



# **PROFESSIONAL OVERSIGHT BOARD**

## **REPORT TO THE SECRETARY OF STATE FOR TRADE AND INDUSTRY**

**YEAR TO 31 MARCH 2006**

**Presented to Parliament pursuant to section 46 (6) of, and paragraph 10 of Schedule 13 to, the Companies Act 1989, as amended by the Companies (Audit, Investigations and Community Enterprise) Act 2004.**

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<b>Contents</b>		<b>Page</b>
<b>Chairman's Foreword</b>		<b>1</b>
<hr/>		
<b>One</b>	<b>Introduction</b>	<b>4</b>
<hr/>		
<b>Two</b>	<b>Independent oversight of the recognised supervisory and qualifying bodies</b>	<b>5</b>
<hr/>		
<b>Three</b>	<b>Monitoring the quality of the auditing of economically significant entities</b>	<b>13</b>
<hr/>		
<b>Four</b>	<b>Future work programme</b>	<b>16</b>
<hr/>		
<b>Appendix 1</b>	<b>Statistical Annex on Regulation by Recognised Supervisory Bodies and Recognised Qualifying Bodies</b>	<b>19</b>
<hr/>		
<b>Appendix 2</b>	<b>The POBA Board, 1 April 2005 to 31 March 2006</b>	<b>32</b>
<hr/>		



## Chairman's Foreword

I am delighted to present to you this report on the second full year's work of the Professional Oversight Board for Accountancy (POBA) and the first year in which the Board has worked with statutory responsibilities for audit regulation delegated to it by an Order under the Companies Act 1989.

POBA's remit derives largely from the Government's 'post-Enron' review of the regulatory regime for the accountancy profession which reported in 2003. Three recommendations helped define our role: that POBA should take responsibility for the statutory oversight of audit regulation; that an Audit Inspection Unit as part of POBA should be responsible for monitoring the audits of those entities which have the greatest impact on financial and economic stability; and that POBA should have a wider non-statutory oversight role of the regulatory activities of the principal accountancy bodies for their members generally. To those responsibilities has been added from April this year (and outside the scope of this report) oversight of the regulation of the actuarial profession.

All our work takes place with POBA as a member of the extended family of the Financial Reporting Council. We play a central part in the FRC's overall aim of promoting confidence in corporate reporting and governance, in particular through the objective of promoting high quality auditing in the UK.

I reported last year, in relation to our statutory role, on our preparatory work for taking on the new regulatory powers and responsibilities. I am pleased to be able to report this year on the first full programme of work in which we have monitored the effectiveness of the regulation by recognised bodies of statutory auditors, and of their compliance with the requirements of the Companies Act 1989. We have also carried out a more detailed review of the effectiveness of the bodies' audit monitoring procedures. Whilst we identify a number of areas in which we believe the recognised bodies can improve their arrangements and their practice overall our conclusion is that each of the recognised bodies has adequate systems and practice so as to enable them to fulfil their statutory responsibilities in relation to audit regulation.

There are two other important initiatives integral to our statutory responsibilities which I should mention. We have worked closely with another part of the FRC, the Auditing Practices Board, to develop a better understanding of the drivers of audit quality and to develop new standards and guidance on audit quality. This work continues. We have also played a key role in the work which the FRC has taken forward with DTI during the year to gain a better understanding of competition and concentration in the UK market for major audits, and to help identify policy options, for example to reduce barriers to new entrants. This has led to the publication by the FRC recently of a discussion paper 'Choice in the UK audit market'.

I also reported last year on the results of the first year's inspections by the Audit Inspection Unit at the four largest audit firms – Deloitte, Ernst & Young, KPMG, and

PricewaterhouseCoopers. In 2005/06 the AIU extended its coverage beyond the Big 4 to include full inspections of the other significant firms (the "Mid 5"), who audit a number of listed or major public interest entities. The AIU publishes separately a report each year and in this report we include a summary of the AIU report for 2005/06<sup>1</sup>.

Our work on audit regulation also contributes to POBA's wider remit to oversee the regulation of accountants, which is an integral part of the FRC's overall work programmes. As part of our wish to maintain an understanding of the sector we published in April 2006 an updated version of Key Facts and Trends in the Accountancy Profession.

However, the major piece of work we undertook in the year on this wider remit reviewed how accountants support the needs of small and medium-sized companies and users of their accounts within the current framework of accounting and auditing standards. Our report published in April found that around 85% of small and medium sized entities use some form of external support for their accountancy work. Our interviews with company directors and their accountants found many good and long-standing working relationships, with most directors being content with the accounting and auditing services they obtained. Our report also found that directors of many smaller companies are unclear over the role of professional accountants as well as the various financial accounting and reporting options available to them, particularly following recent changes to audit thresholds. At the same time individuals and companies who are doing business with small companies whose accounts are not audited are often unclear over the role of professional accountants in the preparation of these accounts. The report sets out the steps needed to improve clarity.

I am keen that we do not simply publish reports and make potentially valuable recommendations to the accountancy bodies and then forget about a subject. We have therefore followed up on the recommendations that we made to the accountancy bodies in our first year of operation, including those relating to the training and education of accountants and the complaints and disciplinary arrangements of the main accountancy bodies. Some good progress has been made by the bodies in response to most of our recommendations although more remains to be done. We will actively review and publicly report on progress with the implementation of our recommendations by the bodies.

The international context for much of our work remains an important consideration. At the European level, with the finalisation of a new 8th Directive on audit regulation, we have worked closely with your Department, with the European Commission and with colleagues across the EU to facilitate the adoption of the Directive's provisions, and in particular to plan for the extension of our regulatory role to the auditors of non-EU companies which are traded on UK regulated markets. This is still very much work in progress but the difficulties of finding ways of giving proper effect to the Directive requirements without expensive and cumbersome regulation which is disproportionate to the likely benefits are increasingly

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<sup>1</sup> All the documents referred to are available at <http://www.frc.org.uk/poba/publications/>

apparent. At the global level we have strongly supported the FRC's aim of developing appropriate international mechanisms for cooperation amongst audit regulators at the global level.

I also want to record my thanks to all the members of the Board, whose wide experience and close involvement in POBA's work have stood us in such good stead. There were no changes to the Board in the period of this report.

Finally, the Board changed its name from the Professional Oversight Board for Accountancy to the Professional Oversight Board, though after the period to which this report relates. That change reflects the extension of our remit to include oversight of the regulation of the actuarial profession. For the purposes of this report, however, we continue to refer to the Professional Oversight Board for Accountancy or POBA.

**Sir John Bourn,  
Chairman,  
Professional Oversight Board  
July 2006**

## One – Introduction

1.1 The Professional Oversight Board for Accountancy (POBA) contributes to the Financial Reporting Council's (FRC) aim of promoting confidence in corporate reporting and governance through the objective of promoting high quality auditing in the UK and in particular by providing<sup>2</sup>:

- independent oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies
- monitoring of the quality of the auditing function in relation to economically significant entities
- independent oversight of the regulation of the accountancy profession by the professional accountancy bodies.

1.2 In September 2005 Parliament approved an Order made by the Secretary of State for Trade and Industry under section 46 of the Companies Act 1989 to delegate to POBA most of the Secretary of State's statutory functions for the regulation of audit in the United Kingdom. This report meets the obligation in paragraph 10(1) of Schedule 13 to the Companies Act 1989 to report each year to the Secretary of State on the way in which we have carried out those responsibilities. This report focuses therefore on the statutory part of our work.

1.3 **Section 2** sets out the way in which we have exercised oversight over those accountancy bodies recognised to qualify statutory auditors in the UK and/or to exercise direct supervision over statutory auditors.

1.4 One of the statutory requirements is that the audits of listed and other entities in which there is a major public interest must be subject to monitoring by a body which is independent of the professional bodies. In practice that function is carried out by the Audit Inspection Unit, which is a part of POBA. Section 3 reports on that work.

1.5 **Section 4** comments on our Work Programme for this year, which is an integral part of the FRC's overall Plan and Budget for 2006/07.

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<sup>2</sup> Following a recommendation of the Morris Review of the Actuarial Profession, the remit of the POBA was extended, as of 1 April 2006, to include oversight of regulation of the actuarial profession. POBA then changed its name to the Professional Oversight Board, to reflect these wider responsibilities.

## Two – Independent oversight of the recognised supervisory and qualifying bodies

2.1 Following the Companies Act 1989 (Delegation) Order 2005, POBA is responsible for the recognition, de-recognition and regular monitoring of supervisory and qualifying bodies for audit in the UK. Audit firms who wish to be appointed as a company auditor in the UK must be registered with, and subject to supervision by, a recognised supervisory body (RSB). Individuals responsible for audit at registered firms must hold an audit qualification from a recognised qualifying body (RQB).

2.2. The following are both RSBs and RQBs:

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

In addition:

- Association of Authorised Public Accountants (AAPA) is an RSB
- Association of International Accountants (AIA) is an RQB
- Chartered Institute of Public Finance and Accountancy (CIPFA) is an RQB

### RSB and RQB monitoring

2.3. Our oversight of the regulatory activities of the RSBs/RQBs is discharged in three ways;

- documenting and understanding each body's regulatory systems including information on how it complies with relevant legislation
- annual compliance testing of the operation of the regulatory systems
- periodic evaluation of the effectiveness of a specific aspect of the regulatory system including complaints and discipline procedures, monitoring visits, audit registration procedures, moderation of examinations, syllabus coverage, overall examination standards, training requirements, monitoring of approved training practices.

2.4. We have visited each RSB and RQB in the current year. For all the bodies except CIPFA, we have updated our documentation of the regulatory systems operated by each body and have tested both the application of those systems and compliance with statutory requirements. CIPFA only became an RQB in July 2005 and therefore was not subject to detailed monitoring, as it had no students training for the audit qualification.

2.5. The main RSB systems are for the registration of audit firms and those responsible for audit at those firms, for monitoring the work of registered firms, handling complaints and member discipline, and for maintaining registrants' professional competence. The main RQB

systems are for registering students, tracking their progress, the provision of courses of theoretical instruction, administering examinations and ensuring that students gain appropriate and sufficient work experience.

2.6. Our primary conclusion is that each of the bodies complies with the requirements set out in the Companies Act and has adequate systems for the fulfilment of its responsibilities under the Act. As a result there is no reason to withdraw recognition for any of the recognised bodies.

2.7. We have reported the results of the testing to each body and have agreed plans of action where suggestions for improvements have been identified. The key themes where the need for improvement was identified are set out below.

2.8. As part of our oversight of the regulatory activities of both RSBs and RQBs, we asked the bodies to provide an annual regulatory report which would include statistical information on their regulatory activities during the year. Appendix 1 sets out the main elements covered in those reports. It includes, where appropriate, explanations provided by the bodies themselves for year on year changes in the statistical regulatory information.

2.9. We have also clarified with each RQB and RSB how it has interpreted those Companies Act requirements on RSBs and RQBs where there is possible uncertainty. For example the requirement that "part" of the three years practical training must be "training in company audit or similar audit work" has generally been interpreted to mean that one year of the three years must be spent training in such work. We plan to review and report on these interpretations in due course.

## **Recognised supervisory bodies**

2.10. We set out below those issues arising from POBA's systems testing and review at each of the RSBs during the year ended 31st March 2006. These are summarised in two categories: A) Issues identified across all RSBs and B) Issues identified at some RSBs. We include our recommendations and comments on best practice. It is for the bodies to give effect to these and we will follow up their actions as part of our 2006/07 work, to ensure that issues we have identified are addressed or sufficient progress in addressing them has been achieved.

### ***A) Issues identified across all RSBs:***

#### **I) Flow of regulatory information**

2.11. It is important that the RSBs have all necessary information to carry out their operations and decisions including the issuing of licences and registrations. We noted that the flow of information between RSBs and RQBs both within individual bodies and between

bodies could improve. Whilst we acknowledge that the bodies compete in some areas, and that the human rights of individuals must also be respected, we consider that the maximum effective exchange and flow of regulatory information between bodies allowable within the law should not be hindered by competition between the bodies. The bodies should ensure the interfaces between their own departments work as smoothly and efficiently as possible. The improved flow of information will help to ensure operations and decisions are supported and reached with full information and in the public interest.

## II) Continuous professional development (CPD)

2.12. There have recently been changes to many of the bodies' requirements for individual members' CPD. In some cases the requirement has been extended to all members, where previously it had only applied to those working in regulated areas such as audit. Some bodies have also moved to measuring CPD on an output basis, focussed on competencies achieved rather than on the number of hours of training courses. Measuring CPD on an output basis has the benefit of ensuring that the training is relevant and successful to the member concerned. However, it can be more difficult to monitor outputs as compared to inputs. We have drawn to the attention of the bodies the challenge of verifying output based CPD to ensure that those responsible for audit work at firms continue to maintain their technical competence in accordance with the Companies Act requirement.

## III) Use of databases to confirm audit clients

2.13. Monitoring staff at the bodies and at POBA have identified cases where member firms submit incomplete information with respect to their number of audit clients. This information is important, as it can determine whether the firm should be visited by the RSB's monitoring unit. To ensure that inspectors have accurate details of the number of audits the firm in question has undertaken, we have recommended that the bodies complete a search on an appropriate database that collates information submitted to Companies House. This search should form part of the planning procedures conducted prior to a visit. The additional information may highlight any material discrepancies between the information submitted by the member firm and the actual number of audits conducted to facilitate appropriate action. Furthermore, the information may indicate instances where the identity of the audit firm has been stolen.

## ***B) Issues identified at some RSBs:***

### IV) Membership of the AIDB Scheme

2.14 Privy Council approval of changes to one the body's bye-laws is still needed to enable that body to participate in the disciplinary scheme of the Accountancy Investigation and Discipline Board. The body concerned is aware of the urgency of the matter given that it is a requirement of the Companies Act that the body participates in independent disciplinary arrangements.

### V) Registrants' respect of body's regulatory authority

2.15. A very small minority of registered auditors were found not to be taking the authority of their body's regulatory function as seriously as POBA would expect. This included instances where conditions or restrictions set by the registration committee were not followed, of non-cooperation with the audit monitoring unit or complaints and investigations departments and of submitting inaccurate information on annual returns. The bodies must be robust and effective in their response to such cases. Such behaviour by members of a professional body brings the appropriateness of their membership into question.

### VI) Resources for regulatory functions

2.16. Staffing issues at one body resulted in inadequate resource being available to deal with regulatory matters in the area of complaints for a short period in the year reviewed. The body is not applying adequate resources and is taking further measures to ensure that such a situation does not arise again.

### VII) Consistency of procedures

2.17. During the systems testing undertaken by POBA, we identified cases where procedures at some of the bodies were not applied consistently to all members. Each body should ensure that its procedures are applied in a consistent way.

### VIII) Recording of the justification of gradings

2.18. Some of the gradings of the outcomes of monitoring visits rely to a large degree on the inspector's judgement of the overall quality of the firm's work and the firm's willingness and ability to action any agreed improvements. This judgement, and the justification of the overall

grading, should be recorded in detail, especially where a high number of issues with a firm's work are identified, but the overall standard of work is deemed satisfactory.

#### IX) Effectiveness of measures taken following inspection visits

2.19. Our work showed that some bodies did not record details of the measures taken following audit monitoring inspections. Furthermore, the effectiveness of the agreed plans was not tracked to determine the success of specific proposals. Details of agreed plans of actions between the body and the audit firm and any conditions or restrictions imposed by the body on the audit firm should be recorded and compliance monitored.

### **Recognised qualifying bodies**

2.20. We set out below those issues arising from our systems testing and review at each of the RQBs during the year ended 31st March 2006. These are summarised in two categories: A) Issues identified across all RQBs and B) Issues identified at some RQBs. We include our recommendations and comments on best practice. It is for the bodies to give effect to these and we will follow up their actions as part of our 2006/07 work, to ensure that issues we have identified are addressed.

#### ***A) Issues identified across all RQBs:***

##### I) Approval of firms to offer audit training

2.21. The Companies Act requires that practical training is given by persons approved by the body. The process for approving and monitoring audit firms which provide training for the recognised qualification varies in approach and detail. We have no difficulty with this in principle. However, monitoring visits to approved firms must be capable of confirming that the training provided by the firms is adequate, as required by the Act. We believe that the visit should also promote best practice in training. All the bodies could benefit from a dual approach to monitoring: as well as confirming the compliance of firms with the undertakings they have given to the RQB, the visits should help the firms by suggesting improvements to promote best practice in training.

## ***B) Issues identified at some RQBs:***

### II) Resources for regulatory functions

2.22. One body does not, in our view, devote adequate resource to the authorisation and monitoring of approved training firms. The body is working with POBA to address this issue.

2.23. In addition, we concluded that all authorised training firms should be visited regularly so that all firms have access to developments in training requirements and can be informed of any relevant regulation changes, such as the recent changes to the body's CPD requirements. At present some bodies do not visit all authorised training firms on a timely basis.

### III) Theft of examination scripts

2.24. One body suffered a theft of unmarked examination scripts which resulted in students having to retake the examination. The body commissioned an independent report into the circumstances of the theft and will implement the findings of the report. As an example of a useful flow of information on regulatory matters, we have recommended that the body shares the report's conclusions and recommendations with the other RQBs, so that they can guard against any similar occurrence.

### IV) Narrative commentary on training records

2.25. Some of the bodies require little or no narrative commentary on the practical training records of a student from the Training Principal who is responsible for signing off the student's training. We have recommended that the bodies require both students and those signing their training records to give narrative detail of the training undertaken, the benefits gained and the competencies demonstrated for each subsection of the training period (e.g. each year or 6-month period).

### V) Inadequately completed training records

2.26. Our compliance testing highlighted cases where students' training records had not been completed with appropriate care and attention. In these cases the team responsible for monitoring training firms at a body should be notified so that an early monitoring visit can be scheduled and the matter addressed with the Training Principal.

## VI) Level of detail of approved training firm inspection visit reports

2.27. The reports written by the inspectors of approved training firms following monitoring visits must contain sufficient detail of the firm's training to allow a third party at the body to assess the adequacy of the training provided. We concluded that some of the bodies' current report formats are too brief and lack adequate detail.

## Review of the audit monitoring activities of the RSBs

2.28. In addition to testing the application of the regulatory systems operated by each body, POBA has undertaken an in-depth review of the audit monitoring activities of the RSBs<sup>3</sup>.

2.29 The Companies Act requires monitoring by the RSBs of audit firms' compliance with the RSB's audit regulations. All the bodies have monitoring units which visit audit firms on a cyclical basis to review the quality of audit work. The inspector reports the outcome of the visit to the body's relevant committee, which decides whether to continue to register the firm and whether any conditions or restrictions are necessary.

2.30 Following this review, we believe the arrangements and the resources applied by the bodies for monitoring fulfils the requirement set out in the Companies Act, Schedule 11, Para 10 (1). However, the review identified areas where the monitoring approach or application of the approach could be improved. These improvements are detailed within the body of the report and, in our opinion, will help to promote further confidence in the work of the profession.

2.31. The key recommendations are:

### I) Tailoring monitoring approach for practices with few audit clients

2.32. As a result of the rise in the audit threshold, the number of firms applying for audit registration is falling, as is the average number of audit clients per firm. The bodies should consider the effect of these changes on the monitoring resources devoted to practices of different sizes and tailor their approach accordingly. We observed that the time and resources spent monitoring smaller firms with a relatively large number of audit clients is not significantly different from the time and resources spent at a smaller firm with very few audits. The number of files selected by an inspector at each visit tends not to vary, other than at the largest firms. We would therefore encourage the bodies to segment firms according to size so that resources can be allocated most effectively.

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<sup>3</sup> <http://www.frc.org.uk/poba/publications/>

## II) Detailed reviews of the audit client's financial statements

2.33. We concluded that the bodies should include a detailed review of the audit client's financial statements and notes as part of the audit file review within the monitoring process. This serves two purposes. First, it confirms the outcome of the auditor's work by assessing the product on which the public places reliance i.e. the audited accounts; and secondly it allows the monitors to make their own assessment of the critical transactions and balances and of potential risk areas which should be the focus of the auditor's work. They can then review the audit work performed and recorded in these key risk areas.

## III) Clearer guidance on the grading of visits

2.34. We concluded that the bodies should produce clearer guidance for inspectors, firms and the registration committees on the gradings of visits. We also concluded that it would be helpful if examples of previous cases with justification of the grading were given to the registration committees to provide a guide for similar cases in the future. Such explanations as to why a specific grade has been given will provide greater clarity for reviewers and the registration committee and will help to ensure consistency across the individual reviewers at each body.

2.35. We expect the bodies to implement our recommendations in a timely way. We will review the extent to which they have been put into effect during our annual compliance review in 2006/7 and will comment on this in our next Annual Report.

## **Three - Monitoring the quality of the auditing of economically significant entities**

### **Background**

3.1 The AIU is responsible for the monitoring of the audits of all listed entities and other entities in whose financial condition there is considered to be a major public interest. By monitoring and promoting improvements in audit quality, it contributes to the FRC's overall aim of promoting confidence in UK corporate reporting and governance. The AIU's monitoring approach is intended to be challenging for the firms focusing on audit partners' judgements as well as audit processes.

3.2 The first annual report, published in June 2005, covered audit inspections of the Big Four firms and their audits of companies in the FTSE 100 and 250 indices. The second annual report from the AIU covers reviews of audits within their full remit and is based on their work on the second year inspections at the Big Four firms<sup>4</sup> and first year inspections at five Other Significant firms<sup>5</sup>. With a few exceptions, the audits reviewed by the AIU were for financial periods ended prior to 31 December 2005. Thus, their second annual report does not cover reviews of audits of financial statements prepared in accordance with International Financial Reporting Standards (IFRS) nor audits conducted in accordance with International Standards on Auditing (ISAs) (UK and Ireland).

### **Quality of Individual Audits Reviewed**

3.3 The AIU's review of individual audits should be set in context. The Big Four firms have a dominant market share in the audit of larger listed companies auditing 99% of the FTSE 100 and 97% of the FTSE 250. Accordingly the Other Significant firms have relatively few audits within scope and subject to review by the AIU. The level of resources and depth of expertise in specialist areas required to audit the largest and most complex groups influences the extent to which the Other Significant firms seek to compete for such work.

3.4 The audits the AIU reviewed at both groups of firms had, in their view, generally been conducted to a high or acceptable standard. There were a small number of audits in both groups which, in the AIU's view, had not been carried out to an acceptable standard.

3.5 The AIU concluded that the key audit judgements which they challenged were generally both appropriate and soundly based. Where the rationale for such judgements was inadequately documented, it reached this view after taking into account oral explanations provided by the firms. There continues to be a need for significant improvement in the quality

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<sup>4</sup> Deloitte & Touche LLP, Ernst & Young LLP, KPMG Audit Plc and PricewaterhouseCoopers LLP.

<sup>5</sup> The five other UK firms which audit a significant number of entities within scope are Baker Tilly, BDO Stoy Hayward LLP, Grant Thornton UK LLP, PKF (UK) LLP and RSM Robson Rhodes LLP.

of the firms' documentation of the rationale for key audit judgements made in reaching the audit opinion.

### **Further progress required in implementing the AIU's recommendations**

3.6 The AIU reported last year that, while no systemic weaknesses in the Big Four firms' overall quality control systems had been identified, improvements were needed in certain areas. In their second year inspections of the Big Four firms the AIU were encouraged by the seriousness with which issues raised by them had been treated by the firms' leadership and the evidence at senior levels of the impact their work was having within the firms.

3.7 The AIU's second year inspections indicated that satisfactory progress had been or is being made by some or all firms in a number of these areas. However, only limited progress had been made in other areas. In areas where cultural changes within the firms appear to be required, it is recognised that improvement takes time. However, the AIU will expect to see clear evidence of significant improvement in certain areas during their next inspections. These areas include, in particular, the extent to which the overriding importance of audit quality is reflected in the firms' human resource processes.

3.8 All the Big Four firms have the resources and capability to undertake audits on the largest scale. They also have the necessary resources to implement effective systems in response to changes to the regulatory framework on a timely basis. The AIU identified some areas, primarily in relation to the new Ethical Standards, where such systems were not fully effective at all the firms on a timely basis.

### **Findings for Other Significant Firms**

3.9 Many of the issues identified in the first year inspections of the Other Significant firms were of a similar nature to those reported last year in relation to first year inspections of the Big Four firms. These issues included, in particular, the need to focus on audit quality in developing the firms' strategies and human resource systems. Due to the nature of their client bases, some of the challenges, such as succession planning on major audits, faced by the Big Four firms do not apply to the same extent to the Other Significant firms. The Other Significant firms are a less homogenous group and the significance of the AIU findings and recommendations varied considerably between the firms.

3.10 The level of resources available to the Other Significant firms, though generally appropriate to their size and market focus, is significantly less than those available to the Big Four firms. There were major changes to the regulatory framework for auditing in the UK during the year. It was apparent that the technical and other central resources required to implement these changes on a timely basis had been stretched in some of the Other Significant

firms. While some were coping well with the extent of change, and had taken action to increase resources in certain areas, other firms in this group had been slower to respond.

### **Audit registration**

3.11 Based on its work, the AIU consider the quality of auditing in the UK to be fundamentally sound. Subject to the agreement of satisfactory action plans by firms in response to the AIU's recommendations they anticipate recommending the continued audit registration of all Big Four and Other Significant Firms inspected.

### **Assessing and Reporting on Progress**

3.12 The AIU will carry out further annual inspections at each of the Big Four firms and full or interim inspections at Other Significant firms in the coming year. During those inspections the AIU will be assessing the progress made by each of the firms against the action plans agreed. The AIU intend to report publicly on their assessment of the progress made by the firms in their next annual report.

3.13 We are currently consulting as to whether any changes to the arrangements for public reporting by the AIU should be made for the future<sup>6</sup>.

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<sup>6</sup> The consultation document, *Reporting on Audit Quality Monitoring (June 2006)*, is available at <http://www.frc.org.uk/poba/publications/>

## **Four – 2006/07 Work Programme**

4.1 Our work programme for the year to 31 March 2007 continues to reflect our three important functions – statutory independent oversight of the UK system of audit regulation, independent monitoring of the quality of the audits of major public interest entities, and broader non-statutory oversight of the regulation of the accountancy profession. However, as noted earlier in this Report, to these responsibilities is now added oversight of the regulation of the actuarial profession and our work programme reflects this.

4.2 There are changes of emphasis in our work. Our audit monitoring activities extend beyond the nine largest audit firms for the first time; and, in relation to the audit regulatory activities of the professional bodies, we have our first opportunity to see how the recognised bodies respond to our earlier recommendations.

4.3 POBA's work programme is an integral part of the Financial Reporting Council's Plan and Budget for 2006/07<sup>7</sup>.

4.4 We draw out the major themes below.

### **1. Statutory oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies**

4.5 We will follow broadly the same approach as last year to monitoring the application of the systems for the regulation of auditors by the RSBs and RQB's - that is we will test both the appropriateness of the bodies' systems for regulation and the way in which they work in practice. A particular focus will be to consider the ways in which the bodies have responded to the recommendations summarised in Part 2 of this Report.

4.6 We propose to review in greater detail and report publicly on the RQB's procedures and practices for the practical training of statutory auditors, including their approval of and oversight of training firms. We are also consulting on new requirements, resulting from the 8th Company Law Directive, that the auditors of public interest entities should publish annual transparency reports including information on their organisation and network arrangements, finances and their arrangements and procedures to ensure audit quality.

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<sup>7</sup> This is at <http://www.frc.org.uk/>.

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

4.7 For 2006/07 the AIU is further extending its coverage. Whilst most of the inspection work will again be at the nine largest firms, the AIU will also review a selection of specific audits of public interest entities conducted by other audit firms. This expansion of coverage will complete the implementation of the new independent inspection arrangements envisaged in the DTI Review of the Regulatory Regime of the Accountancy Profession published in January 2003.

4.8 We have also recently issued a consultation paper setting out the advantages and disadvantages of extending the level of public reporting by the AIU.

## **3. Wider oversight of regulation of the accountancy profession**

4.9 We will continue to work with the bodies to support their implementation of the recommendations from our reviews of complaints and disciplinary matters, training and education of accountants, and the accountancy and auditing needs of small and medium-sized companies.

4.10 We will complete our work with the Auditing Practices Board to develop, for consultation, a paper on the key drivers of audit quality, with a view to developing authoritative guidance on this matter. We will also continue to play a key role in the FRC's work to facilitate a debate over the public interest issues that may arise from the existing competitive environment for audit services to large limited companies in the UK and how they might be addressed.

## **4. International Priorities**

4.11 We continue to support the FRC aim of establishing an International Forum of Audit Regulators; and, on audit inspection, we are developing ways of working cooperatively on a bilateral basis with regulators in other countries, such as the PCAOB in the US, to minimise costly overlapping regulation and to share best inspection practice internationally.

4.12 A major focus for POBA in 2006/07 will be to take forward plans for implementation of the new EU 8th Directive on statutory auditors, which came into effect at the end of June with a two year period for Member States to implement. This requires close working and cooperation with the DTI, and with the European Commission and other Member States through the European Group of Auditor Oversight Bodies. It will be particularly challenging to put in place arrangements which meet the Directive's requirements but are not over-burdensome or expensive in relation to the benefits, and do not unnecessarily detract from UK capital markets.

## **5. Oversight of the actuarial profession**

4.13 We took on our new oversight role in relation to the regulation of actuaries at the beginning of April. Our priorities for 2006/07 are:

- evaluating and reporting on the profession's progress in implementing the recommendations of the Morris Review of the Actuarial Profession, published in March 2005;
- working with the profession to understand its regulatory systems and develop our longer-term methodology for overseeing them;
- assessing and reporting on the availability of information about actuaries and the profession, with a view to improving transparency;
- preparing for a review of monitoring and scrutiny of the quality of actuarial work after two years, as recommended by the Morris Review.

## Appendix 1

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

#### A) Audit Registration

	ACCA	ICAEW <sup>8</sup>	ICAI	ICAS
<b>Number of audit firms</b>				
As at 31.12.05	2,968	5,193	1,044	343
As at 31.12.04	3,053	5,475	1,048	374
As at 31.12.03	3,083	6,336	1,046	423
<b>Number of Office locations, as at 31.12.05</b>				
1	2,656	4,126	975	278
2-3	299	947	64	50
4-10	12	103	5	13
10+	1	17	0	2
<b>Number of Office locations, as at 31.12.04</b>				
1	2,739	4,502	977	305
2-3	302	850	66	54
4-10	11	106	5	14
10+	1	17	0	1
<b>Number of Office locations, as at 31.12.03</b>				
1	2,789	5,375	974	353
2-3	283	837	67	54
4-10	10	106	5	14
10+	1	18	0	1
<b>Number of Principals, as at 31.12.05</b>				
1	2,170	2,822	679	166
2-6	771	2,111	682	157
7-10	21	147	12	12
11-50	6	99	9	7
50+	0	14	3	1

<sup>8</sup> The ICAEW figures are for those firms that were going to be registered as at 1<sup>st</sup> January the following year.

	ACCA	ICAEW <sup>9</sup>	ICAI	ICAS
<b>Number of Principals, as at 31.12.04</b>				
1	2,238	3,067	702	185
2-6	787	2,140	322	170
7-10	21	159	14	12
11-50	7	96	9	7
50+	0	13	1	0
<b>Number of Principals, as at 31.12.03</b>				
1	2,253	3,800	693	220
2-6	806	2,255	330	183
7-10	17	163	13	13
11-50	7	103	9	7
50+	0	15	1	0
<b>Number of new applications<sup>10</sup></b>				
Yr to 31.12.05	151	290	25	22
Yr to 31.12.04	157	319	45	11
Yr to 31.12.03	125	462	50	7
<b>Number of applications refused<sup>11</sup></b>				
Yr to 31.12.05	0	1	0	0
Yr to 31.12.04	0	0	2	0
Yr to 31.12.03	0	0	0	0

All bodies report a fall in the number of registered firms as a result of the increase in the audit threshold and firms no longer requiring audit registration. The fall also reflects mergers of firms and an increase in regulatory costs. The change in the number of audit registrations is less pronounced for the ICAI, reflecting perhaps the smaller increase in the audit threshold in the Republic of Ireland (from €317,434 to €1,500,000).

The above data includes firms that retain their audit registration, even though they do not at present have audit clients.

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

<sup>10</sup> New applications include those firms who are changing status e.g.: to LLP

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

## B) Audit Monitoring

Following recognition in 1991 the Recognised Supervisory Bodies started monitoring their member firms. The three territorial Institutes formed a single Joint Monitoring Unit (JMU) and the ACCA set up a separate monitoring department. From 1st January 2005 the JMU was disbanded and the monitoring of firms was undertaken by each Institute independently. The ICAEW's Quality Assurance Directorate assists the ICAI on visits to larger firms.

The Audit Inspection Unit (AIU) was set up following the government's post Enron review of the regulation of the UK accountancy profession. The AIU monitors the auditors of all listed and other major public interest entities (see Section 3).

The population of firms monitored each year will be different and the number of firms monitored is not necessarily sufficient to compare the data year on year. The new EU 8th Directive requires RSBs to monitor all firms at least once in six years and therefore targets will need to reflect this.

	ACCA	ICAEW	ICAI	ICAS
<b>Number of firms monitored</b>				
Actual 2005	462	905	55	63
Target 2005	Not available	900	50	50
Actual 2004	432	990	64	45
Target 2004	Not available	904	50	45
Actual 2003	456	916	45	67
Target 2003	Not available	889	50	62
<b>Actual firms monitored as a % of audit registrants</b>				
2005	15.6%	17.4%	5.3%	18.4%
2004	14.3%	18.1%	6.1%	12.0%
2003	14.8%	14.5%	4.3%	15.8%

	ACCA	ICAEW	ICAI	ICAS
<b>2005</b>				
Number of firms monitored following a request by the registration/ licensing committee	47	40	4	1
Number of firms with public interest entities visited without AIU <sup>12</sup> involvement	0	39	5	0
Number of firms specifically selected due to heightened risk	70	742 <sup>13</sup>	37	59
Number of firms randomly selected	345	84	9	3
<b>2004</b>				
Number of firms monitored following a request by the registration/ licensing committee	53	48	12	0
Number of firms with public interest entities visited without AIU involvement	0	35	4	0
Number of firms specifically selected due to heightened risk	68	828	42	37
Number of firms randomly selected	315	79	6	8
<b>2003</b>				
Number of firms monitored following a request by the registration/ licensing committee	39	55	5	0
Number of firms specifically selected due to heightened risk	84	721	4	2
Number of firms randomly selected	333	82	6	10

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

<sup>13</sup> Within the ICAEW figure of firms selected due to heightened risk, 281 firms were included as they had not been visited in the previous six years.

## Gradings

The grading process and definition of grades of each body varies. It is therefore not appropriate to use the gradings to compare audit quality between firms registered with the different bodies. Whilst particular care is also needed in interpreting the percentage of “D” outcomes at each body, in general we believe that the percentage of “D” outcomes provided by all the bodies illustrates a commitment to improving audit quality.

The tables below show the gradings for the four bodies for all visits conducted from 2003-2005.

### ACCA

	2005	2004	2003
Number of A & B outcomes	271	247	252
% of A & B outcomes compared to all visits conducted	59	57	55
Number of C+ outcomes	63	55	43
% of C+ outcomes compared to all visits conducted	14	13	10
Number of C- outcomes	60	50	60
% of C- outcomes compared to all visits conducted	6	11	13
Number of D outcomes	98	84	101
% of D outcomes compared to all visits conducted	21	19	22

ACCA grades visits A-D. Those that are graded 'A' are judged to be satisfactory and comply with ACCA's practising regulations and APB's auditing standards. Those visits rated B are deemed to be acceptable 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 second visit will be graded a 'D' and the report will be referred to the Admissions and Licensing Committee (ALC) and/or the Professional Conduct department. The gradings of a visit are not based solely on the standard of audit work and the outcome could be deemed unsatisfactory due to the breach of client money rules or CPD regulations.

In 2005 47 visits were carried out on the order of the ALC. Of these, 40 firms were found to have improved their procedures so that their compliance with auditing standards was satisfactory.

## ICAEW

	2005	2004	2003
Number of A & B outcomes	630	654	517
% of A & B outcomes compared to all visits conducted	73	65	63
Number of C outcomes	194	255	208
% of C outcomes compared to all visits conducted	22	25	25
Number of D outcomes	44	98	102
% of D outcomes compared to all visits conducted	5	10	12

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. In addition QAD believe that the firm has the ability to take action within the stated timescale and that they have the commitment to take the agreed action. A 'C' rated report records instances of non compliance with the audit regulations where the QAD believes that there is a need for follow-up action, due to 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 any further conditions or restrictions. 'D' rated visits record cases of non compliance with the audit regulations that needs to be considered by the ARC.

The proportion of D-graded visits has substantially decreased in 2005, as compared to the two previous years. The ICAEW explained that there were four aspects to this:

- a) The population of firms visited differed.
- b) There has been a general improvement in the ratings year on year as a result of the work undertaken by the QAD. This trend may have also been influenced by the increase in the audit exemption limits, the resulting consolidation of the profession and the perceived concentration of skills among a smaller group of responsible individuals.
- c) Approximately one third of firms visited in 2005 were visited as part of an initiative, requested by the ARC, to visit all firms which had been registered for over 6 years, but not previously visited by the JMU or QAD. The main reason why these firms had not been previously visited is they did not have a sufficiently high risk score to justify or

require a visit. The combined total of 'C' and 'D' ratings from this group was 22%, compared to 27% for all firms inspected.

- d) 9 firms voluntarily surrendered their registrations while the QAD was conducting their visit. These firms were rated as 'A' or 'B' visits as QAD believed there to be no outstanding issues and no further action required.

## ICAI

	2005	2004	2003
Number of A & B outcomes	15	19	19
% of A & B outcomes compared to all visits conducted	27	30	42
Number of C outcomes	28	23	14
% of C outcomes compared to all visits conducted	51	36	31
Number of D outcomes	12	22	12
% of D outcomes compared to all visits conducted	22	34	26

The explanations of A-D gradings for the ICAI are the same as those for the ICAEW. As the number of visits undertaken for the ICAI is small, the fluctuations year on year are not statistically significant, as a slight change in the absolute figure will result in a significant change in the percentage.

## ICAS

	2005	2004	2003
Number of A & B outcomes	35	29	36
% of A & B outcomes compared to all visits conducted	56	65	54
Number of C outcomes	17	14	25
% of C outcomes compared to all visits conducted	27	31	37
Number of D outcomes	11	2	6
% of D outcomes compared to all visits conducted	17	4	9

ICAS noted that it was difficult to compare the gradings year on year as different firms were visited and due to the small number of firms visited variations year on year are high.

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 adequately addressed 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 the appropriate follow up action, such as imposition of conditions and restrictions or withdrawal of registration.

The main difference in ICAS' year on year statistics is in the mix between 'C' and 'D' reports. ICAS note that this is explained in part by the increase in the number of risk driven visits (95% in 2005 compared to 82% in 2003).

### C) Complaints about Auditors

	ACCA	ICAEW	ICAI	ICAS
<b>Number of new cases<sup>14</sup></b>				
2005	13	65	83	4
2004	23	57	67	1
2003	23	67	76	2
<b>Number of cases passed to the AIDB</b>				
2005	0	1	0	0
2004	1	1	0	0
<b>Number of cases passed to committee<sup>15</sup></b>				
2005	9	43	18	4
2004	10	32	24	2
2003	9	33	22	1
<b>Number of complaints<sup>16</sup> closed in the year</b>				
2005	13	69	66	0
2004	20	64	72	2
2003	41	69	85	0
<b>Average time taken to close a complaint</b>				
2005	5 months	17 months	Not available	For cases closed by the Investigations committee = 80 days
2004	5.9 months	12 months	Not available	For cases closed by the Investigations committee = 80 days
2003	7 months	10 months	Not available	Not available

ACCA is the only body who saw a fall in the number of audit related complaints in 2005 compared to prior years. ACCA noted that this may be related to a reduction in the amount of audit work carried out by ACCA members following an increase in the audit threshold.

<sup>14</sup> Cases relate to 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 ICAI and D) the Investigation committee at ICAS.

<sup>16</sup> Complaints relate to audit related complaints only

The ICAEW explained that the increased average time to handle complaints in part reflected the fact that a number of long running and difficult cases were brought to a close in 2005. These all involved lengthy preparation for the Disciplinary Committee.

## D) Student Registration<sup>17</sup>

	ACCA	ICAEW	ICAI	ICAS
<b>Number of new students</b>				
2005	19,981	4,075	1,201	1,020
2004	18,880	3,590	1,090	888
2003	18,235	3,186	978	796
<b>Total number of students</b>				
2005	79,513	10,364	3,880	2,636
2004	73,839	8,445	3,167	2,497
2003	67,665	8,694	Not available	2,431
<b>Number of students who became members</b>				
2005	3,111	2,554	890	Not available
2004	3,394	3,077	657	Not available
2003	3,489	3,166	648	687
<b>Number of members who became audit qualified</b>				
2005	171	172	79	42
2004	179	164	71	19
2003	368	204	69	Not available

The number of new students at all bodies rose in 2005. This can be explained in part by an increase in demand for qualified accountants in response to the rise in regulatory requirements (e.g. Sarbanes Oxley, IFRS). Furthermore the general upturn in the business world has meant that the firms are recruiting more staff.

The proportion of students who become members is considerably lower for the ACCA than for the territorial Institutes, where the number of students who become members is similar to the related student intake.

The table also shows the number of members that became audit qualified. The number of members who become audit qualified is low, compared to the number of students passing the examinations and becoming members. Although a greater proportion of members are entitled to this, the bodies do not offer this automatically and the member has to apply. A large number of members never require the audit qualification and therefore do not apply for it. Proactive notification by the bodies would provide an opportunity for the professional bodies to communicate with their members.

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<sup>17</sup> UK and Republic of Ireland

## E) Registered Training Offices

	ACCA	ICAEW	ICAI	ICAS
<b>Number of registered training offices</b>				
2005	4,518	2,503	713	199
2004	4,474	2,350	667	193
2003	4,429	2,339	620	201
<b>Number with students in training</b>				
2005	Not available	1,423	443	Not available
2004	Not available	1,414	397	Not available
2003	Not available	1,307	Not available	Not available
<b>Number with students training for the audit qualification</b>				
2005	3,786	1,423	Not available	Not available
2004	3,874	1,414	Not available	Not available
2003	3,886	1,307	Not available	Not available
<b>Number of new applications</b>				
2005	Not available	142	36	11
2004	Not available	159	46	18
2003	Not available	159	47	10
<b>Number of applications refused</b>				
2005	Not available	98	Not available	0
2004	Not available	95	Not available	0
2003	Not available	90	Not available	0
<b>Number of registrations withdrawn</b>				
2005	158	3	Not available	5
2004	109	0	1	27
2003	104	0	1	11
<b>Number of approved training offices visited</b>				
2005	643	289	22	42
2004	848	389	23	47
2003	760	400	Not available	39
<b>Number of approved training offices visited as a % of the total</b>				
2005	14.2%	11.5%	3.1%	21.1%
2004	19.0%	16.6%	3.4%	24.4%
2003	17.2%	17.1%	Not available	19.4%

The number of registered training offices in the UK has continued to grow over the past 3 years. One explanation is that the increase in demand for Chartered Accountants and Chartered Certified Accountants has increased the demand for authorised training firms. The bodies have seen an increase in the demand for training offices outside public practice.

The statistics show that the bodies monitored fewer approved training firms in 2005 than in the previous year. We have highlighted the need for one of the bodies to increase resources in this area, and for all of the bodies to ensure that training offices are monitored on a regular basis (See paragraphs 2.20 and 2.22).

## **Appendix 2**

### **PROFESSIONAL OVERSIGHT BOARD FOR ACCOUNTANCY**

1 April 2005 to 31 March 2006

#### **Chair**

Sir John Bourn KCB  
Comptroller and Auditor General

#### **Members**

Richard Barfield

Director of Equitas, Umbro plc. and a number of investment trusts. Formerly Chief Investment Manager of Standard Life in Edinburgh

Tim Barker

Director, Drax Group plc and Electrocomponents plc. Chairman Robert Walters plc. Formerly Vice Chairman of Dresdner Kleinwort Benson

David Crowther

Formerly a senior partner, PricewaterhouseCoopers LLP, responsible for quality assurance and risk management. Director, TT Electronics plc. Member of the Board of the Financial Ombudsman Service

Hilary Daniels

Chief Executive, West Norfolk Primary Care Trust

Roger Davis

Formerly a partner and Head of Professional Affairs, PricewaterhouseCoopers LLP  
Member of the Competition Commission

Stella Fearnley

Professor of Accounting, University of Portsmouth

Paul George

Director, Professional Oversight Board for Accountancy

Michael Jones

Head of Management Services & Administration, Trades Union Congress

Anne Maher

Chief Executive, The Pensions Board for Ireland. Board member of the Irish Accounting and Auditing Supervisory Authority





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