Chapter 4

Audit regulation
Learning objectives

• To describe the form of regulation governing the work of auditors in the UK.
• To explain the role of the various bodies involved in the regulation of auditing.
• To state and explain the requirements of the law on appointment, resignation and dismissal of auditors.
• To describe how the law attempts to strengthen the position of the auditor.
• To explain the professional guidance on appointment, resignation and dismissal.
The need for regulation

• Regulation provides some assurance to users or consumers of a service by a professional firm that certain standards are met.

• The audit profession sets standards which individuals must achieve before they are ‘licensed’ to act as auditors.

• Setting of standards, to which audit practitioners must adhere, ensures work is conducted properly – standards increasingly set at an International level: EU and IFAC.

• Regulation helps to reduce risk for users of auditing service. Risk is an important concept for auditors.

• Regulation enhances confidence, replacing element of trust, lacking when dealing with individual of whom little known.

• Power the state cedes to a professional body dependent on:
  – The state’s attitude towards a particular form of political economy.
  – The state’s opinion of the expertise, integrity and state of development of the professional body.
Company law regulation (1)

• Company law in GB recognizes two types of body to regulate the auditing profession – RSBs and RQBs.

• All main accounting bodies have RSB and RQB status but have to show they have:
  – Rules and practices relating to the eligibility of a person for appointment as a company auditor, ensuring auditors are fit and proper persons, and act with professional integrity and independence.
  – Rules and practices on technical standards, maintaining competence and membership eligibility, and discipline.
  – Arrangements for monitoring and enforcement of its rules and investigation of complaints.
Company law regulation (2)

• RSBs have to participate in arrangements for:
  – Setting standards on professional integrity and independence
  – Setting technical standards
  – Independent monitoring of audits of listed and other major bodies
  – Independent investigation for disciplinary purposes of public interest cases

These paved way for more independent regulation of members of audit profession, as the RSB was required to have no involvement itself in the 4 tasks and should play no role in appointing or selecting individuals responsible for them.

• Role of RSBs is to maintain and enforce rules as to:
  a) eligibility of persons seeking appointment as statutory auditor
  b) the conduct of audit work.
Company law regulation (3)

The role of RQBs is to enforce rules relating to:

• Admission to or expulsion from a course of study leading to a qualification.
• The award or deprivation of a qualification.
• The approval of a person for the purposes of giving practical training or the withdrawal of such approval.
Regulatory system up to 2012 (1)  Figure 4.2

- FRC Ltd Board
  - Accounting Standards Board
  - Auditing Practices Board
  - Board for Actuarial Standards
  - Professional Oversight Board
  - Financial Reporting Review Panel
  - Accountancy and Actuarial Discipline Board
  - Urgent Issues Task Force
  - Executive
Regulatory system up to 2012 (2)

• This system was in force for 10 years, but was replaced by a new system as Enron, the financial crisis and other scandals forced a re-thinking of the regulatory regime. The main players up to 2012 were:

• Financial Reporting Council (FRC), the overall ‘independent regulator’.

• Auditing Practices Board (APB), responsible for setting standards relating to independence, objectivity and integrity, which prior to this had been set by the individual professional accounting bodies.

• Professional Oversight Board (POB) whose function was to oversee the audit function.

• Accountancy and actuarial discipline board (AADB) responsible for hearing significant public interest cases.
Regulatory system up to 2012 (3) Financial Reporting Council (FRC)

- Overall responsibility in the UK, for regulation of accounting, auditing and actuarial profession.
- Management – chair and deputy chair appointed by Secretary of State for Business, Enterprise and Regulatory Reform.
- Role included setting overall strategy and priorities, making appointments to various operating boards and ensuring effectiveness.
- FRC monitored operation of the Combined Code on Corporate Governance, approved changes to it, and provided advice on strategy, budgets and structure. Council membership largely drawn from senior figures in business, professional and financial community.
- Objective: Maintaining high standards of corporate reporting and governance underpins working of ‘markets to the benefit of business, investors, employees, and other interests’ – enhances ‘UK’s economic strength in competitive international markets’.
- The FRC effectively provided an oversight of the main operating boards as shown in Figure 4.2.
Regulatory system up to 2012 (4) Professional Oversight Board (POB)

• Role of POB to provide: oversight of operation and regulation of auditing profession by RSBs and RQBs – monitoring quality of auditing function for listed companies and major public interest bodies – reviewing regulatory procedures and processes of accountancy bodies and actuarial profession and recommending improvement.

• POB concerned with systems RSBs and RQBs had in place.

• Audit Inspection Unit (AIU) of POB: role to monitor audits of listed and other major public interest entities:
  – Focus on quality of auditing.
  – Thorough, robust and challenging approach to inspection visits.
  – Wide-ranging reviews of firm-wide procedures, assessing audit quality.
  – Selection of major audits for review – largely risk based.
  – In-depth reviews of major audits.
  – Review of the quality of reporting to the Audit Committee.

• AIU responsible for reviewing firm’s overall policies and procedures re leadership, human resources, independence, ethics, audit quality, methodological approach.

• AIU only operated for a short time but generally satisfied with the quality of audits they evaluated.
Regulatory system up to 2012 (5) Accountancy and Actuarial Discipline Board (AADB)

- The board consisted of 11 members of whom three were qualified accountants.
- Role was to act as an independent, investigative and disciplinary body for accountants and actuaries in the UK.
- Cases involving the public interest usually referred to AADB (from accountancy bodies/actuarial body) but it had power to look at cases where it saw the need, whether or not the case had been referred.
- Prior to the change in regulatory structure in 2012 AIDB had investigated a number of important cases including MG Rover Group Limited and the 1999 accounts of Equitable Life Assurance Society.
Regulatory system up to 2012 (6) Auditing Practices Board (APB) – objectives

- Establish auditing standards setting basic principles and essential procedures with which external auditors in the UK and the Republic of Ireland must comply.
- Issue guidance on application of auditing standards in particular circumstances and industries, and timely guidance on new and emerging issues.
- Establishing standards and related guidance for accountants providing assurance services where they relate to activities reported in the public domain, and within the ‘public interest’.
- Establish ethical standards in relation to independence, objectivity and integrity of external auditors and those providing assurance services.
- Participate in the development of legislative or regulatory initiatives affecting conduct of auditing and assurance services.
- Contribute to efforts to advance public understanding of roles and responsibilities of external auditors and the providers of assurance services including sponsorship of research.
Auditing standards

- APB adopted all standards issued by IAASB, adding extra material to meet specific UK and Ireland regulatory requirements. Only revised ISA APB did not adopt was ISA 700 on audit reporting.
- Standards contain prescriptions with which auditors are required to comply when performing audit work, setting out basic principles and essential procedures and explanatory material intended to help auditors in interpreting and applying the standards.
- The standards provide a minimum level of performance with which auditors must conform. One purpose is to raise general standard of audit work.
- Auditing standards provide a benchmark by which quality of audit work can be measured – likely court of law would look to compliance with standards when deciding whether a firm has been negligent.

Ethical standards

- IFAC and APB have issued codes of ethics. APB issued five ESs applying to the UK, taking cognizance of the IFAC Code, and change in legislation from implementation of the EU’s Statutory Audit Directive.

Practice notes

- Practice notes - issued by APB to assist auditors in applying auditing standards in particular circumstances and industries.
Regulatory system up to 2012 (8) Accounting Standards Board (ASB)

- ASB concerned with issues relating to accounting standards – issuing new standards or amending existing ones, providing advice or clarification on extant standards, and working with other standard setters, particularly IASB and EU bodies.
- Board consisted of up to 10 members, most of whom have a background in accounting, the accounting profession or the financial sector.
Regulatory system up to 2012 (9) Financial Reporting Review Panel (FRRP)

- UK body, concerned with quality of financial reporting by public and large private companies. Focus on companies not following requirements of Companies Act or accounting standards. FRRP also reviewed Directors’ reports.

- Using risk-based approach, panel reviewed sample of annual accounts of companies in specific industry sectors, or where accounting problems might arise. The panel investigated areas of topical interest. Other annual accounts may have come to its attention because of complaints.

- Generally FRRP carried out initial analysis to determine if accounting regulation had not been followed and importance of non-compliance. If deemed important FRRP would perform more extensive analysis involving a panel of members and the company concerned.

- The outcome might be agreement with company that it voluntarily takes some action. If the panel and company could not agree, FRRP had right apply to the courts to enforce corrective action to the accounts, but never did apply.
Regulatory system up to 2012 (10) Audit monitoring (1)

• Prior to the new regulatory structure ICAEW, ICAI and ICAS carried out their monitoring role through the joint monitoring unit (JMU) with the ACCA having their own monitoring mechanism.

• With the demise of the JMU in 2004, each body performed its own monitoring function.

• Each body has a specialized unit consisting of reviewers or inspectors with experience of auditing to carry out the monitoring role.

• The objective of monitoring is to ensure the RSBs comply with the requirements laid down in Company Law. The role of monitoring audit firms is also required by the EU Eighth Directive.
Regulatory system up to 2012 (11) Audit monitoring (2)

- RSBs check audit firms comply with audit regulations and auditing standards.
- Sample of firms selected for more thorough examination. Audit firms not involved in audit of significant entities normally visited at least once in 6 years. Firms auditing listed companies or other significant entities visited more often, frequency determined by assessment of risk involved and results from previous visit.
- Reviewers discuss risk issues and other matters identified with key audit staff and review audit files.
- Reviewers ensure audit firm complies with standards, Companies Act and other regulatory requirements. At the end of visit reviewers discuss findings with firm personnel.
- Reviewers report to Audit Registration Committee (ARC) in the RSB. ARC gives audit firm indication of result of examination. Follow up action where problems identified, not satisfactorily resolved – may lead to withdrawal of audit registration or conditions on audit registration.
Regulatory system up to 2012 (12)
Report of Coordinating Group on Audit and Accounting issues (CGAA)

• The main concerns of CGAA were:
  – Auditor independence
  – Corporate governance and the role of the audit committee
  – Transparency of audit firms
  – Financial reporting: standards and their enforcement
  – Monitoring of audit firms
  – Competition implications
Current regulatory structure (1)

• An impact assessment carried out in August 2011 outlined the deficiencies in the existing regulatory structure:
  – Its activities were not sufficiently aligned with its mission.
  – Its structure was overly complex with too many powers delegated to subsidiary boards.
  – The FRC as audit regulator was not sufficiently independent and did not have sufficient appropriate sanctions.
Current regulatory structure (2)

• The objective of the proposed changes:
  • To create a more effective, efficient and independent regulator
  • To ensure that the FRC contributed towards efficient capital markets by concentrating on listed companies and large private companies
  • To enhance the quality of auditing through:
    – reinforcing independence from the professional accounting bodies
    – availability of more appropriate sanctions.
Current regulatory structure (5)
FRC Committees

• FRC has three main committees concerned with different aspects of the regulatory role:
  – Codes and standards, concerned with standard setting, supported by three councils
  – Conduct, concerned with monitoring audit firms and disciplining audit firms and members, supported by two committees
  – Executive, with a role of advising on strategic issues and providing oversight of the activities of the FRC.
Current regulatory structure (6)
Financial Reporting Council (FRC)

- FRC board has overall responsibility for ensuring FRC achieves its objectives of good regulation and operates in the public interest.
- The board has statutory responsibility for setting and amending accounting, audit and actuarial standards.
- Standard setting within accounting and auditing is largely done at the International level by IASB and IAASB respectively, so a key role for FRC is to represent the views of the UK in key decision-making and wherever possible influencing policy-making.
- The FRC also responsible for ensuring the effective working of the Corporate Governance Code and the Stewardship Code.
- In 2015 the board of the FRC consists of 15 members of whom six members have had some form of affiliation with a major accountancy firm.
Current regulatory structure (7) Audit and Assurance Council (AAC)

• Role of AAC is to give consideration to and provide advice:
  – to FRC on ‘draft Codes and Standards’, and
  – on research proposals and other initiatives undertaken to inform FRC on pertinent matters

• A further role is for AAC to consider and comment upon proposed developments in relation to international Codes and Standards and regulations.

• More generally AAC is expected to provide strategic input and thought leadership, both in its area of expertise and the work-plan of the FRC as a whole.

• Currently, the board consists of nine members including the chairman who is also a non-executive director of FRC board and is an ex-partner of Ernst & Young. Three of the other members are partners in large audit firms.
Current regulatory structure (8)
Conduct Committee (CC): Role

• To oversee:
  – Monitoring of the RSBs and RQBs Audit Quality Reviews
  – Corporate reporting reviews
  – Professional discipline
  – Regulation of accountants and actuaries.

• The CC is responsible for overseeing the work of the Conduct Division whose objective is to secure high quality corporate reporting by overseeing the above five areas.

• The work of monitoring conduct is split between four teams; Professional Oversight, Professional Discipline, Corporate Reporting Review and Audit Quality Review.
Current regulatory structure (9)  
Professional Oversight (PO)  

• The PO team took over from POB and its role in respect of audit is to determine that RSBs and RQBs continue to comply with the requirements imposed on them by CA 2006 for acting as regulatory bodies.

• RQBs have to have rules and regulations in place relating to aspects such as; practical training, examinations and entry requirements.

• The RQBs must also have arrangements for monitoring compliance with the above.
Current regulatory structure (10) Professional discipline

• CC is responsible for operating independent disciplinary schemes for:
  – Investigation of public interest cases which raise or appear to raise important issues affecting the public interest in the UK; and
  – Where appropriate, bringing disciplinary proceedings against those whose conduct appears to have fallen short of the standard reasonably expected of members or member firms of the relevant professional body.’

• The CC also responsible for ensuring the disciplinary regime is working effectively and publishing disciplinary activities and achievements.

• Cases other than public interest are dealt with by the professional body itself
Current regulatory structure (11) Investigation structure

• The CC considers each case and determines whether an investigation is justified. The process follows an established routine:
  – Decision to investigate
  – Investigation
  – Decision made as to whether disciplinary procedures should be brought against member or member firm
  – Referral to disciplinary tribunal
  – Tribunal hearing
  – Imposition of penalty/sanctions.

• FRC selects three or five individuals, as CC believes appropriate, to form a disciplinary tribunal. The chairman of the tribunal must be a lawyer with the other members being a mixture of both lay persons and accountants but with non-accountants in the majority.
Current regulatory structure (12) Audit Quality Review (AQR) role

- AQR team took over from the AIU with a similar role:
- To monitor the quality of auditing of listed and other major public interest entities, including building societies, large private sector pension funds and charities with income exceeding £100 million.
- AQR team also monitor policies and procedures supporting audit quality within major audit firms. Objective is to monitor and improve quality of auditing.
- Specific audits for review are selected using a risk-based approach.
- The AQR team are particularly interested in whether the audit firm has complied with all relevant auditing, ethical and quality control standards; whether evidence collected and evaluated supports their opinion on the financial statements and the appropriateness of important audit judgements.
- The reviewers look to identify areas which may be of some concern and where they believe audit firms could take action that would enhance audit quality.
Current regulatory structure (13) Corporate reporting reviews

- FRC through CC ensure that the financial information provided by public companies and large private companies complies with regulatory requirements.
- By reviewing directors’ reports and financial statements.
- The focus of enquiry by CC is to see if any of the companies have not complied with the Companies Act 2006.
- The criteria for selecting companies might be based on their sector or their financial condition. Others may bring the company to the attention of FRC.
- Persons from the Financial Reporting Review Panel enter into dialogue with the company concerned about the appropriateness of accounting treatment.
- Outcome might be acceptance of the accounting treatment, or amendment of the financial statements or a decision to apply to the courts to have the statements amended.
Current regulatory structure (14) Supervisory inquiries

- The FRC may ask staff or specialists from different teams within the conduct division to make inquiry as a cross-conduct exercise looking into a matter of concern affecting a public interest entity.
- Typical occasions that might give arise to an inquiry are a major corporate collapse or fraud.
Current regulatory structure (15) European Union influence

• Historically, the EU has had an influence on accounting and auditing in the UK through directives on annual accounts of limited liability companies, the publication of consolidated accounts and auditor independence.

• In 2006, a Directive was issued in respect of transparency reporting, auditor examination requirements, auditor independence and quality assurance.

• After the financial crisis of 2007-8 the EU has been active in producing a number of papers relating to audit, including ownership rules of audit firms and concentration in the audit market.

• A 2010 Green Paper detailed proposals on the role of the auditor, governance and independence of audit firms and the supervision of global audit networks.

• It was followed in May 2014 by issuing a Directive and Regulation with specific requirements regarding the statutory audit of public-interest entities.

• EU thinks that the financial crisis has damaged the credibility of auditing; long audit tenure impinges on auditor independence; market for audit of very large companies too concentrated; risk to audit industry should one of the Big Four no longer exist; and deficiencies in the audit report.
Current regulatory structure (16) European Union regulation provisions 2014

• Make audit reports more informative, such as inclusion of statement about the most important assessed risks of material misstatement including through fraud.

• For public interest entities, additional report to the audit committee, including deficiencies in entity’s internal control and accounting system.

• Prohibition on providing certain non-audit services such as tax advice and designing and implementing internal control or risk management procedures.

• Fees charged by the auditor should not be contingent. Total fees for non-audit work should not exceed 70% of average audit fee over preceding three years.

• Transparency reporting by audit firms s/b increased, including disclosure of audit fees from public interest entities and other clients and fees received from other services.

• Maximum years an audit firm can perform the audit of a public interest entity limited to 10 years. Where audit is subject to a public tendering process or is a joint audit – extended to 20 years and 24 respectively. Maximum period the engagement partner can service any one client is 7 years. The audit firm should have a process for the rotation of audit staff in any audit engagement.

• Prohibition of contracts between public interests entities and third parties that limit the appointment of auditors to certain categories or groups of auditors.
Further regulation of auditing by the law and accounting profession

• To appreciate the legal rules on appointment, resignation and removal of auditors – need to have a firm understanding of the following:
  – Individuals who can act and rules on appointment, removal and resignation.
  – The period for which the auditor is appointed.
  – The statutory relationships between auditors and shareholders.
  – The statutory relationships between shareholders and directors.
  – The practical relationships between auditors and directors.
• See Rosedale Cosmetics plc (Case Study 4.1)
The statutory and practical relationships (1)

Figure 4.6
The statutory and practical relationships (2)

Figure 4.7

01.06.09  James Thomson appointed auditor
20.04.10 James Thomson reappointed by shareholders
12.11.12 James Thomson removed from office by shareholders
James Thomson made written representations prior to the meeting at which he was removed
Andrew McOwan appointed by the shareholders
23.04.2013 Andrew McOwan reappointed by the shareholders
18.02.2014 Andrew McOwan resigned as auditor
18.02.2014 John Dewar appointed by shareholders
John Dewar issues unqualified audit report
Small Companies

- Companies Act 2006 contains provisions to reduce burden of regulation on small companies. E.g. s. 477 provides that a small private company may elect not to have an audit.

- The criteria for being a small company is that it should meet in the current year any two of: turnover not to exceed £6.5 million, balance sheet total not exceed £3.26 million, and average number of employees not greater than 50.

- Members holding not less than 10% of the nominal share capital can, subject to giving due notice, require that an audit be carried out.

- EU wishes to harmonize reporting requirements throughout the EU.
Figure 4.1 Institutional environment of auditors in Germany
Figure 4.2 FRC Ltd board
Figure 4.3 Financial Reporting Council

- FRC Board
  - Codes & Standards Committee
  - Executive Committee
  - Conduct Committee
    - Audit & Assurance Council
    - Accounting Council
    - Actuarial Council
    - Monitoring Committee
    - Case Management Committee
      - Financial Reporting Review Panel
      - Tribunal
Figure 4.4 FRC executive structure – regulatory
Figure 4.5 Period of auditor appointment, and accounting reference period and date

01.01.15

ACCTING REFERENCE DATE

31.12.15

Accounting reference period

01.04.15

Period of auditor appointment

31.12.15

Date of general meeting at which appointed

30.04.16

Date of general meeting at which accounts are laid

*This period must not exceed 9 months (private company) or 6 months (public company)
Figure 4.6 Legal and practical relationships between directors, the audit committee, other management, other user groups and the auditor
**Figure 4.7** Appointment, removal and resignation of auditor of Rosedale Cosmetics plc

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tbody>
<tr>
<td>01.06.11</td>
<td>James Thomson appointed auditor by directors</td>
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<tr>
<td>01.06.11</td>
<td>Andrew McOwan appointed by the shareholders</td>
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<tr>
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<td>20.04.12</td>
<td>Andrew McOwan reappointed by the shareholders</td>
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<td>2.11.2014</td>
<td>James Thomson removed from office by shareholders</td>
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</tr>
<tr>
<td>23.04.15</td>
<td>John Dewar appointed as auditor by shareholders</td>
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<tr>
<td>23.04.15</td>
<td>Andrew McOwan reappointed by the shareholders</td>
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<tr>
<td>03.04.16</td>
<td>Andrew McOwan resigns as auditor</td>
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<tr>
<td>03.04.16</td>
<td>John Dewar resigns as auditor</td>
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<tr>
<td>29.04.16</td>
<td>John Dewar issues unqualified audit report</td>
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