audit Directive.
- 1.3 Our principal responsibilities are as follows:
- Statutory oversight of 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 their professional body;
  - 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 The rest of this report comments in more detail on these responsibilities.
- 1.5 Chapter 2 reports on our monitoring of the direct regulation of statutory auditors by the professional accountancy bodies. This year for the first time we name the individual bodies to which our main findings apply. The Oversight Board concluded last year that this would make our public reporting more informative and transparent, and would underline to the bodies the importance of taking prompt action to address our key recommendations.

- 1.6 Whilst we again raise significant issues this year, we are pleased to report that all the bodies take our findings and recommendations seriously, engage closely with us, and in general respond positively and constructively. We consider that our work has a positive effect on the quality of regulation and therefore on the quality of audit and auditors. Nevertheless, our formal powers to require specific action are limited, essentially to nuclear options, and as a result we are considering with the Department for Business, Innovation and Skills (BIS) whether a wider range of more proportionate powers would allow for more effective oversight.
- 1.7 Chapter 3 reports on our direct inspection of audit firms. The AIU's inspection process continues to be both rigorous and challenging for firms. The actions taken by firms in response to the AIU's inspection findings continue to contribute to an improvement in the overall quality of audit work in the UK. This view is supported by the results of follow-up reviews of individual audits undertaken by the AIU, where it usually finds that all or most matters identified previously have been satisfactorily addressed. While improvement in the overall quality of audits is more difficult to assess, the AIU notes that the proportion of audits assessed as good with limited improvements required has been approximately 50% of all audits reviewed in the last two years. The number of major listed company audits assessed as requiring significant improvement has declined this year, with only one FTSE 350 audit in this category compared with four in each of the previous two years. However, overall the proportion of audits assessed as requiring significant improvement, particularly at smaller firms, remains of concern.
- 1.8 Our regulation of audit must be set in the context of the active debate on the future of audit and of audit regulation in the EU and the UK. The European Commission published its Green Paper 'Audit Policy: Lessons from the Crisis' in October 2010. This covers a wide range of issues, including the scope of audit, the structure of the audit market, the portability of audit qualifications and ethical/independence issues. It also identifies several possible changes to regulatory requirements, including the rotation of auditors, the introduction of mandatory joint audits and greater restrictions on the provision of non-audit services to audit clients.
- 1.9 We are closely engaged in the FRC response to the ideas in the Green Paper and look forward to the consideration of specific proposals, which the European Commission are expected to bring forward later this year.
- 1.10 Within the UK, the House of Lords Economic Affairs Committee report on auditors, published in March 2011, though focused on concentration in the audit market, also includes ideas for sharpening the regulatory tools available to the FRC.
- 1.11 Chapter 6 reports on our oversight of the Actuarial Profession. The Profession's response

to the recommendations we made to it in May 2009 is taking shape, with some targets met, although, as it acknowledges, further work is still required to complete developments in other areas.

1.12 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 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 2010, to report at least once in each calendar year on the discharge of our responsibilities as the Independent Supervisor of Auditors General.

1.13 The Board comprises a non-executive Chair, an Executive Director and up to 11 further non-executive members. Members are appointed for a three-year term, renewable for one further three-year term. Rudolf Ferscha, Roger Marshall and Diane Walters joined the Board on 1 June 2010. However, Roger Marshall resigned from the Board as of 31 October 2010, on his appointment as Chairman of the Accounting Standards Board.

1.14 Richard Barfield left the Board on 31 May 2010, David Crowther on 30 June 2010 and Hilary Daniels on 31 March 2011. All had completed their second three-year term. The Board is grateful for the significant contribution each made during their term of office.

### **DAME BARBARA MILLS DBE, QC**

1.15 I am very sorry to have to report the death of our chairman, Dame Barbara Mills QC, on 28 May 2011 after a short illness. It was a shock to the Board to lose her outstanding leadership so suddenly. She will be sadly missed as a firm leader, wise counsellor and friend.

1.16 Following Barbara's death, the FRC asked me to chair the Board on an interim basis and also invited Hilary Daniels to re-join the Board for an interim period.

John Kellas CBE  
Interim Chair of the Professional Oversight Board  
July 2011

## Statutory Audit Regulation

- All the recognised bodies devote substantial resources to their regulatory responsibilities. Much of the regulatory practice we have seen is of a high standard.
- Whilst in general the bodies continue to respond positively to our recommendations, change can take time to achieve and we are keenly aware that our powers to require specific action by them are limited and lack proportionality. We are considering with the Department for Business, Innovation and Skills whether more proportionate regulatory powers would enable us to exercise our oversight more effectively.
- Nevertheless, there are aspects of regulatory activity at some bodies that give us significant concerns:
  - The procedures for awarding individuals the right to sign audit opinions on behalf of a firm need to be more robust (paras 2.18 to 2.24).
  - We are not confident that one body will be able to meet its statutory obligation to inspect all audit firms undertaking UK audits within six years from June 2008 without decisive action (paras 2.25 to 2.28).
  - Some bodies need to do more to ensure that there is a sound basis for the award of exemptions from examinations where a student holds a degree deemed relevant (paras 2.31 to 2.37).
  - Two bodies, where we previously identified weaknesses in certain examinations, are taking significant steps to address our concerns, though it is too early to conclude whether they have met our concerns fully (paras 2.41 to 2.44).
- For the first time this year we name in the body of the report the individual bodies to which our main recommendations apply.
- The quality of this year's statutory transparency reports by the major firms of auditors of public interest entities has again improved. In contrast reports from smaller firms were often disappointing with many publishing a report which was almost identical to that of the previous year.



## 2 STATUTORY AUDIT REGULATION

2.1 This section reports on our monitoring of supervisory and qualifying bodies for statutory audit in 2010/11 and on our other statutory functions.

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

2.2 Audit firms who 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)<sup>1</sup>
- Institute of Chartered Accountants of Scotland (ICAS)

2.4 In addition<sup>2</sup>:

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

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

<sup>2</sup> 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 agreed to hold its RQB status in abeyance until 2012 and does not at present offer students the option of training for the statutory auditor qualification during that period. We did not therefore carry out a monitoring visit in 2010/11.

2.5 We exercise oversight 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, for example processing exemption applications from students or granting Responsible Individual (RI) status, and making recommendations.

## 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 members<sup>3</sup> 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 Whilst in general the recognised bodies respond positively to our recommendations, change can take time to achieve and we are acutely aware that our powers of enforcement, where a body fails to meet its statutory obligations, are limited and lack proportionality:

- We can seek a High Court order requiring an RQB or RSB to take specific steps to secure compliance, where there has been a failure to meet a statutory obligation.
- We can revoke the recognition of an RSB or RQB, following due process, where it appears to us that a body has failed to meet an obligation under the Act.

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

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<sup>3</sup> The AAPA had 61 registered auditors, as at 31 December 2010.

## 2010/11 MONITORING

- 2.9 We carried out a monitoring visit to each RSB and RQB, to test how they had applied regulatory requirements in practice, in particular where there had been a significant change in the year. Most visits involved 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.
- 2.10 The AIU 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 approves the monitoring units' inspection reports on each firm.
- 2.11 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.
- 2.12 We focused our 2010/11 RSB and RQB visits on the following areas:
- The system for the approval of individuals who wish to be able to sign an audit report on behalf of a registered audit firm. For ICAEW, ICAS and CAI, this means applications for Responsible Individual (RI) status; for ACCA it means applications for the Practising Certificate with Audit (PCAQ). We reviewed a sample of cases to test the application of these procedures in practice.
  - The grant of examination exemptions to students and the accreditation of higher education institutions. We tested the application of these procedures in practice by reviewing samples of (i) exemption applications and (ii) accredited institutions.

## PUBLIC REPORTING

- 2.13 To date our practice has been to report our detailed findings and recommendations privately to each recognised body but not to name individual bodies in this report, other than where it is self-evident to which body we refer. The Oversight Board decided last year that our public reporting would be more informative and transparent were we to name the individual bodies to which our main findings and recommendations apply. Such an approach would also encourage the bodies to respond to our concerns in a timely fashion. This report therefore follows that approach. However, we invite all the bodies to consider the relevance of our findings to their situation.

## RESULTS OF 2010/11 MONITORING

2.14 All the bodies devote substantial resources to their regulatory responsibilities. Much of the regulatory practice we have seen is of a high standard. Inevitably, we focus in a report such as this on aspects of regulatory activity at recognised bodies that give us specific concerns. In particular:

- We have made recommendations that the procedures for verifying recent audit experience and Continuing Professional Development (CPD) prior to awarding Responsible Individual (RI) and PCAQ status should be more robust ( see paragraphs 2.18 to 2.24).
- We have made recommendations aimed at ensuring that exemptions from specific examinations are awarded only where there is a close match between the degree syllabus and the syllabus of the body's own papers and where students have achieved a standard in their degree equivalent to that required for the body's own examinations. The bodies should also do more to monitor the progress of exempted students compared with the general body of students (see paragraphs 2.31 to 2.37).

2.15 More generally, in our private reports to the bodies, we have identified where existing systems and practices have not been applied with sufficient rigour, recommended detailed potential improvements to systems and practices. We have also questioned in some instances whether the way in which the requirements have been interpreted fully meets the statutory requirements.

2.16 During our review visits, we also discussed and examined the bodies' responses to recommendations made in previous reports. Overall, we are pleased to report that the bodies continue to respond positively to our recommendations. We are still not confident, however, despite their current efforts, that Chartered Accountants Ireland will meet their statutory obligation to inspect all audit firms undertaking audit work in the United Kingdom at least once in the six years from June 2008 (see paragraphs 2.25 to 2.28).

## MAIN POINTS

2.17 We give more detail below on the main points from our 2010/11 visits and the progress in response to prior year recommendations. Overall, we see no reason to withdraw the recognition of any RSB or RQB, subject in some cases to the satisfactory resolution of our concerns.

## ISSUES IDENTIFIED AT THE RECOGNISED SUPERVISORY BODIES (RSBs)

### *Approval of applications for Responsible Individual (RI) Status or for a Practising Certificate with Audit (PCAQ)*

- 2.18 Each RSB must have rules setting out how auditors are regulated. Under the procedures followed by ICAEW, ICAS and CAI, an individual who wishes to undertake audit work must (i) hold an audit qualification (AQ) and (ii) be approved as a Responsible Individual (RI). An RI is an individual who takes final responsibility for carrying out an audit on behalf of a registered audit firm and may be a principal or an employee of the registered audit firm. An RI cannot accept an audit appointment unless the firm in which the individual works is also a registered audit firm.
- 2.19 An individual wishing to be an RI must submit an application form to the relevant Institute countersigned by their firm's audit compliance principal who vouches for their integrity, fit and proper status and competence. An individual who wishes to become an RI for the first time, or has not been an RI within the last six months, must provide a summary of their audit experience within the last 24 months, including the type and amount of audit work undertaken and the level of seniority.
- 2.20 ACCA differs from the other RSBs in that it does not separately award RI status to individuals. Instead an ACCA member can apply for a practising certificate with audit (PCAQ), if he or she meets the practical training requirements, including the required number of hours of audit work, in a three year period (pre and/or post admission to membership).
- 2.21 The key difference between the procedures of ACCA and those of ICAEW/ICAS/CAI is that ACCA relies on its continuing professional development (CPD) requirements to give confidence that a member with the PCAQ maintains audit competence. ACCA does not assess a member's current audit competence based on recent audit experience or the audit related element of recent CPD, even though the decision to grant the PCAQ may be taken some years after the applicant has gained the professional qualification. Whilst we understand that in practice this is relevant to only a small number of cases, we consider that it is not safe to assume that an individual who met the education and training requirements for the AQ some years ago, but has not for example carried out audit work for some years, retains the required level of knowledge and competence.
- 2.22 We consider that it is important therefore that the bodies should assess an applicant's current level of competence to do audit work before granting either RI status or the PCAQ. Whilst not an explicit Companies Act requirement, we would expect RSBs to assess competence at the point of granting an individual the right to sign an audit opinion, based

on an individual's recent audit experience and recent audit-related CPD.

2.23 During our RSB visits in 2010/11 we reviewed approximately 80 applications for RI status across ICAEW, ICAS and CAI and 20 applications for a PCAQ from ACCA. Against this background, our main conclusions were as follows:

- As discussed above, the ACCA should adopt the principle 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. ACCA is addressing this and we are discussing with it what changes to its policies and procedures can best give effect to this.
- We found instances at all the RSBs where either the body did not require applicants to provide information about their recent audit experience and/or CPD in all the circumstances where we considered that necessary; or the body did not in our view review the information with sufficient rigour.
- More generally, RSBs appear too reluctant to turn down applications for RI status or a PCAQ, or to impose conditions or restrictions on successful applicants.

2.24 In the light of our findings, we shall develop some broad guidelines, in consultation with all the RSBs, to provide a more consistent basis across the RSBs for making judgements on competence at the point of granting RI or PCAQ status.

*Follow up to prior year recommendations: meeting the Statutory Audit Directive requirements on audit monitoring*

2.25 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.

2.26 Meeting this requirement has proved challenging in some cases. Each RSB provided us with an analysis of how they intend to meet the SAD and agreed to monitor the position closely to ensure that the plans remained realistic. We have continued to monitor progress.

2.27 We are still not confident that Chartered Accountants Ireland, through its 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. The ROI requirement is to carry out QA reviews of each registered audit firm at least once in the six years from May 2010.

- 2.28 CARB has provided us with detailed information on the number of relevant visits completed and planned, and the number of inspectors recruited and active. This showed that since 2008 there has been insufficient resource to carry out the target number of visits required each year, although CARB planned on the basis that there would be greater capacity to conduct more QA reviews in the later years of the visit cycle. Unfortunately, what was already a difficult situation worsened further in 2010, as CARB had to re-deploy its entire team of visit inspectors from routine QA monitoring to urgent review work related to the banking crisis in the Republic of Ireland. The result was that CARB was able to undertake little routine QA work between mid-2010 and mid-2011. Whilst we are sympathetic to CARB's situation, we asked them to develop a plan to address the situation. In particular we asked CARB to identify all registered firms, whether based in the UK or the ROI, that conduct audits of UK companies, and to prioritise visits to these firms when the visit inspectors become available in mid-2011, so that the UK six year target can be met. CAI is developing a plan to address the shortfall. This includes considering the use of fixed-term contractors and making changes to the monitoring model. We will look closely at the credibility of the plan and check that meeting the statutory requirement is not at the expense of effective monitoring. We will continue to monitor the position closely, though it is likely to be some time before we can conclude whether or not the action CARB takes has been effective in addressing our concerns.
- 2.29 Section B in Annex 2 gives statistics on the number of firms monitored by each RSB in the years 2008 to 2010.
- 2.30 Annex 2 also provides information on the outcome of monitoring visits undertaken at firms outside the full scope of the AIU. This information illustrates that such monitoring visits continue to grade a high proportion of firms visited as "unsatisfactory". Last year, at our request, each of the bodies produced three-year action plans designed to identify the issues underlying the results and the steps they would take to address the issues. We will follow up progress made by the bodies against these plans in the year ahead.

## **ISSUES IDENTIFIED AT THE RECOGNISED QUALIFYING BODIES (RQBs)**

### *Granting of exemptions from examinations*

- 2.31 The Companies Act 2006 allows an RQB to award the audit qualification without testing a student's theoretical knowledge of a prescribed subject by examination if he or she has "passed a university or other examination of equivalent standard in that subject".



However, the RQB must test directly the student's ability to apply in practice their theoretical knowledge of the prescribed subjects. Most examinations test both theoretical knowledge and practical application and the dividing line is therefore not always clear-cut. In general, however, exemptions are available from the first stage examinations but not from final stage exams which are substantially weighted towards the testing of practical application.

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

- The processing and granting of applications for exemptions from students;
- Maintaining a detailed comparison between the topics covered in degree modules and tested in exams and the body's syllabus and exams, in order to establish equivalence;
- The accreditation of universities and other institutions that provide degrees in accountancy and related disciplines;
- Maintaining a directory of information about the availability of exemptions and accredited degrees; and
- Ensuring that they do not give exemptions from those examinations that are required to meet their statutory obligation to test directly a candidate's ability to apply theoretical knowledge of required subjects.

2.33 The following table gives context for our comments on exemptions by showing the number of students in the UK and ROI registered with each RQB as at 31 December 2010. The table also shows the percentage of students holding a degree, a relevant degree (i.e. a degree in accountancy or related discipline) and a post-graduate qualification at the time that they registered as students. Where the information is available, we also show the number of students following the audit route or eligible for the audit qualification.

	ACCA	ICAEW	CAI	ICAS	AIA
Number of students in the UK and ROI	91,690	14,510	5,771	2,962	151
% of students holding a degree	48%	82%	94%	99%	57%
% of students holding a relevant degree	43%	19%	80%	38%	47%
% of students holding a post-graduate qualification	10%	7%	20%	N/A	0%
Number of students eligible for the AQ	N/A	9,432	4,114	N/A	1

2.34 All the RQBs have systems in place for granting exemptions from some examinations to



those students who have passed a university examination of equivalent standard in the subject being tested. In general, the RQBs (i) assess applications for exemptions against a list of degrees at accredited universities, and (ii) consider applications in respect of degrees at a non-accredited institution on a case by case basis.

2.35 We selected a sample of exemption applications and accredited degrees, to see how the body applies its procedures in practice and to assess the impact on the standards necessary to gain the audit qualification. Awarding exemptions has become a significant factor in the competition between bodies to attract students. Universities compete for students on the basis that their degrees are eligible for the maximum number of exemptions for students who go on to obtain a professional accounting qualification after graduation. In carrying out this work we had in mind the risks that:

- RQBs have an interest in maximising the number of exemptions on offer, and this could be at the cost of maintaining the quality of the audit qualification;
- RQBs' business relationships with universities may conflict with RQBs' regulatory functions regarding the award of exemptions;
- Universities may fail to maintain the relevance of their syllabus and the standards of their degree classifications, so that exemptions are awarded to students who lack sufficient knowledge to progress with their studies for a professional qualification; and
- Accredited degrees may not be re-assessed on a regular basis.

2.36 The way that the RQBs process exemption applications varies significantly, however, reflecting the numbers of students and the number of universities and degrees from which they are drawn. ICAS and CAI, with relatively small numbers of geographically concentrated students, each have long established relationships with around 25 universities and colleges and the granting of exemptions is carried out by an individual with long experience in the role. The AIA considers exemptions for the current small number of students seeking the UK audit qualification on a case by case basis. ICAEW and ACCA assess applications from much larger numbers of students and from a wider range of institutions. In the case of the ACCA in particular this means that a small administrative team processes applications from students all over the world with a very wide range of degrees, the majority of whom will not go on to seek the UK audit qualification. It is important to understand that in general the bodies have a single system for processing exemptions, not a separate system for those wishing to become statutory auditors. It is also important to note that most exemption applications are made and processed within a period of a few weeks during the year, between a student's graduation in the summer and starting training or employment in the autumn, or within the period before the deadline for entering the examinations.

2.37 Against this background, our main findings were as follows:

- **Contact with universities.** Given continual changes to degree courses and to the requirements of professional accountancy qualifications, it is important that RQBs maintain effective communication with universities and colleges, so that they are informed promptly about syllabus and other changes. We consider that good practice is that there is at least annual contact with the institution and a comparison or mapping between the degree syllabus and the syllabus for the body's own examinations roughly every three years. We found that this process did not work as well as it should at all RQBs, in particular in the case of ICAEW and the ACCA. Either this was because the university neglected to respond within a reasonable timescale, and was not chased with sufficient vigour, or because the audit trail was inadequate to ensure that changes were reflected consistently across different documents and databases.
- **Processing applications.** We reviewed a small sample of exemption applications at ACCA. Whilst not a statistically significant sample the level of inaccuracies found indicates that there may be an unacceptably high level of errors in handling the large volume of exemption applications. We also found that overall there was inadequate evidence of assessments of qualifications from the large number of higher education institutions whose students apply to ACCA. We concluded that ACCA has insufficient resources to manage the volumes effectively and that further quality control measures are needed so that exemptions are awarded only where they should be. We are pleased to note that ACCA conducted a review of the structure and performance of the teams within the operations area and has introduced several new quality control checks. Staff resource issues are being addressed through the creation of a new specialist team within the Admissions Department and a review currently underway may lead to additional measures.
- **Comparative analysis of students' performance.** We found that the bodies had done little formal analysis of the impact of exemptions on the progress of students in their professional studies and on the marks they achieve in the final papers, even though the practice of offering exemptions is long established. The best practice that we found was the analysis currently being carried out by Chartered Accountants Ireland. Whilst we recognise that analysing the data is much easier for an RQB whose students are concentrated in a small number of institutions, we want all RQBs to improve their comparative analysis of students' performance. This will help to identify universities whose students underperform and lead to dialogue

with the university, so that either standards improve or the exemption is withdrawn.

- **Time period for which exemptions are available.** We consider that it is important to limit the period during which qualifications remain eligible for exemptions. We do not consider that it is reasonable to assume that enough knowledge is retained over very long periods. In any event the knowledge that is retained risks being seriously out of date. Accordingly, we have agreed with most of the bodies that exemptions should be available only for qualifications gained within the previous five years. However, Chartered Accountants Ireland continues to allow exemptions for qualifications gained within the previous ten years. One reason they give is that their Chartered Accountants Elevation Programme offers the opportunity to graduates with over four years' relevant work experience to gain the CAI qualification. Granting exemptions is seen as a necessary part of this. CAI also argues that subjects covered in the preliminary examinations, for which exemptions are available, are examined again in the higher level and final examinations.
- **Pass marks.** With a few exceptions, RQBs accept that a student has passed a paper or module if his mark is recognised as a pass by his university or other awarding institution. Some universities award a pass for marks of 40% or more, whereas a body's pass mark for its own examinations is 50%. Our concern is that an exemption based on a mark of 40% is likely to set a lower requirement than sitting the RQB's own examination. Where this is the case, we consider that an RQB should only grant exemptions to students who have gained 50% or more in their university examinations.

*Follow up to prior year recommendations: authorisation and monitoring of approved training offices*

2.38 During our visits to the RQBs in 2010/11, we reviewed progress in implementing our recommendations, which related to:

- Improving the assessment of the quality as well as the quantity of training offered at member firms;
- Making the status of recommendations made by visit inspectors clearer; and
- Improving the completion of visit records.

2.39 Whilst the relevant RQBs (ICAEW, ACCA and CAI) all had agreed to make changes to their procedures for approval and monitoring of training offices, we found that some of the actions taken were insufficient, in particular the recording of information and of conclusions from training office visits. We will continue to monitor progress as part of our work in 2011/12 and take further action, should we conclude that there is insufficient progress.

*Follow up to prior year recommendations: Approval of applications for the audit qualification*

2.40 We reviewed a further small sample of approved applications for the audit qualification given that last year we had found two cases where we considered that the audit qualification had been awarded on the basis of audit experience that did not meet UK statutory requirements. We found no further instances. We therefore consider that the guidelines we have developed in conjunction with the RQBs for determining whether someone is entitled to the UK audit qualification are working effectively.

*Follow up to prior year recommendations: examinations*

2.41 During our RQB visits in 2008/9 we reviewed all the RQBs' syllabi, learning materials and examinations, to ensure that these adequately covered the prescribed subjects and that the examinations were an adequate test of both theoretical knowledge and the ability to apply theoretical knowledge in practice. We identified areas in particular at two RQBs where we considered that testing of some prescribed subjects and of the ability to apply knowledge needed strengthening.

2.42 We have reviewed the steps that these bodies are taking in response to our concerns.

2.43 The ACCA has made significant changes, in particular to its final audit paper, to ensure that it is both sufficiently challenging and an adequate test of a student's ability to apply theoretical knowledge in practice. Whilst we recognise that it takes time to change syllabi and examinations, we are pleased to note that the changes agreed to the final audit paper were in place for the June 2011 sitting. We will carry out a further review of the changes towards the end of 2011.

2.44 In the case of the AIA, we recognise that the body has taken a number of steps to address our concerns as to the standard of some of its examinations and the adequacy of testing of the practical application of theoretical knowledge. In particular, the AIA has prepared a specimen multi-disciplinary case study paper additional to existing exam papers for the UK audit qualification. Nevertheless, we still have concerns that the exam marking scheme

for the Professional Level 2 Auditing paper is too generous and that the paper itself, though improved, still does not test adequately a candidate's ability to apply theoretical knowledge in practice. Whilst progress has been made during the past year, the AIA needs to make further changes as a priority.

## **STATISTICAL ANNEX**

2.45 Annex 2 provides statistical information on the regulatory activities of Recognised Supervisory and Qualifying bodies 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

2.46 We also comment on the more significant points.

## **OTHER STATUTORY REGULATION OF AUDITORS AND AUDIT FIRMS**

### *Transparency Reporting by Auditors of Public Interest Entities*

2.47 In April 2008, and in accordance with the Statutory Audit Directive, the Oversight Board brought into force new legal requirements on the auditors of certain public interest entities to publish annual Transparency Reports. The year to 31 March 2011 is the second in which most firms have been required to produce a Transparency Report and we have recently completed a review of those reports published to date.

2.48 Last year we noted that, although many reports were of good quality, few met all of the statutory requirements. In particular, firms needed to improve the quality of their disclosures in the following areas:

- International networks;
- Independence issues; and
- Financial information.

- 2.49 We were therefore pleased to note that many firms had taken on board our comments. The larger firms in particular provided considerably more information on these and other topics. We also saw a greater emphasis on audit quality in many reports.
- 2.50 The reports from some smaller firms are virtually identical to the previous year's publication. Whilst we appreciate that some of the information in the reports may change little from one year to another, we would encourage firms to think critically about the reports and attempt to avoid 'boilerplate' wording.
- 2.51 On balance we believe that the quality of transparency reporting in the UK is adequate in most respects. We will continue monitoring in this area to ensure that all relevant firms publish a report and that published reports comply with the statutory requirements.

### COMPLAINTS TO THE PROFESSIONAL OVERSIGHT BOARD ABOUT RECOGNISED BODIES

- 2.52 The Oversight Board has a statutory responsibility to ensure that the Recognised Supervisory Bodies have effective arrangements in place to investigate complaints against their members and member firms who are statutory auditors, or about the way in which the bodies have exercised their regulatory functions. We also, by agreement with the six "chartered" accountancy bodies provide independent oversight of the way in which those bodies regulate their members who provide non-audit services. As part of these roles we consider complaints about the way in which a professional accountancy has handled a complaint.
- 2.53 The number of complaints received by the Oversight Board has risen in recent years. Figures for the three years to 31 March 2011 are shown below:

	2009	2010	2011
AAPA	0	0	0
ACCA	2	4	9
CIMA	0	0	0
CIPFA	0	0	0
ICAEW	4	5	12
CAI	0	0	0
ICAS	1	7	0
<b>Totals</b>	<b>7</b>	<b>17</b>	<b>21</b>

- 2.54 None of the complaints we have received in the year to March 2011 involved significant procedural failings at the bodies. However, some identified areas where processes could be

improved or further guidance provided. We have made recommendations to the bodies where appropriate.

### **Monitoring the Quality of the Auditing of Economically Significant Entities**

- The inspection results for 2010/11 are as good as, or even slightly better than, those of the previous year. Of particular note is the reduction in the number of FTSE 350 audits assessed as requiring significant improvement.
- Notwithstanding this, the proportion of audits assessed as requiring significant improvement, particularly at smaller firms, remains of concern.
- The AIU's scope now includes the audits of all banks incorporated in the UK and has given greater emphasis to bank audits.
- There are a number of key issues and concerns where improvements are required if firms are to achieve the consistent performance expected. These include:
  - The need for firms to exercise appropriate professional scepticism in respect of key areas of judgement.
  - Firms must recognise the importance of the proper identification and assessment of threats and safeguards in maintaining auditor independence at a time when the need for more specific prohibitions is being debated.
  - Firms, and in particular smaller firms, should carefully consider whether they have the appropriate resources and expertise and involvement to undertake audits of multi-national groups to the required standard.
  - The auditors of UK components of international financial institutions should ensure they obtain sufficient evidence to support their statutory audit opinion of UK subsidiaries.



### 3 MONITORING THE QUALITY OF THE AUDITING OF ECONOMICALLY SIGNIFICANT ENTITIES

#### INTRODUCTION

- 3.1 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 entities<sup>4</sup>, and of the firms' policies and procedures supporting audit quality. The Board approves the AIU's strategy and work programme and a sub-committee of the Board considers and approves AIU public and private reports on individual firms and specific audit engagements before they are issued.
- 3.2 This section of this report gives a summary of the AIU's 2010/11 Annual Report, which was published on 19 July 2011 and is available on the FRC website.

#### AIU'S REMIT

- 3.3 Firms which audit more than ten entities within the AIU's scope are subject to full scope AIU inspections covering both the review of policies and procedures supporting audit quality and the review of a sample of individual audits. There are currently ten such firms ("the major firms") as follows:

Baker Tilly UK Audit LLP	Grant Thornton UK LLP
BDO LLP	Mazars LLP
Crowe Clark Whitehill LLP	KPMG LLP and KPMG Audit PLC
Deloitte LLP	PKF (UK) LLP
Ernst & Young LLP	PricewaterhouseCoopers LLP

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<sup>4</sup> 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.

- 3.4 The AIU's inspections of "smaller firms", that is firms that audit between one and ten entities falling within the AIU's scope, are limited to a review of a sample of individual audits falling within its scope.

## SCOPE AND COVERAGE OF INSPECTIONS

- 3.5 In 2010/11, the AIU completed full scope inspections, comprising a review of policies and procedures supporting audit quality and individual audits within its scope, at the "Big Four" firms<sup>5</sup>, BDO LLP and Grant Thornton UK LLP. Reports summarising the findings from the inspections at each of these firms will be published in July 2011.
- 3.6 Inspections were also carried out at 12 smaller firms, comprising reviews of one listed or other major public interest entity audit. A report summarising the findings of these inspections will be published later this year.
- 3.7 The AIU currently inspects the Big Four firms on an annual basis. These firms audit approximately 80% of the entities within the AIU's scope, including over 95% of UK incorporated FTSE 350 companies. The AIU's inspections at the other major firms are undertaken over an extended period of approximately two years. Reports on the findings of inspections at Baker Tilly UK Audit LLP, Crowe Clark Whitehill LLP, Mazars LLP and PKF (UK) LLP will therefore be published in 2012.
- 3.8 The AIU undertook a further inspection of the Audit Commission, on a contractual basis in 2010/11, covering certain policies and procedures supporting audit quality and selected individual audits. The audits reviewed included some undertaken by its Audit Practice and some conducted by firms appointed by the Audit Commission ("Appointed Firms"). Audits undertaken by two Appointed Firms were reviewed in 2010/11.
- 3.9 The AIU also undertook an inspection of the National Audit Office on a contractual basis and for the purpose of the Oversight Board's statutory role as Independent Supervisor. This inspection covered progress in addressing findings identified from the previous inspection in respect of policies and procedures supporting audit quality and a review of selected individual audits. The Report of the Independent Supervisor is included as Chapter 5 of this Report.

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<sup>5</sup> The Big Four firms comprise Deloitte LLP, Ernst & Young LLP, KPMG LLP & KPMG Audit PLC, and PricewaterhouseCoopers LLP.

- 3.10 Each year the AIU selects a number of areas of particular focus. For 2010/11, these were the fair value measurement of assets and liabilities, the impairment of assets (including goodwill and other intangible assets), revenue recognition and fraud risks, segmental reporting, the evaluation of going concern and compliance with the Ethical Standards.
- 3.11 Emphasis was also given to the audit of banks, given the inclusion for the first time of all UK incorporated banks as a separate category within the AIU's scope of inspections. This resulted in all UK subsidiaries of overseas banks being brought within the AIU's scope of inspection, as the Oversight Board took the view that this was appropriate, given the level of public interest in the banking sector following the financial crisis. Previously, banks within scope were predominantly listed UK incorporated banks and only certain UK subsidiaries of overseas banks.

## KEY ISSUES AND CONCERNS

- 3.12 Inspection results are as good as, and even slightly better than, those of last year. In particular, the AIU has seen a reduction in the number of FTSE 350 audits assessed as requiring significant improvement<sup>6</sup>. While this is encouraging, the AIU cannot confirm that this is a positive underlying trend until it is replicated more consistently across all types and size of engagement.
- 3.13 Set out below are a number of key issues and concerns arising from the AIU's inspection activities which it believes will contribute to improving audit quality.

### *Professional scepticism*

- The AIU's findings continue to identify the need for firms to ensure that both partners and staff exercise appropriate professional scepticism, particularly in respect of key areas of audit judgement such as the valuation of assets and the impairment of goodwill and other intangible assets.
- A number of actions have been taken, or are in the process of being taken, by firms to address the AIU's concerns in respect of professional scepticism. Since many of these actions were taken subsequent to the completion of the audits reviewed in the 2010/11 inspections, any improvements that might be expected are, therefore, not reflected in the AIU's findings.

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<sup>6</sup> The AIU assesses the quality of each audit it reviews to arrive at an overall grade. For public reporting the AIU uses three grades: good with limited improvements required; acceptable but with improvements required; and significant improvements required.

### *Focus on audit quality*

- Given the current economic climate which has led to a decline in fee income<sup>7</sup>, firms seeking to grow their businesses or obtain further efficiencies in the conduct of audits, must ensure that this is not at the expense of audit quality. The importance of audit quality should be reinforced, and its achievement appropriately rewarded at all levels within audit firms.

### *Auditor independence*

- The proper identification and assessment of threats and safeguards is crucial to the effectiveness of the Ethical Standards in maintaining auditor independence. Firms must recognise that this is particularly important at a time when the need for more specific prohibitions is being debated.
- Partners and staff must be in no doubt that auditor independence must not be compromised by an inappropriate focus on selling non-audit services to audited entities. This continues to be an area of concern.

### *Group audits*

- Firms, and in particular smaller firms, should carefully consider whether they have the appropriate resources, expertise and involvement to undertake audits of multi-national groups to the required standard.
- When performing the audit of a UK subsidiary of a large overseas group where the audit approach is designed for the group as a whole, firms must ensure that they obtain sufficient audit evidence to support their statutory audit opinion on the UK subsidiary. This issue is particularly relevant to the audits of UK components of international financial institutions.

### *Audit committee reporting*

- Audit committee reporting should include a clear and unequivocal statement of the auditors' views on key areas of audit judgement.

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<sup>7</sup> See Professional Oversight Board : Key Facts and Trends in the Accountancy Profession, June 2011

### *Engagement quality control review*

- Engagement quality control reviewers have an important role to play in improving audit quality and ensuring that management's assertions are appropriately challenged. The AIU's findings suggest that the full benefits of this important safeguard have yet to be realised.

### *Audit of disclosures*

- Greater attention should be given to the audit of the disclosures in financial statements, especially those in respect of key areas of judgement, to ensure that sufficient appropriate disclosures to meet the needs of users have been made.

## **EFFECTIVENESS OF AIU INSPECTIONS**

### *Inspection process*

3.14 The AIU's inspection process continues to be both rigorous and challenging for firms. The AIU reports in writing its findings on reviews of individual audits, and requires written responses to the more significant of these. Firms are expected, however, to take action to deal with all such findings, and this is tested by the AIU on a number of follow-up reviews in subsequent years. Such findings, together with findings in respect of a firm's quality control policies and procedures, are summarised in the AIU's private report on each firm to the Audit Registration Committee of the relevant professional body (acting in its statutory capacity as the Recognised Supervisory Body). This report is accompanied by the firm's action plans to deal with matters raised. Implementation of each firm's action plan is tested subsequently by the AIU.

### *Inspections and audit quality*

3.15 The actions taken by firms in response to the AIU's inspection findings continue to contribute to an improvement in the overall quality of audit work in the UK. This view is supported by the results of follow-up reviews of individual audits undertaken by the AIU, where it usually finds that all or most matters identified previously have been satisfactorily addressed. While improvement in the overall quality of audits is more difficult to assess, the AIU notes that the proportion of audits assessed as good with limited improvements required has been approximately 50% of all audits reviewed in the last two years. The number of major listed company audits assessed as requiring significant improvement has declined this year, with only one FTSE 350 audit in this category compared with four in

each of the previous two years. However, overall the proportion of audits assessed as requiring significant improvement, particularly at smaller firms, remains of concern.

- 3.16 Where the AIU has identified that improvements are required in firms' policies and procedures supporting audit quality, the AIU has generally been satisfied with the progress made by firms in addressing these matters.
- 3.17 These results suggest that audit firms take the AIU's findings very seriously. Specific evidence of this may be seen in the fact that in some cases the reviews of individual audits have contributed to decisions regarding the composition of audit engagement teams and the remuneration of the audit engagement partners. The picture here however, is not consistent, but it is clear that quality assessments can be incorporated successfully within performance and appraisal systems for partners and staff.
- 3.18 Notwithstanding this, the AIU believes that having a wider range of specific actions, such as sanctions, available to the FRC would assist in promoting audit quality and in ensuring appropriate action is taken to reduce the number of audits requiring significant improvement.

### *Improving professional standards*

- 3.19 An important aspect of the AIU's inspections is its ability to gain an understanding of how firms are interpreting and applying the requirements of both the Auditing and Ethical Standards, and to suggest changes to the standard-setters where it believes these would enhance overall audit quality. In this respect the AIU has worked closely with the Auditing Practices Board (APB), including in a number of joint responses to consultations by the International Auditing and Assurance Standards Board (IAASB). The AIU has also contributed to the recent revisions to the Ethical Standards and to the APB's August 2010 discussion paper, "Auditor Scepticism: Raising the Bar".

### *Assisting audit committees*

- 3.20 The AIU issues a short report on the significant matters arising on each audit reviewed. Although this is a confidential report addressed to the audit firm, it is expected that the firm will make a copy available to the directors of the audited entity. The aim is to assist the audit committee to assess the effectiveness of the audit. A number of audit committee chairs have recently been asked for their views on the effectiveness of the AIU's work, including the usefulness of these reports. Responses received are generally positive, while also suggesting some areas for improvement, including placing even more emphasis on the

reporting of matters relating to key audit judgements. The AIU will consider how it can further improve its reporting for the benefit of audit committees.

- 3.21 It was clear from comments received that audit committee chairs sometimes had difficulty in assessing the significance of some of the matters raised. This difficulty could be caused by firms characterising some of the AIU's findings as relating to the sufficiency of documentation rather than the underlying audit evidence and judgements and therefore of less significance. The AIU assesses the evidence obtained to support key areas of audit judgement and disagrees with this characterisation of its findings. Furthermore, inadequate documentation may well indicate that unrecorded work has not in fact been undertaken, or that the work has not been undertaken properly. Documentation has an important part to play not only in the quality and comprehensiveness of audit work but also as an effective mechanism for collecting one's thoughts and ultimately improving audit judgement.

#### *Review of scope and approach*

- 3.22 The AIU reviews the scope and focus of its inspections annually to ensure that these continue to reflect the economic climate and other relevant matters. As a result, for example, the list of public interest entities whose audits make up the population from which the AIU draws its sample for review was amended in 2010/11 to include all UK incorporated banks and building societies; previously banks within scope were predominantly listed UK incorporated ones.
- 3.23 The AIU has a policy to review its inspection approach regularly, and regards contacts and co-operation with overseas regulators as opportunities to compare inspection approaches and exchange good practice.

## International Regulatory Responsibilities

- We are closely engaged in the debate on the issues raised by the European Commission's Green Paper on Audit.
- We agreed a Statement of Protocol on regulatory cooperation with the US Public Company Accounting Oversight Board in January 2011, including on joint inspections with the PCAOB in the UK or US. The PCAOB recently resumed inspections of UK firms jointly with the Audit Inspection Unit.
- The European Commission published a Decision in January 2011 that declared that audit regulation in ten countries was "equivalent" to that required within the EU, thereby allowing for mutual reliance on home country regulation of auditors of companies with securities listed in the other jurisdictions.
- The same Decision extended the transitional period for a number of countries, thereby exempting relevant third country audit firms from full regulation for a limited period.
- We are exploring ways of carrying out inspections of third country auditors, recognising that this is difficult to achieve in many cases without disproportionate cost.
- We have continued to encourage the evolution of the European Group of Auditor Oversight Bodies from an advisory body to the European Commission into a more authoritative grouping of EU oversight bodies with specific responsibilities within the EU regulatory framework.
- 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 recently been appointed the Chair of IFIAR 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.



## 4 INTERNATIONAL REGULATORY RESPONSIBILITIES

- 4.1 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. As part of the wider FRC international effort, we are closely involved in the work of both the European Group of Auditor Oversight Bodies (EGAOB) and the International Forum of Independent Audit Regulators (IFIAR).

### EUROPEAN COMMISSION GREEN PAPER ON AUDIT

- 4.2 The European Commission published its Green Paper 'Audit Policy: Lessons from the Crisis' in October 2010. This covers a wide range of issues, including the scope of audit, the structure of the audit market, the portability of audit qualifications and ethical/independence issues. The Green Paper identifies a number of possible changes to the regulatory requirements, including for the rotation of auditors, joint audits and for restricting the provision of non-audit services to audit clients.
- 4.3 Alongside other parts of the FRC we have played an active part in the debate on these issues. Whilst the FRC supports some of the ideas raised by the Commission, it is firmly opposed to others and will seek to influence the Commission further in these areas. In particular we are concerned whether the Commission is striking the right balance between actions taken to support audit quality and those designed to stimulate greater choice of auditors. For example we consider that the proposal for compulsory joint audits will increase costs and pose a threat to audit quality, as work is either duplicated or falls between the cracks where the work of the two firms is meant to join.

### EUROPEAN GROUP OF AUDITOR OVERSIGHT BODIES (EGAOB)

#### *Regulation of Third Country Auditors*

- 4.4 The Statutory Audit Directive 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.

- 4.5 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.
- 4.6 More generally, our experience suggests that the current EU requirements are complex, impracticable and are likely to yield modest benefits for European investors for considerable regulatory cost. In our view there is now a need for the European Commission to give greater flexibility to Member States to apply proportionate and risk-based regulation of audits of non-EU companies.
- 4.7 During 2010/11:
- We continued to work, in cooperation with other members of the EGAOB, towards working arrangements with other countries on the exchange of audit working papers and other information relating to the inspection of audit firms. In January 2011 we agreed a Statement of Protocol with the US Public Company Accounting Oversight Board (PCAOB) that enables regulatory cooperation, including joint inspections of audit firms with the PCAOB. Whilst no other Member State has yet entered into a similar agreement, our understanding is that discussions are well advanced between the PCAOB and several other Member States. By working together in this way, we expect the PCAOB to place increasing reliance on our work and increasingly to reduce its own direct inspection of UK audit firms.
  - The European Commission published a Decision in January 2011 that declared a number of third countries "equivalent" to the EU in term of their audit regulation. The same Decision also sets out a second "transitional" regime that exempts from detailed regulation audit firms from a country which has firm plans to develop its own system of independent oversight.
  - There has been increasing cooperation amongst audit regulators in Member States, particularly in the sharing of best practice amongst independent inspection bodies.
  - We have completed the initial phase of registering third country auditors. As of July 2011 there were 105 registered audit firms from 42 countries.
  - We have started to explore ways of carrying out reviews of third country audits and audit firms from around the world that are likely to be effective but do not

impose disproportionate cost and regulatory burden. This is proving difficult to achieve under the current EU requirements.

### *Future Development of the EGAOB*

4.8 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. Much of that initial phase of work is now complete. We have long argued that the EGAOB needs to evolve into an authoritative grouping of oversight bodies, with specific responsibilities to advise the Commission on developing the EU regulatory framework and to draw together regulatory practice across the EU. Whilst the Commission and a number of oversight bodies agree on the direction of travel, there has as yet been little progress. We expect, however, that the Commission will address this issue as part of its proposals to follow up the Green Paper. One option is to bring audit regulation within the scope of the European Securities and Markets Authority. This is a practical way forward, but there needs to be a well-defined role for auditor oversight bodies, who are best informed on current practice and retain the national responsibilities for audit regulation.

### **INTERNATIONAL FORUM OF INDEPENDENT AUDIT REGULATORS (IFIAR)**

4.9 Oversight Board staff have continued to play a leading role in the activities of IFIAR. The Executive Director has recently been appointed its Chair for the two year period to April 2013.

4.10 IFIAR's objectives are:

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

4.11 Oversight Board staff participate in all of IFIAR's working groups which are as follows:

➤ **Current Issues Task Force**

- Responsible for coordinating plenary meeting discussions of major current events or issues that have the potential to disrupt or substantially impact the

global financial markets and could have an impact on confidence in audit quality.

➤ **Investor Working Group**

- Responsible for organising IFIAR's dialogue with investor representatives.

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

- Responsible for coordinating IFIAR's on-going 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).

➤ **Standards Coordination Working Group**

- Responsible for establishing a forum for IFIAR Members to share views and concerns 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 concerns from other members in their submissions to the IAASB or IESBA.

➤ **Inspection Workshop Working Group**

Responsible for organising the annual Inspection Workshop, aimed at developing and disseminating best practice in independent inspection around the world.

➤ **International Cooperation Working Group**

- Responsible for considering the ways in which IFIAR Members can cooperate and share information relating to audit firm inspections and audit engagements and identifying areas where IFIAR Members can work more efficiently in collaboration.

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

- Discussions with investor representatives on improving choice among audit firms, improving the scope and focus of audit regulation and improving the Auditors' Report.

- Further discussions with the major international networks on their progress in understanding the root causes and actions taken by individual networks to address four common themes emerging from inspection activity. The common themes are auditor scepticism, group audits, the role of the Engagement Quality Control Reviewer and revenue recognition.
  
- Discussions with a major network on the implications of its evolving global structure for audit regulation and audit quality.
  
- The development of a set of core principles for independent audit regulators covering the structure of audit oversight, the operations of audit regulators and the principles for inspection processes.
  
- Discussion with the Chairman of the International Auditing and Assurance Standards Board on the implementation of clarified ISAs and on issues emerging from inspection activity relating to auditing standards.
  
- Discussions with the Chairman of the International Ethics Standards Board on current activity and issues emerging from inspection activity relating to the consistent interpretation of ethical standards for auditors.

## 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 Independent Supervisor.
- At present only the Comptroller and Auditor General (C&AG) undertakes statutory audits. To date these audits have been all of companies within the public sector.
- The AIU reviewed two of the 25 Companies Act audits undertaken by the NAO in respect of financial periods ending on 31 March 2010.
- Progress has been made in addressing a number of our prior year firm-wide inspection findings. However, we expect further action to be taken to address those matters that remain outstanding, particularly in respect of compliance with the Ethical Standards.
- More issues were identified in respect of the individual audits reviewed than in 2009/10. This reflects the more complex nature of the audits reviewed in the current year. The more significant of these related to the consideration of complex accounting treatments, the degree of focus on the balance sheet, particularly the valuation of assets, and the evidence to support going concern.
- These findings suggest that further support is required in the conduct of Companies Act audits. In particular, if the number and complexity of these audits increase, additional and appropriately experienced resources will be required to ensure that they are undertaken to an acceptable standard. We understand that, subsequent to the year under review, the NAO has appointed an additional Responsible Individual to undertake Companies Act audit work, and is considering further the resources applied to this work.
- On the basis of the findings of the AIU, and subject to the NAO's action plan, we consider that the NAO has policies and procedures in place that are generally appropriate to its Companies Act statutory audits.

## 5 REPORT OF THE INDEPENDENT SUPERVISOR OF AUDITORS GENERAL

### INTRODUCTION

- 5.1 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.
- 5.2 One of the conditions in the 2006 Act is that Auditors General who wish to audit relevant 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.
- 5.3 The C&AG’s relevant staff in the National Audit Office (NAO) completed the second year of such audits in respect of accounts for financial years that ended on 31 March 2010 and the Audit Inspection Unit (AIU) monitored this work on behalf of the Independent Supervisor. 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.

### SUPERVISION ARRANGEMENTS

- 5.4 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.
- 5.5 The responsibilities of the Independent Supervisor do not extend to the other work of the C&AG.

## REPORTING REQUIREMENTS

5.6 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*

5.7 Our Memorandum of Understanding (MOU) requires that the C&AG and relevant NAO staff follow prescribed technical and ethical standards 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. We would enter into similar arrangements with other Auditors General as necessary.

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

5.9 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*

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

5.11 For the year ended 31 March 2011 the AIU inspection of the C&AG's statutory audit work comprised:

- updating our understanding of the firm-wide procedures that applied to these audits; and
- reviewing the performance of two of the 25 statutory audits carried out by NAO staff in respect of financial periods ending on 31 March 2010.

5.12 Whilst progress has been made in addressing a number of our firm-wide prior year inspection findings we expect further action to be taken to address those matters that remain outstanding, particularly in respect of compliance with the Ethical Standards.

5.13 More issues were identified in respect of the individual audits reviewed than in 2009/10. This reflects the more complex nature of the audits reviewed in the current year. The more significant of these related to the consideration of complex accounting treatments, the degree of focus on the balance sheet particularly the valuation of assets and the evidence to support going concern.



5.14 We consider that these findings suggest that further support is required in the conduct of Companies Act audits. In particular, if the number and complexity of these audits increase, additional and appropriately experienced resources will be required to ensure that they are undertaken to an acceptable standard. We understand that, subsequent to the year under review, the NAO has appointed an additional Responsible Individual to undertake Companies Act audit work, and is considering further the resources applied to this work.

5.15 On the basis of the findings in this report and subject to the NAO's action plan, we consider that the NAO has policies and procedures in place that are generally appropriate to its Companies Act statutory audits.

5.16 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*

5.17 The C&AG notified the Independent Supervisor of a new Responsible Individual who is now eligible to sign audit reports on behalf of the C&AG, as required by Section 1232. No Auditor General was required to notify the Independent Supervisor of any other information.

*(d) Independent Supervisor's Enforcement Activity*

5.18 We issued no enforcement notices and made no applications for compliance orders in 2010.

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

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

*Article 5: Financial Information*

5.20 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.

5.21 In the financial year 2010/11 the core operating costs of the Professional Oversight Board were £1.1 million<sup>8</sup>. We estimate that less than 5% of those costs related to our role as the Independent Supervisor.

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<sup>8</sup> This includes an allocation of the central overheads of the FRC but excludes the cost of the Audit Inspection Unit.

## Oversight of the Actuarial Profession

Following the Morris Review of the Actuarial Profession, the FRC agreed in 2006 to take responsibility, through the POB, for independent oversight of the UK Actuarial Profession (the Institute and Faculty of Actuaries) and setting technical actuarial standards through the FRC's Board for Actuarial Standards (the BAS).

The 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. During 2010/11, we encouraged the Profession to prioritise its regulatory activities as follows:

- *Technical skills of actuaries* – 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.
- *Ethics and professionalism of actuaries* – to develop a comprehensive set of ethical and conduct standards, guidance and other materials for practising actuaries to support the TASs – for example in the areas of conflicts and whistle-blowing.
- *Working environment for actuaries* – to review the nature and scope of professional regulation of practising actuaries, including the public and regulatory reliance which can be placed on the quality controls at actuarial firms.

Together with the BAS, we updated the FRC's Actuarial Quality Framework, which is used to assess the quality of actuarial work. We also updated the FRC's guidance to users of actuarial work.

FRC staff have attended committee meetings of the International Actuarial Association on education and professionalism and of the Groupe Consultatif on significant issues such as the impact of Solvency II on actuarial practice.

## 6 OVERSIGHT OF THE ACTUARIAL PROFESSION

### INTRODUCTION

6.1 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, which was formed in August 2010 as a result of a merger of two predecessor bodies, 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 appropriate bodies.

### PRIORITIES FOR THE ACTUARIAL PROFESSION

6.2 After making a set of challenging recommendations to the Profession in May 2009, we continued to monitor progress during 2010/11 through active engagement with the Profession on its emerging proposals. For example, in last year's report we urged the Profession to organise its response to our recommendations by setting itself clear milestones for three main work strands:

- Work to clarify the expected technical skills of practising actuaries, and establish a framework for developing, maintaining and confirming their professional competence - including their awareness and understanding of the technical actuarial standards (TASs) issued by the Board for Actuarial Standards (BAS);
- The development of a comprehensive set of ethical and conduct standards, guidance and other materials for practising actuaries to support the Actuaries' Code and the TASs – including in the areas of conflicts of interest and whistleblowing; and
- A review of the nature and scope of professional regulation of practising actuaries, including the public and regulatory reliance which can be placed on quality controls at actuarial firms.

- 6.3 We have also consulted closely with colleagues at the BAS, the Financial Services Authority, the Pensions Regulator and other stakeholders, including the FRC's Actuarial User Committee, which includes representatives of institutional users of actuarial services such as insurers, employers and pension trustees, as well as end-users such as investors, policyholders and pension scheme members.
- 6.4 During 2010/11, the Profession's response has started to take shape with some targets met, although, as it acknowledges, further work is still required to complete developments in other areas. In our input to the Profession, we encourage it to focus on the public interest outcomes it is trying to achieve through its regulation, and the quality of its processes for achieving them.

## ACTUARIAL QUALITY FRAMEWORK AND USER UPDATES

- 6.5 As an aid to more outcome-focused regulation, we and our colleagues at BAS have developed the FRC's Actuarial Quality Framework (AQF), which we updated in June 2010.

### Actuarial Quality Framework

The AQF sets out the main positive indicators which support six factors – or drivers – of actuarial quality:

- Reliability and usefulness of actuarial methods
- Communication of actuarial information and advice
- Technical skills of actuaries
- Ethics and professionalism of actuaries
- Working environment for actuaries
- Other factors outside the control of actuaries.

The AQF has guided our own work in making recommendations to the Profession, and the work of the BAS in issuing outcome-focused technical actuarial standards (TASs). We are pleased that the Profession continues to frame its own regulatory initiatives and responses to our recommendations in terms of this AQF.

The AQF has been well-received by regulators and user groups, although we are keen to promote its use further.

- 6.6 We also worked with colleagues at the BAS to update the FRC's suggested questions for

the principal users of actuarial work (insurance directors, pension trustees and employers) to ask their actuaries in current market conditions. This was issued in November 2010, in conjunction with the FRC's corresponding questions for audit committees.

## **INTERNATIONAL ASPECTS**

- 6.7 Although our oversight responsibilities are limited to the Actuarial Profession's regulation of its members operating in the UK, developments in Europe and beyond impact on the principles and practices adopted. The UK Actuarial Profession is an influential member of the International Actuarial Association (IAA) and the Groupe Consultatif Actuariel Européen (the Groupe) and, as a condition of membership, agrees to meet the requirements set down by these bodies.
- 6.8 FRC staff have attended IAA committee meetings on education and professionalism and meetings with the Groupe, which are held when there are significant issues to discuss, such as the impact of Solvency II on actuarial practice. We also take an active interest in the Profession's criteria for agreeing and applying mutual recognition agreements which enable those who qualify with another body to have their qualification recognised by the Institute and Faculty of Actuaries as a basis for membership. We spoke on professionalism and actuarial oversight at the 13th Global Conference of Actuaries in Mumbai, India, where a large number of students sit both the UK and Indian examinations.

## **EDUCATION AND CPD**

- 6.9 Last year, we called on the Profession to clarify the technical skills users can expect of practising actuaries performing defined roles such as pension scheme actuaries, FSA-approved actuarial roles, with-profits actuaries, reserving actuaries, syndicate actuaries, risk actuaries, and actuaries employed by auditors, by reference to the revised indicators in the FRC's Actuarial Quality Framework. These skills underlie the Profession's examination and work-based skills requirements for students, its CPD expectations for qualified members, and its practising certificate requirements, and will need to include an ability to comply with the requirements of the BAS's Technical Actuarial Standards (TASs).
- 6.10 As the Profession acknowledges, it has found this exercise challenging. The Profession shared its initial thoughts with us and, following feedback from the FRC's Actuarial User Committee and further input from us which the Profession welcomed, it is now reconsidering its initial approach in order to better reflect user expectations of specific roles.

- 6.11 In other respects, the Profession has made more substantive progress. It has updated its examination syllabi, professionalism events and CPD courses for 2011/12 to reflect the TASs. It has also responded to the demand for a specific risk management qualification for actuaries through the development of the internationally recognised Chartered Enterprise Risk Actuary (CERA), including a new examination in Enterprise Risk Management (ST9), which was first held in April 2010. So far 20 members have qualified for the new CERA qualification.
- 6.12 Following our earlier recommendations, the Profession has been benchmarking the quality of its education processes against those of the US Society of Actuaries, and will soon be completing a high-level review of its education system to ensure that it continues to meet expectations. We await the outcome of its review. It has signalled a commitment to greater transparency about the examination process, which we welcome.

## **ETHICAL AND CONDUCT STANDARDS**

- 6.13 With our encouragement, the Profession is updating its ethical and conduct standards, guidance and other materials to support compliance with the principles in the Actuaries' Code, issued in October 2009. We have also worked closely with the Profession and the BAS to ensure the Profession sets 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.
- 6.14 The Profession has developed new ethical and conduct standards in pensions to coincide with the commencement of the application of the BAS's Pensions TAS on 1 April 2011. It is consulting on new standards in life and general insurance to coincide with the mandatory application of the BAS's Insurance TAS on 1 October 2011.
- 6.15 We were initially concerned that the Profession's compliance review standard in pensions would not adequately address compliance with the Pensions TAS. We provided specific input to the Profession to ensure that the review would at least address compliance with the reporting requirements in the TASs. Once the process of adapting its ethical standards to sit alongside the TAS regime has been completed, we expect the Profession to undertake a more fundamental review of its ethical and conduct standards for practising actuaries in each sector, by reference to the FRC's Actuarial Quality Framework.
- 6.16 In April 2011, the Profession issued two guides on whistle-blowing: one for actuaries and one for their employers. The Morris Review originally recommended that the Profession should work with regulators to develop more comprehensive guidance for actuaries on this subject, and we worked with the Profession to help it identify and address perceived

obstacles to whistle-blowing by its members. Many actuarial employers already have their own whistle-blowing policies, but we agreed it was important to explain to employers that actuaries may be subject to professional duties to whistle-blow so that they are adequately supported in their working environment. Through the Profession and other regulators we will monitor the impact of this new guidance on the level of reporting by actuaries.

- 6.17 The main outstanding issue is the difficult area of conflicts of interest, on which we have commented in previous reports. The Profession published a discussion paper in June 2010, in order to gather evidence about the issues faced by its members, and a feedback statement in April 2011. Whilst the time it has taken to develop guidance on recognising and handling conflicts of interest has been a disappointment to us, we now expect the Profession to issue firm proposals later in 2011, with a view to introducing new materials in 2012. We have encouraged the Profession to work closely with the FSA and the Pensions Regulator, which have also been undertaking studies in this area.
- 6.18 We welcome the steps the Profession is taking to review its professionalism courses for new and experienced actuaries. The review will provide an opportunity to incorporate the new more principles-based approach in the Actuaries' Code and the TASs, and to promote the positive indicators in the FRC's Actuarial Quality Framework.

## COMPLIANCE AND DISCIPLINE

- 6.19 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. The Profession only regulates individual members and not actuarial firms.
- 6.20 We concluded in our report in May 2009 on the *Actuarial Profession's progress and priorities in regulating its members* 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 undertake independent monitoring itself 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 consider (i) expanding the scope of its practising certificates requirements to cover all consulting actuaries (see above), and (ii) placing greater reliance on the controls operated by their firms.
- 6.21 The Profession has started speaking to actuarial firms about the scope for compliance monitoring through a partnership with actuarial firms and employers. A discussion paper proposing new voluntary arrangements for firms and the Profession to work together to



promote quality, is expected to be published very shortly.

- 6.22 In May 2011, the Profession published a discussion paper arising from a Strategic Review it began following the merger of its predecessor bodies in July 2010. The paper includes a proposal for the Profession to extend its practising certificate requirements to consulting actuaries who offer their services to external clients in a professional actuarial capacity. This would meet one of our recommendations in May 2009.
- 6.23 The majority of disciplinary cases handled by the Profession over the last two years have concerned breaches of its mandatory CPD scheme. We have monitored these and other cases, and provided input to the Profession's independently chaired Disciplinary Board. For example, we have encouraged the Board to report more fully on the exercise of its functions including those matters which it is committed to keep under review. In dialogue with us, the Profession has reviewed its limits for voluntary settlements which may be imposed without going to the disciplinary tribunal, and raised the limit from £5,000 to £7,500, to ensure that fines can reflect the degree of seriousness of misconduct falling short of dishonesty.

## **OUTLOOK FOR 2011/12**

- 6.24 During 2011/12, we expect to see the Profession consult on and implement its responses to our earlier recommendations, and we will continue to provide independent input to the Profession as part of this process.
- 6.25 We recognise that a number of the areas the Profession has found most difficult are closely linked. For example, the quality assurance arrangements for consulting actuaries depend on the Profession's proposals for partnering with actuarial firms; similarly, the Profession's proposals on education and CPD depend on its ability to clarify the expected competences and skills of specific actuarial roles. The Profession's framework of ethical and conduct standards is also dependent on the BAS's technical actuarial standards (TASs).
- 6.26 With greater clarity on these key issues, there will be scope for the Profession to make further significant improvements in the effectiveness of its professional regulation, while ensuring that its requirements are better targeted to user needs and more proportionate for practitioners.
- 6.27 During 2011/12, and in the following years, we will also work closely with our colleagues at the BAS, as well as the Profession and other regulators, to measure the impact of the TASs and the Profession's ethical and conduct standards to ensure that these aims are being achieved.





### Other Work and Responsibilities

- Our oversight of the accountancy profession is based on an agreement with the members of the six chartered accountancy bodies in 2004.
- The chartered accountancy bodies either give effect to our recommendations or explain publicly why they do not consider it is appropriate to do so.
- We identify issues that could adversely affect public confidence in accountants, undertaking a detailed project where appropriate.
- We reviewed the incidence of audit reports signed by individuals not eligible to do so. We did not find a widespread problem, though we continue to follow up individual cases that come to our attention.
- We repeated a review first undertaken five years ago of the incidence of poor quality accounts filed at Companies House. We concluded that actions taken by the professional bodies appear to have led to significant improvements.
- We are working with the Department for Communities and Local Government on how the regulatory structure for local public sector audit might be developed following the decision to abolish the Audit Commission.

## 7 OTHER WORK AND RESPONSIBILITIES

- 7.1 This chapter comments on our other responsibilities, including our non-statutory oversight of the accountancy profession.

### OVERSIGHT OF THE ACCOUNTANCY PROFESSION

- 7.2 This part of our remit is non-statutory, based on an agreement with the six chartered accountancy bodies under which they will either give effect to recommendations or explain publicly why they do not consider it is appropriate to do so. We fulfil this role by identifying issues that could adversely affect public confidence in accountants and, where appropriate, undertaking a detailed project leading to recommendations to the bodies and others as appropriate.
- 7.3 Most accountancy services outside audit and insolvency work are not regulated by law in the UK. Members of the chartered accountancy bodies or of other professional accountancy bodies compete therefore not only with one another but also with others who are not members of a professional body. Members of the chartered and other professional accountancy bodies rightly differentiate themselves, both from one another and from others offering accountancy services, based on the strength of their qualification and of their continuing regulation of members. It is important therefore that this regulation is effective whilst having regard to the impact of regulation on the ability of their members to compete outside the areas regulated by statute.

### *Quality of Accounts filed at Companies House*

- 7.4 We first reviewed the quality of accounts filed at Companies House in 2005, as part of a review of how the accountancy profession served the needs of small and medium sized enterprises. At that time we found that most accounts were generally informative (though typically contained technical disclosure and minor computational errors) but that a significant number were not fully compliant with relevant accounting standards. The accountancy bodies, in response to our request to address the poor quality found, agreed to provide more support and guidance to their members through their monitoring visits.
- 7.5 At the beginning of 2011 we repeated our analysis to ascertain whether the actions taken since 2005 adequately addressed the problems we had found.

- 7.6 We reviewed a further 97 sets of accounts. Whilst there remain a number of weaknesses and flaws, the overall quality of the accounts information and their 'user friendliness' had improved since our previous review. While the average number of errors per set of accounts has decreased, the areas of relative weakness remain much the same as before.
- 7.7 We have asked the accountancy bodies to maintain pressure on their members to improve the quality of their work in the preparation and review of accounts.

### *Signing of Audit Reports by Ineligible Persons*

- 7.8 In response to concerns expressed by the RSBs, we investigated during 2010 whether the signing of audit reports by those not eligible to do so was widespread.
- 7.9 We established that, of the 185,000 sets of audited accounts filed at Companies House since the end of 2008, some 179,000 were signed by registered auditors as listed on the Joint Audit Register. We then sampled a random 5% of the 1900 firms that appeared to have signed the remaining 6,000 sets of accounts and estimate that less than 0.1% of the total population (or roughly 200 sets of accounts) may not have been signed by an unauthorised person
- 7.10 Based on these findings we have reported back to the RSBs that this is not a widespread problem and therefore do not intend to devote resources to identify pro-actively audit reports signed by unauthorised persons. However, we will investigate cases that are drawn to our attention and take appropriate action.
- 7.11 We have also pointed out to the RSBs that we found a high incidence of audit reports signed in a manner which differs from how the audit firm appears in the Joint Audit Register and asked that they work with their members to eliminate this.

### *Review of Practice Assurance*

- 7.12 We reported in May 2010 on our review of the arrangements of the professional accountancy bodies for monitoring the work of their members in respect of unregulated accountancy services. We made a number of recommendations:

- 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.

7.13 We shall follow up the responses during 2011/12.

#### **FUTURE OF LOCAL PUBLIC SECTOR AUDIT**

7.14 In August 2010 the Secretary of State for Communities & Local Government (CLG) announced the abolition of the Audit Commission. The existing arrangements for local public sector audit are to be replaced by a system whereby councils and other local public bodies choose their own auditor.

7.15 Since the announcement, the Oversight Board has provided, at CLG's request, advice on how a regulatory structure for local public sector audit might be developed. We have suggested that any such structure should be proportionate and might replicate as far as possible the existing arrangements for Companies Act audits, with the bulk of day-to-day regulation done by professional bodies. Any involvement by the Oversight Board and other parts of the FRC should focus on those public bodies whose economic wellbeing is of the greatest public interest, for example the largest local authorities.

7.16 We have also recommended to CLG that the abolition of the Audit Commission be used as a catalyst to increase competition in the audit market more generally, perhaps by using the Commission's practice to form the basis of a new private sector firm.

#### **AUDIT CHOICE**

7.17 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. Last year we noted that, while the majority of the recommendations had been implemented, there was limited evidence that these were having any significant impact on market concentration and the risks arising from that concentration.

7.18 In the last year the House of Lords held an inquiry into audit and the audit market. More recently the Office of Fair Trading has signalled its intention to consider the issues arising

from concentration in the audit market. We welcome this announcement.

- 7.19 The Oversight Board, through the FRC, has provided substantial input into these debates and continues to do so. We will await the outcome of these external initiatives before announcing whether to do anything further with the original MPG recommendations.

#### **NOTIFICATIONS OF CHANGE OF AUDITORS**

- 7.20 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”<sup>9</sup>; 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.

- 7.21 In the year to 31 March 2011, there were 342 notifications in respect of “major audits”. 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.

- 7.22 We commented last year that we were pleased that the Department for Business, Innovation and Skills had consulted on how it might simplify these arrangements, in view of our concerns that the regulatory benefits were small in relation to the additional bureaucracy imposed on audit firms and companies that have an audit. The Department published a summary of the responses to the consultation in March 2010. Our experience over the last year confirms our view that reform is desirable. We hope therefore that the Government will find an opportunity to simplify the legal requirements.

#### **KEY FACTS AND TRENDS IN THE ACCOUNTANCY PROFESSION**

- 7.23 We published the ninth edition of Key Facts and Trends in the Accounting Profession in June 2011. This brings together in one place a range of information from the major audit

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<sup>9</sup> Principally UK companies with securities listed on the Main Market or on AIM, along with their subsidiaries.

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 Board oversees the regulation of audit and accountancy. Despite the difficult economic conditions, the profession remains attractive with the overall number of members and students continuing to increase both in the UK and worldwide. However, the impact of the economic downturn is reflected in both the total fee income and audit fee income of registered audit firms.

## Work Programme 2011/12

- Our statutory regulation of audit will focus on:
  - Our annual compliance visits to each recognised body to review in particular:
    - A sample of audit firm monitoring visit files.
    - The adequacy of the advanced stage examination papers and procedures.
    - The effectiveness of monitoring of compliance with Continuing Professional Development arrangements.
    - The execution of three year plans by the recognised bodies to improve the quality of audit by smaller firms.
  - The development of a programme of Quality Assurance Reviews of third country auditors.
  - Reporting on the findings of the Audit Inspection Unit in accordance with the requirements of our role as Independent Supervisor of the Auditors General.
- Our monitoring of the quality of major audits will focus on:
  - The firm wide procedures at the largest firms and the auditors' performance of some 100 individual major engagements.
  - Our reviews of individual engagements will focus on the, application of new 'clarified' ISAs, revenue recognition and fraud, going concern, fair value accounting, estimates, impairments, Audit Committee reporting, and compliance with ethical standards.
- Our oversight of the Actuarial Profession will focus on:
  - The Actuarial Profession's work to clarify the expected technical skills of practising actuaries.
  - The Profession's development of a comprehensive set of ethical and conduct standards to support the Actuaries' Code and the TASs.
  - The Profession's review of the nature and scope of professional regulation of practising actuaries.
- Our oversight of the accounting profession will focus on assessing the effectiveness of the professional bodies' response to our recommendations on practice assurance;



## 8 WORK PROGRAMME 2011/12

### INTRODUCTION

8.1 In this section we set out the major themes within our work programme under four main headings: statutory regulation of the audit, monitoring the quality of major audits, oversight of the accounting profession, and oversight of the actuarial profession. Our work programme is an integral part of the FRC's Plan and Budget, which was issued for consultation in December 2010 and finalised in April 2011.

### STATUTORY REGULATION OF AUDIT

8.2 Our statutory regulation of audit will focus on:

- Our annual compliance visits to each Recognised Supervisory and Qualifying Body. We will continue to follow our risk based approach, focusing on areas which have either not been reviewed for some time or which are considered to have the greatest inherent risk. In particular, we will review:
  - audit firm monitoring visits, looking in particular to ensure that all significant findings are appropriately reported, that the firms' responses adequately address the issues raised and that any follow up actions are completed promptly;
  - the adequacy of the advanced stage examination papers for the audit qualification including syllabus coverage, preparation, moderation and marking;
  - the procedures for monitoring compliance with, and the effectiveness of, CPD arrangements;
  - the execution of the three year plans by the recognised bodies to improve the quality of audit by smaller firms and reduce the incidence of unsatisfactory outcomes from audit monitoring visits; and
  - the bodies' actions in response to significant previous recommendations;
- The development and execution of an inspection programme for those third country auditors of UK issuers subject to the full EU regulatory requirements;

- The response of the Comptroller and Auditor General to issues arising from the AIU's review of statutory audits undertaken by the C & AG.

8.3 We will also address audit related issues from the feedback on *Effective Company Stewardship*:

- Work as part of the FRC to influence the European Commission's proposals on audit, following the consultation on its 2010 Audit Green Paper;
- Follow closely the consideration by the Office of Fair Trading of issues arising from concentration in the audit market; but await the outcome before deciding if we should take further steps;
- Work with the FRC on its reform agenda.

#### **MONITORING THE QUALITY OF MAJOR AUDITS**

8.4 Our monitoring of the quality of major audits will cover some 100 individual audit engagements and reviews of firm-wide procedures at eight of the largest firms, with the following areas of focus:

- Fair value accounting estimates and disclosures, impairment of assets, revenue recognition, related parties and going concern.
- how the revised Auditing Standards ("Clarified ISAs") are being applied by firms and individual audit teams in practice.
- Whether appropriate professional scepticism has been applied in the above areas.
- The quality of reporting to Audit Committees.
- The regulatory challenges of firms organised on a regional basis.
- Through IFIAR, ensuring that the major firms continue to address the key recurring global inspection themes of professional scepticism, revenue recognition, engagement quality control reviews and group audits.

#### **OVERSIGHT OF THE ACTUARIAL PROFESSION**

8.5 Our oversight activities will continue to focus on:

- The Actuarial Profession's work to clarify the expected technical skills of practising actuaries, and to establish a framework for developing, maintaining and confirming their professional competence - including their awareness and understanding of the BAS's technical actuarial standards (TASs);
- The Profession's development of a comprehensive set of ethical and conduct standards, guidance and other materials for practising actuaries to support the Actuaries' Code and the TASs - for example in the areas of conflicts of interest and whistle-blowing; and
- The Profession's review of the nature and scope of professional regulation of practising actuaries, including the public and regulatory reliance which can be placed on quality controls at actuarial firms.

8.6 In addition we will:

- Monitor developments that could adversely affect public confidence in the work of actuaries; and
- Work with FRC colleagues to promote the use of relevant measures of actuarial quality by other regulators and users of actuarial work.

## **OVERSIGHT OF THE ACCOUNTING PROFESSION**

8.7 Our oversight activities will focus on:

- Assessing the effectiveness of the professional bodies' response to our recommendations on practice assurance;
- Considering the effectiveness of the professional bodies' systems for ensuring members maintain competence;
- Publishing a further edition of Key Facts and Trends in the Accountancy Profession; and
- Monitoring developments that could adversely affect public confidence in accountants.

## **RESOURCES**

8.8 In 2010/11 the operating costs of the Oversight Board (excluding the Audit Inspection Unit) were £1.1 million, excluding support services provided centrally and the cost of actuarial oversight which is funded separately. The average number of staff was nine, including two

staff responsible for oversight of the Actuarial Profession. Income from the registration of third country auditors allocated to 2010/11 was £106k.

- 8.9 The costs for 2010/11 of the Audit Inspection Unit, which is funded separately, were £2.4 million, excluding support services provided centrally. The average number of staff in post was 19.

## 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.
- The Oversight Board has a specific obligation to set statutory requirements on auditors of public interest entities to prepare and publish annual transparency reports.
- The 2006 Act sets out a legal framework for the registration and regulation of auditors of issuers from outside the European Economic Area that have issued securities admitted to trading on UK regulated markets. This reflects requirements in the Statutory Audit Directive. The Government has delegated the responsibility for setting and administering the detailed requirements on third country auditors to the Oversight Board.

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.

## ANNEX 2

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

#### A) Audit Registration

	ACCA	ICAEW	CAI	ICAS
<b>Number of audit firms</b>				
As at 31.12.10	2,278	3,958	986	235
As at 31.12.09	2,503	4,113	985	242
As at 31.12.08	2,569	4,279	991	260
<b>Number of Office locations, as at 31.12.10</b>				
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
<b>Number of Office locations, as at 31.12.09</b>				
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
<b>Number of Office locations, as at 31.12.08</b>				
1	2,294	2,999	914	195
2-3	264	1,145	73	46
4-10	9	118	4	13
10+	2	17	0	1

	ACCA	ICAEW	CAI	ICAS
<b>Number of Principals, as at 31.12.10</b>				
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
<b>Number of Principals, as at 31.12.09</b>				
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
<b>Number of Principals, as at 31.12.08</b>				
1	1,778	2,092	630	100
2-6	767	1,924	337	138
7-10	14	147	14	14
11-50	10	101	8	7
50+	0	15	2	1
<b>Number of new applications<sup>10</sup></b>				
Yr to 31.12.10	132	270	49	44
Yr to 31.12.09	100	218	30	8
Yr to 31.12.08	99	285	34	19
<b>Number of applications refused<sup>11</sup></b>				

<sup>10</sup> New applications, other than for ACCA, include those firms changing status, for example from a partnership to an LLP

	ACCA	ICAEW	CAI	ICAS
Yr to 31.12.10	0	1	3	0
Yr to 31.12.09	0	1	6	0
Yr to 31.12.08	0	0	2	0

Despite an increase in the number of new applications for audit registration, the overall number of registered audit firms continues to decline. This 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 largest part of the decrease is in the number of sole practitioners with audit registration. A number of sole practitioners have merged with other firms to consolidate their audit approach or have passed on this work to larger firms where there are greater economies of scale. 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. We comment in Section 2 (paras 2.25 to 2.30) on the challenges this presents.

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



	ACCA	ICAEW	CAI	ICAS
<b>Number of firms monitored</b>				
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 2008	401	988	88	54
Target 2008	Not Available	800	None set	50
<b>Actual firms monitored as a % of audit registrants</b>				
2010	15.7%	19.1%	9.8%	21.3%
2009	17.0%	18.4%	10.4%	21.1%
2008	15.6%	23.1%	9.6%	20.8%

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. As explained in Section 2, CAI monitoring staff<sup>12</sup> were required to spend most of their time on work related to the Irish banking crisis in 2010/11, so that many fewer visits than planned were completed. This exacerbated a problem we had drawn to their attention prior to this. It will be some time before we can judge whether the measures that CAI is putting in place to address the backlog of visits has been successful.

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<sup>12</sup> The Chartered Accountants Regulatory Board (CARB) carries out all the monitoring functions of the CAI, in accordance with the CAI Bye-laws.

	ACCA	ICAEW	CAI	ICAS
<b>Reason for monitoring visits</b>				
<b>2010</b>				
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 <sup>13</sup> 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
<b>2009</b>				
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
<b>2008</b>				
Number of firms monitored following a request by the registration/ licensing committee	43	33	9	1
Number of firms with public interest entities visited without AIU involvement	0	46	3	0
Number of firms specifically selected due to heightened risk (including early follow ups)	38	89	39	51
Number of firms randomly selected	320	820	37	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 monitoring results of one year are not typically directly comparable with the results of previous

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<sup>13</sup> AIU = Audit Inspection Unit

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 entirely random but will almost certainly include a disproportionate number of weaker firms. However, the percentage of visits undertaken in 2010 that show unsatisfactory work is little changed from the outcome of visits undertaken in 2009.

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 2008-2010.

<b>ACCA</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Number of A & B outcomes	223	238	211
% of A & B outcomes compared to all visits conducted	62	56	52
Number of C+ outcomes	38	64	95
% of C+ outcomes compared to all visits conducted	11	15	24
Number of C- outcomes	9	21	31
% of C- outcomes compared to all visits conducted	3	5	8
Number of D outcomes	87	102	64
% of D outcomes compared to all visits conducted	24	24	16

ACCA grades visits A-D. Those that are graded 'A' are judged to be good and comply with all material aspects of the Global Practising Regulations (GPRs) and Code of Ethics and Conduct (CEC). Those visits rated B are judged to be satisfactory and any deficiencies found in audit work are minor and unlikely to have compromised the audit opinion issued. Visits are graded 'C+' or 'C-' by the ACCA if the audit work is unsatisfactory at a single visit and improvements are required. The 'C-' grade indicates that the improvements required are significant. When a firm has a second unsatisfactory visit and there are no mitigating factors, the firm will be referred to the Regulatory Assessor/ Admissions and Licensing Committee (ALC) and the visit graded a 'D'. In addition, where there are serious breaches of other regulations, such as a firm's failure to meet the eligibility requirements for audit registration, then the matter will be referred to the Professional Conduct Department and the visit graded a 'D'. The gradings of a visit are not based solely on the standard

of audit work; the outcome could be deemed unsatisfactory due to a breach of client money rules or Continuing Professional Development regulations.

ACCA has explained that the number of firms monitored in 2010 was lower than in 2009 because there was one fewer member of staff during the year. 31% of the monitoring was of firms with no audits clients (2009 28%). These visits are carried out by using a desk-top questionnaire, and in the absence of serious non-compliance are generally awarded a satisfactory outcome. This substantially improves the overall percentages.

ICAEW	2010	2009	2008
Number of A & B outcomes	486	494	601
% of A & B outcomes compared to all visits conducted	64	65	61
Number of C outcomes	132	140	218
% of C outcomes compared to all visits conducted	17	19	22
Number of D outcomes	80	94	124
% of D outcomes compared to all visits conducted	11	12	13
Number of N outcomes	57	29	45
% of N outcomes compared to all visits conducted	8	4	4

The above figures represent those reports finished 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 regulatory 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 proposed actions, set out in the closing meeting notes, adequately address all the issues and that the firm is committed to take the agreed action. A 'C' rated report records instances of non-compliance with the Audit Regulations where the QAD considers that there is 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. 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 or the firm has applied to withdraw from registration and QAD proposes acceptance.

ICAEW has commented that the percentage visit gradings in 2010 remains consistent with 2009.

<b>Chartered Accountants Ireland<sup>14</sup></b>	<b>2010<sup>15</sup></b>	<b>2009</b>	<b>2008</b>
Number of A & B outcomes	21	22	23
% of A & B outcomes compared to all visits conducted	21	24	26
Number of C outcomes	40	38	38
% of C outcomes compared to all visits conducted	39	42	43
Number of D outcomes	41	29	27
% of D outcomes compared to all visits conducted	40	32	31

The CAI considers all visits graded A to C as 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 61% of visits (67% in 2009) achieving good or satisfactory results (outcomes A, B and C). The increase in 'D' reports arose because monitoring resources were concentrated on visits to firms considered to present higher risk including firms where QAC had asked for an early follow up visit to be carried out.

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<sup>14</sup> The Chartered Accountants Regulatory Board (CARB) carries out all the monitoring functions of the CAI, in accordance with the CAI Bye-laws.

<sup>15</sup> Although there were 97 audit monitoring visits completed by CARB during 2010, the Quality Assurance Committee considered the outcome of 102 visits included some undertaken in 2009.

ICAS	2010	2009	2008
Number of A & B outcomes	30	33	20
% of A & B outcomes compared to all visits conducted	60	65	37
Number of C outcomes	17	13	22
% of C outcomes compared to all visits conducted	34	25	41
Number of D outcomes	3	5	12
% of D outcomes compared to all visits conducted	6	10	22

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. A 'D' rating is given when the standard of compliance is such that the Audit Registration Committee needs to consider appropriate follow up action, such as imposition of conditions and restrictions or withdrawal of registration.

ICAS has commented that overall the outcomes from the 2010 visits were similar to those in 2009 with over half of the firms visited reporting positive outcomes and no follow up action required. There was a small increase in the number of firms required to submit evidence to the Audit Registration Committee but a decrease in the number of more serious cases. In ICAS's view, the small number of recent regulatory changes has led to improved compliance by firms as they become more familiar with the requirements. In addition many of the firms visited in 2010 were lower risk as higher risk visits had been carried out earlier in the visit cycle.

C) *Complaints about Auditors*

	ACCA	ICAEW	CAI <sup>16</sup>	ICAS
<b>Number of new cases<sup>17</sup></b>				
2010	24	95	20	2
2009	27	93	17	10
2008	26	91	80	7
<b>Number of cases passed to the AADB</b>				
2010	0	3	0	0
2009	0	0	1	2
2008	0	2	0	0
<b>Number of cases passed to committee<sup>18</sup></b>				
2010	8	66	20	2
2009	5	53	7	6
2008	5	77	32	5
<b>Number of complaints<sup>19</sup> closed in the year</b>				
2010	24	89	13	1
2009	25	76	6	6
2008	13	135	86	4

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<sup>16</sup> 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.

<sup>17</sup> Audit related complaints only

<sup>18</sup> Cases passed to the committee relate to: A) the Disciplinary Committee for the ACCA B) Cases considered by the Investigations Committee and referred to the Disciplinary Committee for the ICAEW C) the Complaints Committee, Disciplinary Committee and Appeal Committee for the CAI and D) the Investigation and Professional Conduct Enforcement Committee at ICAS.

<sup>19</sup> Audit related complaints only

Average time taken to close a complaint				
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 <sup>20</sup> = 3.8 months. For cases closed by Secretariat = 1.5 months.
2008	7.3 months	10 months	9.5 months	For two cases closed by IPCEC = 5.2 months. Cases closed by Secretariat = 0.5 months.

The figure of CAI complaints for 2009 is for audit related complaints only. The figures for 2008 and 2010 include complaints against Registered Auditors regardless of the nature of the complaint.

ICAS has explained that the number of new audit related complaints was at its lowest level for over five years although in 2010 as in 2009 the overall volume and complexity of complaints continued to increase. ACCA and ICAEW have not identified any particular reasons for the movements in their complaints statistics.

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<sup>20</sup> Investigation and Professional Conduct Enforcement Committee



#### D) Student Registration

	ACCA <sup>21</sup>	ICAEW	CAI	ICAS	AIA <sup>22</sup>
<b>Number of new students</b>					
2010	19,597	5,652	1,205	820	3
2009	19,265	4,854	1,432	740	8
2008	21,787	5,104	1,665	1,030	27
<b>Total number of students</b>					
2010	90,044	17,653	5,771	3,004	151
2009	93,864	16,517	6,171	3,119	143
2008	93,510	16,165	5,958	3,437	136
<b>Number of students who became members</b>					
2010	4,071	3,290	1,332	768	0
2009	3,583	3,418	1,093	863	0
2008	4,736	2,827	1,237	745	4
<b>Number of members who became audit qualified</b>					
2010	98	1,020	926	29	0
2009	111	2,180	998	27	0
2008	108	3,551	867	26	0

All the bodies, other than CAI and AIA, have seen a small increase in the number of new students registering to train as accountants. The number of students enrolling with CAI continues to be affected by the continuing economic downturn with less demand for the take-on of students across all sectors.

Since 2008 ICAEW and CAI have awarded the audit qualification automatically to all new members who meet the eligibility requirements. ICAS awards the audit qualification only when eligible

<sup>21</sup> ACCA figures are for students in UK and ROI only

<sup>22</sup> AIA figures are for students in UK and ROI only

members apply for it. ACCA also grants its practising certificate with audit only to eligible members who apply.

*E) Registered Training Offices in UK and Ireland*

	ACCA	ICAEW	CAI	ICAS	AIA <sup>23</sup>
<b>Number of registered training offices</b>					
2010	4,622 <sup>24</sup>	3,322	837	167	23
2009	4,822	3,115	828	168	20
2008	4,794	2,854	771	185	0
<b>Number with students training for the audit qualification</b>					
2010	3,371	1,059	460	N/A	0
2009	3,606	1,122	578	N/A	0
2008	3,697	1,401	598	N/A	0
<b>Number of new applications</b>					
2010	N/A	267	61	9	3
2009	N/A	239	74	12	20
2008	N/A	295	60	18	0
<b>Number of applications refused</b>					
2010	N/A	0	0	0	0
2009	N/A	1	0	1	0
2008	N/A	1	0	0	0
<b>Number of registrations withdrawn</b>					
2010	376	0	0	10	0
2009	73	2	0	29	0

<sup>23</sup> The registration of training offices by AIA is subject to processing of final details and final approval.

<sup>24</sup> The ACCA figures appear high in comparison to the number of ACCA audit registered firms as many of ACCA's training offices are audit registered with another RSB; ACCA also registers each location of a firm as a separate training office.

	ACCA	ICAEW	CAI	ICAS	AIA <sup>23</sup>
2008	146	2	0	10	0
<b>Number of approved training offices visited<sup>25</sup></b>					
2010	1,052	522	161	34	0
2009	768	433	180	41	0
2008	597	214	148	42	0
<b>Number of approved training offices visited as a % of the total</b>					
2010	22.8%	15.7%	19.2%	20.4%	0%
2009	15.9%	13.9%	21.7%	24.4%	0%
2008	12.5%	7.5%	19.2%	22.7%	0%

The bodies have experienced some demand from new employers to become authorised to train students although the number of training offices has remained fairly constant.

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 explained that the higher number of training offices that have had their registration withdrawn is due to a detailed review of the Approved Employer database which identified firms that had ceased trading, merged with other firms or ceased to train ACCA trainees and members.

The increase in the number of training office visits carried out by ICAEW reflects the investment in additional resource in 2009 to ensure 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.

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<sup>25</sup> This includes both authorisation visits to firms seeking registration for the first time and review visits to firms that are already registered.

## ANNEX 3

### PROFESSIONAL OVERSIGHT BOARD

1 APRIL 2010 TO 31 MARCH 2011

Chair  
Dame Barbara Mills  
DBE QC  
Director of the Serious Fraud Office from 1990 to 1992. Director of Public Prosecutions and Head of the Crown Prosecution Service from 1992 to 1997. Adjudicator for HM Revenue and Customs from 1998 to 2009. Former Member of the Competition Commission

#### *Members*

Richard Barfield  
(to 31 May 2010)  
A director of a number of investment trusts and adviser to two pension funds. Formerly Chief Investment Manager of Standard Life in Edinburgh.

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.

David Crowther  
(to 30 June 2010)  
Formerly a senior partner of PricewaterhouseCoopers LLP, with global responsibility for quality assurance and risk management.

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

Rudolf Ferscha  
(from 1 June 2010)  
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

John Kellas, CBE  
Chair of the International Auditing and Assurance Standards Board, 2004 – 2008. Previously, the senior UK technical partner of KPMG.

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

Roger Marshall  
(from 1 June 2010 to  
31 October 2010)  
Until 2009 a senior audit partner in PricewaterhouseCoopers. Chaired PwC's Global Audit Policy Board in 2003-2007 and its global Corporate Reporting Task Force in 2008-2009.

Diane Walters  
(from 1 June 2010)  
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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