



## **PROFESSIONAL OVERSIGHT BOARD**

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

**YEAR TO 31 MARCH 2010**

# **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 2010**

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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## ONE – 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 statutory independent oversight over the regulation of auditors by recognised professional bodies. This marked 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 re-enacted in the 2006 Act and extended, as part of the UK's full implementation of the Statutory Audit Directive, to include in particular the regulation of the auditors of companies from outside the EU with securities traded on UK regulated markets. We review directly, through the Audit Inspection Unit (AIU), the quality of the audits of listed and other major public interest entities. We are also the Independent Supervisor of Auditors General for the purposes of the 2006 Act.

1.3. Overall, six years on, we feel able to conclude that we are having a positive impact on the work of auditors and on confidence in audit. Our monitoring of the work of the recognised bodies has encouraged a robust approach to audit regulation. The AIU's inspection process is both rigorous and challenging for firms. The actions taken by firms in response to its inspection findings in previous years have contributed 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 all or most matters identified previously have been satisfactorily addressed, and by the increased proportion of audits assessed as good with only minor improvements required, although it is too early to determine whether this is a trend. Similarly, 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.

1.4. None of this provides a guarantee against a serious audit failure or leaves room for complacency. Moreover, our work must also be set in the context of the renewed debate on the role and relevance of audit, particularly of financial institutions, in the wake of the financial crisis. It is obviously of concern if we are reporting on the performance of audit firms against a model of audit that is itself in need of modernisation. As part of the Financial Reporting Council, we are closely involved in the consideration of these issues.

1.5. We also exercise independent non-statutory oversight of the regulation of actuaries and accountants by their respective professional bodies. Oversight of the regulation of actuaries was added to our responsibilities in 2006, following the Morris Review of the Actuarial Profession. We have encouraged the Profession to take greater responsibility for the regulation of its members when

working outside recognised statutory roles.

1.6. Oversight of the regulation of the accountancy profession is by agreement with the six UK chartered accountancy bodies<sup>1</sup>. We have focused on specific aspects of the regulation by the professional bodies of the non-statutory work of members in public practice, to help create the conditions in which firms provide high quality services, particularly to support the accounting and business needs of small businesses.

1.7. The rest of this report comments in more detail on our principal responsibilities:

- oversight of audit regulation by recognised professional bodies
- direct monitoring of the quality of major audits
- international regulatory responsibilities
- oversight of the Actuarial Profession
- oversight of the accountancy profession
- Independent Supervisor of Auditors General

We include summary tables of key points under each of these areas.

1.8 More formally, 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 RSBs.
- 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.

Annex 1 sets out our statutory remit in more detail.

1.9 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. Lillian Boyle, Iain Cheyne CBE, John Kellas CBE and Mick McAteer joined the Board at the beginning of April 2009. Subsequent to 31 March 2010, Rudolf Ferscha, Roger Marshall and Diane Walters joined the Board on 1 June. Roger Davis, Stella Fearnley and Anne Maher left the board at the end of December 2009, Richard Barfield on 31 May 2010 and David Crowther on 30 June 2010. All had completed their second three-year term. The Board is grateful for the significant contribution each made during their term of office.

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<sup>1</sup> Association of Chartered Certified Accountants, Chartered Accountants Ireland, Chartered Institute of Management Accountants, Chartered Institute of Public Finance and Accountancy, Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants of Scotland

## **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.
- Nevertheless, there are aspects of regulatory activity at some recognised bodies that give us significant concerns.
- At some bodies:
  - the monitoring of approved training offices needs to be more rigorous;
  - the procedures for verifying audit experience prior to awarding the audit qualification need to be more robust;
  - complaints need to be investigated without undue delay.
- There are detailed points for each body where existing systems and practices have not been applied with sufficient rigour, or where we have questioned whether the interpretation of statutory requirements fully met requirements.
- Whilst the bodies have taken many positive steps in response to previous recommendations:
  - we are not confident that all RSBs will meet their statutory obligation to inspect all relevant audit firms at least once in the six years from June 2008 without close monitoring and decisive action;
  - we are not yet in a position to conclude that the syllabi and examinations are adequate at all of the bodies.
- The quality of this year's statutory transparency reports by auditors of public interest entities is higher than the previous year's voluntary reports, though few fully meet all the legal requirements.
- The majority of the recommendations of the Market Participants Group on audit choice have now been implemented, but there is limited evidence that they have had a significant impact on market concentration.

## **TWO – STATUTORY AUDIT REGULATION**

2.1 This section reports on our monitoring of supervisory and qualifying bodies for statutory audit in 2009/10 and on our other statutory functions.

### **Monitoring of Recognised Qualifying Bodies (RQBs) and Recognised Supervisory Bodies (RSBs)**

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)
- 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

2.5. We exercise oversight by:

- Checking that each body still has effective arrangements in place to meet all the statutory requirements for continued recognition, and making recommendations;
- Reviewing and testing the way in which each body's regulatory systems are applied in practice, and making recommendations;
- Evaluating the effectiveness of an aspect of the regulatory system, for example complaints handling or audit firm monitoring, and making recommendations.

<sup>2</sup> Pending a review of demand for its Cert CAA qualification, and putting in place all the necessary requirements, the Chartered Institute of Public Finance and Accountancy (CIPFA) has agreed to hold its RQB status in abeyance for two years.

## **2009/10 Monitoring**

2.6. 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. However, we decided that we needed only a short visit to review one body's RQB status, in the light of our findings in previous years and the actions taken in response. During our visits we also reviewed the bodies' responses to recommendations made in prior years.

2.7. The AIU also undertook certain oversight activities in relation to inspections of smaller firms by the monitoring units of the professional bodies. 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.

2.8. We ensured that we had up to date documentation of all the bodies' regulatory systems. All RSBs and RBQs 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 (see also para 2.47 below).

2.9. We report our detailed findings and recommendations privately to each recognised body. To date, we have not named individual bodies in this report, other than where it is self-evident to which body we refer. However, the Oversight Board has decided that our public reporting would be more informative and transparent if we name the individual bodies to which our main findings and recommendations apply. We propose therefore to start to name individual bodies in next year's report.

2.10. We identify in this report the key issues identified and the main recommendations made. Whilst these do not necessarily apply to all the bodies, we invite all the bodies to consider the relevance of these findings to their situation.

2.11. We focused our 2009/10 RSB and RQB visits on the following key areas:

- The effectiveness of the bodies' procedures for handling the initial and final stages of complaints and discipline cases. We selected a sample of cases to test the application of these procedures in practice.

- The monitoring and approval of training offices and the maintenance of student training records. The RQBs (other than CIPFA and AIA) carry out a programme of monitoring visits to training offices which provides the basis for granting, renewing and removing training office status from firms. Monitoring visits to training offices also ensure that a firm's training arrangements continue to meet the body's requirements.

2.12. At each body we also reviewed any significant changes in their regulatory systems, and progress made in response to prior year recommendations.

### **Results of 2009/10 Monitoring**

2.13. All the bodies devote substantial resources to their regulatory responsibilities. Much of the regulatory practice we have seen is of a high standard. Nevertheless, there are aspects of regulatory activity at some recognised bodies that give us significant concerns. In particular, we have made recommendations aimed at ensuring that complaints are investigated without undue delay, that the monitoring of approved training offices is more rigorous and that the procedures for verifying audit experience prior to awarding the audit qualification are more robust.

2.14. 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 and questioned in some instances whether the way in which the requirements have been interpreted fully meets the statutory requirements.

2.15. During our review visits, we also discussed and examined the bodies' responses to recommendations made in previous reports. Whilst we are pleased to report that the bodies have taken many positive steps, there are two issues of particular continuing concern:

- We are still not confident that all the RSBs will meet their statutory obligation to inspect all relevant audit firms at least once in the six years from June 2008 without close monitoring and decisive action (see para 2.33);
- Some bodies have yet to implement fully the changes we consider are necessary to strengthen their syllabi and examinations (see para 2.44).

## **CIPFA**

2.16. 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 fully develop the examinations and arrangements for practical training needed to offer RQB training leading to the award of the statutory auditor qualification.

2.17. We reviewed CIPFA's possible plans to develop the necessary examinations to be able to offer students the option of training for the statutory audit qualification. CIPFA has concluded that it may not be appropriate at this stage to continue to develop a qualification that meets all the statutory requirements. This is in the light of our review, its own plans to review its professional Chartered Public Finance Accountant qualification, and an assessment it is making of likely demand for its own recognised professional qualification. In the meantime CIPFA has agreed to hold its RQB status in abeyance for two years and will not offer students the option of training for the statutory auditor qualification during that period.

## **AIA**

2.18. The AIA has regulatory systems in place for its RQB recognition. These include the examinations, arrangements for approving training offices and the practical training of students. As there were no AIA students in training for its audit qualification, our review focused on its examinations and on the actions taken in response to our prior year recommendations. One student has now started training for the audit qualification. We note, however, our concern in the continued recognition of a qualification for which there have been no or very few students for a number of years and we have had an initial discussion with the AIA on its plans for attracting a significant number of students for the audit qualification.

## **AAPA**

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

## Main Points

2.20. We summarise below the main points from our 2009/10 visits and the progress in response to prior year recommendations.

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

#### *Complaints handling: disciplinary outcomes*

2.21. Disciplinary and appeal hearings are the final stage of the complaints process when a complainant raises serious issues. We considered:

- A comparison between a) penalties included as part of consent orders offered by regulatory committees and b) penalties imposed by disciplinary and appeals tribunals.
- The processes by which bodies prepare cases for disciplinary and appeal tribunals.
- Whether the bodies act with sufficient rigour against members who attempt to frustrate the process by delay or other means.
- The extent to which the bodies consider whether a particular complaint raises serious public interest issues and should be referred to the Accounting & Actuarial Disciplinary Board (AADB).

2.22. We reviewed some 30 disciplinary and appeals tribunal cases closed by the RSBs in 2008 and 2009. Some of these cases were opened and investigated in earlier years, when the procedures may have been different. The number of complaints resulting in a hearing before a Disciplinary Tribunal represents only a very small percentage of the total number of complaints received.

2.23. It is not uncommon for a tribunal either to dismiss a case or take a more lenient view on penalties than had previously been proposed by a regulatory committee. Whilst in some measure this is to be expected as part of a fair disciplinary system, when it occurs frequently, it encourages members to obtain legal representation and contest cases brought against them at every stage. It is also likely to lead to the body's disciplinary process becoming more expensive.

2.24. Based on our review of case files, we concluded that an underlying factor was a difference of view or understanding between regulatory staff and tribunal members as to the standard of proof required by a tribunal. Another issue was the inability of bodies to compel witnesses to attend disciplinary hearings. We have recommended that the bodies consider more carefully the standard of proof likely to be required by a tribunal when deciding which charges to press against a member. They should also consider how best to explain to complainants and witnesses the importance of their attending disciplinary hearings and how to present evidence in a way that is acceptable to a tribunal.

***Common areas of weakness identified during our review of complaints and discipline cases***

2.25. The initial assessment of complaints is carried out by the professional conduct staff of the RSB. We assessed how effective the bodies are in clarifying concerns raised with them and in understanding the basis for a complaint. We wished to ensure that complaints are being reviewed effectively; not closed prematurely and without a careful consideration of the issues raised; and that complaints excluded as outside the body's remit do not in fact fall within their remit. We also looked at the time taken by the body to assess, investigate and close the complaint in the sample of case files we reviewed.

2.26. Of the some 100 complaints closed by RSB professional staff in 2008 and 2009 that we reviewed across the RSBs, we had concerns in around one third about the length of time taken to close the case. There are two main underlying reasons: a failure of supervision and progress-chasing procedures to work effectively; and a lack of resources leading to excessive workloads of investigating officers and managers, high staff turnover and inefficient working practices.

2.27. Delays for whatever reason are unsatisfactory to the complainant and to the registered audit firm, who may then lose confidence that the body will deal with the matter appropriately. We have stressed that managers and their staff should hold regular meetings to review complaint cases in progress and set timetables to complete cases that are realistic in relation to workloads.

2.28. In the case of one body, the workloads of its complaints investigating officers have remained above capacity for several years. We have recommended that the body increase its resources so that it can meet a target of completing investigations within six months in most circumstances. We will continue to monitor closely that the RSBs have effective arrangements for the investigation of complaints during future monitoring visits.

2.29. One role of the bodies' professional staff is to filter new complaints in order to identify those matters that might result in a liability to disciplinary action. Whilst this role is essential, in practice it can place the onus too much on the complainant initially to provide a sufficiently strong case to persuade RSB staff that the complaint merits further investigation. We have raised this issue in previous years and we continue to consider that the RSBs should increase the level of investigative work that they do in their initial consideration of some complaints. This is particularly relevant where there is a significant knowledge gap between a complainant and a registered firm.

2.30. Members (and others, such as firms and students, who are bound by a body's rules and regulations) are required to co-operate fully with their body on complaints including providing promptly such information, books, papers or records as the investigating officers may request to assist in the investigation. We continue to find instances at all the bodies where, to varying degrees, members did not co-operate fully within the timescale, often despite repeated reminders. In many such cases, no additional sanction followed. We have told the bodies to review their approach, to see whether they should take a tougher stance on further disciplinary action where a member fails to co-operate fully and promptly with the investigating officer.

2.31. We continue to have concerns about the RSBs' willingness both to refer cases to the AADB and to provide objective advice for the AADB on the need for an investigation. We continue to discuss this relationship with both the RSBs and the AADB, in order to help maximise the effectiveness of the revised AADB Scheme.

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

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

2.33. Meeting this requirement has proved very challenging in some cases. Each RSB has provided us with an analysis of how they intend to meet the SAD and agreed that they will monitor the position closely to ensure that the plans remain realistic. We are still not confident that all the RSBs will meet their statutory obligation to inspect all relevant audit firms at least once in the six years from June 2008 without close monitoring and decisive action. We have asked one body to clarify its plans and to provide us with information on a quarterly basis of progress in respect of both the number of relevant visits completed and the number of inspectors recruited and active.

2.34. Table B in Annex 2 gives statistics on the number of firms monitored by the RSBs in the years 2007 to 2009.

#### ***Follow up to prior year recommendations: signing audit reports without appropriate authority***

2.35. A number of complaints received by the RSBs reveal audit reports that have been signed by members of the body who are not “Responsible Individuals” (RIs) and therefore not entitled to sign audit reports on behalf of a firm. Such individuals tend to argue that they were not aware of the need for RI status and that they considered that it was sufficient to hold a practising certificate. We concluded previously that part of the reason for this was that the bodies did not always make it sufficiently clear to their members, or did not reinforce the message often enough, that holding a practising certificate did not in itself confer the right to accept audit appointments or to sign an audit report. In response, the bodies amended the wording of the relevant letters sent to members. We will review in our subsequent monitoring whether this change has had the impact required. This is important to protect the public and to maintain confidence in statutory audit.

2.36. We also recognise that there are cases where individuals who are not members of any recognised body hold themselves out as a statutory auditor and sign audit reports. This weakens confidence in statutory audit, is unfair to statutory auditors and is not a problem that the bodies are themselves able to address. Given this concern, which cannot be addressed by the RSBs, we propose in the coming months to establish the extent to which this is a problem in practice and to explore ways of improving protection for the public. Pending this review, where we are aware that an individual or firm has signed an audit report when ineligible to do so, we seek an explanation from the “ineligible” auditor. We also write to the relevant companies to point out that the audits in question are not valid and that the companies should consider the need to re-file their accounts at Companies House.

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

##### ***Authorisation and monitoring of approved training offices***

2.37. Schedule 11 of the 2006 Act requires that an RQB must ensure that only persons approved by the body “as persons whom the body is satisfied will provide adequate training” give practical training for auditors. The RQB must also have arrangements for

monitoring the adequacy of the practical training given by persons it approves for that purpose.

2.38. During our visits to the RQBs in 2009/10, we:

- Reviewed the records of 72 visits carried out by RQB inspectors to approved training offices in 2008 and 2009;
- Observed a small number of such visits; and
- Considered all aspects of these visits including visit planning and scheduling, work programmes, authorisation and withdrawal of approved training office status, and reporting.

2.39. We made a number of recommendations to some RQBs, including that:

- Further consideration should be given as to how to improve the assessment of the quality as well as the quantity of training offered at member firms at one RQB.
- The visit reports at another RQB needed to make clearer the status of recommendations made by visit inspectors, in particular whether or not a failure by a firm to implement changes would lead to the loss of approved training office status; and
- The completion of visit records at one RQB was insufficiently detailed in too many cases and must improve.

2.40. The relevant RQBs have agreed to make changes to their procedures for approval of training offices. We will monitor progress with the relevant bodies in subsequent years.

#### *Approval of applications for practising certificates with the audit qualification*

2.41. We reviewed the training records of 70 individuals who have been awarded the audit qualification, to ensure that they are being properly completed.

2.42. We found two cases where we considered that the audit qualification was awarded inappropriately. In one, a body awarded the UK audit qualification based on a mutual recognition agreement not involving the UK, when it should have been clear that the individual did not meet UK statutory requirements. The body has made clear to the individual that they do not hold a UK audit qualification. In another case, a body awarded

the qualification based on a period of audit experience that was much shorter than is required. The body has agreed to apply new guidelines we are developing in consultation with the RQBs for determining whether someone is entitled to the UK audit qualification.

#### ***Follow up to prior year recommendations: availability of audit work***

2.43. The reduction in the number of statutory audits following the substantial increase in the audit threshold in recent years has raised questions about the amount and variety of audit work available in some approved training offices. We recommended previously that the RQBs should assess more carefully the variety and amount of audit work available for students as part of their approval and monitoring of training offices. Where there was a concern, we told the bodies to ensure that students were aware of this possible difficulty and to monitor the training office closely.

2.44. The bodies concerned have changed their procedures, so that as part of approving a training office, the reviewer assesses whether trainees wishing to gain the audit qualification will have access to enough audit experience during their training. Where this is judged not to be the case, this is flagged on the system and discussed with the trainee.

#### ***Follow up to prior year recommendations: examinations***

2.45. 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 a number of areas at some RQBs where we considered coverage and testing of the prescribed subjects needed strengthening. We identified particular weaknesses in the testing of the ability to apply knowledge. In response, one body agreed to cap the number of marks available for the testing of theoretical knowledge and to include more questions based on case studies. At another body, we identified significant shortcomings in to the examination coverage of the prescribed subjects.

2.46. We reviewed the steps that the bodies are taking in response to these significant concerns. Although the bodies are addressing the issues seriously, it takes time to change syllabi and examinations and there is not yet sufficient progress to enable us to conclude that all the examinations at all of the bodies are sufficiently challenging. We will review progress carefully in 2011.

## **Statistical Annex**

2.47. 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

2.48. We comment in more detail in the Annex on particular tables and figures. However, we would emphasise the following points:

- The information on the outcome of audit monitoring visits continues to show that there is a significant problem with the quality of audits subject to monitoring by the bodies. Depending upon how visit grades are categorised and determined, the percentage of visits that show unsatisfactory work was of the order of a quarter of all visits undertaken by all bodies in 2009, with some bodies identifying significantly higher numbers of unsatisfactory visits. We reviewed a statistically significant sample of reports from audit monitoring visits carried out by the bodies. This was initially to establish whether there was a positive correlation between the number of audits a firm undertook and the quality of that work. When we did not find such a correlation, we concluded that the issues underlying the unacceptably high level of 'unsatisfactory' outcome were more complex. We therefore invited the supervisory bodies to produce three-year action plans that identified the issues underlying the statistics and the steps they would take to address the issues. Each body has made a considerable effort to provide a detailed and thoughtful response and with a range of ideas to develop and take forward. We have suggested that they extend their efforts in working together and we will review progress against their plans as part of our annual review visits to each body and assess the impact on audit quality.
- Whilst the number of registered audit firms in the UK and the Republic of Ireland has continued to decline – from roughly 10,000 in 2004 to 7,900 firms at the end of 2009 - the rate of decline has reduced significantly in recent years.
- There was a significant decline in the number of new students registered to train as accountants with the recognised bodies in the UK and Republic of Ireland,

from 29,300 in 2008 to 26,300 in 2009, which may reflect current economic conditions.

## **Other Statutory Regulation of Audit Firms**

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

2.49. 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 2010 saw the publication of the first set of mandatory Transparency Reports.

2.50. Overall, we believe that the quality of this year's reports is higher than the previous year's voluntary reports. We were particularly pleased to see helpful and informative reports produced by a number of the smaller auditors of public interest entities.

2.51. Despite this, very few reports met all of the legal requirements. The Oversight Board has recently published an analysis of the 2009 reports<sup>3</sup>, which details common themes arising and suggestions for firms on improving the quality of their 2010 reports. We have referred one case of material non-compliance to the firm's RSB for investigation with a view to possible disciplinary action.

2.52. The report noted that particular improvement was required in the quality of most firms' disclosures in the following areas:

- international networks;
- independence issues; and
- financial information.

2.53. The report also encouraged firms to make greater use of transparency reports to compete on audit quality.

2.54. The Oversight Board will continue to monitor transparency reporting to ensure that all relevant firms publish a report and that published reports comply with the statutory requirements.

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<sup>3</sup> 'Transparency reporting by auditors of public interest entities: review of mandatory reports', POB, 2010

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

2.55. 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 or about the way in which the bodies have exercised their regulatory functions. More generally, we also consider complaints that raise concerns about the way in which a professional accountancy or actuarial body has handled a complaint.

2.56. An analysis of the complaints received by the Oversight Board in the three years to 31 March 2010 is given below:

Complaints made to the Oversight Board			
Year end 31 March			
	2008	2009	2010
<b>AAPA</b>	0	0	0
<b>ACCA**</b>	1	2	4
<b>CIMA</b>	0	0	0
<b>CIPFA</b>	0	0	0
<b>ICAEW**</b>	3	4	5
<b>CAI</b>	0	0	0
<b>ICAS</b>	2	1	7*
<b>Institute of Actuaries</b>	0	0	1
<b>Faculty of Actuaries</b>	0	0	0
<b>Totals</b>	<b>6</b>	<b>7</b>	<b>17</b>

\* 4 of the 7 complaints against ICAS in 2010 involved parties in 2 particular cases making almost identical complaints.

\*\* One complainant made allegations against both ACCA and the ICAEW

2.57. There is no obvious reason for the increase in the number of complaints in 2009/10 and this may simply reflect statistical variation. We will continue to monitor the situation.

2.58. In some cases, it is possible to resolve a complaint informally. Where this is not possible, the Oversight Board reviews relevant papers held by the professional body in order to determine whether that body has followed its procedures in its handling of the complaint. Following that review we report our findings to both the body and the

complainant, and advise the complainant whether the body is to take any action based on our comments.

2.59. None of the complaints reviewed in 2009/10 indicate major failings on the part of any of the bodies. However, in a number of cases we asked the bodies to take further action with regard to the complaint and/or have made recommendations for changing or improving their procedures.

### **Review of audit proposals**

2.60. During the year the Oversight Board carried out an exercise to understand how auditors and audit committees demonstrate and assess audit quality. This exercise included a review of recent audit proposals for a selection of listed companies and interviews with some of those companies' audit committee chairmen.

2.61. The key findings were:

- There was limited evidence of firms seeking objectively to distinguish themselves from others on the grounds of audit quality.
- The Big Four firms tended to use their size and/or brand as proxies for quality.
- Firms outside of the Big Four were more likely to refer to external yardsticks such as AIU reports or compliance with Ethical Standards.
- There was little indication that the fee quoted was the sole or even the main deciding factor for the client – although the majority of the tenders dated from a period before the full impact of the economic crisis became apparent.
- The vast majority of the proposals stressed the personal qualities of the partners and senior staff who would make up the proposed audit team, and conversations with audit committee chairmen confirmed that the personnel involved were usually the key factor in their decisions.

2.62. The findings of this exercise, and in particular the importance both firms and potential clients place on the personal qualities of senior members of the audit team, raise issues for the Oversight Board. Over the next few months, we will give some thought as to how this key driver of audit quality might be better assessed. We will also consider what more we can do to promote other drivers of audit quality.

### **Audit choice**

2.63. As in previous years, the Oversight Board took forward the recommendations of the Market Participants Group (MPG) on behalf of the FRC. During the year we published

two progress reports detailing the extent of their implementation.

2.64. The majority of the recommendations have now been implemented, but there is limited evidence that they have had a significant impact on market concentration and the risks arising from that concentration. Over the next six months, we will assess the effectiveness of the recommendations as a whole and make clear proposals on what further action is required.

### **Notifications of change of auditors**

2.65. 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>4</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.

2.66. In the year to 31 March 2010, there were 376 notifications in respect of “major audits”. However, many of these related to subsidiaries of major listed companies and followed a change in the ownership of the subsidiary. The other common reason given for the change of auditors was that there had been a competitive tender. In a small number of cases, we judged that the notifications should be drawn to the attention of the Financial Reporting Review Panel, Companies Investigations Branch of the Department for Business and/or the Audit Inspection Unit.

2.67. We commented last year that, whilst we saw some regulatory benefit from the notifications in respect of major audits, we doubted that the benefits matched the additional bureaucracy imposed on audit firms and all companies that have an audit. We were pleased therefore to see that the Department for Business launched a consultation in November 2009 on how it could simplify the arrangements for the provision of information to the accounting and audit authorities, as well as to shareholders and creditors when auditors leave office. The Department published a summary of the responses to the consultation in March 2010. Our view is that there are some useful simplifications to the existing requirements that can be made and would hope that the new Government will find a suitable opportunity to change the law during this Parliament.

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<sup>4</sup> Principally UK companies with securities listed on the Main Market or on AIM, along with their subsidiaries.

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

### **Main Findings**

- Firms have responded positively to the challenges arising from the economic downturn, particularly in relation to the audit of going concern.
- Firms have policies and procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base.
- Despite the quality of the firms' policies and procedures, the number of audits assessed by the AIU as requiring significant improvements remains too high.
- A higher proportion of audits conducted by firms outside the largest nine require significant improvements.
- The findings suggest that firms are not always applying:
  - Their procedures consistently on all aspects of individual audits;
  - Sufficient professional scepticism in relation to key audit judgments.
- Consideration should be given to establishing competency requirements specifically for auditors of listed and major public interest companies.
- Firms must embrace the principles underlying the Ethical Standards and accept that they should not provide non-audit services to audit clients where appropriate safeguards do not exist.

## **THREE – 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>5</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. The Oversight Board approves the AIU's Annual Report based on advice from the sub-committee.

3.2. This section of this report gives a summary of the 2009/10 Annual Report of the Audit Inspection Unit, which was published on 21 July 2010 and is available on our website.

### **AIU's Remit**

3.3. Firms that audit more than ten entities within the AIU's scope are subject to full scope AIU inspections. There are currently nine such firms ("the major firms"), as follows:

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

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 the individual relevant audits.

<sup>5</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.

## **Coverage of inspections**

3.5. In 2009/10, 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>6</sup> and PKF (UK) LLP. Public reports summarising the findings from the inspections at these firms will be published later in 2010.

3.6. The AIU currently inspects all 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 entities within its scope.

3.7. In 2009/10 the AIU altered the frequency and timing of its inspections at the other major firms in line with its risk-based approach. This will result in inspections at these firms being undertaken and reported on over an extended period of approximately two years. Inspections of Baker Tilly UK Audit LLP, BDO LLP, Grant Thornton UK LLP and Horwath Clark Whitehill LLP (all of which were inspected in 2008/9) will therefore next be reported on in 2011 or 2012.

3.8. The AIU also carried out reviews of one or more audits of listed or other major public interest entities at eleven smaller firms. A separate report on the findings from these inspections will be published later in 2010.

3.9. In addition, the AIU undertook inspections on a contractual basis at both the Audit Commission and the National Audit Office (NAO), at their request, covering both policies and procedures supporting audit quality and selected individual audits. As a part of its work at the NAO, the AIU completed its first review of the statutory audits undertaken by the Comptroller & Auditor General (C&AG) in the first quarter of 2010. This work was undertaken to support the Board’s role as the Independent Supervisor, on which we report in Section 5.

3.10. In the year to 31 March 2010, including reviews performed under contractual arrangements with the Audit Commission and the National Audit Office, the AIU completed the review of 109 engagements, compared with 99 in 2008/9.

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<sup>6</sup> The Big Four firms comprise Deloitte LLP, Ernst & Young LLP, KPMG LLP & KPMG Audit PLC, and PricewaterhouseCoopers LLP.

## **Impact of AIU inspections**

3.11. The AIU's inspection process is both rigorous and challenging for firms. The actions taken by firms in response to its inspection findings in previous years have contributed 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 all or most matters identified previously have been satisfactorily addressed, and by the increased proportion of audits assessed as good with minor improvements required, although it is too early to determine whether this is a trend. Similarly, 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. Audit firms take the AIU's findings very seriously and the outcomes from the reviews of individual audits have contributed to decisions regarding the composition of audit engagement teams, and the remuneration of the audit engagement partners.

3.12. An important aspect of the AIU's inspections is its ability to gain an overall 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").

3.13. The AIU's individual public reports on the nine major firms, published since late 2008, together with its confidential reports on the individual audits it reviews, should provide the directors of companies with valuable sources of information to assist them in assessing the effectiveness of their auditors and the audit process in general. The AIU has issued some 175 reports on individual audits since 2008. The findings from these will have contributed to decisions on the appointment of audit firms.

## **Key messages to the audit profession.**

3.14. The AIU's focus is on matters where it believes improvements are required to safeguard and enhance audit quality. Set out below are the key messages arising from its inspection activities in this regard.

### *Audit quality: major firms*

3.15. The AIU's inspections in 2009/10 confirm that major firms have policies and

procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base. Nevertheless, improvements to these policies and procedures have been recommended at all firms.

3.16. Notwithstanding the quality of firms' policies and procedures, the number of audits assessed as requiring significant improvement at major firms (eight audits or 11 % of audits reviewed at major firms excluding follow-up reviews) is too high. Firms are therefore not always consistently applying their policies and procedures on all aspects of individual audits.

3.17. Policies and procedures however can only go so far in supporting and encouraging desirable behaviours to deliver audit quality. While firms are willing to change these and to provide additional training to staff, such actions will be insufficient without effective behavioural change, which is more difficult to achieve.

#### *Audit quality: smaller firms*

3.18. The AIU continues to find that a higher proportion of audits conducted by smaller firms require significant improvement. Six of the 11 smaller firm audits reviewed in 2009/10 (excluding follow-up reviews) were assessed as requiring significant improvement (2008/9: five of the 11 audits reviewed). Firms should not undertake audits unless they have the appropriate level of resources and expertise to ensure they are performed to an acceptable standard.

3.19. The AIU believes consideration should be given to establishing competency requirements specifically for auditors of listed and major public interest entities.

#### *Professional scepticism*

3.20. Firms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients. The AIU has identified situations where differing and conflicting judgments are accepted by the same firm for clients operating in similar industries. Some firms have processes designed to confirm consistency of key judgments across their client base; these could be considered by all firms, but they also need to be applied effectively.

3.21. Auditors should exercise greater professional scepticism particularly when reviewing management's judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern.

*Quality of audit evidence*

3.22. Auditing Standards recognise that third party evidence is generally the most reliable form of audit evidence and it should be obtained wherever practicable in relation to important matters. Firms should revisit their audit approaches to ensure that appropriate consideration is given to the availability of such evidence, particularly independent confirmations of balances and that these are more frequently sought.

*Going concern*

3.23. Firms have responded positively to the challenges arising from the economic downturn by issuing a significant amount of guidance to audit teams to assist in their evaluation of going concern. The APB has also been active in the provision of additional guidance to assist auditors in this area.

3.24. Notwithstanding this, a number of shortcomings relating to the audit of going concern were identified at both major and smaller firms. While acknowledging that much of the work in this area is done well, audit teams need to ensure that the key factors material to the going concern assessment in each individual case are appropriately considered and resolved.

*Use of specialists*

3.25. The increasing use of internal specialists, especially by major firms, to evaluate valuations performed by client specialists and to assist in the audit of other complex audit areas such as taxation and pension balances contributes to improving the quality of audit evidence obtained in these areas. Where firms make use of internal specialists they must ensure that this work is properly integrated with the work of the main audit team. In particular, it should be clear from the audit files how the audit team has responded to any matters arising from the work of specialists.

*Provision of non-audit services to audit clients: Ethical Standards*

3.26. Ethical Standards require firms to identify areas of potential risk to independence such as the provision of services other than the audit to an audit client. Firms need to embrace more fully the principles underlying the Ethical Standards which require threats to be mitigated by appropriate safeguards if the work is to be undertaken. Firms are perhaps too ready to conclude that existing procedures, required in any event in the audit, provide that necessary degree of safeguard. They must accept that non-audit services should not be provided where safeguards cannot appropriately mitigate threats to their independence.

3.27. Surveys<sup>7</sup> of fee income show that the ratio of non-audit fees to audit fees for audit clients in the UK has declined over the years. However the rate of decline has been small in recent years and the AIU is concerned that one major firm has embarked on a growth strategy where a key driver is the development of non-audit services to be provided to audit clients.

*Areas of AIU focus*

3.28. Building on its experience in 2009/10, the AIU's inspections in 2010/11 will focus on the impairment of goodwill and intangibles, together with going concern, fair value accounting estimates, compliance with the Ethical Standards, segmental reporting, revenue recognition and fraud. These areas of focus reflect the challenges auditors face in the current economic downturn and changes in financial reporting. There will also be an increased focus on banking audits.

*Revised Auditing Standards*

3.29. Major firms appear to be making the necessary changes to both their audit methodologies and supporting IT systems to accommodate the requirements of the Revised Auditing Standards ("Clarified ISAs") which take effect for audits with December 2010 year ends. The AIU will assess the overall state of preparedness of firms for the implementation of the Clarified ISAs as part of its 2010/11 inspections.

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<sup>7</sup> 'Key Facts and Trends in the Accountancy Profession' issued by the Oversight Board in June 2010.



## **International Regulatory Responsibilities**

### **Cooperation in the European Union: European Group of Auditor Oversight Bodies**

- Substantial progress on arrangements for mutual reliance with third countries that have developed systems of audit regulation.
- Difficulties remain in the way of reaching sensible cooperative arrangements between the EU and the US but recent signs of progress.
- Completed initial phase of registering auditors of non-EU issuers of securities traded on main UK markets.
- Started to develop detailed arrangements for quality assurance reviews of audit firms from countries that have no plans to develop effective and independent audit regulation.
- Developed a protocol with other Member states to provide a basis for cooperation and information sharing within the EU.
- Strongly supporting moves by European Commission for the EGAOB to change from an advisory body into a more authoritative grouping of EU oversight bodies with specific responsibilities within the EU regulatory framework.

### **Cooperation through the International Forum of Independent Audit Regulators**

- IFIAR's principal objectives are to share knowledge and experience of independent regulation and promote collaboration in regulatory activity.
- Executive Director of the Oversight Board is Vice Chair of IFIAR
- Work has focused on:
  - Discussions with global leadership of six largest audit networks on quality control procedures and common inspection issues
  - Discussions with major investors on audit quality
  - Sharing of experiences in addressing implications of financial crisis on auditing
  - Sharing and disseminating best regulatory practice, particularly in audit inspection.

## **FOUR – INTERNATIONAL REGULATORY RESPONSIBILITIES**

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4.1. The increasing need for international cooperation on audit regulation is reflected in the considerable effort we make at both a European level, through the European Group of Auditor Oversight Bodies (EGAOB), and globally, where cooperation is developing under the auspices of the International Forum of Independent Audit Regulators (IFIAR). This is particularly important to improve group audits and to facilitate the effective regulation of audits of companies from third countries with securities listed on the main UK market.

### **Cooperation in the European Union - the European Group of Auditor Oversight Bodies (EGAOB)**

4.2. The Statutory Audit Directive (SAD), which was fully implemented in the UK by June 2008, reserves the responsibility for registering and regulating audit firms to each Member State, but requires much closer cooperation between Member States both for the regulation of cross border audits within the European Union and in relation to third countries.

### **Cooperation on the Regulation of Third Country Auditors**

4.3. The Directive includes specific provisions on the regulation of the auditors ("third country auditors") of companies from outside the EU that issue securities traded on EU regulated markets. These are designed to protect European investors by strengthening confidence in the audits of non-EU companies traded on European markets. The Oversight Board has the responsibility, within a statutory framework, for setting and applying the detailed requirements for the regulation of the auditors of non-EU companies traded on UK regulated markets.

4.4. The issue is important because the UK has a substantial number of relevant third country issuers, reflecting the importance of the London markets internationally.

4.5. Our aim, 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 very largely rely on one another's work, with

appropriate exchange of information, rather than imposing unnecessary duplicative regulatory arrangements.

4.6. Against this background, our priorities in 2009/10 have been:

- **To work within the EGAOB towards arrangements for mutual reliance with third countries.** There was substantial progress in respect of a number of developed countries, including Australia, Canada, Japan and Switzerland, where the way to concluding arrangements is now clear. We would expect to agree suitable bilateral working arrangements with those countries during 2010/11
- Achieving this goal more generally faces several difficulties:
  - The US oversight body, the Public Company Accounting Oversight Board (PCAOB) has a different perspective, reflecting its statutory obligations. It continues to see the need for its own inspection programme of auditors in relevant third countries, albeit alongside the local regulator wherever possible. Restrictions on the ability of both the PCAOB and EU audit regulators to share otherwise confidential information has further complicated the position. More recently there are signs of progress by the US and the EU towards developing appropriate cooperative arrangements. Given the importance we attach to cross border regulatory cooperation, we have strongly supported moves to overcome the difficulties and provide a basis for sensible cooperation between EU regulators and the PCAOB.
  - More generally, systems of independent audit regulation around the world are at widely differing stages of development. This restricts the ability of the EU to take positive decisions on equivalence in the short to medium term for a wide range of countries. We have strongly supported European Commission proposals for a second transitional regime that would exempt from detailed regulation audit firms from a country which has firm plans to develop its own system of independent oversight. For firms from countries that have no plans to develop effective audit regulation and oversight, we are starting to develop detailed arrangements for our own programme of quality assurance reviews.
- **To complete the initial phase of registering third country auditors** in accordance with the requirements of the Directive, the related Commission Decision on Transitional Provisions and the implementing measures in the UK.

We have worked closely with our EU counterparts to ensure as far as possible that there is consistency of approach across Member States. To the end of May 2010 we had registered 87 audit firms from 39 countries.

### **Cooperation on Regulation of EU Auditors**

4.7. The Directive sets requirements for cooperation between Member States on the regulation of EU audit firms. This is increasingly important now that two of the largest audit firms, Ernst & Young and KPMG, have made major structural changes, to integrate the national network firms in Europe much more closely. Whilst the national firms retain a separate legal identity, the businesses are owned and run as a broad regional partnership.

4.8. These changes have important implications for how EU oversight bodies regulate the firms. In particular, as key decisions on audit procedures and practices are taken increasingly outside individual jurisdictions, it becomes more important for oversight bodies in different Member States to work closely together. At the initiative of the AIU, a college of regulators has been established to ensure that effective inspections can be organised on a pan-European basis, in particular in relation to aspects of KPMG's overall procedures and practices across the European business. This adds value to the regulatory process and reduces the overall burdens on the firms. There are plans to work on a similar basis in relation to Ernst & Young.

4.9. Against this background we were closely involved in developing with fellow EGAOB Members a protocol, to which all EU oversight bodies can subscribe, setting out the detailed basis for cooperation and information sharing between regulators, in accordance with the Directive.

### **Future Development of the EGAOB**

4.10. 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. The Commission and oversight bodies in many Member States including ourselves are agreed that the EGAOB needs to evolve into an authoritative grouping of oversight bodies, with specific responsibilities within the EU regulatory framework.

## **International Forum of Independent Audit Regulators (IFIAR)**

4.11. Oversight Board staff have played a leading role in the development of IFIAR, of which the Executive Director is currently the Vice Chair.

4.12. 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 contacts with other international organisations which have an interest in audit quality.

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

- Discussions with the global leadership of the six largest audit firm networks to understand better their global quality control procedures and strategy and to receive their commitment to address the root causes of common audit inspection findings in respect of professional scepticism, revenue recognition, group audits and engagement quality control reviews;
- Discussions with major investors to understand better their views on audit quality and related issues;
- Discussions with the Chair of the International Audit and Assurance Standards Board (IAASB) to improve the interaction between audit standard setters and audit inspectors;
- The sharing of experiences in addressing the implications of the financial crisis on audit; and
- Discussions on improving regulatory cooperation.

4.14. The Oversight Board, through its Audit Inspection Unit, has also played a leading role in IFIAR's work to support the development of independent inspections around the world, particularly by organising and participating in audit inspection workshops, through which experience can be shared and best practice disseminated.



### **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 twenty-four Companies Act audits undertaken by the NAO in respect of financial periods ending on 31 March 2009. It also reviewed the firm-wide procedures that applied to these audits.
- None of the issues the AIU identified on the statutory audits reviewed were considered to be significant.
- The AIU identified areas for improvement based on its review of the NAO's firm-wide procedures. The number and nature of these was consistent with the AIU's experience when first visiting other firms and audit organisations. The NAO has prepared an action plan in response to the AIU's findings.
- On the basis of the AIU's work and the NAO's action plan, we conclude that the NAO has policies and procedures in place that are generally appropriate to its size and the nature of its Companies Act statutory audit client base and thus to undertake such audit work to an acceptable standard. We have identified no matters that would call in question the C&AG's eligibility for appointment as a statutory auditor.

## **FIVE – 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 first such audits in respect of accounts for financial years that ended on 31 March 2009 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 audit work of the C&AG.

## **Reporting Requirements**

5.6. We report below in accordance with the requirements of Article 4(a) to (e) 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 completed its first review of some of the statutory audits undertaken by the C&AG in the first quarter of 2010.

5.9. We 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. The AIU inspection of the C&AG's statutory audit work comprised:

- reviewing the performance of 2 of the 24 statutory audits carried out by NAO staff; and
- reviewing the procedures that applied to these audits.

5.12. None of the issues the AIU identified on the statutory audits reviewed were considered to be significant.

5.13. The AIU identified areas for improvement based on its review of the NAO's firm-wide procedures. The number and nature of these was consistent with the AIU's experience when first visiting other firms and audit organisations. The NAO has prepared an action plan in response to the AIU findings.

5.14. On the basis of the AIU's work and the NAO's action plan, we conclude that the NAO has policies and procedures in place that are generally appropriate to its size and the nature of its Companies Act statutory audit client base, and thus to undertake such audit work to an acceptable standard. We have identified no matters that would call in question the C&AG's eligibility for appointment as a statutory auditor.

5.15. 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***

5.16. The C&AG notified the Independent Supervisor of a change of address and a change of the Audit Compliance Officer, 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***

5.17. We issued no enforcement notices and made no applications for compliance orders in 2008.

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

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

**Financial Information**

5.19. 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.

5.20. In the financial year 2009/10 the core operating costs of the Professional Oversight Board (including an allocation of the central overheads of the FRC) were £1.4 million. We estimate that less than 5% of those costs related to our role as the Independent Supervisor.

## Oversight of the Actuarial Profession

- Following the Morris Review of the Actuarial Profession, the FRC agreed in 2006 to take responsibility 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 Profession has the primary responsibility for the regulation of its members acting in their professional capacity. The Profession will 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.
- Our priority areas for the Profession during the year were as follows:
  - Ethical and conduct standards - the Profession finalised its more outcome-focused Actuaries' Code. We are now looking for the Profession to build on this through a comprehensive set of standards, guidance and education, including adequate guidance on conflicts of interest and whistle-blowing.
  - Education and CPD - we are looking for a clearer message from the Profession about the competence and skills expected of practising actuaries, including in relation to the BAS's new technical actuarial standards.
  - Compliance and discipline - we are looking to the Profession to strengthen the reliance it can place on the quality controls at actuarial firms.
- Together with the BAS, we have updated the FRC's Actuarial Quality Framework, which is used to assess the quality of actuarial work. We have also updated the FRC's guidance to users of actuarial work.

## SIX – OVERSIGHT OF THE ACTUARIAL PROFESSION

### Introduction

6.1. The Actuarial Profession in the United Kingdom is relatively small, but is particularly influential in advising insurers, pension schemes and other financial institutions that require long-term planning and modelling of financial risks and investments. The Institute of Actuaries and the Faculty of Actuaries, which recently agreed to merge, regulate their members jointly as the Actuarial Profession. We oversee the Profession by virtue of an agreement made in 2006 between the FRC and the Profession following the recommendations of 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. We set the agenda for our oversight of the Profession during 2009/10 with our report in May 2009 on the *Actuarial Profession's progress and priorities in regulating its members*. In the report we encouraged the Profession to focus on the public interest outcomes it is looking to achieve in regulating its members, and the quality of its regulatory processes for achieving them, in:

- *Ethical and conduct standards* – by finalising its new more outcomes-focused Actuaries' Code, and developing high quality supporting standards, guidance, materials and training which will equip its members to meet the expectations in the new Code, as well as the technical actuarial standards being developed by the Board for Actuarial Standards (BAS);
- *Education and CPD* – through a clearer message about the competence and skills expected of practising and non-practising actuaries who work in different areas, and how these can be supported and validated, particularly for actuaries who offer professional actuarial services in risk management and banking; and
- *Compliance and discipline* – by strengthening the reliance which can be placed on quality controls in the working environment for practising actuaries, and making the Profession's own limited monitoring activities more effective in meeting the expectations and concerns of users of actuarial work.

## **Actuarial Quality Framework**

As an aid to outcome-focused regulation, we have worked with our colleagues at the Board for Actuarial Standards (BAS) to develop the FRC's Actuarial Quality Framework, which was published in January 2009. The Framework sets out the main positive indicators which support six factors – or drivers – of actuarial quality:

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

The Framework 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) for actuarial work. We also worked together in November 2009 to update the FRC's suggested questions for users of actuarial work to ask their actuaries in current economic conditions. We are pleased that the Profession has framed its own regulatory initiatives and responses to our recommendations in terms of this Framework.

We invited stakeholders to comment on the Framework, and have recently reviewed it with our BAS colleagues based on comments received during 2009. Overall, the Framework has been well received, and few changes have been suggested. However, we updated some of the indicators in June 2010, to reflect the content of the final TASs issued by the BAS and our own recommendations to the Profession.

6.3. Overall the Profession's response has been positive but has taken longer than expected and is therefore still mostly work-in-progress.

## **Ethical and conduct standards**

6.4. The Profession's new Actuaries' Code came into effect in October 2009. The Profession has actively promoted the new Code, and has updated its mandatory professionalism courses for newly qualified and more experienced actuaries.

6.5. The Profession has made less progress in developing supporting standards and other materials, particularly in difficult areas such as conflicts of interest and whistleblowing which were highlighted by the Morris Review. However, it has recently issued a discussion paper to gather evidence about conflict of interest issues. We have also highlighted the need for the Profession to pick up the ethical and conduct materials contained in the existing Guidance Notes when the BAS replaces these with its own specific technical actuarial standards (TASs) in 2011.

6.6. We have been working with the Profession and the BAS to help ensure the Profession sets realistic expectations and milestones for its work on ethical and conduct standards, with adequate resources and processes for ensuring that it delivers high quality regulation, and supports awareness and compliance with the BAS's new technical actuarial standards.

## **Education and CPD**

6.7. The Profession is guided by a published set of skill sets in setting its examinations and work-based skills requirements for newly qualified actuaries. Following our earlier recommendations, it has been actively benchmarking the quality of its education processes against the US Society of Actuaries, and has initiated a high-level review of its education system to ensure that it continues to meet expectations.

6.8. The Profession has responded to the demand for a specific risk management qualification for actuaries through the development of the international Chartered Enterprise Risk Actuary (CERA) qualification for existing actuaries, which includes a new examination in Enterprise Risk Management (ST9). The first examination was held in April 2010 and successful candidates who qualify as an Associate or Fellow will be awarded the CERA qualification.

6.9. The Profession's expectations of practising actuaries are also implicit in its CPD requirements and offerings, and its requirements for practising certificates. The Profession has increased its annual CPD requirement for holders of practising certificates from 15 to 30 hours. However, we have encouraged the Profession to be clearer about the technical skills it expects, by reference to the 'technical skills of actuaries' driver in the FRC's

Actuarial Quality Framework and the FSA's framework for significant influence functions. The Profession has told us that this work is underway, with an expected completion in the spring of 2011.

### **Compliance and discipline**

6.10. 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 also regulates only individual members and not actuarial firms.

6.11. We concluded last year that the primary strategy for the Profession 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, and (ii) placing greater reliance on the controls operated by their firms.

6.12. It would be for the Profession to determine the appropriate conditions for the issue of a practising certificate. However, based on the 'working environment for actuaries' driver in the Actuarial Quality Framework, we suggested that these might include:

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

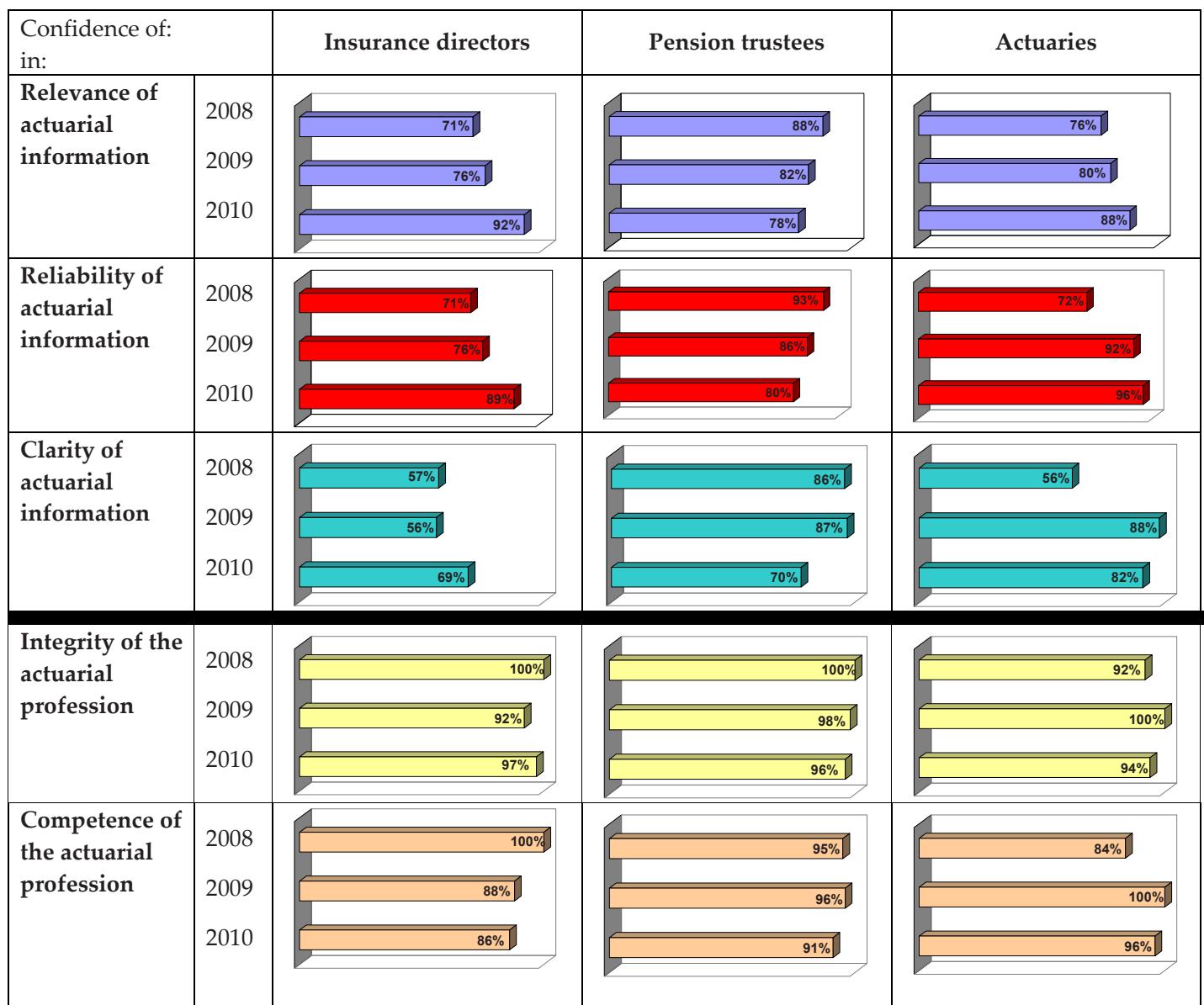
6.13. The Profession has responded positively to these recommendations, and has started speaking to actuarial firms about the scope for compliance monitoring through firms. The Profession's Corporate Plan for 2010/11 emphasises the need for the Profession to engage with actuarial firms, and we expect to see it develop proposals during the next year.

## Measuring the impact of regulation

The FRC publishes a regular confidence survey, which includes confidence in actuarial information and the actuarial profession.

This year we expanded the size and scope of the survey to include a wider range of stakeholders and a greater number of questions relating to the Actuarial Quality Framework, initiatives from the FRC and the Profession.

Overall, responses of directors of insurance companies, and actuaries themselves suggest increasing confidence, and responses of pension trustees declining confidence, both in actuarial information and in the integrity and competence of the actuarial profession.



## **Oversight of the Accounting Profession**

- 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.
- As the provision of most accountancy services outside of audit and insolvency work is not restricted to members of accountancy bodies, we must strike a balance between regulation to encourage high quality work and the need to avoid making regulated accountants uncompetitive.
- We identify issues that could adversely affect public confidence in accountants, undertaking a detailed project where appropriate
- In 2010 we reviewed how the bodies monitor member firms in practice outside statutory work and recommended:
  - greater transparency of the monitoring work performed
  - enhancements to the scope of reviews
  - improved follow up procedures.

## **SEVEN – OVERSIGHT OF THE ACCOUNTING PROFESSION**

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### **Introduction**

7.1. Our oversight of the accountancy profession is based on an agreement with the members of the six chartered accountancy bodies in 2004 when the Oversight Board was established. 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. The bodies have agreed that they will either give effect to recommendations or explain publicly why they do not consider it is appropriate to do so.

7.2 It is important to bear in mind that the provision of most accountancy services outside audit and insolvency work is 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.

### **Review of Practice Assurance**

7.3. The major project we undertook in 2009/10 was a review of the arrangements of the professional accountancy bodies for monitoring the work of their members in respect of non-regulated accountancy services. What is generally known as “practice assurance” was introduced by the professional bodies to protect the public and to increase confidence in the work of professional accountants, and to provide guidance to members undertaking non-regulated work. In some cases these arrangements have been in operation for over ten years.

7.3. We consider that monitoring of non-regulated members is an important way in which the bodies can improve the quality of work performed by professional accountants.

7.4. Our review was restricted to those bodies with which there is agreement that the Oversight Board will provide independent oversight in relation to non-regulatory work.

7.5. The final report was published in May 2010 and made eight recommendations, under the following three headings:

#### ***Publicly available information***

7.6. We made 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. In particular, we wanted it to be clearer to the public that such monitoring focuses on the processes that the member in practice has in place but does not include a review of the technical quality of the work carried out.

#### ***Enhancements to the existing arrangements***

7.7. Four recommendations focused on how the bodies could improve the existing reviews and ensure that members and the public can gain greater benefits from the work undertaken during these visits. We highlighted the importance that the public place on the requirement that a professional accountant must comply with a Code of Ethics and have asked the professional bodies to consider a more comprehensive review of this, as part of their monitoring arrangements. In addition we have asked the professional bodies to highlight all elements of best practice to members to ensure that a consistent standard is achieved regardless of the size of practice. In order to reduce the burden placed on members we have suggested that the bodies consider tailoring subsequent visits to members in order to target specific risks inherent to the practice.

#### ***Improved follow up procedures***

7.8. We concluded that there is a need for all bodies to improve their procedures for following up the monitoring activity they undertake. In particular we consider that the professional bodies should require members to respond to all matters raised and should review the responses received, to gain maximum benefit from the reviews,

7.9. The extent to which a particular recommendation is relevant to a particular body inevitably varies and we have asked each body to respond, explaining how they intend to address the recommendations, by 1 September 2010.

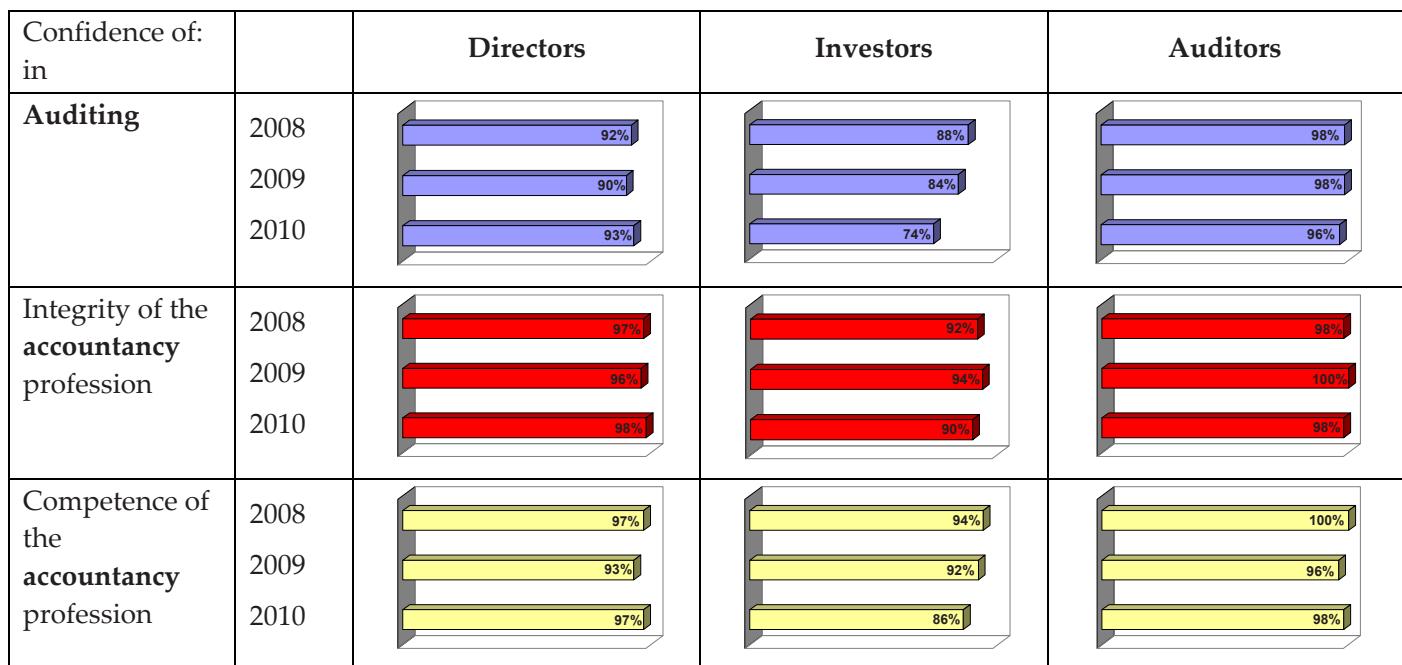
## Key Facts and Trends in the Accountancy Profession

7.10. We published the eighth edition of Key Facts and Trends in the Accounting Profession in June 2010 (<http://www.frc.org.uk/pob/publications/pub2301.htm>). This provides information on both the principal UK accountancy bodies and on the larger UK audit firms.

### Measuring the impact of regulation

The FRC publishes a regular confidence survey, which includes confidence in auditing and the accountancy profession.

Overall, the responses suggest high and relatively stable levels of confidence of directors of listed companies and of auditors, but with a marked reduction in the confidence of investors in 2010 both in auditing and in the competence of the accountancy profession.



## **Work Programme 2010/11**

### **Our statutory regulation of audit will focus on:**

- Our annual compliance visits to each recognised body to review in particular:
  - The systems and practice for the approval, renewal and removal of individual statutory auditors.
  - The systems for the award of examination exemptions.
  - The execution of three year plans by the recognised bodies to improve the quality of audit by smaller firms.
- Initiating a programme of Quality Assurance Reviews of third country auditors.

### **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 audit of segmental reporting, revenue recognition and fraud, going concern, fair value accounting estimates impairments, 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;
- Considering the effectiveness of the professional bodies' systems for ensuring members maintain competence.

## **EIGHT – WORK PROGRAMME 2010/11**

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### **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 2009 and finalised in May 2010.

### **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 more inherent risk. In particular, we will review, the procedures for approval, renewal and removal of individual statutory auditors, and the award of examination exemptions; and we will also look closely at the bodies' actions in response to significant previous recommendations;
- The development and execution of clear 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;
- The development and execution of an inspection programme for those third country auditors of UK issuers who fall outside European transitional regulatory arrangements;
- Assessing with other stakeholders the need for further action in the light of the continued significant risks arising from the high degree of concentration in the audit market and progress in implementing the recommendations of the Market Participants Group;
- The response of the Comptroller and Auditor General to any issues emerging from the AIU's review of their statutory audits; and

- Working with other parts of the FRC to assess the relevance of audit and the appropriateness of the existing scope.

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

8.3. Our monitoring of the quality of major audits will focus on:

- The firm wide procedures at the six largest firms and the auditors' performance of some 100 individual major engagements;
- Our reviews will continue to include an assessment of the impact of commercial pressures on audit quality;
- Our reviews of individual engagements will focus on audit of segmental reporting, revenue recognition and fraud, going concern, fair value accounting estimates impairments, and compliance with ethical standards;
- The regulatory challenges of firms organised on a regional basis; and
- Through IFIAR, ensuring that the major firms address the key recurring global inspection themes of scepticism, revenue recognition, engagement quality control reviewers, and group audits.

### **Oversight of the actuarial profession**

8.4. Our oversight activities will 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.

8.5. 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**

8.6. 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**

8.7. In 2009/10 the operating costs of the Oversight Board (excluding the Audit Inspection Unit) were £1.4 million, excluding support services provided centrally and the cost of actuarial oversight which is funded separately. The average number of staff was nine<sup>8</sup>. Income from the registration of third country auditors allocated to 2009/10 was £55,000.

8.8. The costs for 2009/10 of the Audit Inspection Unit, which is funded separately, were £2.3 million, excluding support services provided centrally. The average number of staff in post was 19.

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<sup>8</sup> This includes two staff responsible for oversight of the Actuarial Profession.

## **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, 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 <sup>9</sup>	CAI	ICAS
<b>Number of audit firms</b>				
As at 31.12.09	2,503	4,113	985	242
As at 31.12.08	2,569	4,279	991	260
As at 31.12.07	2,697	4,526	1,006	266
<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
<b>Number of Office locations, as at 31.12.07</b>				
1	2,417	3,297	929	212
2-3	267	1,107	72	41
4-10	11	107	5	11
10+	2	15	0	2
<b>Number of 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

<sup>9</sup> The ICAEW figures are for those firms that were to be registered as at 1 January the following year.

	ACCA	ICAEW <sup>9</sup>	CAI	ICAS
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 Principals, as at 31.12.07</b>				
1	1,894	2,265	654	109
2-6	770	1,986	329	132
7-10	25	156	13	17
11-50	8	106	9	7
50+	0	13	1	1
<b>Number of new applications<sup>10</sup></b>				
Yr to 31.12.09	100	218	30	8
Yr to 31.12.08	99	285	34	19
Yr to 31.12.07	77	272	41	19
<b>Number of applications refused<sup>11</sup></b>				
Yr to 31.12.09	0	1	6	0
Yr to 31.12.08	0	0	2	0
Yr to 31.12.07	0	0	0	0

The overall decrease in the number of registered audit firms can be explained largely by the increase in the audit threshold, resulting in a lower number of entities requiring an audit. The lower number of entities requiring an audit has meant that some firms have found that there is no longer a good business case for retaining their audit registration; have merged with other firms; or have passed on this work to larger firms where there are greater economies of scale. However, the rate of decrease has slowed in 2008 and 2009 in comparison with previous years. Some firms with no audit clients have decided to 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.

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

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

## 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 (para 2.33) on the challenges this presents.

	ACCA	ICAEW	CAI	ICAS
<b>Number of firms monitored</b>				
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
Actual 2007	285	975	42	41
Target 2007	Not Available	920	50	40
<b>Actual firms monitored as a % of audit registrants</b>				
2009	17.0%	18.4%	10.4%	21.1%
2008	15.6%	23.1%	9.6%	20.8%
2007	10.6%	21.5%	4.2%	15.4%

As explained in Section 2 of this report and illustrated in the figures above, we consider that meeting the requirements of the SAD could prove challenging for some bodies. We asked all RSBs to provide us with a detailed analysis of how they intend to meet the SAD, and to confirm that they will keep a close watch on the position to ensure that their plans are realistic. 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.

	<b>ACCA</b>	<b>ICAEW</b>	<b>CAI</b>	<b>ICAS</b>
<b>Reason for monitoring visits</b>				
<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 <sup>12</sup> involvement	0	46	2	1
Number of firms specifically selected due to heightened risk	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	38	89	39	51
Number of firms randomly selected	320	820	37	0
<b>2007</b>				
Number of firms monitored following a request by the registration/licensing committee	48	21	6	0
Number of firms with public interest entities visited without AIU involvement	0	29	3	0
Number of firms specifically selected due to heightened risk	35	244	21	38
Number of firms randomly selected	202	681	12	0

<sup>12</sup> AIU = Audit Inspection Unit

## 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. In general, the monitoring results of one year are not directly comparable with the results of previous years. In order to visit every firm in a six-year cycle, the individual firms visited in one year are mostly different from those firms visited in another year.

Particular care is needed also in interpreting the percentage of "D" outcomes at each body, especially given that the sample of firms inspected in any year is unlikely to be random but will almost certainly include a disproportionate number of weaker firms. However, as explained at Section 2 para 2.47, the percentage of visits that show unsatisfactory work was of the order of a quarter of all visits undertaken by all bodies in 2009.

The tables below show the gradings for the four bodies for visits conducted from 2007-2009.

ACCA	2009	2008	2007
Number of A & B outcomes	238	211	159
% of A & B outcomes compared to all visits conducted	56	52	56
Number of C+ outcomes	64	95	65
% of C+ outcomes compared to all visits conducted	15	24	23
Number of C- outcomes	21	31	20
% of C- outcomes compared to all visits conducted	5	8	7
Number of D outcomes	102	64	41
% of D outcomes compared to all visits conducted	24	16	14

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' by the ACCA if the audit work is unsatisfactory at a single visit and improvements are required. When a firm has a second unsatisfactory visit and there are no mitigating factors, the firm will be referred to the Regulatory Assessor/ Admissions and Licensing Committee (ALC) and the visit graded a 'D'. In addition, where there are serious breaches of other regulations, 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 although the number of firms monitored in 2009 was consistent with the previous year, 28% of these were firms with no audit clients (2008 4%). 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 which affects the overall percentage.

ICAEW	2009	2008	2007
Number of A & B outcomes	494	601	582
% of A & B outcomes compared to all visits conducted	65	61	60
Number of C outcomes	140	218	283
% of C outcomes compared to all visits conducted	19	22	29
Number of D outcomes	94	124	110
% of D outcomes compared to all visits conducted	12	13	11
Number of N outcomes	29	45	N/A
% of N outcomes compared to all visits conducted	4	4	-

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

The ICAEW class all visits graded A-C as satisfactory. Visits graded 'A' are those where there are no instances of non-compliance with the Institute's audit regulations and no regulatory action is required. 'B' rated visits are those with evidence of non-compliance with the audit regulations of the Institute, but where the Quality Assurance Directorate (QAD) is confident that the firm's proposed actions set out in the closing meeting notes adequately address all the issues and that the firm has the commitment to take the agreed action. A 'C' rated report records instances of non-compliance with the audit regulations where the QAD considers that there is 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. A new visit grading was introduced during 2008 (N rated visits). This grade is given to firms with no audit clients; these would have previously been given a C rating.

ICAEW has commented that the percentage visit gradings in 2009 remains consistent with 2008.

<b>CAI</b>	<b>2009<sup>13</sup></b>	<b>2008</b>	<b>2007</b>
Number of A & B outcomes	22	23	10
% of A & B outcomes compared to all visits conducted	24	26	24
Number of C outcomes	38	38	17
% of C outcomes compared to all visits conducted	42	43	40
Number of D outcomes	29	27	15
% of D outcomes compared to all visits conducted	32	31	36

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

CAI has commented that there are no significant movements in the visit statistics with 67% of visits (69% in 2008) achieving good or satisfactory results (outcomes A, B and C). The small increase in D reports arose primarily due to the selection of firms at the end of the visit cycle.

<b>ICAS</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Number of A & B outcomes	33	20	21
% of A & B outcomes compared to all visits conducted	65	37	51
Number of C outcomes	13	22	14
% of C outcomes compared to all visits conducted	25	41	34
Number of D outcomes	5	12	6
% of D outcomes compared to all visits conducted	10	22	15

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<sup>13</sup> Although there were 102 audit monitoring visits completed by CARB during 2009, only in 89 of these visits had the outcome of the visit been considered by the Quality Assurance Committee.

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. 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.

The substantial improvement in gradings for 2009 over 2008 is likely to reflect at least in part that the firms perceived as more risky were visited earlier in the visit cycle.

### C) Complaints about Auditors

	ACCA	ICAEW	CAI	ICAS
<b>Number of new cases<sup>14</sup></b>				
2009	27	93	17	10
2008	26	91	80	7
2007	15	106	78	8
<b>Number of cases passed to the AADB</b>				
2009	0	0	1	2
2008	0	2	0	0
2007	0	0	0	0
<b>Number of cases passed to committee<sup>15</sup></b>				
2009	5	53	7	6
2008	5	77	32	5
2007	4	70	37	6
<b>Number of complaints<sup>16</sup> closed in the year</b>				
2009	25	76	6	6
2008	13	135	86	4
2007	7	86	92	4
<b>Average time taken to close a complaint</b>				
2009	9.4 months	11 months	6 months	For cases closed by IPCEC <sup>17</sup> = 3.8 months. For cases closed by Secretariat = 1.5 months.

<sup>14</sup> Audit related complaints only

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

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

<sup>17</sup> Investigation and Professional Conduct Enforcement Committee

	<b>ACCA</b>	<b>ICAEW</b>	<b>CAI</b>	<b>ICAS</b>
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.
2007	6.4 months	12 months	9.8 months	For cases closed by IPCEC = 1.5 months Cases closed by Secretariat = 1.4 months.

The figure of CAI complaints for 2009 is for audit related complaints only. Previous years included complaints against Registered Auditors regardless of the nature of the complaint.

ICAS has explained that they experienced a significant increase in all types of complaint in the first half of 2009 although there was no discernible trend in their nature. Not only did the volume of complaints increase but also their complexity.

## D) Student Registration

	ACCA	ICAEW	CAI	CAI	AIA
<b>Number of new students</b>					
2009	19,265	4,854	1,432	740	10
2008	21,787	5,104	1,665	1,030	27
2007	20,052	5,057	1,758	1,140	58
<b>Total number of students</b>					
2009	93,864	16,517	6,171	3,119	250
2008	93,510	16,165	5,958	3,437	281
2007	90,653	15,422	5,126	3,460	286
<b>Number of students who became members</b>					
2009	3,583	3,418	1,093	863	0
2008	4,736	2,827	1,237	745	4
2007	3,891	2,459	971	657	2
<b>Number of members who became audit qualified</b>					
2009	111	2,180	998	27	0
2008	108	3,551	867	26	0
2007	161	225	104	41	0

All the bodies show an overall decrease in the number of new students registering to train as accountants with the recognised bodies in the UK and Republic of Ireland, from almost 30,000 in 2008 to some 26,000 in 2009. One major reason has been the economic downturn, with less demand for the take-on of students across all sectors.

The table above shows the number of members who became audit qualified in 2008. The significant difference in ICAEW's and CAI's figures in 2008 and 2009 compared to prior years reflects the fact that in 2009 these bodies awarded the audit qualification to all those members who met the eligibility requirements since 2006 but had not received the audit qualification.

## E) Registered Training Offices in UK and Ireland

	ACCA	ICAEW	CAI	ICAS	AIA
<b>Number of registered training offices</b>					
2009	4,822	3,115	828	168	N/A
2008	4,794	2,854	771	185	N/A
2007	4,794	2,938	722	174	N/A
<b>Number with students training for the audit qualification</b>					
2009	3,606	1,122	N/A	N/A	N/A
2008	3,697	1,401	N/A	N/A	N/A
2007	3,777 <sup>18</sup>	1,493	N/A	N/A	N/A
<b>Number of new applications</b>					
2009	N/A	239	74	12	N/A
2008	N/A	295	60	18	N/A
2007	N/A	176	40	25	N/A
<b>Number of applications refused</b>					
2009	N/A	1	N/A	1	N/A
2008	N/A	1	N/A	0	N/A
2007	N/A	4	N/A	0	N/A
<b>Number of registrations withdrawn</b>					
2009	73	2	N/A	29	N/A
2008	146	2	N/A	10	N/A
2007	76	1	N/A	11	N/A
<b>Number of approved training offices visited</b>					
2009	768	433	180	41	N/A
2008	597	214	148	42	N/A
2007	623	164	138	43	N/A
<b>Number of approved training offices visited as a % of the total</b>					
2009	15.9%	13.9%	21.7%	24.4%	N/A
2008	12.5%	7.5%	19.2%	22.7%	N/A
2007	13.0%	5.6%	19.1%	24.7%	N/A

<sup>18</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.

CAI has increased the number of approved training offices and the number of approved training offices visited in order to help promote their training in business options. Other bodies have experienced less demand for new employers to become authorised to train students although the number of training offices has remained fairly constant.

ACCA has explained that the main reason why training offices have had their registration withdrawn is the inability of firms to provide appropriate work experience.

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, it has not yet approved any training offices.

## **ANNEX 3**

### **PROFESSIONAL OVERSIGHT BOARD**

**1 April 2009 to 31 March 2010**

***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

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

Chair of the CII Audit Committee. Past President of the Chartered Insurance Institute. Formerly Managing Director of Scottish Provident International.

Anthony Carus

Consulting Actuary in private practice 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

Member of the Board and Audit Committee Chair, TT Electronics plc and of the Treasury Solicitor's Department. 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.

Roger Davis

- to 31 December 2009

Member of the Competition Commission. Formerly Head of Professional Affairs, PricewaterhouseCoopers LLP

Stella Fearnley

- to 31 December 2009

Professor of Accounting, the Business School, University of Bournemouth

Paul George

John Kellas, CBE

Director of Auditing, FRC, and Director, Professional Oversight Board Chair of the International Auditing and Assurance Standards Board until 2009. Formerly 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.

Anne Maher

- to 31 December 2009

Director, Allied Irish Banks plc and of Retirement Planning Council of Ireland. Formerly Chief Executive, The Pensions Board for Ireland

***Secretary***

John Grewe



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