



Statutory Audit Directive

Chris Cantwell provides details of the DTI's consultation on the UK implementation of the EU Statutory Audit Directive. The Institute will be responding to the consultation on this Directive which has an impact on all statutory audits carried out in the UK.

The Department of Trade and Industry (DTI) has issued a consultation document on the UK implementation of the European Union (EU) Statutory Audit Directive [R!](#). The Directive was published in the Official Journal of the EU on 29 June 2006 (see article in the September issue of *Audit & Beyond*) and Member States have until 29 June 2008 to adopt and publish the provisions necessary to comply with the Directive. The deadline for responses to the DTI's consultation document is 1 June.

The existing UK framework for statutory audits already provides for a significant proportion of the areas covered by the Directive. There are, however, some new provisions and the Government proposes to build on the existing framework in its implementation of these provisions.

Specific topics covered by the Directive include:

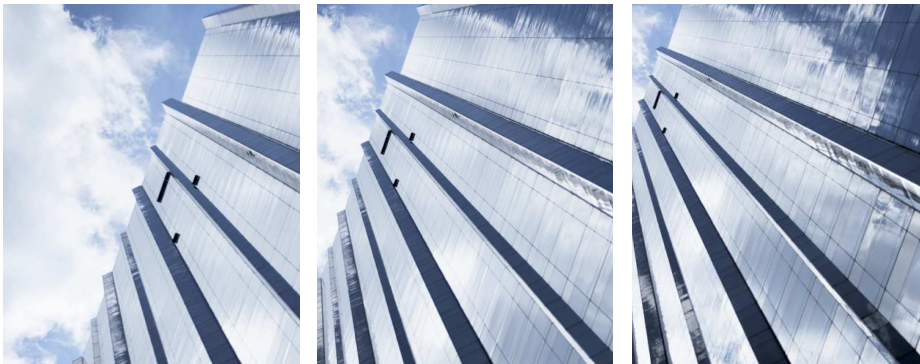
- Education and training requirements for those approved to carry out statutory audits.
- Registration requirements which will be put into effect by the Recognised Supervisory Bodies (RSBs) including the ICAEW.
- Ethical requirements which the APB's Ethical Standards need to comply with.
- International auditing standards which will be adopted by the EU (European consultation on this is expected later this year).
- Public oversight, investigations and discipline including quality assurance arrangements put in place by the RSBs.
- Requirements regarding appointment and dismissal of auditors.
- Requirements that only apply to the audits of "public interest entities". In the UK the definition of these is expected to be limited to fully listed companies.
- Arrangements for overseas auditors - this subject was covered in the recent consultation by the European Commission (see article in the March issue of *Audit & Beyond*).

Further information regarding the Statutory Audit Directive, including related links, is available on the Institute website [R!](#). If you have any comments on any of the issues covered in this consultation, please send these to chris.cantwell@icaew.com.

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Promoting Audit Quality



Chris Cantwell summarises the points made by the Institute in its response to the FRC's discussion paper *Promoting Audit Quality*. The Institute views the Financial Reporting Council's initiative as important but does have some significant concerns.

The Institute has responded to the Financial Reporting Council's (FRC) discussion paper *Promoting Audit Quality* **R!**. As outlined in the February issue of *Audit & Beyond*, the discussion paper addresses the FRC's objective of promoting and maintaining confidence in the audit process.

*'it is important ...
to take a bottom up approach'*

The Institute considers that there is much in the FRC's paper which is good and is pleased that for the most part a balanced view is given. However, the Institute does have some significant concerns and the main comments in the response can be summarised as follows:

- Care is needed to avoid inadvertently giving the wrong message that audit quality is a significant problem when there is not the evidence to support this. Although it is healthy to have an informed debate and dialogue with investors, and others, about whether quality is satisfactory and how to improve audit quality (as is happening in the *Audit Quality Forum*

R!), the Institute considers it important to keep matters in perspective. The Institute is not aware of stakeholders having fundamental concerns with the current arrangements.

- It is important to consider the possible impact of any proposed measures on audits as a whole, and generally to take a 'bottom-up' approach, with extra measures (if necessary) being imposed for audits of public interest entities (PIEs). A 'bottom-up' approach would often be the most appropriate way of tackling these issues. For example, having a base for all audits with extra measures being imposed for audits of PIEs, rather than the 'top-down' approach resulting from considering PIE audits first with special 'exemptions' for smaller entity audits being added later.
- There is merit in a broad view of what audit quality means when addressing the issues covered in the paper rather than just focusing on 'market quality', which is quality in the eyes of principal external stakeholders.
- It is vital for the audit profession to continue to appear attractive in order to recruit and retain people of the right calibre and skills.
- Regulatory overload and complex and lengthy standards can be detrimental to the achievement of audit quality in

the long term, and the Institute calls on the FRC/ APB to assess the impact of recent changes before further changes are proposed.

- The FRC and responsible parties in the UK have a crucial role to play in shaping international developments, in particular making the case for principles-based standards and the use of professional judgement.
- Appropriate education and training is fundamental to the success of the audit profession. The paper's concerns over existing professional training are in the Institute's view unsubstantiated, particularly given everything that has already been done in the recent review of the ACA.
- Concerns over make-up of audit teams in firms are in the Institute's view overstated. Specifically, the use of the term 'inexperienced' is inappropriate in this context.

The full version of the Institute's response to the FRC on this Discussion Paper is available to members on the Faculty website **R!**.

Integrity

a new perspective

Integrity matters: it underpins and supports the reliability of high quality information, is vital to the reputation of individuals and organisations, and the economic development of nations. Yet, paradoxically, whilst the importance of integrity is widely acknowledged, there is no generally accepted understanding of what it means. **Anne Davis** explains.

Promoting integrity in society is a real challenge since integrity is a relative concept, influenced by context, culture and the passage of time. Given the importance of integrity to the accounting profession and in particular to reporting, the Reporting with Integrity publication **R!** (which is part of the series of publications in the ICAEW's Information for Better Markets campaign) **R!** brings together ideas from different disciplines to obtain a more comprehensive understanding of what is meant by integrity, both as a concept and in practice. Moreover, because this report sees reporting with integrity as a joint endeavour of individuals, organisations and professions, including the accounting profession, the concept of integrity is considered in all these contexts.

The report proposes that there are five key aspects of integrity:

- Moral values
- Motives
- Commitments
- Qualities
- Achievements

An individual of integrity is guided by moral values and motives which are translated into commitments. Such an individual draws on qualities, such as open-mindedness, to assess the right thing to do from a wider community perspective. An individual's commitments in pursuit of 'doing the right thing' are also likely to require personal qualities, including perseverance and courage, if they are to lead to the hard-won achievements expected of individuals of integrity.

Integrity is special because all its aspects need to be linked and aligned in a consistent manner to form the whole. In the words of Hank Paulson, US Treasury Secretary and former Chairman and CEO of Goldman Sachs, 'It completes us ... To me, integrity the root word, really has to do with the whole man ...'¹ This wholeness or congruence may be easy to express, but it is difficult to put into practice since personal, social, organisational and environmental factors influence behaviour.

Integrity is not something that is generally self-assessed; it relies on the assessment by another person who may be influenced by their own beliefs and expectations of how a person of integrity ought to behave. The report proposes that a person of integrity will be likely to:

- Be honest and truthful
- Be fair
- Comply with laws
- Act in the interests of the wider community
- Be open and adaptable
- Take corrective action
- Demonstrate consistency

Whilst it is helpful to list the characteristics usually linked to behaving with integrity, the report recognises that there will always be ambiguity when evaluating whether or not an individual has integrity.

Applying the five aspects of integrity and the seven behavioural characteristics to organisations is more difficult since an organisation is made up from a collection of individuals from different backgrounds, with different beliefs, values and motives, working in different departments, and responsible for different goals, processes and activities. So, how does an organisation create a common link between individuals from different backgrounds working in different departments, involved in different processes?

The report proposes that a robust framework that links individuals to a

common view of the organisation's moral values, motives, commitments, qualities and achievements is needed to establish integrity in an organisation. This framework consists of five key drivers:

- Leadership
- Strategy
- Policies
- Information
- Culture

The drivers need to be interconnected with each other, mutually reinforcing and effective throughout the organisation. This requires determined and energetic management.

The accounting profession as a whole also has an important role to play in instilling integrity in organisations and in reporting. The reporting process of a country or market is a complex web of interactions, communications and discussions between individuals in different organisations. Some individuals involved in the corporate reporting process work for a reporting entity and others do not. The individuals and organisations involved in the reporting process have different objectives and responsibilities. They are also likely to have varying levels of integrity.

The report suggests that an overall reporting process with the integrity to inspire confidence will be seen to be honest and truthful, to be fair, to comply with laws, to promote community interests, to be open and adaptable, to take corrective action and to show consistency. Integrity in reporting needs to be underpinned by moral values such as honesty, motive (such as a desire to inform), commitments to the interests of shareholders and others, qualities such as scepticism and perseverance, and achievements in the face of opposition. However, reporting with integrity also relies on the reporting entities, audit firms, professional bodies and other organisations taking steps to promote integrity through their leadership, strategy, policies, information and culture.

1. Quoted in Adrian Robert Gostick and Dana Telford, *The Integrity Advantage*, Salt Lake City, Utah: Gibbs Smith, 2003

Proposed changes to SME thresholds - potential implications for audit exemption thresholds



Background

The Department of Trade and Industry (DTI) is currently consulting on its plans to implement Directive 2006/46/EC of the European Parliament and the Council on Company Reporting, which was adopted on 14 June 2006. One of the key proposals in the DTI consultation paper is to raise the SME thresholds, and this potentially has implications for the audit exemption thresholds.

Overall objective

The overall objective behind the Directive is to enhance confidence in the financial statements and annual reports published by European companies.

Specific measures

The specific measures in the Directive cover the following areas:

- Increasing the SME thresholds
- Extend the application of fair value accounting
- Disclosure requirements in respect of off-balance sheet transactions and related party transactions
- Corporate governance statement for publicly traded companies
- A requirement to ensure the collective responsibility of board members towards the company for the annual accounts and reports

SME thresholds

Particular importance to SMEs is the option for Member States to raise the turnover and balance sheet thresholds defining small and medium-sized companies by 20%. As highlighted in April's issue of *Audit & Beyond* the DTI proposes to take advantage of the option to raise the SME thresholds and the proposed thresholds are set out in the table below.

Audit exemption

Whilst the DTI is not specifically consulting on any changes to the audit exemption thresholds, it is our understanding that

the Government may also raise the audit exemption thresholds to the small company thresholds, i.e. a turnover of not more than £6.5 million and a balance sheet total of not more than £3.26 million. In its paper, the DTI estimates that 1,100 medium-sized companies and 6,100 small companies would become eligible to take advantage of audit exemption.

How to comment

The consultation paper can be viewed on the DTI website [R!](#). The consultation period ends on 1 June 2007. Questions 1, 2 and 3 of the consultation paper look at the consequences of raising the SME thresholds.

If you have views on the proposed changes to the SME thresholds and, in particular, a possible further increase in the audit exemption thresholds, please send them to louise.maslen@icaew.com.

Louise Maslen | Manager, Audit and Assurance Faculty

SME Thresholds			
	Turnover (not more than)	Balance sheet (not more than)	No of employees (no change)
Small company	£6.5 million	£3.26 million	50
Small group	£6.5 million net (or £7.8 million gross)	£3.26 million net (or £3.9 million gross)	50
Medium-sized company	£25.9 million	£12.9 million	250
Medium-sized group	£25.9 million net (or £31.1 million gross)	£12.9 million net (or £15.5 million gross)	250

ITF 01/07 - New assurance guidance on internal controls of IT services

The ICAEW's Information Technology Faculty and Audit and Assurance Faculty have worked together to develop FIT01/07: *Assurance reports on the outsourced provision of information services and information processing services* **R!**. This replaces the existing guideline FIT 1/94.

ITF 01/07 is consistent with the International Auditing and Assurance Standards Board (IAASB) International Framework for Assurance Engagements **R!** and ISAE 3000 *Assurance engagements other than audits or reviews of historical financial information* **R!**. The new guidance is closely aligned with the AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties*, issued by the Audit and Assurance Faculty in 2006 **R!**.

Need for new assurance guidance
Reporting accountants have previously

performed their work on internal controls based on 'agreed-upon procedures', or reported on factual findings of the tests as agreed with the client. As the complexities of outsourced operations and related internal controls increases, reports containing the test results are becoming bulkier, and harder for the client to obtain the overall comfort over the suitability or effectiveness of internal controls. Under the new assurance reporting guidance, reporting accountants issue an overall conclusion that conveys assurance to the users of the report.

ITF 01/07 and AAF 01/06

The revised ITF 01/07 follows on from AAF 01/06 that was also revised from agreed-upon procedures to an assurance engagement. As AAF 01/06, ITF 01/07 sets out the responsibilities of a service organisation as well as guidance for reporting accountants. While the scope of AAF 01/06 covers financial services, ITF 01/07 offers guidance on information and

information processing services. ITF 01/07 also reduces the detailed guidance on risk management by referring to AAF 04/06 *Assurance engagements: Management of risk and liability* **R!**.

'We have learnt that reporting accountants are already using AAF 01/06 in relation to financial service activities and this reassures us that the assurance framework should work. We now hope that this guidance is useful for practitioners working in IT services and IT processing services' said John Court, Head of the IT Faculty. The IT Faculty also welcomes comments on the new guidance, for instance suggested sources of criteria that could be useful. In contrast to AAF 01/06 where specific internal control objectives may be developed as minimum requirements, there are many established criteria in IT outsourcing that can be used as criteria. For further information, please go to www.icaew.com/itfac.

RICS regulatory reform - an update

In April 2005, Sir Bryan Carsberg published his review of the Royal Institution of Chartered Surveyors (RICS) regulatory functions. His recommendations were approved in October 2006 at an EGM by a majority of 97% of members. As previously reported in the December/January issue of *Audit & Beyond*, RICS is now working to implement a new regulatory system based on his recommendations.

Principles-based rules

One major change to RICS regulation is the move to principles-based rules. This move means that the rule book, which is currently approximately 60 pages long, will be reduced to fewer than 10 pages. The members' accounts rules were particularly lengthy but the new rule simply states: "A Firm shall preserve the security of clients' money entrusted to its care in the course of its practice or business." Comprehensive help sheets support the new, shortened rules, which provide further guidance for those who need it.

Monitoring of firms

At the moment, RICS monitors individual members for compliance with the rules. Under the new system RICS will monitor their firms for matters that are dealt with at firm level. Regulated firms will be entitled to use the new designation; 'Regulated by RICS'.

More appropriate monitoring

There will also be changes to the firms monitored by RICS. At present, any firm offering a surveying service to the public in the UK with one or more chartered surveyor principals is bound by the regulations. Under the new rules firms offering a surveying service to the public in the UK where 50% or more of their principals are RICS members will be required to register with RICS. Other firms with a minority of RICS principals which agree to abide by the RICS rules may opt-in to RICS regulation.

Enforcement

RICS' enforcement of the rules will change under the new system, with an end to publication of minor breaches. The biggest change in enforcement will be an end to the requirement for firms holding clients' money to submit an independent accountant's report. Instead, RICS will visit firms on a regular basis to ensure that clients' money is being held safely and appropriately. Firms with a 2007 accounting year end date or later will no longer be required to submit an accountant's report to RICS.

Timescale

At the moment RICS regulation is in a transitional period between the old and new rules. The new regulatory system will come into force on 4 June 2007.

Colette Best | RICS Professional Regulation and Consumer Protection

Inside the minds of convicted fraudsters - everything you need to know



It is widely recognised that fraud is a significant problem. According to recent market research commissioned by Protiviti, 12% of workers have committed fraud in the workplace. Such frauds include 'cooking' the books, fiddling expenses, taking physical assets, stealing intellectual property or taking bribes and kickbacks.

Sean Holohan, Protiviti's Head of Integrity Risk, set about unearthing the facts about workplace fraud at the March Internal Audit lecture. Drawing on the findings of his organisation's recent research with convicted fraudsters, Sean provided practical advice on the warning signs of fraud and how to implement a proactive fraud risk management programme **R!**.

The warning signs of fraud

Many fraudsters are not caught and tend to be educated, clever and, on the surface, well balanced and trustworthy individuals. Most fraudsters are not career criminals.

Fraudsters commit fraud for a number of reasons. Often it does not start as a fraudulent act nor is it usually planned at the outset, but may commence as an act of simple opportunism. Fraudsters' other reasons for their activity can include personal grievances against the organisation, the need to reduce personal debts, greed, boredom, blackmail, a wish to have a different lifestyle, or a search for status that the appearance of wealth may bring.

According to the research, much of the fraudulent activity occurs in the supply chain where there may be weaknesses caused by poor segregation of duties. Fraudsters use their skills and knowledge of

the procedures of the organisation and of others to perpetrate their frauds. Over time, fraudsters keep a close eye on processes and on the behaviours of others in order to identify areas of vulnerability within the organisation including:

- Spotting weaknesses and poor administration processes
- Poor communication and reporting procedures
- Temporary staff in key roles

The research also suggests that the audit or oversight functions were rarely perceived as a deterrent often because the auditors didn't ask the right questions; and even when they did, they did not follow up and seek verification.

'Auditors didn't ask the right questions; and even if they did, they did not follow up and seek verification'.

Reducing opportunities for fraud

Poor internal controls, lack of segregation of duties, disillusioned employees and ineffective internal audit were all highlighted as creating an environment in which fraud could be more easily committed. Sean suggested the following could help to reduce the opportunities for fraud:

- Increasing the effort - make it less easy by the use of preventative controls
- Increasing the risk of getting caught via detective and monitoring controls
- Reducing the rewards
- Managing the resources available
- Reducing provocations
- Removing excuses
- Managing personal debt - some employers take a proactive approach to employee debt management offering financial and other counselling services

Proactive fraud risk management starts from the acknowledgement that fraud is happening; understanding how much of a problem it is likely to be, where it is likely to be occurring in a business, how it is

happening and who is likely to be perpetrating it. In other words, think like a fraudster to catch a fraudster.

Elements of an effective anti-fraud programme

Effective anti-fraud policies bring together a mix of preventative and detective measures to help manage fraud risk, together with a number of steps that can act as a further deterrent to those considering fraud.

Tone at the top, the culture of the organisation, affirmation to a Code of Conduct or ethical behaviour, whistleblower programmes and active investigation and disciplinary procedures all feature high on the preventative steps in an anti-fraud programme. Detective measures include the identification of fraud risk, the implementation and monitoring of controls designed to mitigate those risks, and focussed data mining procedures using fraud profiling.

Sean Holohan highlighted five steps in fraud profile auditing, being:

1. Understand the business.
2. Identify the main characteristics of possible fraud and error (develop your own scenario-based fraud profiles - ask 'what would you do to commit fraud?').
3. Use software to examine raw data for those profiles.
4. Monitor employee behaviour for unusual characteristics (and empower the workforce to do this too).
5. Investigate on an exception basis.

Noting that fraudsters exploit weaknesses in the business, Sean's summary included the useful advice that to combat fraud it is essential that auditors understand the business and be imaginative. This was an informative and useful lecture, but if you took only one thing away, it was probably that you need to think like a fraudster to catch a fraudster.

Norma Pavitt | Operations Manager, Audit and Assurance Faculty

FSA focuses on client asset reports in the insurance sector

The Financial Services Authority (FSA) has recently visited over 150 firms to gauge levels of compliance with the rules around client money, including those relating to auditors' client asset reports. Since January 2005, general insurance intermediaries (firms which act as brokers) have been regulated by the FSA and subject to their rules regarding client money.

Client money includes premiums customers have paid to the broker for their insurance policy which has not yet been passed to the insurer, and claims money or refunds being made to the customer which have been passed to the broker but are not yet with the customer.

Under the FSA's rules, where a general insurance intermediary has held more than £30,000 of client money at any point in the reporting period or holds client money in non-statutory trust client bank accounts, it is required to appoint an auditor. This requirement comes from the FSA's rules in Chapter 5 of the Client Asset Sourcebook (CASS) **R!** and in Chapter 3 of the

Supervision Manual (SUP) **R!** and applies regardless of whether a firm is exempt from having a statutory audit of its financial statements, for example because it is small.

Once appointed, the auditor's responsibility is to report to the firm on whether or not the firm has:

- Maintained systems adequate to enable it to comply with Chapter 5 of the CASS sourcebook; and
- Complied with the rules in Chapter 5 of the CASS Sourcebook during the year and at the date of the report

The report should cover a period of up to 53 weeks and has to be made within four months of the end of the relevant reporting period.

Some insurance brokers are not aware of their responsibilities to appoint an auditor and, where they have been appointed, some auditors are not aware of the

guidance available to them. This includes the FSA's publication Guide to Client Money for General Insurance Intermediaries (May 2006) **R!** and web-based training course, which are relevant to both firms and their auditors.

Auditors will also find the ICAEW's Technical Release 1/06 *Interim Guidance for Auditors of Insurance Intermediaries on Client Asset Reporting Requirements* **R!** and the APB's Practice Note 21, *The Audit of Investment Businesses in the United Kingdom* **R!** useful. The Institute's new Financial Services Faculty has prepared an article on this topic, which its members can find in the March edition of the magazine FS Focus (www.icaew.com/fsfaculty). Finally, the FSA's recent press release on its client money work can be found on their website, www.fsa.gov.uk.

Claire Stone | Financial Services Faculty

Bulletin Board Faculty update

Companies Act 2006 roadshows

To provide you with a practical overview of the new legislation and its key implications for businesses, relevant both to practice and company, a series of half day roadshows are being held throughout England and Wales. More information including full dates and locations, booking options and the roadshow programme is available via the ICAEW Companies Act website www.icaew.com/companiesact

FAC's search engine expanded

IFACnet, the global multilingual search engine developed by the IFAC and its members has expanded its resources to address the needs of small and medium accounting practices (SMPs), in addition to professional accountants in business. IFACnet

enables SMPs to easily locate information on a wide range of technical, marketing, human resource and other matters, including such topics as succession planning, managing a small firm, staff recruitment and retention, and promoting firm services.

APB revises guidance on the audit of occupational pension schemes (PN15)

APB has announced the publication of a revision of Practice Note (PN) 15: 'The audit of occupational pension schemes in the United Kingdom'. The guidance reflects comments received in response to the consultation draft issued in August 2006 for public comment. Copies of the Practice Note may be downloaded free of charge from the APB website at www.frc.org.uk/apb

Changing your details

If any of your details have changed you can update them online at www.icaew.com/members, by email to members.registration@icaew.com, or in writing to Members Registration, ICAEW, Gloucester House, 399 Silbury Boulevard, Milton Keynes, MK2 2HL.

Internal audit lecture

Educating management to understand and accept their risk and control responsibilities
Monday 18 June 2007, Gill Bolton, GEB Business Solutions. The lecture will start at 6pm and will be followed by wine and a finger food buffet. The lecture will be held at Moorgate Place and costs £34.04+VAT. For more information please visit www.icaew.com/aaf to book online.

Related

Page	Article	Document(s) mentioned	Get a copy
1	Statutory Audit Directive	DTI consultation paper Institute update on the Directive	www.dti.gov.uk/consultations/page38046.html www.icaew.com/index.cfm?route=144792
2	Promoting Audit Quality	FRC Discussion Paper <i>Promoting Audit Quality</i> <i>Audit Quality Forum</i> Institute response to FRC Discussion Paper	www.frc.org.uk/publications/pubs.cfm available in 'consultations' section of the Faculty website. www.icaew.com/aaf www.auditqualityforum.com
3	Integrity - a new perspective	Reporting with Integrity Information for better markets campaign	www.icaew.com/index.cfm?route=127759 www.icaew.com/bettermarkets
4	Proposed changes to SME thresholds - potential implications for audit exemption thresholds	Consultation paper	www.dti.gov.uk/consultations/index.html
5	ITF 01/07 - New assurance guidance on internal controls of IT services	ITF 1/07: <i>Assurance reports on the outsourced provision of information services and information processing services by service organisations made available to third parties</i> IAASB International Framework for Assurance Engagements ISAE 3000 <i>Assurance engagements other than audits or reviews of historical and financial information</i> AAF 01/06 <i>Assurance reports on internal controls of service organisations made available to third parties</i> AAF 04/06 <i>Assurance engagements: Management of risk and liability</i>	www.icaew.com/technicalreleases www.ifac.org/iaasb www.ifac.org/iaasb www.icaew.com/technicalreleases www.icaew.com/technicalreleases
6	Inside the minds of convicted fraudsters - everything you need to know	Learning from fraudsters	www.protiviti.co.uk
7	FSA focuses on client assets	Chapter 5 of the Client Asset Sourcebook (CASS) Chapter 3 of the Supervision Manual (SUP) Guide to Client Money for General Insurance Intermediaries (May 2006) 1/06 <i>Interim Guidance for Auditors of Insurance Intermediaries on Client Asset Reporting Requirements</i> APB's Practice Note 21, <i>The Audit of Investment Businesses in the United Kingdom</i>	www.fsa.gov.uk/Pages/Handbook/index.shtml www.fsa.gov.uk/Pages/Handbook/index.shtml www.fsa.gov.uk/pubs/other/Client_Money_Guide.pdf www.icaew.com/technicalreleases www.frc.org.uk/publications/pubs.cfm



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