



PROFESSIONAL OVERSIGHT BOARD

REPORT TO THE SECRETARY OF STATE FOR BUSINESS, ENTERPRISE & REGULATORY REFORM

YEAR TO 31 MARCH 2007

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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Chairman's Foreword

I am pleased to report to you on the work of the Professional Oversight Board for the year to 31 March 2007. The Board has now been in existence for just over three years and 2006/07 was the second full year in which the Board exercised statutory responsibilities for the oversight of audit regulation.

Our responsibilities derive principally from the Government's 2003 'post-Enron' review of the regulatory regime for the accountancy profession which reported in 2003. In particular they flow from three recommendations: that an Oversight Board should take responsibility for the statutory oversight of audit regulation; that an Audit Inspection Unit as part of the Oversight Board should be responsible for monitoring the quality of audits of those entities which have the greatest impact on financial and economic stability; and that the Oversight Board should have a wider non-statutory oversight role over the regulatory activities of the principal accountancy bodies in relation to their members generally.

Oversight of the regulation of the actuarial profession was added to our responsibilities in April 2006, following the Morris Review of the Actuarial Profession. That work is well under way. Strictly speaking it falls outside the scope of this report, and we therefore comment only briefly in Chapter 5 on what we have done and are doing.

A major part of the work on which we report concerns our oversight of audit regulation. This involves updating our understanding of each body's regulatory systems, testing these in practice, reporting findings and making recommendations to the bodies, and following up on the responses to previous recommendations.

The Oversight Board also undertakes projects to consider particular aspects of the bodies' regulatory activities in greater depth and started a project in 2006/07 on how the bodies meet practical training requirements for auditors.

We are expecting a number of changes to our statutory responsibilities from April 2008. These flow from the Companies Act 2006 and the revised 8th Company Law Directive and principally concern changes to audit regulation arising from the 8th Directive, new requirements to regulate third country audit firms arising from the 8th Directive and new responsibilities for the supervision of Auditors General, in the exercise of a new function as statutory auditor, for which the Companies Act 2006 provides. I am pleased to report that we are working closely with your officials in the new Department of Business, Enterprise and Regulatory Reform on the legislative and other arrangements which are necessary to give effect to all these changes. We are also working closely with the European Commission and other oversight bodies in the EU to ensure that the

measures necessary at EU level produce workable and proportionate regulatory requirements.

Monitoring the quality of the audits of economically significant entities through the Audit Inspection Unit (AIU) has also continued to be a major focus of the Board's work in 2006/07. The scope of this work was similar to 2005/06 in that we visited both the four largest audit firms and the five other firms that audit the largest number of entities within their remit. In addition we reviewed for the first time a sample of audits within scope undertaken by other UK audit firms. We reported publicly on the key findings and themes of these inspections in June. This report includes a summary of the AIU's work.

A particular feature of the work in 2006/07 has been AIU-led inspections together with the US Public Company Accounting Oversight Board at two of the "Big 4" UK audit firms. These have been particularly valuable in helping to pave the way for arrangements under which the UK (and the EU as a whole) and the US are able to place reliance on one another's regulatory arrangements.

The Oversight Board initiated a debate with stakeholders during the year on the way in which AIU findings on audit firms are reported, with a view to seeing if more information on individual firms could be made available publicly and whether information on individual audits reviewed might be made available to the company's Audit Committee. We published firm proposals in June 2007 to change the way in which we report on inspections.

The Oversight Board has also, as a member of the extended FRC family, continued to work closely with other parts of the FRC on key projects which relate to our wider responsibilities. In particular in 2006/07 the Board has been closely involved in the FRC project on Choice in the UK audit market and, with the Auditing Practices Board, in the work to develop the FRC Discussion Paper Promoting Audit Quality.

On the regulation of auditors and accountants we continue to be satisfied that the recognised bodies take their regulatory responsibilities seriously and that much regulatory practice is of a high standard; that, with some exceptions, the bodies have adequate resources to undertake these functions effectively; and that they meet their statutory obligations for audit regulation. The bodies have also for the most part responded positively to the recommendations we have made previously. That said, some aspects of audit regulation at some bodies are – perhaps inevitably – weaker than others. And even where regulation is working well there is often scope to do some things even better. We continue therefore to report findings and make detailed recommendations to all of the recognised bodies, and we report on the more significant of these in this report. Examples include the need at a number of RSBs and RQBs to strengthen internal communication between departments, to ensure that all relevant

information is available when decisions are taken on the registration of audit firms or the approval of training offices; weaknesses in the processes for reviewing training records at some RQBs; and the inadequate recording at some RQBs of the reasons for specific conclusions reached following an approval or monitoring visit to a training office.

In terms of our inspections of the major audit firms there is again much to give confidence that the quality of the audit of the most economically significant companies in the economy is generally sound. 2006/07 was a challenging year for the major audit firms. The majority of the audits we reviewed related to financial statements prepared for the first time in accordance with International Financial Reporting Standards; and this was also the first full year in which the firms undertook their audit work in accordance with International Standards on Auditing (UK and Ireland). In the main the firms responded well, deploying significant resources and taking a robust approach to the challenges presented by the implementation of IFRS. However, the new auditing standards, particularly in relation to audit risk and fraud, contain significant new requirements and the firms need to do further work to embed these fully through training and fine-tuning their audit systems and methodologies.

We try to ensure that our own inspections are principles-based and therefore a number of our recommendations to firms relate to the principles underlying the objective of a particular standard rather than to the specific requirements. Firms sometimes argue that in making such recommendations we are inappropriately 'going beyond' the relevant standards. This is not in our view consistent with calls for principles-based regulation. We also consider that a focus on key audit judgements, and the effective documentation thereof, is central to the principles-based approach to auditing in the UK and we continue to remind firms of the importance of this.

This report also provides a suitable opportunity after three years to step back a little and assess the overall impact of the new systems of monitoring both major audit firms and the accountancy bodies. In our view these changes have brought benefits both in terms of developing confidence in audit and accountancy in the UK and in helping to effect changes for the better in the arrangements, systems and practices of audit firms and accountancy bodies. We have therefore included a section in this report on this.

I also want to record my thanks to all the members of the Board and to the staff, whose wide and varied knowledge and experience have stood us in such good stead. No members left the Board and I was delighted to welcome Anthony Carus to the Board in May 2006, with his wide experience as an actuary.

Sir John Bourn,
Chairman,
Professional Oversight Board
July 2007

One – Introduction

1.1 The Professional Oversight Board contributes to the Financial Reporting Council's (FRC) aim of promoting confidence in corporate reporting and governance by:

- 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
- independent non-statutory oversight of the regulation of the actuarial profession by the professional 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 the Oversight Board 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 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 the Oversight Board. Section 3 reports on that work.

1.5 Section 4 reflects on the impact of the Board's work since it was formed in 2004.

1.6 Section 5 comments on our Work Programme for 2007/08, which is an integral part of the FRC's overall Plan and Budget.

Two – Independent oversight of the recognised supervisory and qualifying bodies

2.1 The Oversight Board has statutory powers delegated to it by Government 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 visited each RSB and RQB in 2006/07. For all the bodies except CIPFA we have updated our documentation of the regulatory systems it operates and, with the

exception of CIPFA and the AIA we have tested the application of all those systems in practice.

2.5 CIPFA became an RQB in July 2005 but has not fully introduced all systems for the recognised qualification. As a result it is not in the position to accept students who wish to train as auditors.

2.6 Whilst the AIA has systems in place for an RQB, which include examinations and arrangements for approving training offices, and has trained students for the audit qualification in the past, it does not at present have students training for the audit qualification. We were not therefore able to test the way in which systems such as student registration and the recording of training records worked in practice in relation to audit.

2.7. Our overall conclusion is that, subject to the reservations in 2.5 and 2.6, the way in which these systems operate in practice at least meet Companies Act requirements. All the bodies take their regulatory responsibilities extremely seriously and much of the regulatory practice which we have seen is of a high standard. That said, external scrutiny is always likely to identify aspects which are less strong or where there is further room for improvement. Much of our work and our private reports to the bodies therefore address potential improvements in the bodies' systems and practices or the identification where those systems and practices are not fully applied.

2.8. As part of our oversight of the regulatory activities of both RSBs and RQBs, the bodies provide an annual regulatory report which includes 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 for year on year changes in the statistical regulatory information.

2.9. Last year's compliance reviews highlighted a need for improvement within the area of student training records and practical training; we therefore decided to undertake a more detailed review of practical training in conjunction with the RQBs. This project will be completed during 2007/08.

2.10. We have reported the results of the testing to each body individually and have agreed plans of action, where suggestions for improvements have been identified. During our review visits conducted at the end of 2006 and the beginning of 2007 we also discussed and examined the bodies' responses to recommendations made in our 2006 reports. The main points from our visits are summarised below according to the regulatory area to which they relate. In addition points that relate to both RSBs and RQBs, spanning more than one regulatory area, have been grouped together as general points.

2.11. Paragraph 2.30 and Appendix 2 comments on the action taken by the relevant RSBs and RQBs in response to the recommendations made following last year's visits and summarised in our July 2006 report to you.

General issues relating to RSBs and RQBs

2.12 We identified four points which are relevant to a number of RSBs and RQBs.

Resources for regulatory functions

2.13 Whilst the RSBs and RQBs had sufficient resources to carry out their functions effectively and efficiently in most areas of their audit regulatory functions we had concerns at two bodies at the level of resources available for specific regulatory functions. One body in our opinion did not have adequate resources either for monitoring audit firms or for the approval and monitoring of training offices. We had concerns at a second body about the adequacy of their resources for handling complaints efficiently. These concerns did not reflect a lack of will on the part of the bodies to provide the necessary resources but rather specific difficulties in recruiting experienced staff for certain functions. Where we consider that this could cause significant problems we have asked the bodies to explain how they intend to continue to meet the requirements of the Companies Act. We have also stressed more generally the importance of monitoring closely resources for regulatory activities so that early action can be taken.

Length of service of Committee members

2.14 Some of the RSBs and RQBs do not have procedures for the rotation of committee members. We recognise the considerable value which the experience and expertise of committee members brings. However, we consider that it is important to strike a balance between the experienced members who have served for a considerable length of time and newer members who are able to bring new ideas and a fresh perspective to the Committee. We have recommended that the bodies concerned consider amending their constitutions to limit the number of terms that members can serve on a Committee.

Interface between internal regulatory departments

2.15. The interface between regulatory departments at a number of the RSBs and RQBs needs to be strengthened. We noted examples where firms were continuing to act as registered auditors and train students when it may not have been appropriate for them to do so. If the relevant information had been shared between the applicable regulatory functions an informed decision could have been made and suitable action taken in order to protect the public better.

Approving audit registration and training offices

2.16. We noted a number of instances where some RSBs had granted audit registration and some +RQBs approved training offices prior to receipt of all relevant information. We have made clear to the relevant bodies that in general audit registration and training firm authorisation should not be granted prior to receipt of all relevant and necessary information and confirmations. In exceptional circumstances, when the RSB or RQB believe there are strong reasons to approve the firm before it has provided all the information, the body should make clear that audit registration or training office approval are subject to specific actions, and should follow this up in a timely manner.

Issues identified at Recognised Supervisory Bodies

2.17 All the recognised supervisory bodies have well developed systems for carrying out their functions as an RSB and in most respects these work well. Our comments should be read in that context. We draw out below the more significant findings and recommendations arising from the monitoring visits to the RSBs in 2006/07.

Audit Registration

Ownership requirements for registered audit firms

2.18. One RSB currently does not request sufficient information from partnerships to determine that the firm meets the ownership requirements of the Companies Act 1989. Schedule 11 of the Companies Act states that a firm is only eligible for appointment as a company auditor if it is controlled by qualified persons. We have told the RSB in question to develop the appropriate systems to check that existing registered partnerships meet the statutory requirements and recommended that they amend the application form for registered auditor to ensure that future applications can be assessed properly. Whilst we note that there is a current debate on the ownership rules, and that the European Commission has commissioned a study on this, the RSBs must have appropriate mechanisms in place to ensure compliance with the statutory requirements in place at any point in time.

Registration Committees for Audit

Relationship with the Audit Inspection Unit

2.19. Two of the RSBs have audit registration committees who receive reports from the Audit Inspection Unit (AIU). We attended committee meetings where the AIU presented their findings on the larger UK audit firms. We consider that it is helpful if the registration committees consider at the same time the AIU report and the relevant monitoring unit's report on the same firm. This will highlight to the committee any differences and ensure that they are able to question both parties. Where this is not possible it is important that both the AIU and the relevant monitoring department are involved in the discussions of the other party's report. In any event registration committees should not confirm the firm's registration status until both reports have been reviewed.

Referral of firms to the registration committee following a monitoring visit

2.20. One body's current procedures mean that a firm is not referred to the registration committee following their first monitoring visit even if the review highlights significant shortcomings in the quality of audit work performed. We recommended that where the overall conclusion is unsatisfactory the firm should be referred to the registration committee. The body has now re-stated its procedures with regard to unsatisfactory outcomes to first visits, making clear that a significant failure to carry out audits to a satisfactory standard will lead to referrals to the registration committee.

Audit Monitoring

Justification of the results of monitoring visits

2.21. We concluded that not all RSBs record sufficient explanation for decisions made and conclusions reached following a monitoring visit to a firm. It is important that clear and adequate explanations for areas of judgement are provided so that other staff and committee members reading the reports are able to understand fully the reasoning behind the conclusions.

Registered auditors who have no audit clients

2.22. We discussed with the RSBs the arrangements for monitoring firms who hold registered auditor status but do not have any audit clients. Some of the bodies have decided to review these firms using a desk top monitoring approach rather than a visit.

Whilst we have no difficulty with this approach, we consider that it is important that the body is notified if that firm is appointed as an auditor in the future. This would give the RSB the opportunity to arrange an early follow up visit, to review the competency of staff and the procedures and systems, to confirm these are adequate to undertake statutory audit work.

Continuous professional development (CPD)

CPD monitoring

2.23. One of the RSBs does not at present have a system for monitoring compliance with their CPD requirements other than as a part of audit monitoring visits, though they are planning to introduce such a system. We have discussed this with the body concerned and emphasised the need to ensure that procedures are in place, as an integral part of satisfying Companies Act requirements. More generally, all of the RSBs have changed or are in the process of changing their requirements for CPD and the monitoring of CPD. We will therefore arrange a forum with the RSBs in 2008 to discuss the implementation of the new schemes.

Issues Identified at Recognised Qualifying Bodies

2.24. All the recognised bodies have well developed systems for carrying out their functions as an RQB. Overall these are working well, though we plan to look further at the awarding of exemptions from examinations in the year ahead; and we have identified some important issues at some of the bodies in the areas of training office approval and training records. We draw out below the more significant findings and recommendations arising from the monitoring visits to the RQBs in 2006/07.

Student registration and progression

Review of training records

2.25. A number of the RQBs had weaknesses in their processes for reviewing training records. In particular, whilst we did not review statistically significant samples, we found examples where records had been completed retrospectively, details recorded incorrectly and where the student had provided inaccurate information. We have emphasised to the relevant bodies the importance of reviewing training records comprehensively and ensuring that they do not admit individuals to membership or award the recognised professional qualification when it is not appropriate to do so.

Examinations

Testing candidates' ability to apply theoretical knowledge

2.26. A number of the RQBs have a final audit examination that must be sat by all students regardless of the extent of their practical audit experience. In terms of the audit qualification, these papers take the main weight in testing a candidate's ability to apply audit knowledge in practice, a specific Companies Act requirement. We have concerns, where this paper is mandatory and where a substantial proportion of candidates are unlikely to have had any practical audit experience, that the paper can provide both an adequate test of a candidate's ability to apply audit knowledge in practice and an appropriate test for students with no audit experience. We have therefore asked the relevant bodies to provide an explanation of how they consider their paper is able to satisfy both objectives. We are pleased to note, however, that guidance is to be provided making clear to candidates that it is highly desirable to have gained some practical audit experience before attempting the paper.

Approval and Monitoring of Training Offices

Justification of initial approval or continued approval of training offices

2.27. A number of the RQBs do not record adequately why specific conclusions have been reached or what follow up points need to be addressed following an approval or monitoring visit to a training office. In our view it is important that the reviewer provides a clear explanation of the conclusions from such visits. In some cases the forms used for recording need to be amended.

Availability of audit work

2.28. The reduction in the number of statutory audits following the substantial increases in the audit threshold in recent years has raised questions about the amount and variety of audit work available in some approved training offices. Whilst we have not drawn any general conclusions on this as yet, and will continue to review this situation, we have recommended that the RQBs assess the variety and amount of audit work available for students as part of their approval and monitoring of training offices. Where there is a concern that students may not receive sufficient experience the body should ensure that the student is aware of this and should monitor the training office closely.

Training offices with no students

2.29. We noted that a number of training offices approved by the RQBs were not at present training students. Whilst the RQBs continue to review these offices as part of the cyclical reviews of all training offices, such offices are usually assessed as low risk. We consider that all the bodies should have procedures in place so that such offices are treated as of higher risk, once they take on students, and are then subject to an early review to confirm their suitability as a training office. The bodies should also have similar procedures in place where there are significant changes within a training office, to enable an evaluation of its relative risk profile.

Response to prior year recommendations

2.30. We are pleased to note the steps that the bodies have taken and changes they have made in response to the recommendations we made following our 2005/06 visits. Due to the timing of our original recommendations it was still too early in a number of cases to see the effect in practice of agreed changes to requirements and practices. However, the implementation was discussed with staff. We have noted a few areas where the response to recommendations appears to have been inadequate or slow. These include: the flow of regulatory information internally between different regulatory functions, consistency in the approval or continued approval of training offices, tracking the implementation of conditions imposed on audit registrants and training offices, the approval of training records, and the recording by reviewers of their conclusions following approval and monitoring visits to training offices. We have reiterated the importance and the reasoning behind the original recommendations, and will review all outstanding issues again as part of the next cycle of visits.

2.31. Appendix 2 comments on the responses by the bodies to the principal recommendations we made last year.

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

Background

3.1 The Audit Inspection Unit is that part of the Oversight Board responsible for monitoring the quality of the audits of listed and other major public interest entities. We publish each year the precise scope of inspections. Our programme of inspections visits is designed to promote high quality auditing and thereby contributes to the FRC's overall aim of promoting confidence in corporate reporting and governance.

3.2 We monitor firms' compliance with the regulatory framework for auditors in the UK which, for the period under review, comprised the following:

- The Auditors' Code;
- International Standard on Quality Control (UK and Ireland) 1 ('ISQC 1');
- International Standards on Auditing (UK and Ireland) ("ISAs (UK and Ireland)");
- APB Ethical Standards and ethical guidance issued by the relevant professional body; and
- The UK Audit Regulations and Guidance.

3.3 Our responsibility extends beyond monitoring compliance with the specific requirements of the UK regulatory framework and includes an assessment of significant audit judgments.

3.4 In addition to our work, the monitoring units of the professional accountancy bodies in the UK, who register firms to conduct audit work, remain responsible for monitoring audit work outside our scope (i.e. the audits of entities which do not have any listed securities and those in whose financial condition there is not otherwise considered to be a major public interest).

Coverage of Inspections

3.5 During 2006/07, we undertook full scope inspection visits, comprising the review of firm-wide procedures and individual audits within their scope, at nine firms, eight of which were registered by the ICAEW. The remaining firm was registered by ICAS. The nine firms were:

- Deloitte & Touche LLP, Ernst & Young LLP, KPMG Audit Plc and PricewaterhouseCoopers LLP at which they carried out their third inspection visit, having carried out their first visit in 2004/5; and

- Baker Tilly UK Audit LLP, BDO Stoy Hayward LLP, Grant Thornton UK LLP, PKF (UK) LLP and RSM Robson Rhodes LLP at which they carried out their second inspection visit, having carried out their first visit in 2005/06.

3.6 We also carried out inspection visits at seven smaller firms¹. For these firms, the focus of our work is on reviewing the small number of listed or other major public interest entities audited by them. We rely on the monitoring unit of the professional body with whom they are registered for the review of the firms' quality control systems and procedures.

3.7 The expansion of coverage of firms in 2006/07 to include the smaller firms completes the implementation of the programme of independent audit inspections as envisaged in the Review of the Regulatory Regime of the Accountancy Profession published by the Department of Trade and Industry (now the Department for Business, Enterprise and Regulatory Reform – DBERR) in January 2003.

3.8 In the year to 31 March 2007, we completed the review of 103 audits of listed or other major public interest entities. This compares with 77 such audits reviewed in 2005/06 and 27 such audits in 2004/5. The 31 March 2007 figures reflect a one-off acceleration of the planned programme of audit reviews and consequently we envisage reviewing a lower number of audits in 2007/08.

3.9 The audits reviewed related to financial statements for financial periods ended prior to 31 December 2006, the majority of which were prepared under International Financial Reporting Standards (“IFRS”) for the first time. 2006/07 was also the first full year in which firms were required to undertake their audit work in accordance with the ISAs (UK and Ireland)² and comply with the requirements of the Ethical Standards³. As such we consider that 2006/07 was a challenging year and acknowledge the considerable efforts made by the firms in responding to the challenges these changes presented.

3.10 During 2006/07 two inspection visits of the Big Four firms, by agreement with the firms concerned, were conducted jointly with staff from the US Public Company Accounting Oversight Board (PCAOB), but led by the AIU inspection teams. Our inspections of the other two Big Four firms are likely to be conducted on a similar basis with the PCAOB during 2007/08. (In 2005 a joint review of BDO Stoy Hayward LLP was

¹ The first such review took place in 2005/06 but is combined with reviews undertaken in 2006/07 for public reporting purposes.

² All references in this report to ISAs (UK and Ireland) are to International Standards on Auditing (UK and Ireland) which came into effect for audits of financial statements for periods commencing on or after 15 December 2004.

³ All references in this report to Ethical Standards are to the APB Ethical Standards which came into effect for audits of financial statements for periods commencing on or after 15 December 2004.

undertaken with the PCAOB). We believe that, in the absence of full reliance on home country systems, effective co-operation with overseas audit regulators in the conduct of audit inspections, where appropriate, is in the interests of all parties involved including the firms themselves. It facilitates cost effective regulation and avoids unnecessary duplication of work.

Overview of findings

3.11 The findings from the AIU review process in 2006/07 are set out in the third annual public report we published on 27 June 2007.

3.12 In overall terms we considered that significant progress had been made by all firms in addressing their prior year recommendations, after taking account of the extent and nature of the recommendations made and the number of inspection visits undertaken. We noted the positive response by all firms to their recommendations, with very few instances where no action had been taken at the time of our subsequent visit, to implement a prior year recommendation.

3.13 We were satisfied with the manner in which firms responded to the implementation of IFRS and accordingly made no recommendations in relation to this in our public report. Our view is that this reflects the significant level of resources allocated and the robustness of the approach taken by firms to the challenges presented by the implementation of IFRS.

3.14 Our public report contains 21 recommendations to the profession arising from our findings in 2006/07. Our inspectors will be monitoring progress made by the firms in addressing these recommendations during their next inspection visits.

3.15 The implementation and application of the ISAs (UK and Ireland) was a key area of focus of our inspection visits. We have made recommendations in relation to both the firms' methodologies and systems, and the training required for staff to ensure compliance with the requirements of the ISAs (UK and Ireland), particularly in relation to the audit risk and fraud ISAs (UK and Ireland)⁴. These particular ISAs (UK and Ireland) contain a significant number of new requirements and in our view further work is required by all firms to fully embed these requirements within their audits.

3.16 While we noted that there had been an improvement in the overall quality of documentation on the files we reviewed, we saw no clear improvement in the sufficiency of documentation to support key audit judgments. Our view is that, if key judgments are not properly recorded at the time, there is a substantial risk that the rationale may be incomplete and that it will not be possible for the AIU inspectors to see from the

⁴ The audit risk and fraud ISAs (UK and Ireland) refer to ISAs (UK and Ireland) 315, 330 and 240.

documents on file the rationale behind judgments. We also considered that, if the firms' own audit files did not contain a comprehensive record of the key judgmental aspects of the audit alongside compliance-related information, then this could be detrimental to the on the job training of audit staff. We consider that a focus on key audit judgments is central to the principles-based approach to auditing in the UK and we continue to remind firms of this.

Conclusion

3.17 On the basis of our work, we consider that the quality of auditing in the UK is fundamentally sound. Subject to the agreement of satisfactory action plans by firms in response to their recommendations, we anticipate recommending the continued audit registration of all firms for which we undertake full scope inspections.

3.18 In relation to the smaller firms reviewed, the scope of our work was limited to the review of one or more audits falling within our scope. We provide the findings from these reviews to the monitoring unit of the relevant professional body for inclusion in their overall report on the firm to the relevant Audit Registration Committee. Accordingly, it is the monitoring unit who make a specific recommendation in relation to the continued audit registration of these firms.

Four – Review of the First Three Years of the Board’s Work.

4.1 Three years into the life of the Oversight Board is perhaps a good time to stand back from our immediate priorities, to take stock and to report to you on what we consider the Board has achieved in the three original responsibilities that the Government asked it to undertake: the independent inspection of the audit of public interest entities, the independent oversight of audit regulation, and the general oversight of the regulation by the professional accountancy bodies of their members.

4.2 Overall we consider that the Board can justifiably conclude that its work has made an important contribution to confidence in the work of auditors and accountants. Our monitoring of the regulatory activities of the recognised bodies has helped support a robust approach to the establishment and enforcement of audit regulations. And, though the evidence is still largely anecdotal, there is increasing recognition from audit firms, professional bodies, participants in the capital markets, and audit committee chairs that audit monitoring by the AIU is proving effective in promoting improvements in the quality of auditing of major entities.

Inspection of Audit of Public Interest Entities

4.3 The Audit Inspection Unit has now undertaken independent inspections at the four largest UK audit firms for three years and at the next five firms for two years. With a small number of other jurisdictions the UK has been at the forefront of developing and implementing independent external inspection of the audits of major public interest entities, which others are now following.

4.4 Independent inspection has brought two significant benefits. First, it has provided a substantial body of evidence that the quality of auditing in the UK is fundamentally sound. Of course this is no guarantee against a significant auditing scandal occurring in the UK, though it is a significant factor in restoring the confidence in external audit which the auditing scandals first and foremost in the US significantly weakened. Secondly, there is increasing recognition around the world that independent inspection along the lines we have developed has had a positive impact on audit quality by identifying the weaker aspects of an audit firm’s procedures and practices and forcing the firm to examine and improve them. There is good evidence in the UK of the positive response of all the major firms to the work of the AIU. For example we are pleased to see the extent to which the firms are embedding audit quality within their strategies, procedures, communications and partner and staff appraisals. Other areas include

greater attention being paid to partner rotation monitoring, long association of partners with audit clients and other independence and ethical issues.

Oversight of Audit Regulation

4.5 We have completed the second round of RSB/RQB annual compliance visits, reviewing the bodies' regulatory systems. Overall this work should provide confidence that the UK has a well developed structure of audit regulation delivered by a number of professional bodies. All of the bodies take their responsibilities very seriously and devote significant resources and efforts to meeting their obligations. That is not to say that the systems we review are perfect in every detail or work perfectly in practice. We find instances across the bodies of weaknesses in systems and in the application of these systems in specific cases. In all instances we have highlighted to the bodies the points of weakness that we have identified and made recommendations for improvement. It is clear that our involvement helps ensure that the bodies remain alert to their responsibilities and our recommendations help to deliver incremental improvements to systems and practices. Following our 2005/06 visits we have noticed a significant improvement in the flow of regulatory information between the RSBs and the RQBs both in terms of volume of information and efficiency with which requests are handled. Furthermore we have noted that the bodies are taking a more robust approach to the enforcement of regulations, particularly for example in the response to cases by the audit registration committees.

4.6. The bodies have in the most cases responded well to our recommendations. However, in some cases it is too early for us to assess the results of changes in practice and in some specific areas the bodies either do not agree with our recommendations or have not addressed the issues fully. We will continue to work with the bodies to ensure that the maximum benefits are gained from our oversight of their regulatory systems and practices.

The Board's General Oversight of the Accountancy Profession

4.7 The Government decided in 2003 that the Oversight Board should continue the work of the Review Board of the Accountancy Foundation in providing independent oversight of the arrangements made by the major accountancy bodies for the education, training, discipline and professional standards of their members.

4.8 We carry out this remit through in-depth projects, which have taken between six and twelve months to complete. By agreement the CCAB bodies either follow our recommendations or explain publicly why they do not intend to do so. Our work in this area is in the context of the FRC's objective that accountants, and the firms to which they

belong, meet high standards of practice and ethical behaviour, and have regard to the public interest. Whilst we have published findings and recommendations on specific projects, we have not previously assessed the impact of this work.

4.9. We believe that our first three years of oversight activity has helped to ensure that clients and employers of professionally qualified accountants can continue to rely on them to act with integrity and competence, and with regard to the public interest. We comment on our major projects below. Our ability to carry out general oversight projects and to effect change is reliant on the cooperation of the bodies. We invite and appreciate guidance from the bodies on our projects, but it is important that the bodies accept more readily that the choice of areas for review and the approach to be taken in carrying out the review is ultimately a matter for our judgement. With very few exceptions, the bodies have accepted our recommendations. Their implementation work has sometimes taken longer than we expected, and in some areas has not been as comprehensive we had intended, but we believe that it has still resulted in tangible improvements.

Complaints and Discipline Procedures Review, February 2005

4.10. Our review of complaints and discipline procedures followed up on a 2002 report of our predecessor body, the Review Board of the Accountancy Foundation.

4.11. We noted that where the bodies did have arrangements for independent arbitration of disputes between members in practice and their clients these were limited to handling fee disputes. We considered that independent arbitration should be available for disputes of any kind, where both parties are willing to submit to the process. We made six further recommendations regarding how the arbitration schemes should operate. *All of the CCAB now offer an arbitration scheme for members and complainants covering any disputes.*

4.12. Our review also suggested that some bodies could do more to implement the recommendations of the Review Board on the use of engagement letters by members in practice, the bodies' processes for handling complaints, the power of disciplinary tribunals to reduce or waive fees, and the use of open disciplinary hearings by the bodies. *In general all bodies have accepted and are implementing these recommendations. It should be noted that in relation to the use of open disciplinary hearings ICAS have chosen not to adopt this and have published their explanation for non-compliance. The ICAEW whilst encouraging their members to use engagement letters for all types of business do not require this.*

Review of Training and Education in the Accountancy Profession, April 2005

4.13. Our review of the bodies' regulation of the training and education of accountancy found that the arrangements currently in place are generally successful. We focused our recommendations on a small number of issues that we considered needed to be addressed in order to maintain public confidence in the profession and to ensure that the profession develops a training and education strategy for its future success.

4.14. We considered that by the time trainees qualify they should have a well-rounded understanding of the importance of the accountancy profession to the public interest. We found that this understanding was too often inadequately developed during training. This could provide a weak foundation for an adequate commitment to the profession's values and codes of conduct. *Through changes to their syllabi, new induction programmes and other initiatives the bodies are taking steps to improve trainees' understanding of the importance of the accountancy profession to the public interest. We will continue to monitor the effectiveness of these changes.*

4.15. We considered there was a need for most of the bodies to clarify the different levels of knowledge and understanding needed across different parts of the syllabus. This was needed to help maintain focus on underlying accounting principles rather than technical detail, to highlight to trainees what their training has not fully covered, and to improve understanding of the differences between the qualifications. *The bodies now have clearer information on the level of knowledge and understanding of accounting standards and other technical material required of trainees.*

4.16. Prior to the workshops held to inform the review there had for many years been no forum at which the bodies, accountancy firms, tuition providers, and academic experts could work together to review and address long-term issues facing the profession's training and education arrangements. *The CCAB has since held two forums, one dealing with continuing professional development and the other with ethics education. Both events have been closely integrated with the development of relevant standards and guidance by the International Federation of Accountants, helping to ensure that the output of the forums is translated into changes to bodies' qualifications.*

4.17. There is an understandable obstacle around confidentiality to the sharing of "real-life" experience across the profession. However by working through independent intermediary organisations we believe that greater sharing of experience would be achieved. This would help the wider profession to learn from individual firms' mistakes and successes. *The CCAB held an ethics training forum in December 2006 which considered the potential for using the experience of the firms as a basis for case studies. At present the bodies use 'generic' case studies but there is no mechanism by which recent 'real life' issues faced by a firm can be used for training across the wider profession in a timely fashion. The workshop noted that while there are some practical, commercial and legal difficulties in using 'real life' case studies, it*

is possible to overcome these difficulties in a bid to deliver professional ethics education and continuing professional development which enable the accountancy profession to fulfil its public interest remit. Whilst the Board recognises that the issues surrounding this recommendation are particularly complex, there remains a need for the CCAB to establish arrangements by which the first 'real life' cases could be developed with the cooperation of the firms.

Review of How Accountants Support the Needs of Small and Medium-Sized Companies and their Stakeholders, March 2006

4.18. This review 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 many directors of smaller companies and individuals and companies who are doing business with these companies are unclear over the role of professional accountants. We recommended steps to improve clarity including the possible use of a cross-body report for non-audited accounts prepared with the involvement of professional accountants and steps to improve the quality of financial accounts that are prepared with the involvement of professional accountants. *The bodies have put in place, or are planning, a range of materials and initiatives in response to our recommendations. We will review progress more fully this year.*

Five – Work Programme 2007/08

5.1 The Board's work programme for the year to 31 March 2008 continues to reflect our four responsibilities - statutory independent oversight of the UK system of audit regulation, independent monitoring of the quality of the audits of major public interest entities, broader non-statutory oversight of the regulation of the accountancy profession, and oversight of the regulation of the actuarial profession.

5.2 The work programme is an integral part of the Financial Reporting Council's Plan and Budget for 2007/08. We draw out the major themes below.

Statutory oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies

5.3 2007/08 will be the third full cycle of review for the RSB and RQB monitoring and as such we believe it is appropriate to review our approach to monitoring the application of the systems for the regulation of auditors by the RSBs and RQBs. We will discuss our proposed change in method with the bodies this summer. However, we envisage that our visits will be tailored closely to the needs of the specific bodies, as identified during our 2005/06 and 2006/07 monitoring visits. We will continue to monitor the bodies' compliance with the requirements of the Companies Act and monitor the progress of their implementation of our recommendations summarised within Section 2 and Appendix 2.

5.4 During 2007/08 we will complete and publish our review of practical training.

Monitoring the quality of major audits

5.5 For 2007/08 the Audit Inspection Unit will carry out full scope inspections at the eight largest firms (following the proposed merger of Grant Thornton and Robson Rhodes), as well as reviewing a sample of public interest audits at smaller firms. During these inspections we will review both firm-wide procedures and a sample of individual audits, and issue recommendations to improve audit quality. We will also assess the progress made by each firm against the action plans agreed with them this year.

5.6 The AIU is committed to a process of continuous improvement in the light of feedback from the firms subject to inspection and from others on how the process might be improved. As a part of that the AIU identified the need to improve its IT

infrastructure and the 2007/08 inspections will be supported by a new IT platform which will assist in ensuring greater consistency and improving the quality of documentation.

5.7 The Board has also recently published specific proposals following consultation to implement revised arrangements for reporting the results of inspections from 2007/08. At present the Board issues an annual public report setting out the overall findings and conclusions arising from our inspection visits but does not to publish any part of our reports on individual inspection visits. Under the new arrangements the Board would publish high level reports on the major audit firms and prepare new-style reports on each individual audit reviewed by the AIU which audit firms will be able to share with their clients.

Wider oversight of regulation of the accountancy profession

5.8 Much of our effort for 2007/08 will continue to focus on wider FRC initiatives, in particular:

- taking forward the project to enhance the efficiency of the market for audit of major public interest entities by considering actions;
 - to increase the choice of auditors;
 - reduce the risks of a firm leaving the market without a good reason; and
 - reducing uncertainty and disruption costs in the event of a firm leaving the market;
- developing further the work with the Auditing Practices Board to promote awareness amongst the providers and users of audit services of the drivers of audit quality.

5.9 We will also continue to work with the accountancy bodies to support and review their implementation of the recommendations from our previous work on:

- How accountants support the needs of SMEs
- Training and Education in the Accountancy Profession
- The Complaints and Discipline Procedures of the Accountancy Bodies.

International Priorities

5.10 Member States have until June 2008 to implement the EU Eighth Directive on Statutory Audit. We will continue to play a major role in 2007/08 both with the DTI in the UK's implementation of the Directive's provisions, and with the European

Commission and other oversight bodies in the EU on the further measures and arrangements necessary at a European level. Our objective is to try to ensure that there are 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.

Oversight of the actuarial profession

5.11 We took on our new oversight role in relation to the regulation of actuaries at the beginning of April 2006. Our initial priorities were to understand the profession's regulatory arrangements, assess and report on the availability of information about actuaries and the profession, and to evaluate and report on the profession's progress in implementing the recommendations of the 2005 Morris Review of the Actuarial Profession.

5.12 This work has provided the basis for us to take forward as priorities for 2007/08:

- A review of the arrangements for the scrutiny and monitoring of actuarial advice, working in conjunction with the actuarial profession, other regulators and the users of actuarial advice.
- The development of a wider discussion and understanding of the main drivers of the quality of actuarial information, working with the Board for Actuarial Standards, the actuarial profession and the users of actuarial information.

Resources

5.13 In 2006/07 the operating costs of the Professional Oversight Board (excluding the Audit Inspection Unit) were £1.3 million, excluding support services provided centrally. The average monthly number of staff in post was 7. For 2007/08 the equivalent budgeted figures are £1.4 million and 9 staff.

5.14 The costs of the Audit Inspection Unit are accounted for separately. The cost for 2006/07 was £2.3 million and the 2007/08 budget is £2.8 million. The AIU is planning to operate with 19 staff in 2007/08 compared to an average of 16 in 2006/07.

ANNEX 1

STATISTICAL ANNEX: REGULATORY ACTIVITIES OF RECOGNISED SUPERVISORY AND QUALIFYING BODIES

A) Audit Registration

	ACCA	ICAEW ⁵	ICAI	ICAS
Number of audit firms				
As at 31.12.06	2,741	4,817	1,028	300
As at 31.12.05	2,968	5,193	1,044	343
As at 31.12.04	3,053	5,475	1,048	374
Number of Office locations, as at 31.12.06				
1	2,454	3,660	958	238
2-3	275	1,039	66	48
4-10	10	103	4	12
10+	2	15	0	2
Number of Office locations, as at 31.12.05				
1	2,656	4,126	975	278
2-3	299	947	64	50
4-10	12	103	5	13
10+	1	17	0	2
Number of Office locations, as at 31.12.04				
1	2,739	4,502	977	305
2-3	302	850	66	54
4-10	11	106	5	14
10+	1	17	0	1
Number of Principals, as at 31.12.06				
1	1,954	2,481	666	127
2-6	753	2,115	339	148
7-10	28	146	12	17
11-50	6	105	10	7
50+	0	12	1	1

⁵ The ICAEW figures are for those firms that were going to be registered as at 1st January the following year.

	ACCA	ICAEW ⁵	ICAI	ICAS
Number of Principals, as at 31.12.05				
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
Number of Principals, as at 31.12.04				
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
Number of new applications⁶				
Yr to 31.12.06	89	258	35	14
Yr to 31.12.05	125	290	35	7
Yr to 31.12.04	157	319	45	11
Number of applications refused⁷				
Yr to 31.12.05	0	0	0	0
Yr to 31.12.05	0	1	0	0
Yr to 31.12.04	0	0	2	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 however, the audit threshold has risen further and the number of audit registration is anticipated to fall further in the future.

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

⁶ New applications include those firms who are changing status e.g.: to LLP

⁷ 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
Number of firms monitored				
Actual 2006	371	731	33	69
Target 2006	Not Available	875	50	50
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 firms monitored as a % of audit registrants				
2006	13.5%	15.2%	3.2%	23.0%
2005	15.6%	17.4%	5.3%	18.4%
2004	14.3%	18.1%	6.1%	12.0%
Reason for monitoring visits				
2006				
Number of firms monitored following a request by the registration/licensing committee	37	42	9	1

	ACCA	ICAEW	ICAI	ICAS
Number of firms with public interest entities visited without AIU ⁸ involvement	0	35	2	1
Number of firms specifically selected due to heightened risk	74	240	6	65
Number of firms randomly selected	260	396	16	1
2005				
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 ⁹ involvement	0	39	5	0
Number of firms specifically selected due to heightened risk	70	742 ¹⁰	37	59
Number of firms randomly selected	345	84	9	3
2004				
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

⁸ AIU = Audit Inspection Unit

⁹ AIU = Audit Inspection Unit

¹⁰ 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. We will be discussing in the year ahead what further support, if any, is required to assist registered firms deliver high quality audits.

The tables below show the gradings for the four bodies for all visits conducted from 2004-2006.

ACCA

	2006	2005	2004
Number of A & B outcomes	182	271	247
% of A & B outcomes compared to all visits conducted	49	59	57
Number of C+ outcomes	64	63	55
% of C+ outcomes compared to all visits conducted	17	14	13
Number of C- outcomes	33	60	50
% of C- outcomes compared to all visits conducted	9	6	11
Number of D outcomes	92	98	84
% of D outcomes compared to all visits conducted	25	21	19

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 2006, 37 visits were carried out on the order of the ALC. Of these, 30 firms were found to have improved their procedures so that their compliance with auditing standards was satisfactory.

ICAEW

	2006	2005	2004
Number of A & B outcomes	457	630	654
% of A & B outcomes compared to all visits conducted	64	73	65
Number of C outcomes	188	194	255
% of C outcomes compared to all visits conducted	27	22	25
Number of D outcomes	64	44	98
% of D outcomes compared to all visits conducted	9	5	10

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.

- a) The proportion of D-graded visits substantially decreased in 2005, as approximately one third of the visits undertaken during 2005 were to firms who had never been visited before as they were lower risk compared to the two previous years. The ICAEW explained that differences are likely to arise year on year as the population visited will be different. The reasoning for the similarity in the profile of the outcomes of visits in 2006 and 2004 is that the ICAEW reverted to randomly selecting visits. The ICAEW's ultimate objective is to select 95% of visits on a random basis.

ICAI

	2006	2005	2004
Number of A & B outcomes	7	15	19
% of A & B outcomes compared to all visits conducted	23	27	30
Number of C outcomes	10	28	23
% of C outcomes compared to all visits conducted	32	51	36
Number of D outcomes	14	12	22
% of D outcomes compared to all visits conducted	45	22	34

ICAI noted that it is difficult to compare the gradings year on year as different firms are visited in order to meet the requirements of the 8th Directive. They also point out that in 2006 a greater proportion of their visits were follow-up visits, which resulted in "D" reports.

ICAS

	2006	2005	2004
Number of A & B outcomes	33	35	29
% of A & B outcomes compared to all visits conducted	50	56	65
Number of C outcomes	21	17	14
% of C outcomes compared to all visits conducted	30	27	31
Number of D outcomes	15	11	2
% of D outcomes compared to all visits conducted	20	17	4

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.

ICAS noted that it was difficult to compare the gradings year on year as different firms were visited in order to meet the requirements of the 8th Directive and due to the small number of firms visited variations year on year are high.

However, ICAS have tried to explain the reasoning for a reduction in A and B rated visits and an increase in the number of C and D rated visits. One explanation is the increase in regulatory changes that have taken place particularly the adoption of the International Standards on Auditing. The adoption of ISAs amongst the firms has varied whilst some have made good attempts at ISA compliance, others have not prepared sufficiently and as such still have a number of issues to address. The impact has been an increase in the number of C and D rated visits.

C) Complaints about Auditors

	ACCA	ICAEW	ICAI	ICAS
Number of new cases¹¹				
2006	10	78	113	4
2005	13	65	84	4
2004	23	57	67	1
Number of cases passed to the AIDB¹²				
2006	1	2	1	0
2005	0	1	0	0
2004	1	1	0	0
Number of cases passed to committee¹³				
2006	4	57	27	2
2005	9	43	18	4
2004	10	32	25	2
Number of complaints¹⁴ closed in the year				
2006	16	81	87	2
2005	13	69	66	0
2004	20	64	72	2
Average time taken to close a complaint				
2006	8.6 months	20 months	11 months	For cases closed by Investigation & Professional Conduct Enforcement Committee = 188 days
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 = 180 days

¹¹ Cases relate to audit related complaints only

¹² AIDB suggest an emphasis on the exclusion of referrals i.e. 'taken on' rather than 'passed to'

¹³ 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.

¹⁴ Complaints relate to audit related complaints only

ACCA is the only body who saw a fall in the number of audit related complaints in 2006 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.

The ICAEW explained that the increased average time to handle complaints in part reflected the fact that a number of the older cases particularly those allocated to staff who left in 2005 were closed.

D) Student Registration¹⁵

	ACCA	ICAEW	ICAI	ICAS
Number of new students				
2006	21,395	4,639	1,497	1,188
2005	19,981	4,075	1,201	1,020
2004	18,880	3,590	1,090	888
Total number of students				
2006	85,296	11,680	4,525	3,154
2005	79,513	10,364	3,880	2,636
2004	73,839	8,445	3,167	2,497
Number of students who became members				
2006	3,356	2,604	884	511
2005	3,111	2,554	890	Not available
2004	3,394	3,077	657	Not available
Number of members who became audit qualified				
2006	165	197	80	25
2005	171	172	79	42
2004	179	164	71	19

The number of new students at all bodies rose in 2006. 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 ACCA have explained that fewer students are becoming members as they are unable to meet the practical training requirements.

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 currently 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.

¹⁵ UK and Republic of Ireland

E) Registered Training Offices

	ACCA	ICAEW	ICAI	ICAS
Number of registered training offices				
2006	4,663	2,595	681	160
2005	4,518	2,503	713	199
2004	4,474	2,350	667	193
Number with students in training				
2006	Not available	1,383	454	144
2005	Not available	1,423	443	Not available
2004	Not available	1,414	397	Not available
Number with students training for the audit qualification				
2006	3,772	1,383	Not available	Not available
2005	3,786	1,423	Not available	Not available
2004	3,874	1,414	Not available	Not available
Number of new applications				
2006	Not available	312	33	15
2005	Not available	142	36	11
2004	Not available	159	46	18
Number of applications refused				
2006	Not available	56	Not available	0
2005	Not available	98	Not available	0
2004	Not available	95	Not available	0
Number of registrations withdrawn				
2006	143	4	Not available	11
2005	158	3	Not available	5
2004	109	0	1	27
Number of approved training offices visited				
2006	701	168	53	49
2005	643	289	22	42
2004	848	389	23	47
Number of approved training offices visited as a % of the total				
2006	15.0%	6.5%	7.8%	30.6%
2005	14.2%	11.5%	3.1%	21.1%
2004	19.0%	16.6%	3.4%	24.4%

The number of registered training offices in the UK has continued to grow for most of the bodies 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 in the UK and internationally.

ANNEX 2

RESPONSES TO RECOMMENDATIONS 2005/06

During our 2006/07 annual compliance visits of the RSB and RQBs we reviewed the bodies' progress in implementing our prior year recommendations. We summarise below details of the action taken to date and any proposed plans to address the issues raised.

It should be noted that the majority of the work we reviewed during our RSB and RQB visits was undertaken prior to the agreement and finalisation of the prior year recommendations. We therefore discussed the action plans and progress of implementation with appropriate staff. Where possible we reviewed how changes, which had been made, were working in practice.

A) Issues identified across all RSBs

A1 Flow of regulatory information

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.

Progress:

We have noted an improvement in the flow of information between the bodies enabling the bodies to carry out their operations on a more fully informed basis. Unfortunately the sharing of information within the bodies has not improved to the same extent as across the bodies and as noted in paragraph 2.15 we have reiterated the need for the bodies to share information between departments and to strengthen their communication channels between regulatory departments.

A2 Continuous professional development (CPD)

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.

Progress:

A number of the bodies implemented new CPD schemes in 2005/06 and 2006/07 with the remainder making changes in 2007/08. The RSBs have circulated details of the changes to their CPD schemes to members and are reiterating the importance of CPD to their registered firms. CPD monitoring is carried out by specific teams and we have noted the need to share any non compliance with CPD regulations with the CPD team so this can be followed up and the appropriate action taken (refer to paragraph 2.23.) When all the RSBs have put through their changes to the CPD schemes we intend to hold a discussion forum for the RSBs to provide an opportunity for them to share any issues and concerns that have arisen in relation to monitoring of CPD and members' implementation of the new schemes. Once the new schemes have been implemented we anticipate looking at this area in more detail.

A3 Use of databases to confirm audit clients

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.

Progress:

Following our visits to the RSBs last year we suggested that the bodies complete a search on an appropriate database that collates information submitted to Companies House as part of their planning for monitoring visits. The reasoning behind this recommendation was so the bodies could determine the number of audit clients that firms have and help to prevent any identity theft arising. Since issuing last year's report we have performed some additional analysis of summary databases and discussed this with all RSBs at the round table meeting we held in September 2007, we have concluded that due to the inaccuracies of the summary databases the proposed recommendation is not appropriate. However, as the bodies are keen to address this issue the CCAB is working with Companies House to ensure that auditors who sign accounts are entitled to do so and are listed on the audit register. We support the effort that has been made in this area and have encouraged the bodies to continue to progress this.

B) Issues identified at some RSBs:

B1 Membership of the AIDB Scheme

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.

Progress:

At the time of last year's report to the Secretary of State one of the RSB's had not obtained approval from Privy Council to participate in the disciplinary scheme of the Accountancy Investigation and Discipline Board. Approval for all bodies has now been obtained.

B2 Registrants' respect of body's regulatory authority

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.

Progress:

As part of our visits to the bodies in 2006/07 we attended meetings of all of the RSB audit registration committees. It was clear that the registration committees concerned have strengthened their position in relation to the small minority of members who do not comply with the bodies' orders. There has been an increase in the number of cases that are referred to discipline and non compliance with an order could bring into question the appropriateness of the individual being registered with a professional body.

B3 Resources for regulatory functions

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.

Progress:

The resource issue identified at one RSB last year has been addressed and the body in question has invested a large amount of time and effort in this area to try and reduce the back log that arose as a result of resource constraints in 2005/06. Whilst there is still a back log of work it is clear that action has been taken by the body concerned. During our 2006/07 RSB and RQB visits we identified other regulatory areas where resource constraints have affected the level of work undertaken and we have highlighted this to the bodies' concerned (paragraph 2.13.)

B4 Consistency of procedures

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.

Progress:

During our 2005/06 fieldwork we identified some cases where procedures at some of the bodies were not being applied consistently to all members. Our 2006/07 visits did not identify inconsistent procedures being adopted in the same areas as the 2005/06 visits. However, we did note instances at two RQB's where consistent procedures were not being adopted for the approval and monitoring of training offices. We highlighted these cases to the bodies in question emphasising the need to adopt consistent procedures at all times. We will continue to examine this during future reviews.

B5 Recording of the justification of gradings

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.

Progress:

Last year we noted following our RSB visits and the work we did in relation to audit monitoring that the outcomes of monitoring visits were not always clear to follow and tended to rely to a large degree on judgement of the reviewer. A number of the bodies have added additional sections for reviewers to provide explanations of the reasoning behind decisions made. However, as noted in paragraph 2.21 not all RSBs have addressed this issue, we have reiterated the importance of this point and are working with RSBs to ensure suitable explanations are provided in the future.

B6. Effectiveness of measures taken following inspection visits

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.

Progress:

Our prior year reviews showed that some bodies were not recording the details of the measures taken following an audit monitoring visit and tracking the progress of implementation of specific conditions imposed. We have noted an improvement in relation to the documentation of conditions imposed and agreed plans of action by the bodies. Unfortunately this has not been mirrored in respect of tracking progress of implementation and therefore the need to track the implementation of conditions has been reiterated to the bodies concerned. When conditions are not followed it is important that the body should ensure that suitable action is taken and the case is referred to the appropriate department.

C) Issues identified across all RQBs:

C1 Approval of firms to offer audit training

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.

Progress:

Last year we highlighted to the RQBs the benefits of taking a dual approach to monitoring to confirm the firm's compliance with the bodies training requirements and to help the firm by suggesting improvements to promote best practice. The bodies implementation of this recommendation has been limited and we continued to note a number of areas of improvement in relation to the approval and monitoring of training offices and as a result are undertaking a specific project in this area. We believe that some of the bodies should provide further information to firms to help them improve the standard of training they offer and the support they offer students. We will review the bodies' progress in implementing this recommendation during our annual compliance reviews in 2007/08.

D) Issues identified at some RQBs:

D1 Resources for regulatory functions

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.

Progress:

The body in question has invested a considerable amount of time and effort to address this issue. As a result there have been significant changes to the internal structure of this department. Following our visit to this body in 2006/07 we have made additional recommendations for improvement and will continue to monitor the body as there continues to be resource constraints that could negatively impact on the work in this area. We have highlighted in paragraph 2.13 that there continues to be, a shortage of resources in regulatory areas in a number of RSBs and RQBs.

D2 Theft of examination scripts

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.

Progress:

Following the theft of examination scripts, the RQB in question commissioned an independent report into the circumstances of the theft. The findings of the report were shared with the other RQBs during 2006/07 and we have encouraged all of the bodies to ensure they have a spare examination paper which could be used if a similar situation were to arise.

D3 Narrative commentary on training records

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).

Progress:

The bodies concerned have either amended or are in the process of changing their training records and have now provided Principals space in which to comment on the student and their training. As 2007 is the first year the new records are to be used we will review the use of this space during future compliance visits.

D4 Inadequately completed training records

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.

Progress:

We continue to see examples where training records have not been completed with appropriate care and attention particularly when there has been no requirement for the training Principal to provide narrative comments in relation to the students work and training. We have highlighted all instances identified during our review and are encouraging the bodies concerned to implement further checks to ensure that training records are completed accurately. We accept that due to the timing of the finalisation of our reports last year the majority of the training records reviewed during our 2006/07 visits had been completed prior to the finalisation of the report. We will continue to review this during our annual compliance reviews in 2007/08.

D5 Level of detail of approved training firm inspection visit reports

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.

Progress:

Whilst it was evident that some of the bodies had endeavoured to provide further information in relation to the outcome of an approval or monitoring visit of a training office. The reviews we undertook at the RQBs during 2006/07 illustrated that this had not been implemented at all of the bodies. We understand that three of the remaining RQBs are in the process of updating their inspection forms and will ensure that reviewers are required to provide more detailed explanations of the outcome of the visit. We have reiterated this point to the RQBs this year (see paragraph 2.27.)

We expect the bodies to implement our recommendations from this period in a timely way. We will review the extent to which they have been put into effect during our annual compliance review in 2007/08 and will comment on this in our next Annual Report.

ANNEX 3

PROFESSIONAL OVERSIGHT BOARD

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