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The Institute of Chartered Accountants in England & Wales

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

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7 April 2003

Charles D Niemeier Esq
Acting Chairman
Public Company Accounting Oversight Board
1666 K Street NW
Suite 900, Washington DC 20006
United States of America

Dear Mr Niemeier

As I mentioned during my presentation at the roundtable on Monday I am Chairman of the Ethics Committee of the Institute of Chartered Accountants in England and Wales the body with responsibility for registration of firms and 'responsible individuals' and I am writing to you in this capacity.

You will see from the attached description that the Institute has well developed procedures for ensuring that all firms that carry out audits in England and Wales are registered and regularly inspected. The United Kingdom pioneered the concept of independent inspection of firms (as opposed to firm on firm reviews) and the inspection system described in the note has been developed and refined over a number of years. As you are I am sure aware, these procedures will be further strengthened when the responsibility for inspection and discipline in respect of listed companies transfers to the new United Kingdom Public Oversight Board.

The English Institute's registration procedures could be readily adapted to meet the needs of the PCAOB by establishing a separate register of firms who carry out audits of SEC registrants and making arrangements for the information on that register to be exchanged with the PCAOB with the agreement of the member firms.

Further, we would support arrangements whereby the work of the independent inspection teams are appropriately focussed to give you the comfort that you need in terms of the quality of work on SEC registrants and that the results of this work is shared with the PCAOB in an agreed form. We would also support the active involvement of the PCAOB in disciplinary investigations involving audits of SEC registrants.

We believe that this approach could help to resolve many of the difficult legal issues surrounding registration and oversight which were discussed at the roundtable.

Yours sincerely

A. Fereel

pp Neil Lerner
Chairman, Ethics Committee

AUDIT REGULATION WITHIN THE UK
An ICAEW Perspective

1. Summary

Legislation requires that all firms that carry out statutory audits in the United Kingdom have to be 'Registered Auditors'. This requires them to register with a number of Recognised Supervisory Bodies ("RSBs") and to comply with Audit Regulations governing suitability to act, compliance with ethical codes and auditing standards and quality control. The largest RSB, and the one that registers all of the larger audit firms, is the Institute of Chartered Accountants in England & Wales ("the Institute" or "the ICAEW"). The activities of the Institute in this respect, and the other RSBs, are subject to independent oversight by a framework agreed with the Department of Trade and Industry ("DTI" - the branch of the UK government responsible for audit).

We believe that this process provides an effective and efficient regulatory environment to ensure that audit firms act independently and competently in the public interest, when carrying out statutory audit work.

The elements of this process are described in more detail below.

2. Registration requirement

The regulation of company auditors is a requirement of European Union law[1] and is implemented in the UK by the Companies Act 1989. The Act also includes an additional requirement not in EU law to monitor the work of Registered Auditors.

The regulation and monitoring requirements have been delegated by the government to RSBs. An RSB is permitted to register firms to carry out company audit work in the UK, and firms may not carry out statutory audits without being registered. While they are registered (registration may be withdrawn if firms fail to comply satisfactorily with the Audit Regulations) they may call themselves Registered Auditors. All listed companies in the UK and all medium and large private companies (including subsidiaries of overseas companies) must have their annual financial statements audited by a Registered Auditor.

Only 'Responsible Individuals' within audit firms, may take responsibility for audits and sign audit reports. These are appointed by the firms but approved by the Institute.

Each accountancy body has Audit Regulations governing the conduct of audit work. Firms' compliance with these is monitored directly by the accountancy bodies (see below for further enhancements of this process, currently under way). This process is, in turn, subject to independent oversight.

3. Audit regulations

The key elements of the Audit Regulations are summarised below, but the full Regulations are available on the ICAEW website at

[1] The European Commission Eighth Directive

http://www.icaew.co.uk/auditnews. Alternatively we will be pleased to provide a copy.

The registration application process gathers: name of the firm and any associations; the offices it operates from and the numbers of staff in each location; total income; names and membership details of partners, affiliates, any Responsible Individuals not otherwise listed; any other owners of the firm; the number of audit clients and whether any of them are listed or other public interest entities; and a basic checklist-overview of competence procedures. Other information, for example detail of internal quality control procedures and information backing up 'fit and proper' certifications (see below), is self –certified but further detail is obtained when carrying out monitoring visits.

The Introduction to the Institute's Audit Regulations summarises the requirements for firms to become and remain Registered Auditors. These are, in essence, to:

- carry out audit work with integrity;
- be and be seen to be independent;
- comply with auditing standards;
- make sure that all principals and employees are fit and proper persons; and
- make sure that all principals and employees are competent and continue to be competent to carry out audit work.

These are analysed below under the categories of suitability, compliance and quality control.

Suitability

Qualifications

Registered audit firms must be owned by a majority of qualified individuals, other partners or directors must be members or affiliates of the Institute and the firm must have procedures to ensure that their audit processes cannot be subject to undue influences by other parties. Qualified individuals, in essence , must be members of the ICAEW or one of a number of equivalent bodies.

For some areas of the work of the profession there are particular requirements that have to be met by the qualification. For audit these requirements are set out in the EC *Eighth Directive* and reflected in the Companies Act 1989. Our general requirements for entry and training are determined by this legal framework. In summary form the principal requirements are:

(a) Satisfy certain minimum education requirements;

(b) Complete a minimum three-year period of training with an approved training organisation;

(c) Complete a course of theoretical instruction, pass the ICAEW's professional examinations; and

(d) Be fit to be a member. This is considered further below.

All Responsible Individuals (i.e. those qualified individuals designated with the right to sign audit reports) must have complied with these requirements to become qualified individuals. In addition they must hold a practising certificate. Any member seeking a practising certificate and/or working in audit must maintain professional indemnity insurance and achieve a minimum level of Continuing Professional Education each year. The purpose of the Continuing Professional Education requirements is to ensure that Chartered Accountants working in specialised areas maintain appropriate levels of technical and ethical competence. The audit firm is responsible for ensuring that such competence is maintained.

Fit and proper status

Audit firms are required to confirm annually that they and anyone in them, who carries out audit work, are 'fit and proper'. Matters to be considered include financial reputation and reliability over the last ten years, criminal convictions and disciplinary proceedings (with no time limit), and relevant civil actions over the last five years. Like other requirements of the Audit Regulations, compliance with this process is subject to overview by the monitoring body (see below). The Audit Regulations give guidance on the maintenance of competence for those involved in audit work.

Affiliates (see above) have to be certified to be fit and proper, as well as agreeing to be bound by the Institute's codes and disciplinary process.

Compliance

The Audit Regulations require the firm and any members involved in audits, to adhere to the Institute's ethical code, which includes requirements to act, inter alia, with integrity and independence. The auditor independence requirements comply with the European Commission Recommendation on Statutory Auditor Independence, published in May 2002.

Auditors are also required by the Audit Regulations to comply with Statements of Auditing Standards (SASs) issued by the independent Auditing Practices Board (see section 4a below). These standards cover a wide range of audit quality and reporting issues. In addition, auditors must comply with a series of other technical requirements, including retaining audit working papers for at least six years and ensuring that financial statements on which a report is given are in accordance with relevant legislation.

Quality Control

Internal

A Registered Auditor must monitor, at least annually, how effectively it is complying with the Audit Regulations. In practice, this means establishing quality control procedures. To confirm this work is undertaken, firms are required to carry out their own Audit Compliance Review (ACR) every year and report the results to the Joint Monitoring Unit (see below). These procedures are reviewed as part of the external monitoring process.

The ACR in its simplest form is in two parts. The first part covers a firm's obligations under the audit regulations such as:

- independence;
- fit and proper status;
- competence;

- appointment and re-appointment;
- professional indemnity insurance; and
- continuing eligibility.

The second deals with `cold' reviews of completed audit work to ensure that the firm's audit procedures were followed.

Monitoring

Monitoring of firms' compliance is delegated to an independent monitoring inspectorate (in the case of the ICAEW, the Joint Monitoring Unit) but decisions about audit registration are made by a registration committee of the Institute, based on the reports received from the inspectorate. The Audit Regulations give the committee power to require firms to improve their procedures where appropriate or impose restrictions or withdraw registration where there is serious non-compliance.

The Joint Monitoring Unit (JMU) includes 37 independent, full time, experienced Chartered Accountants acting as Inspectors. Monitoring visits are made every year to the 20 largest firms, who audit 95% of the listed companies, and every 3 years to a further 80 firms who audit the remaining 5%. (The timing of these visits is based on an analysis of risk and public interest factors.)

For the 20 largest firms, the results of the ACR are reviewed in detail during the annual JMU visit and parts of it are re-performed by the JMU Inspectors.

Following discussions with the DTI, monitoring of audits of listed companies is to be transferred to a new Audit Inspection Unit operating under the Professional Oversight Board (see section 4a below). This intended to further improve the perception of independent monitoring, rather than to change the fundamental approach to monitoring.

Discipline

Complaints from the public, the JMU and the Financial Reporting Review Panel (see section 4b below) about the conduct of auditors will be investigated and regulatory or disciplinary action is taken where appropriate. This can include fines, required corrective action, withdrawal of firm registration and/or expulsion of individuals from membership (and thus entitlement to practice).Public interest case are considered by the Joint Disciplinary Scheme (referred to in section 4a below).

Oversight

An annual report is made to the DTI on the outcome of audit regulation and monitoring under the delegated self-regulation arrangements. An example DTI report is available at http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_34722.

In addition, the accountancy bodies' regulation of the accountancy profession is itself subject to scrutiny by the independent Accountancy Foundation and its subsidiary boards, to ensure that it operates in the public interest. This aspect is considered further below.

4. Independent Oversight of Auditors and the Profession

<u>a) The Accountancy Foundation</u>

Background

A system of non-statutory independent oversight of the accountancy profession's own systems of regulation, monitoring and discipline has largely been in place since early 2002. Changes have been agreed with the DTI following an appraisal of initial operations, published in January 2003. The summary below describes the current system but refers to the prospective changes as appropriate.

The key feature of the system is its independence from control or undue influence by the accountancy profession itself. Its purpose is to ensure that the professional bodies' own systems of regulation, monitoring and discipline operate in the public interest.

The system largely draws on proposals originally developed by the CCAB[2] and published by them in September 1998. These proposals provided a base from which the Government could take forward its commitment to ensure that there was a framework of independent regulation for the accountancy profession.

Set out below is an outline of the key features of the system with particular reference to audit.

Overview

There are five bodies: The Accountancy Foundation; the Review Board; the Ethics Standards Board; a reconstituted Auditing Practices Board; and the Investigation and Discipline Board. The setting or monitoring of accounting standards are dealt with by the Financial Reporting Council ("FRC"), set up some years ago, and which is to take on the overall control of the whole arrangement under the revised structure. (see section 4b).

The system is currently funded by the CCAB bodies. Such an arrangement could be seen as a means by which the profession could exert undue influence. To ensure that this is not the case, funding is channeled through the Accountancy Foundation on the basis of budgets put forward by the Foundation after consultation with its subsidiary bodies. The new funding arrangements will reflect those of the FRC, noted below.

The Accountancy Foundation

The Foundation has three main functions.

- It appoints the members of the Boards of each of the bodies, ensuring that in each case, non-accountants represent a majority of the Board members.
- It acts as the channel for finance and ensures that the new system is adequately funded.
- It has an overall responsibility for the success and good health of the new system and is the key point of contact with the Government, the accountancy profession and others to this end.

[2] The six principal United Kingdom and Ireland accountancy bodies (including the ICAEW) are members of the Consultative Committee of Accountancy Bodies (CCAB).

The members of the Foundation Committee of the Accountancy Foundation are nominated by the bodies specified in its constitution. The Chairman has been Lord Borrie, a barrister and former Director General of Fair Trading. The other current members of the Committee are nominated by: The National Association of Pension Funds; The Bank of England; The Audit Commission, The National Consumer Council, The Trades Union Congress, The Confederation of British Industry and The Central Bank of Ireland.

The Review Board

The Review Board's task is in two parts. It monitors the operation of the three associated bodies in the new system to confirm that they are functioning in accordance with their remit. It also reviews the professional accountancy bodies' arrangements for monitoring the work, training, qualification and registration of auditors, for handling complaints and for the conduct of investigation and discipline cases falling outside the remit of the IDB.

Both the Review Board's recommendations and the responses of the bodies concerned are made public. The Review Board will in any event publish a report annually on the overall operation of the new system.

The Review Board's constitution rules out membership by practicing accountants, and by accountants involved in any way in the governance of any accountancy body. It is of the essence of the system that the Review Board should, to the maximum extent possible, be independent of the accountancy profession and only two of its present members hold an accountancy qualification.

The Review Board will be replaced by a Professional Oversight Board, operating under the FRC but with a similar remit to that described above.

The Auditing Practices Board

The new APB has taken over the functions previously carried out by the current Auditing Practices Board set up by the accountancy bodies. The new Auditing Practices Board's constitution permits no more than 40% of the Board's membership to be accountants who would be eligible for appointment as company auditors. In determining the composition of this 60% element the Accountancy Foundation has been mindful of two factors: firstly the need to ensure that the APB is composed of those interested in, or able to contribute towards, the enhancement of standards of auditing; and secondly the overriding need to ensure that the 60% element brings to the Board a truly independent perspective.

The Chairman of the new APB is Richard Fleck, a barrister. The APB's operation is not to be altered by the revised arrangements, other than that it will report to the FRC and will also take on responsibility for setting auditor independence ethical standards.

Ethics Standards Board

The Ethics Standards Board sets the agenda for what issues need to be covered by the accountancy bodies' ethical guidance and to oversee the result. The CCAB bodies, acting collectively, prepare appropriate guidance and liaise with the ESB to ensure that the outcome is in the public interest. The functions of the ESB are to be merged into that of the Professional Oversight Board as part of the reorganisation. As noted above, this will no longer include auditor independence, which will be the direct responsibility of the APB.

The Investigation and Discipline Board

The IDB will in due course take over the function of the present Joint Disciplinary Scheme, though this will inevitably take some time to complete as existing cases are completed with the due process of the law. The existing JDS is operated by ICAEW and ICAS but the IDB's role will be extended to cover all the CCAB bodies within the UK.

The focus of the IDB will, as with the JDS, be disciplinary cases of potential public concern; other cases will continue to be dealt with by the individual accountancy body of the member concerned.

The constitution of IDB Limited provides for a Board with a 60% independent element of the membership.

b) <u>Financial Reporting Council</u>

The FRC and its subsidiary bodies the Accounting Standards Board and the Financial Reporting Review Panel were established in1989. In parallel the Government introduced related provisions into company law: the accounting provisions of the Companies Act 1985 were amended by the Companies Act 1989.

A significant company law change affecting annual accounts was provision for the compulsory revision of accounts where the court is satisfied that the original accounts do not show a true and fair view or do not otherwise comply with the requirements of the Companies Act 1985. The legislation also made possible the voluntary revision of defective accounts, and it is this procedure that in practice has so far been followed when correction has been needed.

Among other legislative changes, accounting standards were given legal definition, and large companies are required to disclose whether or not they complied with them.

Although the FRC and its companion bodies have the strong support of Government they are not government-controlled, but rather part of the private sector process of self-regulation and this is reflected in their constitutions, membership and financing. The Department of Trade and Industry, together with the Northern Ireland Department of Economic Development and the National Audit Office, provides around one-third of the FRC's finances, around one-third coming from the CCAB, and the balance from listed companies and the banking and investment communities. It is expected that this financing arrangement will be maintained to cover the operations of the Accountancy Foundation, when they are brought together under the FRC.

The Financial Reporting Council

The FRC's constitution provides for a Council whose function is to determine the general policy. The constitution also provides for a chairman and up to three deputy chairmen of the Council to be appointed by the DTI and the Bank of England acting jointly.

Normally, under the company's constitution, the board of directors can be expected to include representatives from the accountancy profession, the City, and industry and commerce generally.

The chairman of the Accounting Standards Board and the chairman of the Financial Reporting Review Panel are members of the Council, and the Government and the Bank of England each have the right to nominate one member. The remaining members and observers are appointed by the chairman and deputy chairmen. The membership is designed to include wide and balanced representation at the most senior level of preparers, auditors and users of accounts and of others interested in them.

The remit of the Council is to provide support to the operational bodies—the Accounting Standards Board and the Financial Reporting Review Panel—and to encourage good financial reporting generally. The Council publishes an annual report reviewing the state of financial reporting and making known the views of the Council on accounting standards and practice.

The operations of the FRC's existing subsidiaries are not particularly relevant to the PCAOB audit firm registration process but are briefly summarised below for completeness.

The Accounting Standards Board

The ASB's role is to make, amend and withdraw accounting standards. The ASB does not need outside approval for its actions, though it is the practice of the Board to consult widely on all its proposals.

An Urgent Issues Task Force (UITF) has been established as a committee of the ASB. Its main role is to assist the Board in areas where an accounting standard or Companies Act provision exists, but where unsatisfactory or conflicting interpretations have developed or seem likely to develop. The UITF operates in a broadly similar way to its counterparts in Canada and the USA by seeking to reach a consensus on the issue under consideration.

The Financial Reporting Review Panel

The FRRP's role is to examine departures from the accounting requirements of the Companies Act 1985, including applicable accounting standards, and if necessary to seek an order from the court to remedy them. Like the ASB the FRRP does not need outside approval for its actions.

The role of the Review Panel Its authority stems from the Companies (Defective Accounts) (Authorised Person) Order 1991. By agreement with the Department of Trade and Industry the normal ambit of the Panel is public and large private companies, the Department dealing with all other cases.

The Panel does not scrutinise on a routine basis all company accounts falling within its ambit. Instead, it acts on matters drawn to its attention, either directly or indirectly. By agreement with the Financial Standards Authority (the UK body responsible for, inter-alia, the UK Listing Authority), a more pro-active role is to be adopted between the two organisations going forward.

Where accounts are revised at the instance of the Panel, either voluntarily or by order of the court, but the company's auditor had not qualified his audit report on the defective accounts the Panel draws this fact to the attention of the auditor's professional body.