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Promoting Audit Quality

A Discussion Paper from the Financial Reporting Council

A response by

The National Association of Pension Funds
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This response is from the National Association of Pension Funds (NAPF). The NAPF is the leading voice of workplace pension provision in the UK. Some 10 million working people are currently in NAPF Member schemes, while around 5 million pensioners are receiving valuable retirement income from such schemes. NAPF members hold assets of some £750bn, and account for one sixth of investment in the UK stock market.

The NAPF welcomes the opportunity to comment on the FRC discussion paper.

Pre-amble

Good quality consistent audit reporting is a cornerstone of maintaining investor confidence in the companies in which they are invested. Investors need the reassurance that such audits bring and it is therefore no surprise that auditor related issues have attracted considerable investor interest and comment recently. Whilst not the subject of this Discussion Paper and response, the related issues of capping auditor liability, UK concentration in the Big Four auditing firms and international convergence need to be kept in mind.

Questions

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

It is very important that the culture generated by a firm's managing and senior partners encourages and fosters professionalism and high standards of professional and personal integrity. It is fundamental that concepts of right and wrong and the recognition of personal responsibility to the shareholders in the companies which they audit are recognised. The ultimate need to need to take a stand on a core matter of principle and, if necessary to resign, must be understood and appreciated by all. High standards to aid the exercise of professional judgment are central to this and will enable firms to fulfil their duties and responsibilities to the owners – the shareholders.

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

Pressure areas include conflicts of interest, pressure on employees to maximise revenues as against maintaining high professional standards and issues relating to a (probably smaller) audit firm having a single dominant client. A further difficulty relates to problems that firms have in retaining sufficient good quality professionals to work in the audit field. The perception amongst investors is that the best staff move as soon as possible to higher margin areas leaving a quality gap together with a lack of experienced team members. By implication there has been under-investment in the audit practice as compared to other services provided by these firms. This may be related to the market place in which firms operate, but the issue needs to be systematically addressed.

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

NAPF believes that firms should have robust policies on dealing with conflicts of interest which are available for public scrutiny. There is also some investor concern that when matters go awry the profession's investigations are insufficiently strong and timely. Whilst it would be going too far to suggest that the prevailing culture is to whitewash, it is surprising how seldom transgressors are named as a result of the disciplinary process. NAPF believes that strengthening and improving transparency would improve investor confidence in the profession's probity. A further helpful measure would be for firms to be more willing to disclose their view of a firm based on the audit. The standard boiler plate language used does not help investors.

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

The NAPF agrees that these are key drivers of audit quality. In particular the necessity to keep skills up to date is recognised. However the modalities to achieve this seem largely to reside in individual firms rather than in the industry as a whole. NAPF would welcome discussion on whether a more formal framework should be established to ensure that all members of audit teams can maintain and enhance their knowledge and skills.

Audit firms use an industry framework of rules and practices within which accountability to the underlying client coupled with the exercise of professional judgement is central.

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

As indicated in the answer above, on-going training is seen by institutional investors to lie at the heart of keeping skills current and to keep pace with emerging best practice. Experiences and lessons learnt at clients needs to be shared by those working for the firm in that field.

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

NAPF notes the apparent lack of a specialised module covering auditing but accepts that this may not be viable or possible to introduce when it is not known in what field the individual will specialise. Thus on a pragmatic basis the emphasis must be, for those who choose to remain working in the audit field, to train up and deepen audit related skills and knowledge and ensure that such skills are kept up to date. The NAPF response to question 2 above links to this.

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

Covered in the responses above.

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

None that the NAPF is aware of.

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

The NAPF shares concerns that have been expressed by Institutional Investors that the global audit network may not always share common firm wide standards. Some such global networks have the sense of being a collection of national firms using a common marketing banner – a franchise operation in practice. NAPF would welcome re-assurance that greater attention is being paid to ensuring commonality within such global networks of the firm's standards.

The question of whose audit standards are applicable to a subsidiary arises. Should this be simply those pertaining to the subsidiary in the country where it operates or should they be the ones operating in the parent's domicile? Cases of subsidiaries unexpectedly failing - thus bringing the parent company down - are not unknown; a suspicion that weaker auditing standards for the subsidiary may be partly responsible continues to linger. There is, of course, also pressure from international convergence on standards but some see this as likely to result in a levelling-down process. NAPF's view is that investors would wish auditing of subsidiaries to be carried out to the same standards as that applying to the domicile of the parent company (i.e. where the company is listed).

10. ***Are there any factors that determine whether audit opinions command confidence?***

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

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

Q's 10, 11 &12. NAPF believes that institutional investors also need to show greater flexibility and openness of mind in looking at audit reports. Essentially the present systems results in what is in effect a pass or fail "mark". Because a "fail" (a qualified audit report) can be highly damaging to a company, great steps are taken to avoid this. If audit reports are to be more useful to investors they may need to show shades of grey and investors will need to learn how to regard them. It will always remain a matter for the audit firm's professional judgement as to whether something should be included in a "grey" report. But many investors are surprised that so little is reported. An example might be where a company's computer system for a key function has reached or is approaching the end of its operational life – and the company has not put in plans to replace or otherwise tackle with the issue. It is suggested that including such an item would be fairer to investors and would spur the company into dealing with the issue.

NAPF notes and supports the excellent work in improving matters in this area carried out under the auspices of the ICAEW led Audit Quality Forum. Several good papers have been produced with a number of useful suggestions. One of which is that audit firms should reasonably be required to give a positive assertion on a matter of emphasis. This is supported by NAPF.

Investors need to be more flexible in accepting the use of smaller audit firms and should support their use in appropriate cases. Not all listed companies are global and thus an opportunity to engage a smaller firm exists. Clearly this will vary from company to company but the Big Four need not necessarily be the automatic choice for all large listed companies.

Investors also support periodic re-tendering of audits and there are a variety of views concerning the appropriate length of an audit mandate and the need to rotate the company's audit; NAPF suggests that this is an area that the FRC might look into. A useful precedent is the Morris Review of the actuarial profession[1] which reported in March 2005. The Review noted that fewer than 10% of actuarial contracts are re-tendered in any given year. It proposed that trustees should put actuarial contracts

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[1] http://www.hm-treasury.gov.uk/media/CA0/9C/morris_final.pdf

out to tender at least every six years. A review of actuarial services provided to a pension fund should be carried out every three years (to coincide with valuations) by a suitably qualified person (who might be a trustee). The Morris Review proposed that every other year an informal evaluation should be conducted.

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

Time pressures caused by commercial and marketing needs to release preliminary data on time might cause a difficulty if the audit found an important issue that needed to be resolved prior to this. The audit firm would face considerable pressure to ensure that the release window was not missed and there is a risk that the audit firm might be persuaded to gloss over the issue.

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

The audit committee is a forum for non executive directors (NEDs) to have oversight of the companies business. Arguably its prime focus is to allow NEDs to understand and monitor what the company is doing. Thus NAPF has long supported the establishment of audit committees and the essential role they play. NAPF suggests that it may be worth studying a sample in future to assess how well the system works; there does not seem to be much UK empirical based evidence on this. Finally NAPF suggests that consideration be given to giving investors the right to vote on Audit Reports when there are substantive issues.

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

If it were possible to develop a methodology that was not prescriptive this would indeed be helpful.

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

It is surprising that this does not, as a matter of course, take place now. NAPF agrees that it should be encouraged.

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

None identified.