



PROFESSIONAL OVERSIGHT BOARD FOR ACCOUNTANCY

REPORT TO THE SECRETARY OF STATE

YEAR TO 31 MARCH 2005



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Report to the Secretary of State (Year to 31 March 2005)

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Chairman's Foreword

It is with great pleasure that I present this report on the first full year's work of the Professional Oversight Board for Accountancy (POBA) in anticipation of our statutory responsibilities. POBA's activities contribute to the Financial Reporting Council's primary aim of promoting confidence in corporate reporting and governance and thus supporting national and international capital markets.

POBA was established following the Government's review of the regulatory regime for the accountancy profession which reported in January 2003. The review concluded that, whilst the regulatory regime in the UK was amongst the best in the world, the time was ripe to strengthen it further by injecting stronger independent regulation and oversight. Three recommendations in particular have defined our role: that POBA should take responsibility from the DTI for the statutory oversight of audit regulation; that there should be a new Audit Inspection Unit as part of POBA which would take over from the professional bodies responsibility for monitoring the audits of those entities which have the greatest impact on financial and economic stability; and that POBA should take on the wider accountancy remit of our predecessor body, the Review Board of the Accountancy Foundation.

We established our priorities for 2004/05 with these considerations very much in mind. We set out some of the detail of our first year's work relevant to our statutory responsibilities in the body of this report. I comment here on the progress we have made on four key priorities the Board identified.

First, we concluded that it was essential within the first year to set up the Audit Inspection Unit (AIU), establish a new approach to monitoring the quality of audit, and to carry out an extensive programme of monitoring at the four largest audit firms. These were ambitious targets. I am pleased to say that by the end of March not only was the AIU fully operational but the first round of inspection work at the four largest audit firms was largely complete. This enabled the AIU to publish in June a public report on the first year of inspections. (POBA publications can be found at <http://www.frc.org.uk/poba/publications/>)

Secondly, we recognised that we needed to be ready to assume the statutory powers to exercise oversight of the recognised professional accountancy bodies. (Although the General Election led to a delay in Parliamentary consideration, the delegation order has now been approved.) We took the opportunity to document and assess the regulatory systems and practices by which each of the professional bodies fulfils its role as a recognised audit supervisory and/or qualifying body. This will enable us to carry out detailed testing and monitoring of the regulatory systems during 2005/06. We could not have done this without the full cooperation of the accountancy bodies and we are grateful for that.

Thirdly, we were keen to develop a more detailed understanding of the scale of the recognised professional bodies and the effectiveness of the key aspects of their regulatory systems. With regard to scale, we thought that it would be helpful to publish a new edition of Key Facts and Trends in the Accountancy Profession with a greater focus on information relevant to our statutory responsibilities. With regard to key regulatory systems our focus was on complaints and discipline and training and education. In so doing we were able to build on the work of the Review Board, contribute to our wider remit to oversee the regulation of accountants and to make recommendations for improvement to the professional accountancy bodies. Our work on complaints and discipline reviewed the progress of the accountancy bodies in implementing the Review Board's recommendations. Perhaps the most important new issue we identified as a priority was the education and training of accountants, which is a critical long term influence on confidence in financial reporting and in the profession more widely. We therefore undertook a wide-ranging review of the adequacy of the training and education of accountants in the UK, focusing on the way in which this influences the quality of financial reporting. We worked closely with the professional bodies, accountancy firms, tuition providers, universities and those training for a professional qualification in accountancy. Our report, published in April, identified a number of specific issues that need to be carefully addressed.

Fourthly, we recognised from the beginning that our work is set increasingly in an international context and that we need to work with other similar oversight bodies. We have therefore worked strongly in support of the FRC's overall aim of developing appropriate international mechanisms for cooperation amongst audit regulators both at the global and EU levels. We have also worked closely with officials in the DTI as the negotiations have developed on new regulatory requirements for auditors in the EU; and we have developed good working relationships with key regulators in other countries particularly in Europe and North America.

Finally, I want to record my thanks to Gareth Jones and Sarah Wood, who retired from the Board under our rotation arrangements. Both had also served on the Review Board, and we benefited greatly from their wide experience. I also welcome David Crowther and Richard Barfield, who joined the Board in the course of the year, and Hilary Daniels, who joined on 1 April this year.

Sir John Bourn,
Chairman,
Professional Oversight Board for Accountancy
October 2005

One - Introduction

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 by providing:

- 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.

As part of this, the Secretary of State for Trade and Industry has delegated to POBA as of 5 September 2005, statutory functions relating to the regulation of audit in the United Kingdom. This report focuses on our activities in preparation for the formal assumption of these delegated responsibilities.

POBA report on the key facts and trends in the accountancy profession

In February 2005, we published the third edition of 'Key Facts and Trends in the Accountancy Profession' (<http://www.frc.org.uk/poba/publications/>). The first and second editions were published by the Review Board of the Accountancy Foundation.

The report provides a statistical summary of the accountancy profession and shows the trends on:

- the members and students of the six chartered accountancy bodies
- the income and staffing of the six bodies
- the fee income of the largest UK audit firms
- numbers and size of audit registered firms

The information in the report illustrated the underlying health and importance of the accountancy profession in the UK, with the overall numbers of students and members continuing to grow.

Two - Independent oversight of the recognised supervisory and qualifying bodies

Following the delegation order POBA is responsible for the recognition, ongoing monitoring and de-recognition of supervisory and qualifying bodies. A person responsible for a company audit must hold a qualification of a recognised qualifying body (RQB) and the audit firm must be registered with, and subject to supervision by, a recognised supervisory body (RSB).

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

The Chartered Institute of Public Finance and Accountancy (CIPFA) has recently been recognised as an RQB.

RSB and RQB monitoring

Our oversight of the regulatory activities of the RSBs/RQBs will be discharged in three ways;

- documenting and understanding each body's regulatory system 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 i.e. complaints and discipline procedures, monitoring visits, audit registration procedures, moderation of examinations, syllabus coverage, overall examination standards, training requirements, monitoring of approved training practices etc.

In its first year, and in preparation for assuming its delegated statutory powers, we have visited each of the bodies and documented and assessed the regulations, systems and practices by which each of the bodies fulfils its role as an RSB and/or RQB. We have found that the bodies have well-developed and complex systems for meeting their obligations and that the bodies devote considerable time and resources to these functions.

We will update this systems documentation and compliance test the systems' operation annually.

RSB regulatory systems

Schedule 11 of the Companies Act 1989, as amended by the Companies (Audit Investigation and Community Enterprise) Act 2004, sets out the requirements which supervisory bodies must meet. The bodies fulfil these requirements chiefly through three processes: audit registration, audit monitoring, and enforcement.

Audit registration

All the RSBs (other than the AAPA) register audit firms not individual auditors (the Act allows both firms and individuals to be appointed company auditor). All firms registered for audit are listed on the Joint Audit Register administered by ICAS on behalf of all of the RSBs. The register lists the firms' names, addresses and the individuals who are nominated by those firms to be responsible for audit work. At present the register is available to the public for inspection at each of the RSBs' head offices.

The following table shows the number of registered auditors with each RSB at 31 December 2004:

RSB	Registered auditors
ACCA	3,053 firms (2003: 3,083 firms)
AAPA	107 firms and individuals (118)
ICAEW	5,475 firms (6,336)
ICAI	1,048 firms (1,046)
ICAS	374 firms (423)

All registered firms provide their RSB with an annual return, to confirm that they still meet the conditions for registration. The information given on the return is confirmed by periodic inspection during audit monitoring.

Audit monitoring

All the RSBs monitor the firms that are registered with them for audit purposes. This is performed by the ACCA's monitoring unit for ACCA registered firms and for AAPA registered auditors. Until recently the monitoring of firms registered with the ICAEW, ICAI and ICAS was performed by a joint monitoring unit, but each Institute now has its own monitoring function. In addition, the Audit Inspection Unit (AIU), part of POBA, performs the independent monitoring of the auditors of major public interest entities.

The monitoring confirms the undertakings given by the firm in its application for audit registration or its annual return, and confirms that the firm complies with the regulations of the RSB. In addition to checking facts (such as control of the firm and the qualifications of persons responsible for audit work), the monitoring also focuses on the quality of the audits performed and compliance with audit regulations.

For this year the RSBs have continued to submit Annual Reports on the monitoring and the outcomes of the visits to the Secretary of State - the three institutes jointly submit one report and the ACCA submit one report which includes the AAPA. The reports also cover other regulatory activity by the bodies including complaints and discipline, education and training and the costs of regulation. These reports will come directly to POBA following the delegation order.

We have discussed issues arising from the reports with the bodies as part of our preparation for monitoring the RSBs. The main points in the reports were:

ICAEW/ICAS/ICAI

- 13% reduction in audit registrants due to the increase in the audit threshold
- 1,099 monitoring visits were made in the year, approx 16% of registrants
- 87% of visits resulted in no action required or agreed plans for improvements
- 46 firms had their registration withdrawn in the year, 15 following monitoring visits - the others were for other reasons such as non-payment of fees
- Overall response in feedback from firms monitored was that the system was working well

ACCA/AAPA

- Only a small reduction in number of registrants
- 315 (2003: 330) routine and 121 (123) non-routine visits were made in 2004
- 81% (88%) of all firms visited were deemed satisfactory or resulted in agreed plans for improvements.
- 6 firms had their licence removed by the Admissions and Licensing Committee (ALC), a further 17 surrendered their licence before the ALC considered their case.

Effective audit monitoring is the key to reinforcing the quality of audit work and enforcing compliance with auditing standards in the UK. The focus of our review of RSBs in 2005/6 will be on the effectiveness of the bodies' audit monitoring.

Enforcement: Complaints and discipline procedures

In February 2005, we published a report which followed up the extensive review of the chartered accountancy bodies' complaints and discipline procedures by the Accountancy Foundation's Review Board in November 2002. Our report looked at issues left open by the previous report, relating to the

need for an ombudsman for the accountancy profession and/or a compensation scheme for the profession. It also followed up the bodies' implementation of the recommendations in the previous report. It is a statutory requirement that an RSB has effective procedures for complaints and member discipline in relation to audit; however, our report was not limited just to audit related complaints.

The Review Board's report in November 2002 asked the accountancy bodies to submit their views on whether an ombudsman was needed for the accountancy profession. We considered the bodies' submissions and consulted with other relevant authorities including the British and Irish Ombudsman Association, the Financial Ombudsman and the Legal Services Ombudsman.

We concluded that:

- Provided there was effective implementation of enhanced independent alternative dispute resolution (ADR) mechanisms, the establishment of an Ombudsman scheme for the whole profession would not be proportionate or cost-effective at this time.
- The bodies should develop ADR procedures (or in some cases refine existing schemes) for dealing with simple service and fee disputes.
- A single, independent arbitration scheme should be set up across the bodies to offer an alternative to court proceedings where both parties were willing to participate.

We have requested that the bodies provide detail of proposed ADR schemes by November 2005. In addition, we reissued six key recommendations from the previous report and will continue to monitor the bodies' implementation of both reports' recommendations, alongside our monitoring of their complaints and discipline procedures as part of the RSB monitoring process.

RQB regulatory systems

Schedule 12 of the Companies Act 1989 sets out the requirements which a body offering a recognised professional qualification for audit purposes must meet. These requirements fall into three main areas:

- a course of theoretical instruction;
- examinations; and
- practical work experience.

Course of theoretical instruction

All the RQBs offer a course of theoretical instruction, either directly themselves or through training providers, often using material provided by one of the bodies. A candidate must first complete a course of theoretical instruction in order to gain a recognised professional qualification.

Examination

The Company Auditors (Examinations) Regulations 1990 prescribe subjects which must be tested by an RQB's examinations. All of the RQBs have provided to POBA a mapping of the prescribed subjects to their syllabuses. The examinations must test both theoretical knowledge of these subjects and the ability to apply that knowledge. They must require a standard of attainment at least equivalent to UK degree standard. All of the RQBs have procedures for setting, moderating and monitoring each exam, which include committees on which independent academic experts sit.

POBA will undertake a programme of monitoring the operation of the systems and procedures by which the bodies control and ensure the standard of the examinations.

Practical work experience

All of the RQBs require a minimum of three years practical experience, a substantial part of which is training in company audit work or similar work under the supervision of a qualified auditor.

Four of the bodies require their members to hold a practising certificate to be able to engage in public practice, that is to sell accountancy services to the public. This is not a statutory requirement, but is part of the professional bodies' self-regulation. The requirements for a practising certificate are often for more than three years experience, and the bodies require a member to hold a practising certificate to be able to be nominated by an audit registered firm as an individual responsible for audit. Thus the minimum legal requirements for auditors' practical experience (as set out in the 1989 Act) are often exceeded in practice by the bodies.

POBA report on the training and education of accountants

In anticipation of POBA's role regarding the independent oversight of RQBs and as part of POBA's wider role for the independent oversight of the accountancy profession, we undertook a review of the adequacy of training and education of accountants and auditors. We consulted widely, through a panel of academics specialising in the field, through an Expert Group with representatives from a wide range of organisations involved in designing and delivering training, and through two public consultations.

We found that the current arrangements for training and educating accountants help attract many of the brightest graduates and other talented people to the profession and, through a combination of theoretical and practical training, produce many highly competent individuals who are able to progress to senior positions in business and the public sector. The professional accountancy bodies are also working to develop the commitment to career-long learning within their membership.

However, we also identified a small number of specific issues that 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. In particular we concluded that:

Trainees need to have a stronger understanding of the importance of the work of the accountancy profession to the effective working of the capital markets and the wider public interest.

Such an understanding is an essential foundation for a meaningful commitment to the profession's values and codes of conduct, including to career-long learning.

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

Background

Following Enron and other well-publicised corporate reporting failures, the UK Government undertook a review of the regulatory regime for auditors and accountants in the UK. The report 'Review of the Regulatory Regime of the Accountancy Profession' was issued in January 2003. That report recommended enhancing the monitoring of the audits of listed and other major public interest entities through a new independent inspection unit (the AIU) reporting to a professional oversight board (the POBA) within an integrated independent regulator (the FRC).

The AIU is taking over responsibility for the monitoring of the audits of all listed and other entities in whose financial condition there is considered to be a major public interest on a phased basis. 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 more challenging for the major firms, focusing on audit partners' judgments as well as on audit processes. Consequently the AIU has developed and implemented an approach to audit monitoring for the major firms based on the following characteristics:

- Focus on the quality of auditing, with our recommendations to firms prioritised on this basis
- Thorough, robust and challenging approach to inspection visits
- Wide-ranging reviews of firm-wide procedures, including an assessment of how the culture within firms impacts on audit quality
- Selection of major audits for review which is largely risk-based
- In-depth reviews of major audits, focusing on the quality of the group audit, including critical assessment of the key audit judgments made and a detailed review of compliance with UK Auditing Standards
- Review of the quality of reporting to the Audit Committee.

Scope

The scope of the AIU's inspections is the audit of all entities with listed securities (both equity and non-equity securities) and other entities in whose financial condition there is considered to be a major public interest. This approach is designed to ensure that independent inspection is focused on those audited entities and audit firms in respect of which the level of public interest is highest.

POBA is responsible for approving the AIU's work programme and, in particular, determining which audited entities fall within the "major public interest" category and therefore within the scope of its work. In March 2005 we published a summary of all entities within the scope of independent

inspection for 2005/6. The monitoring units of the professional bodies remain responsible for the monitoring of those audits within the scope of audit regulation in the UK but outside the scope of independent inspection by the AIU.

Conclusions

The AIU's reviews of individual audit engagements indicated that the key audit judgments exercised in relation to financial reporting issues appeared, in the great majority of cases, to be both appropriate and soundly based. However, as a result of insufficient documentation in many cases, it was often necessary to form a view as to the appropriateness of such judgments on the basis of oral explanations provided to the inspectors. Insufficient audit documentation both reduces the effectiveness of firms' own quality control processes and makes it more difficult to adopt a monitoring approach focusing on key audit judgments (rather than an approach characterised by some as "box ticking"). The AIU referred two cases, where it was not satisfied that the accounting treatment adopted and/or disclosures provided complied with UK GAAP, to the FRC's Financial Reporting Review Panel (the issues concerned did not affect reported profits in either case).

The AIU inspections identified no systemic weaknesses in the overall policies, procedures and systems of quality control operated by the firms and indicated that, when properly applied, those procedures and systems should provide reasonable assurance that appropriate audit opinions are issued by the firms. However, the AIU identified certain areas in which it considers that improvements to these policies, procedures and systems, and/or the application thereof, are needed to improve audit quality within the firms.

The AIU believes that the risks the above matters pose for the quality of individual audit engagements must be addressed by the firms. It has made a number of recommendations to each of the firms in private reports as to the actions it believes are appropriate to address the issues arising from its work.

Partners of the audit firms do not normally face external questioning on their audit judgments; this and the comprehensive and detailed nature of the AIU's monitoring have presented challenges to the firms, which we do not underestimate. The test will be the extent to which the audit firms embrace and value recommendations arising from the monitoring process.

The largest firms have now had the opportunity to adjust to the new regulatory regime and the AIU will monitor the actions taken by them to implement the recommendations. It will review the extent to which they have done so during its 2005/6 inspections.

A report prepared by the AIU describing the principal themes and issues arising from its 2004-5 inspections was published by the POBA in June 2005 (<http://www.frc.org.uk/poba/publications/>).

Four - future work programme

Our work programme for the year to 31 March 2006 still relates to our three principal 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. But there is a distinct change of emphasis in our work from the first year as we move further beyond the set-up period and build up our detailed monitoring both of major audit firms and audits and of the audit regulatory activities of the professional bodies.

POBA's work programme is an integral part of the Financial Reporting Council's Plan and Budget for 2005/06. The details of POBA's work programme can be seen at [http://www.frc.org.uk/documents/pagemanager/frc/Planandbudget\(final\).pdf](http://www.frc.org.uk/documents/pagemanager/frc/Planandbudget(final).pdf).

We draw out the major themes below.

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

Last year was principally concerned with preparation for taking on our regulatory powers. 2005/06 will mark the first full year in which we monitor the effectiveness of the regulation by recognised bodies of statutory auditors, and their compliance with the Companies Act 1989, as amended by recent legislative changes. In addition to testing the regulatory systems generally, we have concluded that a particular focus should be a review of the effectiveness of the bodies' audit monitoring procedures.

Under the delegation order, POBA is also given specific but limited powers to set legal requirements in relation to audit regulation, for example on the register of auditors and on the information to be made public about audit firms. These requirements have not changed for many years and we propose to consult on new requirements, taking into account new legislation at the European level - the draft 8th Company Law Directive on the Regulation of Auditors. For example, we will review and consult on the requirements for the audit register including the ways in which it can be accessed by the public.

We are also undertaking a specific project to look at the extent of information which the major audit firms make publicly available about themselves - for example their structures, finances and their arrangements for ensuring the quality of their audits - with a view to consulting on statutory requirements which meet the requirements of the new 8th Directive.

There are two other important initiatives which are integral to our statutory responsibilities. We are working closely with another part of the FRC, the Auditing Practices Board, and with the DTI on developing new standards and guidance on audit quality; and we are working with the DTI on research to give us a better understanding of competition and concentration in the UK market for major audits, to help identify policy options, for example to reduce barriers to new entrants.

2. Monitoring the quality of major audits

For 2005/06 the AIU is extending its coverage beyond the Big 4. In addition to a further programme of inspections at the Big 4, there will be full inspections of the next tier of audit firms (the "Mid 5"), who audit a significant number of listed or major public interest entities. And there will be a review of the small number of audits of FTSE 350 companies audited by other firms

3. Wider oversight of regulation of the accountancy profession

Our responsibilities do not relate simply to large accountancy firms and public interest clients; we concluded that our major project for 2005/06 under this heading should be to undertake research into the accounting and auditing needs of small and medium sized companies and users of their accounting information, how these needs are met by the accountancy profession; and to review the relevant activities of the professional bodies in the light of this research.

4. International Priorities

This continues to be of major importance. Our priorities are (i) to develop ways to monitor audits of major international businesses, working with regulators in other countries, such as the PCAOB in the US, to develop new ways of cooperative working and to share best inspection practice internationally; and (ii) to work within the overall FRC objective of developing sensible international mechanisms for cooperation and coordination amongst audit regulators.

Appendix 1

PROFESSIONAL OVERSIGHT BOARD FOR ACCOUNTANCY

2004/05

Chair

Sir John Bourn KCB
Comptroller and Auditor General of the United Kingdom

Members

Richard Barfield (*from 1 June 2004*)
Director of Equitas, and of Umbro plc. Formerly Chief
Investment Manager of Standard Life in Edinburgh

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

David Crowther (*from 1 July 2004*)
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 (*from 1 April 2005*)
Chief Executive, West Norfolk Primary Care Trust

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

Stella Fearnley
Professor of Accounting, University of Portsmouth

Paul George
Director, POBA

Gareth Jones (*to 31 December 2004*)
Formerly Managing Director Wholesale Banking, Abbey National plc

Michael Jones

Head of Management Services & Administration, Trades Union Congress

Ann Maher

Chief Executive, The Pensions Board for Ireland.

Board member of the Irish Accounting and Auditing Supervisory Authority

Sarah Wood (*to 31 December 2004*)

Director of Economic and Environmental Policy, Local Government Association



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