ADVISORY COMMITTEE ON THE AUDITING PROFESSION

SUBMISSION BY

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1. Introduction.

1.1 It is a privilege to be asked to give evidence to this Committee. As explained in Appendix 1, I have been involved with the auditing profession over many years and in a number of capacities, most recently as Chairman of the UK Auditing Practices Board (the APB), which is part of the Financial Reporting Council (the FRC) and as Chairman of the Consultative Advisory Group of the International Ethical Standards Board for Accountants. Appendix 2 summarizes the APB's responsibilities in respect of the auditing profession under the UK's regulatory framework and how those responsibilities have evolved.

1.2 In the period since 2002, the APB has issued

- A complete suite of auditing standards;
- Ethical standards to address the integrity, objectivity and independence of auditors;
- Five investment reporting standards; and
- Bulletins addressing emerging issues and guidance notes for particular industries or sectors.

1.3 Possibly of more relevance to this Committee may be the fact that since 1992 the APB has published a range of consultation papers that have addressed key issues facing the auditing profession. These have included:

- The Future Development of Auditing (and its successor consultation papers);
- Fraud: Choices for Society;

- Aggressive Earnings Management; and

- Promoting Audit Quality[1];

- The Auditor's Report: a time for change?

We have also issued a consultation paper on Limitation of Liability Agreements (which auditors will be entitled to enter into with the companies they audit after April 2008).

1.4 This experience has, I believe, provided an unusually broad insight into the issues facing the audit profession, the concerns of stakeholders and other users, and the factors that determine audit quality. Importantly, it has also included a regulatory perspective.

1.5 In this paper, I have

- set out in summary form the considerations that I believe are central to the future success of the audit profession;

- commented upon the role of auditing and ethical standards within the regulatory framework;

- summarized the FRC's project 'Promoting Audit Quality' and the key conclusions that emerged;

- made some suggestions as to the key steps that might be taken to secure and enhance the future of the audit profession.

[1] http://www.frc.org.uk/about/promotingauditquality.cfm

2. The key challenges facing the audit profession.

2.1 In my view, the key challenges facing the audit profession fall into three categories:

- How to ensure that the audit profession meets the needs of stakeholders?
    - Whether the profession meets stakeholders' expectations, particularly in relation to the detection of fraud, and
    - Whether, in today's world, the current reporting model remains appropriate.
- How to ensure that quality audits are performed?
    - Whether there is an excessive dependence upon audit methodologies,
    - Whether professional judgment is adequately established as a core competency, and
    - Whether there is a tension between running a multi-faceted business and providing a professional service.
- Whether, given the modern, global business environment, there exists an appropriate relationship between the audit profession and the business, regulatory and political communities?
    - Whether there are appropriate arrangements in place to ensure the continued health of the audit profession, given the level of concentration,

the barriers to entry and the risk of an audit firm failure, whether for regulatory or civil liability reasons, and

- Whether that position can be improved to the benefit of all concerned.

2.2 Most of these issues have been considered by the FRC and the APB in the course of their projects to address

- Choice in the UK Audit Market – in relation to which Paul Boyle, the FRC's Chief Executive, gave evidence to this Committee in December, and

- Promoting Audit Quality, which is discussed in Section 4 below.

3 Auditing and ethical standards within the regulatory framework.

3.1 Given my particular area of responsibility as Chairman of the APB, it is appropriate that I set out my views on the role that auditing and ethical standards play within the UK regulatory framework.

3.2 The role that auditing standards play is often over-emphasised. As a result, there are some who attach unwarranted importance to auditing standards and appear to believe, wrongly in my view, that the majority of issues facing the auditing profession would be addressed if all auditors adhered to comprehensive auditing standards. I believe that this approach is misconceived and that to pursue such an approach would be disastrous for the future of the audit profession. I hold this view because auditing standards do not and, in my view, cannot address all situations that can arise. They can never be used as a substitute for the proper exercise of professional judgment.

3.3 Auditing necessarily involves the exercise of judgment. Whilst there may be some 450 requirements within the ISAs (UK and Ireland) and APB Ethical Standards, they are not designed to specify the particular actions to be taken to achieve audit quality. For example, they do not prescribe exactly how much work needs to be performed; nor do they set out the precise criteria for making each judgment that may be called for in the course of an audit.

3.4 On the contrary, following the so-called 'principles based' approach, auditing standards set out the work to be performed or the judgments to be made in order that a particular objective is achieved. Determining whether those requirements have enabled the particular objective of a standard to be achieved requires the audit team to exercise judgment.

3.5 Some securities regulators, aware that auditing standards are not a panacea, call for ever more comprehensive and prescriptive auditing standards. Given the variety of different entities (banks, insurance companies, oil companies etc.), the differences in the size of entities and their corporate governance arrangements, and the variations in the economic conditions that they experience, it is wholly unrealistic to expect auditing standards to specify the work that would need to be performed to meet every circumstance. Any attempt to do so is bound to fail.

3.6 Recognising this, the UK's Audit Inspection Unit (AIU) has, since its inception, considered broader aspects of audit quality than just auditing standards. To obtain agreement for what those broader aspects of audit quality should be, the AIU participated in the FRC's project on Promoting Audit Quality (see Section 4 below). The FRC's work on audit quality has been made available to a number of other audit inspection functions through the International Forum of Independent Audit Regulators (IFIAR) and will hopefully be influential in improving best practice internationally.

4. The FRC's project 'Promoting Audit Quality' and the key conclusions that emerged.

4.1 In November 2006, the FRC issued a Discussion Paper entitled ‘Promoting Audit Quality’. In issuing this paper the FRC hoped to establish the main elements of audit quality and thereby to:

- Assist audit committees to fulfil their responsibilities to evaluate audit effectiveness,
- Help develop consensus, both in the UK and internationally, as to need for audit inspections to address wider concerns than just compliance with auditing standards, and
- Help investors understand more about the nature of auditing. Some UK investors are liable to mistakenly characterise concerns relating to limitations in financial reporting/accounting standards as ‘audit quality’ issues.

4.2 Early work on the ‘Promoting Audit Quality’ project involved trying to identify a workable definition of audit quality. Existing UK descriptions[2] identify certain features that are thought necessary if an audit is to be of a high quality. However, none of these definitions provides an objectively verifiable measure of the sufficiency of evidence that is required before an audit opinion may properly be given and, therefore, the quality of the audit undertaken. This is unsurprising given the variation in the entities involved (size, industry, corporate governance arrangements – see paragraph 3.5 above,) and that the evaluation of audit judgments is inherently difficult.

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[2] For example the AIU’s definition is ‘*“Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgments…A quality audit [also] involves appropriate and complete reporting by the auditors which enables the Audit Committee and Board properly to discharge their responsibilities.”*[2]

4.3 Similarly a body of academic research has sought to investigate whether differences in 'audit quality' can be identified. Significantly, whilst such research reveals ways in which audit quality in general can be assessed, it has not resulted in a definition of a high quality audit that can be used as a 'standard' against which actual performance can be assessed.

4.4 This definitional difficulty arises from several factors, and in particular:

- The nature of the market for the provision of audit services with limited competition and transparency,
- The audit report does not provide users with information to assess the underlying quality of the audit,
- An audit opinion is subjective, and
- Users play only a limited role in relation to the retainer of the audit firm or the instructions given to it (and have no knowledge of the scope of the work undertaken).

The market for the provision of audit services

4.5 In most circumstances, the performance of a product, or the outcome of a service, provides an effective and visible measure of the quality of that product or service. In other circumstances, purchasers and users can assess the quality of the product or service based on their knowledge of the work undertaken and the reputation of those responsible for it. This is not the case with an audit because the way in which an auditor has approached the audit, the extent of the audit evidence obtained, and the key judgments that have been made are not disclosed or made available to those who rely on audited financial statements.

4.6 Since an audit is a statutory requirement in the UK, it is not open to companies and shareholders to address this limitation by choosing another means of achieving the objective. As a result, those providing an audit service are not open to competition from

competing products. The position is further exacerbated by the fact that only a small number of firms conduct the majority of audits of larger companies.

4.7 This combination of a service that lacks transparency, the lack of competition from competing products and the small number of providers could lead to a situation where a poor quality audit is performed; but market forces do not penalise the audit firm concerned. It is therefore incumbent on audit regulators to assess the quality of audits being performed and to try to ensure a uniformly high standard.

The audit report does not provide users with information to assess the underlying quality of the audit.

4.8 The form of an audit report in the UK is specified by law and auditing standards, with the consequence that it has become standardised. Save in the rare circumstances where the report is modified, either by a qualification or by an emphasis of matter paragraph, the audit report simply informs a reader that, in the opinion of the auditor, the financial statements in question show a true and fair view, in accordance with the relevant financial reporting framework, and have been prepared in accordance with the applicable law.

4.9 Virtually no information is provided about the way in which the auditor has approached the audit, the extent of the audit evidence obtained, and the key judgments that have been made. Furthermore, shareholders have no ability or opportunity to question or challenge the service provided by the auditor.

An audit opinion is subjective

4.10 The essence of an audit report - the statement that the financial statements in question show a true and fair view (or fairly present) - is a subjective opinion. It is not a definitive assertion that those financial statements are accurate. An audit is therefore designed to provide ‘reasonable assurance’ as to the accuracy of the financial statements.

For the purpose of an audit, 'reasonable assurance' is defined to be a high but not absolute level of assurance. What is 'reasonable' is a matter of judgment in each particular circumstance. This allows for different views to be held as to the extent and nature of audit evidence that is needed to support the required opinion.

Users play only a limited role in relation to the retainer of the audit firm or the instructions given to it (and have no knowledge of the scope of the work undertaken).

4.11 Auditors determine the scope of an audit, and the company (through its management and non-executive directors) inputs into it. But users have no such opportunity to input. As a result, users cannot rely on a detailed knowledge of the audit process that has in fact been undertaken to obtain reassurance. As a result, they obtain reassurance from other factors – such as the fact that the auditor is professionally qualified, the reputation of the audit firm and the regulatory regime that governs the preparation of the financial statements and the conduct of the audit.

4.12 It is important to appreciate that the lack of transparency that is inherent to the audit process may also be a disadvantage to <u>both</u> the companies and audit firms involved. Companies have no means of communicating the importance that they attach to the quality of the audit of their financial statements. Audit firms have no means of demonstrating the effectiveness of the work that they carry out – obligations of confidentiality prevent audit firms from publishing information regarding frauds detected, errors corrected and systems of internal control strengthened as a result of their work.

The approach taken by the FRC

4.13 To overcome this definitional problem the FRC decided that the most appropriate approach was to define those key factors, or drivers, that determine whether a quality

audit is undertaken and assess the way in which audit firms and individual accountants perform against them. This involved:

- Identifying those factors, or drivers, that determine whether an audit is of high quality;
- Considering whether there are threats to those drivers; and
- Assessing the extent to which the FRC (through one or more of its operating bodies) should take action to reinforce the effectiveness of those drivers.

4.14 The FRC believes that the drivers of audit quality fall into four groups:

- The culture within an audit firm;
- The structure and skills of the audit team;
- The quality of the audit process (being a combination of the ethical standards, auditing standards and the firms' audit methodology);
- The reliability and usefulness of audit reporting; and
- Factors outside the control of auditors.

4.15 The Discussion Paper acknowledged that the structure of the audit market and its impact on choice and competition could also have an influence on audit quality. However, this area was not addressed in the Discussion Paper because the structure of the audit market was the subject of the separate consultation process taking place under the auspices of the FRC.[3]

Responses to the consultation paper

4.16 The FRC had many responses to its Discussion Paper, including responses from investors and the corporate sector. Most respondents welcomed the FRC's initiative in

[3] A Discussion Paper, "Choice in the UK Audit Market" was issued in May 2006 and was followed by stakeholder meetings. The FRC has now established a Market Participants Group ('MPG') to provide advice to the FRC and, in particular, the MPG has identified and assessed possible actions which market participants could take to mitigate the risks arising from the characteristics of the market for the audit for major public interest entities in the UK.

pursuing its 'Promoting Audit Quality' project, notwithstanding that many of the respondents considered that financial reporting in the UK operates effectively and that audit is fundamentally sound.

4.17 The major points made in the responses and the FRC's reaction are summarized below.

The need for a 'framework of audit quality'

4.18 There was a high degree of support for the FRC's approach of identifying the drivers of audit quality. The FRC is therefore publishing a Framework setting out the drivers of audit quality for the information and use of stakeholders - especially audit firms, audit committees and investors. The FRC recognises that audit quality is a dynamic concept and that the drivers of audit quality may change over time. The FRC intends periodically to update this framework in the light of comments received.

4.19 The FRC hopes that audit firms will use the framework to structure annual communications about their policies and the actions they take to ensure high quality audits are performed. Such communications could form part of the 'Transparency Reports' that are already being issued by the major audit firms and which will shortly be required by regulations.

Culture within audit firms

4.20 Investors believe that an audit firm's approach to governance, in particular the 'tone from the top,' is an important influence on its culture. Whilst a number of respondents recognise that there have been positive developments in this area over recent years, they also note that there is still scope for improvement, not least, in relation to how this is communicated externally. They assert that transparency as to the governance and policies applied by firms to achieve audit quality will greatly assist market forces. Both the responses to the Discussion Paper and the interim and final reports of the Market Participants Group[4], demonstrate a demand from investors for greater transparency

[4] The MPG's interim and final reports can be found at www.frc.org.uk/press/pub1302.html and www.frc.org.uk/press/pub1420.html

about the corporate governance of the major audit firms and a desire that they should comply with appropriate elements of the FRC's Combined Code or an adaptation of it.

Role of audit committees

4.21 Most respondents considered that the introduction of audit committees had added credibility to the financial reporting process. Investors commented that they take reassurance from the fact that most members of these committees take their responsibilities seriously and seek to fulfil them to the best of their abilities. Some respondents think that audit committees could do more to evaluate the effectiveness of the external audit[5]. However, others are of the view that the breadth of audit committees' current responsibilities means that they have little time to undertake a thorough evaluation of the effectiveness of the external audit.

Skills and personal qualities of audit partners and staff

4.22 There is widespread agreement amongst all categories of respondent that the factors identified in the Discussion Paper - technical skills, personal qualities and practical experience - are key drivers of audit quality. It is these factors that allow auditors to understand their client's business, undertake a rigorous audit and make high quality audit judgments.

4.23 A number of respondents commented that the UK profession benefits from allowing graduates of all disciplines to train as auditors, so allowing talented people with a mixture of skills to enter the profession. Whilst the UK profession does not currently appear to have a problem recruiting the right calibre of trainees, there is a general view that retention of the best staff after qualification continues to present a challenge.

4.24 Many outside the profession blame the firms' dependence on rigid procedures and audit methodologies for the poor retention rate amongst qualified staff. One investor

[5] The AIU is currently consulting on how best to report on the results of its monitoring activity. One element of these proposals is that the AIU would provide a separate report on each audit reviewed to the audit firm. The audit firm would then be able to share that report with the audit committee of the client. This process is likely to affect the work that audit committees currently undertake in reviewing the effectiveness of the audit.

commented that it thought the main reason for the poor retention rate is that *"…audit work has been reduced to a mechanical process rather than one requiring judgment by front-line staff. We believe that too much decision-making has been removed from those who actually carry out the audit such that audit is seen as mechanical work rather than an interesting profession"*. They assert that devolving more authority and responsibility to those actually carrying out the audit work would assist staff retention and promote quality in individual audits and across the market as a whole.

4.25 While there is relatively little support for a fundamental review of the curriculum that leads to qualification as an accountant, a number of commentators say that there is a need to supplement this, especially after qualification, with specific training in auditing. A number of commentators were concerned that fee pressures was changing the extent to which inexperienced staff developed effective auditing skills from 'on-the-job' coaching and mentoring.

The staffing model for audit performance

4.26 The biggest area of disagreement between the audit firms and other respondents to the Discussion Paper relates to the staffing model used by the larger audit firms. Some comment that a staffing model that involves relatively inexperienced, unqualified, members of staff carrying out much of the audit work does not reflect the need for expertise to be applied at all stages of the audit. These commentators note that, while the complexity of business had changed considerably over the last 30 years, this has not been reflected in the approach to staffing adopted by firms

4.27 Investors, in particular, were concerned that if issues go unnoticed at early stages of an audit they may never reach review by a more experienced manager or partner. One commentator expressed concern that there is a perception that *"… in practice much of the audit work performed can be superficial in nature if following rigid procedures and is frequently performed by inexperienced trainees. One of the difficulties facing the audit profession is that it traditionally places considerable reliance on trainees. This could be regarded as flawed as failure to identify problems in the detail may not be picked up later in the chain."*

4.28 Audit firms defend their approach. They assert that the work of less experienced staff is effective because of their investment in training and methodologies, and because junior members of the team are closely supervised by senior staff and partners. Indeed, they claim that the staffing model used helps the professional development of junior staff, as they are given responsibility early and are able to learn from the experience of their more senior peers. One large firm commented, "*We do not see that there is any evidence to suggest that there is a flaw in the 'pyramid structure' or in the training provided. Partners and managers are heavily involved in the key risk areas of an audit and staff members are adequately briefed, trained and supervised on the roles that they are assigned to*".

4.29 Reservations about the use of junior staff to undertake audit fieldwork is inextricably linked to the training provided to such staff. The FRC notes that the education committee of IFAC has recently issued IES 8[6]. IES 8 introduces the concept of an audit professional as someone who exercises significant judgment in the audit of financial statements. In the FRC's view, the practical experience relevant to an audit professional suggested in IES 8 is greater than the current minimum requirements set by the UK professional accountancy bodies to meet the requirements of the UK Companies Act. The manner and extent to which the UK accounting profession adopts IES 8 may have an impact on the way that audit fieldwork is undertaken.

4.30 The FRC recognises this is a complex issue – and a very important one. It has therefore agreed with the accounting bodies that a task force, comprising representatives of audit firms, professional bodies and other stakeholders, should be established to consider:

- The FRC's interpretation of IES 8

[6] IES 8: Competence Requirements for Audit Professionals: This International Education Standard (IES) prescribes competence requirements for audit professionals, including those working in specific environments and industries. IFAC member bodies need to establish policies and procedures that will allow members to satisfy the requirements of this IES before they take on the role of an audit professional. The responsibility for the development and assessment of the required competence is shared by IFAC member bodies, audit organisations, regulatory authorities and other third parties.

- The potential impact of IES 8 on the training of auditors and;
- The concerns expressed by companies and investor representatives.

Audit reports

4.31 Views on the usefulness of the audit report vary considerably. Although some respondents are comfortable with the current approach, some institutional investors contend that investor confidence would be enhanced if auditors reported more matters of possible interest to investors – irrespective of whether the matters are disclosed elsewhere in the financial statements. One institutional investor commented that "*many investors are surprised that so little is reported*" and cites, as an example of a matter that might be reported, the situation where a company's computer system has reached the end of its operational life and the company has no plans to replace the system. It notes that "*including such an item would be fairer to investors and would spur the company into dealing with the issue*".

4.32 A number of respondents request changes to the current format of the auditor's report which they believe is overly legalistic and to contain so many caveats and provisos that its usefulness is limited. Some want to see a reorganisation of the audit report so that the opinion appears earlier in the report; whilst others call for more radical changes, such as the introduction of narrative reporting to make the auditor's report more informative in areas such as estimates, judgments, sufficiency of evidence and uncertainties.

4.33 Given the wide range of views, the APB has recently issued a Discussion Paper 'The Auditor's Report: A time for change?' to explore what might be done to address some of the investors concerns.

Regulatory change

4.34 There is a widely shared view that the volume of recent changes to UK legislation,

accounting standards and aspects of audit regulation had been significant. This change had been difficult for the audit firms to assimilate and there is a need for a period of stability to allow those changes to be fully understood and embedded in the firms' systems.

Overseas audits

4.35 While the quality of auditing in the UK is generally seen as being acceptable, a number of investors expressed concern at inconsistency in the quality of audits of UK owned subsidiaries based in overseas jurisdictions. One investor asserts that global audit networks may not always achieve common firm-wide standards, noting that whilst global auditing networks use the same methodologies, effective application in practice depends on the skills and expertise of the local workforce.

4.36 Concerns of investors relating to the quality of audits of overseas subsidiaries appear to be compounded by the lack of transparency of the audit firms, particularly those that have operations based in other jurisdictions.

5 Some concluding thoughts

5.1 Drawing upon some of the analysis set out earlier in this paper, I set out some concluding thoughts. In so doing I must emphasise that they are my personal views and not necessarily those of the bodies that I represent.

5.2 ***Auditing standards*** are an important aspect of audit quality but there are other, potentially even more important factors. There is a risk that, after a certain point, making auditing standards even more specific could have a negative impact on audit quality. In my view the soon to be completed IAASB 'Clarity ISAs' will provide an appropriate balance between clarifying the intent of the standards and allowing experienced auditors the flexibility that is necessary both to respond to specific risks and circumstances and to keep auditing 'interesting'. I do not believe that further effort is needed, at this stage, to further refine auditing standards – those resources would be better directed towards:

- Encouraging all counties to use IAASB Clarity ISAs,
- Developing training to ensure that Clarity ISAs are effectively and consistently deployed, and
- Ensuring that IAASB has the right working relationship with international audit regulatory bodies so that, over time, failings in auditing identified by the regulatory bodies are addressed, where appropriate, in improvements in standards.

5.3 ***Auditor independence and objectivity*** is an essential aspect of audit quality. But views differ internationally and more needs to be done to establish an international consensus as to appropriate international ethical standards. In my view this is more a political than a technical issue and effort needs to be directed towards obtaining the support of national governments and regulatory bodies so that they appreciate that the harmonisation of international ethical standards would be beneficial to them.

5.4 Probably the major contributors to audit quality are ***the skills and personal qualities of audit partners and staff***. There are many elements to this including the:

- Calibre of staff entering the auditing profession,
- Method and timing of training provided to auditors (both before, and after, qualification), and
- Motivation and the retention of experienced staff.

The UK believes that it has benefited from allowing university graduates of all disciplines to train as auditors, so allowing talented people with a mixture of skills to enter the profession. In my view however in the UK there remains more to be done to improve training and retention rates.

5.5 Increasing the ***level of experience*** of those members of the audit team undertaking audit field work is linked to improving retention rates. In section 4, I have described the work we are undertaking in the UK to explore this area further. I suspect that this issue is likely to be equally relevant internationally.

5.6 Assessing the adequacy of the skills and personal qualities of audit partners and staff would seem to be an important aspect of audit inspection. However, methods and criteria to do this are still in their infancy. I therefore welcome the creation of the International Forum for Independent Audit Regulators (IFIAR) and hope that it will result in coordinating improved evaluation of the 'softer' aspects of audit quality over the coming years.

5.7 The precise role of ***audit committees*** varies by jurisdiction. In the UK, audit committees of listed companies have a specific responsibility to evaluate external auditor effectiveness. This activity can have a direct impact on audit quality as audit committees should be able to observe aspects of audit quality that are hidden to other stakeholders. From our work on 'Promoting Audit Quality' it seems that different audit committees approach this responsibility in different ways. By publishing the 'Framework for Audit

Quality', the FRC hopes to both energise some audit committees in this area and to increase the range of issues considered by all audit committees.

5.8 I think there are benefits to be gained from strengthening the ***governance arrangements of the larger audit firms***. In the EU, legislation requires audit firms to publish 'Transparency Reports' which provides an opportunity for larger audit firms to project a distinctive approach. There is a danger, however, that audit firms will not respond to the challenge and these reports will just contain 'boiler-plate language'.

5.9 I would also welcome a reconsideration of the approach taken by the major firms to corporate governance and their relationship with regulators and others responsible for the effectiveness of the financial markets.

5.10 ***Auditor's reports*** also contain 'boiler-plate language'. It will be important to explore what can be done to make such reports more 'narrative' in nature - such as by describing important features of the financial statements or the audit undertaken. However, while 'narrative reports' are likely to be of interest to investors, I fear that both companies and auditors will resist the pressure for reform in this area and legislation will be needed if change is to be achieved.

5.11 My final observation relates to ***the long term sustainability of the auditing profession***. While there may be short term actions that can be taken to recruit to and retain within the auditing profession high calibre of staff, in the medium term I believe the quality of the staff available to audit firms can only be maintained or enhanced if auditors increase the relevance of their work to the financial community.

5.12 While annual financial statements are an important source of information to investors their relative importance has probably declined during the last twenty years and will probably continue to decline in the next twenty. The value of the auditor's report can not be higher than the financial statements themselves.

5.13 The major audit firms have developed a number of assurance services these do not usually involve public reporting. However, to ensure that the auditing profession remains relevant, and can therefore justify premium fees for its services, I believe that it needs to be more adventurous in areas such as reporting on:

- Prospectuses
- Interim financial statements
- Corporate governance and systems

5.14 To do this will require innovation and risk. The necessary innovative skills are probably present; but liability actions over the last twenty years have caused the auditing profession to become very defensive. Hopefully changes in the auditor liability arrangements that have taken place in a number of countries will facilitate a change of attitude of the leadership of audit firms and allow them to expand their services in a way that responds to public demand.

Richard Fleck

Appendix 1 RJH Fleck - Credentials

Richard Fleck, a senior partner in the UK law firm, Herbert Smith, has a wide-ranging practice embracing international corporate transactions, dispute resolution, and competition and regulation, including

- transactions for NYSE (Euronext), Time Warner (AOL), Fortune Brands (Pernod Ricard/Allied Domecq), Grand Metropolitan (now Diageo), BAT, De Beers, Virgin and Fosters Brewing Group;
- international commercial disputes such as the collapse of Enron, the DeLorean Motor Car Group, Johnson Matthey Bankers, the Reksten Shipping Group bankruptcy and resulting investigation, the disputes involving Lonrho/House of Fraser, and Nissan UK/Nissan Motor Company Limited, and the settlement of the Lloyd's of London insurance market dispute, and .

He is the only non-US lawyer to be chosen following surveys of the General Counsel of Fortune 1000 companies undertaken by Fortune magazine to identify those lawyers who provide outstanding client service. He was one of the few lawyers to be nominated in successive years – in 2005, 2006 and 2007.

His external activities include:

- Appointment by The Bank of England as an inspector under the Banking Act 1986;
- Preparing the Report on "The responsibilities of Senior Management" published by The Securities and Investments Board; More recently, he participated in the Company Law Reform review and has been a member of two consultative groups set up by The Financial Services Authority in the context of its review of the Listing Rules.
- Participant in the Consultancy Group on Accounting and Auditing established by the Treasury and the Department of Trade and Industry following the Enron and WorldCom failures.

- Chairman of the Auditing Practices Board, having been a member of the Board and its predecessor bodies since 1986

  In the period since he has been Chairman of the APB, the APB has issued:

  - a comprehensive suite of auditing standards (ISAs (UK & Ireland), based on the standards issued by the International Audit and Assurance Standards Board, supplemented where necessary to reflect the particular requirements of UK law and regulations,
  - the first UK standards to address the integrity, objectivity and independence of auditors (Ethical Standards for Auditors 1 to 5, and the associated standard, Provisions Available of Small Entities),
  - four standards setting out the approach to be taken by accountants providing reports for inclusion in investment circulars (SIRs 1000 to 4000), and
  - ethical standards for reporting accountants based on the Ethical Standards for Auditors (ESRA).

- Membership of The Financial Reporting Council;
  - He was a member of the FRC group chaired by Sir Robert Smith that prepared guidance for audit committees in 2003;
  - He chaired the FRC group that developed the FRC 2006 publication, 'Promoting Audit Quality';
  - He participated in the FRC Group that produced the consultation paper on 'Limitation of Liability Agreements'.

- Chairman of the Consultancy and Advisory Group to the International Ethical Standards Board for Accountants.

Appendix 2 – The APB's responsibilities in respect of the auditing profession under the UK's regulatory framework and how those responsibilities have evolved.

Auditing Standards

1. Until 1991, the responsibility for setting auditing and ethical standards lay wholly with the accountancy professional bodies[7]. However, in the late 1980's, a number of audit failures led to the UK Government to pressurize those professional bodies to strengthen their processes to improve the quality of auditing. This led to the establishment of the Auditing Practices Board (APB) in 1991 and the commencement of audit inspection activities by the professional bodies. An important feature of the APB when it was established was that 50% of its members were required not to be practicing auditors[8].

2. APB issued its first auditing standards in 1994. These were supplemented and improved over the period to 2004. Many of the initial standards focused on the process of auditing but the APB also undertook innovative work in developing standards on going concern, fraud, compliance with laws and regulations, audit firm quality systems and auditor reporting to audit committees – all of which were areas where, at that time, no auditing standards existed anywhere in the world`.

3. Following from the financial difficulties in South East Asia (the so called collapse of the 'Tiger economies') international regulators put pressure on IFAC[9] to improve the quality of international auditing standards. As a result the International Auditing Practices Committee

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7 In the UK and Ireland there are 6 main accountancy bodies of whom 4 (ICAEW, ACCA, ICAS and ICAI) are Recognised Supervisory Bodies for legal purposes.

8 From 2003 60% of the APB are not allowed to be practicing auditors.

9 IFAC is the global organization for the accountancy profession. It works with its 155 members and associates in 118 countries to protect the public interest by encouraging high quality practices by the world's accountants. IFAC members and associates, which are primarily national professional accountancy bodies, represent 2.5 million accountants employed in public practice, industry and commerce, government, and academia.

(IAPC) (the forerunner of the International Audit and Assurance Standards Board (IAASB)) commenced a major investment in improving International Standards on Auditing (ISAs).

4. In 2004, APB took the decision to more clearly base UK auditing standards on ISAs and a suite of ISAs (UK and Ireland) was issued. The ISAs (UK and Ireland) adopted the text of the international standards (ISAs issued by the IAASB) supplemented by additional UK specific standards and guidance.

5. International pressure to improve the ISAs has continued and IAASB is currently 'clarifying' its 32 ISAs, and revising about a half of them (the Clarity Project). A major challenge for IAASB during this process has been to maintain an appropriate balance between clarifying the intent of its standards and maintaining a 'principles based approach' to standard setting.

6. IAASB's Clarity Project will be completed by the end of 2008 and IAASB has announced that the effective date for its clarified standards will be audits of financial statements for periods beginning on or after 15 December 2009. Although no date has yet been specified, the adoption of ISAs by the EU will become feasible once the Clarity Project has been completed. I hope that the ISAs will become mandatory in the European Union as that has the potential to greatly enhance the prospect that auditing will be undertaken to a consistent standard around the world – a valuable objective in an increasingly global business environment.

Ethical standards for auditors

7. In 2002 public confidence in US accounting, auditing and corporate governance practices was severely shaken by events relating to companies such as Enron, Worldcom and Tyco. Financial irregularities at Parmalat and Ahold in 2003 showed that Europe was not immune from such scandals. In response the UK Government set up a review of audit and accounting issues and the regulatory regime for the accountancy profession.

8. In January 2003 the UK Government announced reforms designed to raise standards of corporate governance of listed companies, strengthen the accountancy and audit profession and provide a more effective system of regulation of the profession. These reforms involved:

    - Responsibilities for setting auditing standards being consolidated with the setting of accounting standards within the FRC;
    - Responsibility for audit inspection of public interest entities being transferred from the professional bodies to a new group[10] within the FRC; and
    - Responsibility for setting standards for the independence, objectivity and integrity for auditors being transferred from the professional bodies to the APB.

9. The APB welcomed this extension in the scope of its activities; being given responsibility for issuing standards on auditor independence, objectivity and integrity recognised the close interrelationship that exists in all professional activities between operational standards and ethical considerations.

10. APB had been aware, since its inception, of the importance that users of financial statements place on auditor independence and of their concerns that the commercial activities of audit firms and their partners, including the provision of non-audit services, may impair auditor objectivity. Accordingly, in 2003 APB set itself the challenging objective of developing Ethical Standards that enhance public confidence in the quality of the audit process, that were rigorous and likely to be effective in practice, and were clear to auditors, audit committees and those monitoring audits. APB finalised its Ethical Standards for Auditors in autumn 2004.

11. Just as there is a strong argument for international harmonisation of auditing standards, so too is there merit in harmonising the ethical standards that apply to auditors. In my view, the APB's Ethical Standards establish a useful benchmark for international standards for auditor objectivity and independence and they are currently being used by the International Ethical Standards Board for Accountants (IESBA) in its project to revise and strengthen the IFAC Code of Ethics.

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[10] The Audit Inspection Unit of the Professional Oversight Board