FINANCIAL REPORTING COUNCIL

Discussion Paper – Promoting Audit Quality

Comments from Standard life Investments
(to be read in conjunction with our letter dated 30 March 2007 to Mr J Grant of the FRC)

Q1. Are there other important indicators of an audit firm's culture that are not referred to above?

An audit firm's approach to transparency about its governance and communication about its business is an important indicator of its culture. It is indicative of the tone from the top. However, when we evaluate such information communicated by firms it can be difficult to distinguish between substance and spin. We commend to the FRC the introduction of a voluntary Code of Communication and Transparency for firms undertaking the audit of listed companies in order to raise standards and to strengthen the culture of such firms.

Q2. Are there pressures that could compromise the culture of audit firms that have not been identified above?

The confidentiality agreements which are entered into between audit firms and their clients serve to compromise the culture of firms, who can be confident that cultural and other shortcomings will remain private. When auditors resign these agreements provide a two-way safe harbour which benefits the firms and their clients but is to the detriment of the public in general and of shareholders in particular.

That said, we do recognise the importance of an appropriate level of client confidentiality, especially in relation to commercially sensitive information. But we are concerned that the current confidentiality arrangements provide a cloak of convenience when auditors resign or are sacked without credible explanation. This can mask circumstances that should legitimately be brought to the attention of shareholders and other third parties. For example, when the auditor has unresolved concerns about the company's corporate governance or when the auditor is sacked following a dispute between the company and the auditor on accounting issues. This concern is acute in the event that there is a change of auditor and there is no credible explanation as the reason for the change.

Q3. Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?

There are two steps that merit consideration.

First, audit firms should be encouraged to seek feedback from institutional investors about how their culture is perceived and to monitor trends in that feedback over time.

Second, companies should be encouraged to permit audit firms to explain their firm's culture and governance in the explanatory notes that typically accompany AGM notices. This would assist shareholders to make informed decision(s) regarding the re-election of auditors.

Q4. Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?

Yes but it would be wrong to presume that this is necessarily an exhaustive list of such key drivers.

Q5. Has this paper identified the issues that could result in an inadequately trained or skilled workforce for audit – if not, what other issues are there and why are they issues?

A requirement for firms to have effective and appropriate whistle-blowing processes would help to deter firms from taking short-cuts on training and on staffing properly audit assignments; it would provide a check and balance when short-comings arise. The whistle-blowing processes should come within the scope of the regular reviews undertaken by the Audit Inspection Unit.

Q6. Should there be a fundamental review of the qualification and training requirements for auditors?

Conducted independently and under appropriate terms of reference, such a review would help to strengthen public and shareholder confidence in auditors. The terms of reference should encompass the consideration of licensing of accountants to undertake the audits of listed companies. The licences should be subject to periodic renewal and should not be evergreen. The benefits of such licensing, mindful that individual accountants will be signing audit reports in the future under the terms of the 2006 Companies Act, include establishing and maintaining a minimum level of training and competence amongst engagement partners. This is particularly important given that it is essential that auditors keep abreast of changes in accounting and auditing environments.

Q7. Are there other factors that determine whether an audit process is effective?

See Q9.

Q8. Are there threats to the effectiveness of the audit process that have not been identified above?

See Q9.

Q9. Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?

Improved accountability to and face-to-face dialogue with institutional investors about the firm (for example, its governance, changes in its organisation and its approach to audit quality) would provide a low-cost and useful step that would serve to sharpen the firms' awareness of the importance of having an effective audit process. We have witnessed some improvements in accountability and communication over the last year but there is ample scope to do more.

Another step which the FRC should consider is undertaking research to evaluate whether the bunching of corporate year-ends around 31 December impacts on the effectiveness of the audit process. For example, does it result in key audit resources being spread too thinly as a result of having to meet a large number of reporting deadlines in a short time period? Informal feedback we receive from companies suggests that this could be an issue.

Q10. Are there other factors that determine whether audit opinions command confidence?

There are two other factors that determine the confidence that audit opinions command.

- In the case of audit opinions on consolidated financial statements, the proportion of the group results which are not audited by the group auditor. If the proportion is significant, the information invites an explanation and provides a basis for investor engagement.

- The nature of advice and other services provided by the auditors to the client. Tax advice and due diligence on entities acquired by the client are types of such services which have the potential to undermine investor confidence in audit opinions, although we acknowledge that in certain situations such advice and services can yield useful benefits to the company.

Q11. Are there other reasons why users may not have confidence in the audit opinion?

The incidence of caveats and provisos in audit opinions undermines significantly the confidence that shareholders and investors place in them. These caveats and provisos serve to protect the interests of the auditors in the event of audit failure. As such they are fundamentally unwelcome. It would be very useful if the FRC would investigate ways to minimise these caveats and provisions and thereby help to strengthen confidence in the audit opinion.

Lack of knowledge on the pat of investors about some of the smaller firms of auditors of listed companies serves to undermine confidence in their audit opinions. These firms should be encouraged to engage with institutional investors in order to try to establish a basis for trust and confidence.

Q12. Are there further steps that could be taken to reinforce confidence in an audit opinion? In particular, what changes to the form and content of the audit report should be considered?

See Q11 above.

In addition, more discursive audit opinions would encourage shareholders and investors to read the audit opinion. The FRC should consider what it can do to create an environment that would motivate auditors to take a more enlightened approach to audit opinion content. In particular greater use of matters of emphasis would be a great step forward. As things stand, matters of emphasis are perceived by many in a negative light. Rather matters of emphasis should be seen as helping to inform shareholders and investors. It would be extremely useful for the FRC to commission the provision of practical guidance for auditors and audit committees to assist them in achieving more useful audit reports.

Q13. Are there other external factors that have the potential to adversely affect audit quality?

There are no other external factors other than those identified elsewhere in these comments.

In respect of the external factors identified in the Discussion Paper we should like to make the following comments:

- In our engagements with companies we have found limited evidence to suggest the review of audit effectiveness has a significant impact on audit quality. We support the view that a brief summary of the work undertaken by the audit committee to evaluate audit effectiveness would be useful and would strengthen accountability; such summaries would help to enhance the credibility of the evaluations and they would reassure investors that audit committees address the quality of the audit. However, if the summaries were to have boilerplate content their usefulness would evaporate.

- Audit committees have experienced ‘scope creep’ over the last decade. It is commonplace these days for audit committees to have responsibility for regulatory compliance, risk management as well as audit matters. This presents practical challenges, especially bearing in mind the non-executive composition of audit committees, to fit everything in. Consequently, the allocation of committee time to evaluating the quality of the audit can sometimes fall short of expectations.

- The role of shareholders, as described in 7.7 and 7.8 is theoretically correct but in practice auditors do not take a public position on the issues cited and consequently there is nothing for shareholders to support. This is a matter of regret and, as noted in our earlier comments, we should like to see auditors being more transparent when there are matters that they feel should be brought to the attention of shareholders. Refer to Q2 and Q8 for examples.

- The pressures caused by the accelerated reporting regime should be considered in tandem with the concentration of year ends around 31 December as noted in our response to Q9.

Q14. Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective?

Based on our discussions with companies and audit firms we believe that audit committees in general take their responsibilities seriously and seek to fulfil them, especially as they relate to audit, to the best of their abilities. As investors we take re-assurance from this. However, as noted in Q13 above, the increased burden of responsibilities on audit committees that goes beyond external audit is an issue which merits serious consideration by the FRC.

However, the audit committee reports published in Annual Reports do not always do justice to the responsibilities discharged. Inevitably there is some degree of boiler-plating in respect of disclosures and we should find it useful if there was more discursive comment in the reports regarding deliberations and decisions of the committee – including those in respect of their engagements with the auditors. Such improved transparency would go a long way to strengthening investor confidence in audit quality and it would make the role of audit committees more effective.

Q15. Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?

We are not convinced more detailed guidance is required. A competent audit committee should by definition be equipped to form a responsible view as to what needs to be done to evaluate audit effectiveness. In addition guidance from other bodies is already available to audit committees. More detailed guidance from the FRC might have the effect of 'standardising' the approach taken, which could lead to a box-ticking approach by audit committees, with unintended and adverse consequences.

Q16. Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?

Yes. But to be useful it is important that such a summary – we would prefer the word 'description' to 'summary' – provide sufficient insights and substance relevant to the company concerned so as to enable investors to engage effectively on the issue. For example, the key factors it evaluated: again, this is an area where the FRC could commission guidance to assist audit committees in determining what could be usefully disclosed.

Q17. Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?

1. The approach of regulators and quasi- regulators when there has been a prima-facie breakdown in audit quality often takes an excessive time to reach conclusions and sometimes lacks transparency as to progress. Also the approach can be very expensive for all concerned. This adversely affects the overall audit process. We should like the FRC with other relevant parties to examine ways in which the approach can be fast-tracked so that more timely recommendations and outcomes are delivered.

2. As noted earlier, we are concerned that the current approach to auditor change has the potential to adversely affect the audit process. It is important that this be addressed and in a way that uses the external parties cited in Section 7 to minimise the risks referred to in this question.

March 2007