

# Audit & Beyond

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Audit and  
Assurance Faculty

## 2006 review of Faculty activities

2006 has been an exceptionally challenging year for the audit profession. Not only did the profession face the first-year implementation of ISAs (UK and Ireland), but it also had to deal with the implementation of ISQC (UK and Ireland) 1 and begin planning for the future implications of the Statutory Audit Directive. The Faculty has endeavoured to provide members with timely and practical guidance to assist with the implementation of these regulatory developments as well as addressing wider issues around audit quality and the role of assurance services.

### International standards on auditing (ISAs)

The ISA implementation sub-group has met on a regular basis throughout the year to ensure members were equipped with the necessary information and advice to manage the change to ISA compliant audits. It also sought to ensure members had the opportunity to feed into an International Auditing and Assurance Standards Board (IAASB) consultation on the 'clarity' project, which seeks to provide a new set of clarified ISAs. A one-day event was held at Chartered Accountants' Hall to enable Faculty members and staff to meet face-to-face with representatives of the Auditing Practices Board (APB) to discuss the proposals and feed in their views. In addition, the Faculty has kept members abreast of developments with ISAs through regular articles in the Faculty newsletter and through the annual roadshow, which dealt with the practical issues arising from the first audits conducted under ISAs.

### Statutory Audit Directive

This Directive is the most comprehensive

single European Union (EU) legislative initiative to impact on the audit profession and following several years of negotiation, the final text was published in the Official Journal of the EU in June of this year. There is a two-year implementation period for most aspects of the Directive. Whilst the UK is probably considerably further down the road than some other EU Member States in meeting the Directive's requirements, there are a number of significant issues where there could be major implications and the UK profession needs to be engaged.

The Faculty has been closely involved with developments on the Directive, for example working with the DTI in the UK and playing an active part at European level including participating in the work being done by FEE (the European Federation of Accountants) on the Directive. The Institute will continue to be proactive in seeking to shape the way matters develop and will respond to forthcoming UK and EU consultations. The ICAEW has already responded to the recent POB consultation document on implementation of Article 40 of the Directive on transparency reporting by auditors of UK public interest entities – see page 8.

### Audit quality

The Faculty has continued its focus on audit quality and through the *Audit Quality Forum* has produced a number of reports which consider the fundamentals of audit quality, examining the relationship between shareholders, boards, auditors, regulators and other stakeholders in the audit. The reports published to date: *Audit purpose, Principles...*

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## Help us improve AAF member services: prize draw entry for research participants

The Faculty is looking into how we can improve the value that our members get from our publications – and we want to know what you, and other members think.

We're looking for Faculty members who can give us 20 minutes for a telephone interview/20 minutes to complete an online survey, and share their thoughts on the ideas that we're developing – and give us their ideas on how we can improve our publications. If you do take part – and we hope you will – we'll automatically enter you into a prize draw to win £100 Marks and Spencer vouchers. For further details please contact Norma Pavitt at [norma.pavitt@icaew.co.uk](mailto:norma.pavitt@icaew.co.uk).



# Accounts compilation – your say

The ICAEW guidance on compilation engagements for companies (Audit 02/04) was issued in 2004. At the time, the increase in the audit exemption threshold to £5.6 million meant that a significant number of additional companies would become eligible to take advantage of audit exemption. These newly exempt companies varied in size and complexity and it was important to develop timely principles-based accounts compilation guidance that would be applicable in these different circumstances.

Prompted by the launch of the new ICAEW Assurance Service there has recently been some press coverage on the guidance issued by professional bodies and the value and use of compilation reports.

## Guidance on compilation engagements

A recent article in the *Daily Telegraph* newspaper highlighted that ‘...the APB [Auditing Practices Board] is keen for accountants to expand on compilation reports, which are already offered and could provide an authoritative overview of a company’s financial position.’ The article adds that, according to Jon Grant of the APB, the Institute of Chartered Accountants of Scotland (ICAS) had already expanded its compilation reviews in this way.

So what is the difference between the ICAEW and ICAS guidance? If you were to look at the report you might be mistaken for believing that there were no differences between the sets of guidance because the reports used are very similar. The directors of a company are therefore likely to derive the same degree of comfort from the involvement of chartered accountants from either body in the accounts compilation.

ICAS guidance to its members on carrying out an accounts compilation is, however, more prescriptive in terms of the procedures required. For example, it specifically states that their members:

- Would normally vouch major transactions such as fixed assets

- Would normally perform some basic cut-off procedures. In reviewing completed accounts, this would normally comprise an overall analytical review of the accounts together with a follow-up of unexpected variances
- Should assess any estimates and judgements made by management
- Would normally ensure that all statutory and accounting standard disclosure requirements have been met

ICAEW guidance is silent on the nature of the procedures to be performed but says that the accountants consider whether the financial statements are consistent with their understanding of the business and whether the financial statements are misleading. In so doing, the accountants make such enquiries of management and undertake such procedures as they judge appropriate.

The working group which developed Audit 02/04 carefully considered what guidance to give on procedures to be followed. It quickly came to the conclusion that compilation engagements differed quite considerably in scope and whilst the common denominator was the report and accounts, there was no clear starting point. The group at the time therefore felt that it was not appropriate to specify the types of procedures to follow and believed that chartered accountants should make their own professional judgement of what procedures to undertake based on the need to ensure that the accounts are consistent with their understanding of the business and whether they are misleading.

Regardless of the nature of the work performed for a compilation engagement, the report is clear that no opinion is being expressed on the accounts. This differs from both the audit and the ICAEW Assurance Service where accountants give an opinion based on their work.

## Reporting

As reported in the October issue, one of the recommendations from the Professional Oversight Board’s review of the accounting needs of small and

medium-sized entities was that the professional bodies should consider the use of a cross-profession compilation report that includes a broad description of the scope of the engagement and a positive description of professional accountants’ obligations.

As previously highlighted, the ICAEW is already working with the other CCAB bodies to consider these suggestions. The challenge is to develop a compilation report that users might find more useful without raising expectations that some form of assurance opinion is being given by the accountants and thereby contributing to an expectation gap and potentially exposing accountants to greater risk.

## Seeking your views

We want to seek members’ views on the issues raised above. The recent *Beyond the threshold* consultation (which was included with the October issue of *Audit & Beyond*) explores the future needs of audit-exempt companies and how chartered accountants can support those needs. It discusses accounts compilation and asks the following two questions:

What improvements could be made to the illustrative report in Audit 02/04?

Should the guidance for chartered accountants include detailed procedures to follow when performing a compilation engagement?

We would welcome the views of our membership on these issues or any of the other issues raised in the consultation. Comments can be sent to [tda@icaew.co.uk](mailto:tda@icaew.co.uk). You can download a copy of the *Beyond the threshold* consultation at [www.icaew.co.uk/assuranceservice](http://www.icaew.co.uk/assuranceservice).

Louise Maslen, Manager, Audit Practice Issues, Audit and Assurance Faculty

# Forthcoming changes to audit exemption for charities

New Charities and Companies Acts 2006 will introduce changes to audit exemption for charities. This article provides information about forthcoming changes, whilst practitioners should continue to follow the existing rules until the government publishes the implementation dates.

Currently charities that are incorporated or registered under the Companies Act 1985 (charitable companies) and other charities (non-company charities) are required to be audited by a registered auditor if their gross annual income exceeds £250,000. Charitable companies must also have an audit if their balance sheet total is more than £2.8 million. The Charities Act 2006 was passed on 8 November 2006 and introduces changes to the thresholds among other provisions. The timescale for the changes to take effect has not yet been announced. The Office of the Third Sector will publish an implementation timetable in early 2007. The following notes therefore set out future provisions: they are not yet in force.

These provisions apply to charities in England and Wales, although similar provisions will apply to charities in Scotland and Northern Ireland. In future, non-company charities will have to be audited by a registered auditor if they have:

- Gross annual income over £500,000
- An aggregate value of assets over £2.8 million and gross annual income over £100,000

Below this threshold, non-company charities may have an independent examination instead of an audit. An independent examination is not required if the charity's income does not exceed £10,000. If the income is above £250,000 then the independent examiner must have an appropriate accountancy qualification. Suitably qualified individuals will be:

- A member of a body for the time being specified in s. 249D(3) of the

Companies Act 1985 (i.e. those qualified to be reporting accountants)

- A member of the Chartered Institute of Public Finance and Accountancy
- A Fellow of the Association of Charity Independent Examiners

A late amendment to the Companies Bill moved the audit provisions relating to small charitable companies to the Charities Act. Under section 32 of this Act, charitable companies will need an audit by a registered auditor if the charity has:

- Gross annual income over £500,000
- A balance sheet total (aggregate assets) over £2.8 million

Charitable companies with an income between £90,000 and £500,000 and assets of £2.8 million or less will not be required to have their accounts audited if they provide an accountant's report in accordance with section 32. This report is expected to be an independent examiner's report but this, and the qualification for the person giving the report, will not be confirmed until the relevant Ministerial order is made. For a charitable company with income of £90,000 or less, then neither an audit nor an accountant's report is required unless its aggregate assets are over £2.8 million.

## Non-company charity

	New rules
Audit	Gross income greater than £500,000 or income over £100,000 and aggregate assets over £2.8 million
Independent examination	Gross income over £10,000 but not exceeding £250,000: independent examination by an independent person with appropriate ability Gross income over £250,000 but not exceeding £500,000: independent examination by examiner with specified qualification
Total exemption	Income not exceeding £10,000

## Charitable company

	New rules
Audit	Income over £500,000 or aggregate assets over £2.8 million
Group rules for audit	Member of a non-small group or aggregate group income over £700,000 net (£840,000 gross) or group assets over £2.8 million net (£3.36 million gross)
Accountant's report	Income over £90,000 but not exceeding £500,000 and aggregate assets not exceeding £2.8 million
Total exemption	Income not exceeding £90,000 and aggregate assets not exceeding £2.8 million

This article does not cover charities that are subject to other legislation such as the Friendly and Industrial and Provident Societies Act 1968 (Audit Exemption)(Amendment) Order 2006 or the Housing Act 2004.

## New structure for charities

Charities which want a corporate structure currently have to register both as charities and as companies, which means they have to meet the dual regulatory burdens of both the Charity Commission and Companies House. The Charities Act creates a new vehicle for these charities – the Charitable Incorporated Organisation (CIO). A CIO will have the advantages of a corporate structure, such as reduced personal liability for trustees, without the burden of dual regulation. Creating CIOs will require additional, secondary legislation and the recently formed Office of the Third Sector will start consultations in preparation for this legislation early in 2007.

*Kate Sayer is a partner at Sayer Vincent, a firm that works exclusively in the charity and not-for-profit sector. She is also a member of the SORP Committee convened by the Charity Commission.*



# Audit exemption thresholds: the debate goes on...

The last increase to the UK small and medium-sized company and audit exemption thresholds was in early 2004. The audit exemption threshold was set at a turnover of £5.6 million which at that time was the maximum permitted by the EU. Recent amendments to the 4th and 7th EU Company Law Directives have given EU Member States an option to increase SME accounting thresholds by 20 per cent. The DTI intends to consult on this and other aspects of the changes to the 4th and 7th Directives early in the new year. The consultation is also likely to include a proposal to raise the audit threshold. Louise Maslen looks at some of the potential issues to consider, including the possible pros and cons of a further increase to the audit exemption threshold.

## Evidence-based policy

It is easy to see why raising the thresholds might be an attractive option to Government. Given the increased complexity of audits and the new auditing and ethical requirements to be met by auditors we might applaud Government's commitment to seeking to reduce regulatory burdens on smaller companies but let's not forget that these companies make up a significant portion of the economy. They might be deemed to be 'small' in comparison to many listed companies but with turnovers in excess of £5.6 million, they are not insignificant in size. Any new proposal to raise the threshold needs to be backed up by strong supporting evidence. There are a number of other factors to consider.

## Fraud and economic crime

By raising the thresholds is there a potential impact on the level of fraud and economic crime and how does this tally with the Government's tough stance on fraud and money laundering?

Recent surveys from the accounting firms have highlighted the increasing prevalence of fraud. A recent KPMG

survey on reported fraud noted that insider fraud continues to lead the way. Managers are named as the biggest perpetrators and shareholders as the biggest victims. The involvement of an independent auditor could reduce the opportunities, from their work on systems and internal controls. The raising of the thresholds will allow less external independent scrutiny which may allow some in companies to exploit the position.

## Quality of information

Would an increase in the threshold impact on the quality of the information in accounts on the public record and confidence in financial reporting?

The Professional Oversight Board recently carried out a review of the accounting needs of small and medium-sized companies. As part of this review, the POB looked at the quality of accounts filed at Companies House. Whilst the majority of accounts reviewed were generally informative although they included some technical disclosure or minor computational errors, a sizeable minority of accounts appeared to include more significant technical issues that could call into question the usefulness of the accounts.

Whilst the problems were identified across all sets of accounts sampled, including audited accounts, it does raise particular questions about the quality of information on the public record for those audit-exempt companies who choose not to use qualified accountants and the lack of any enforcement mechanisms to improve quality in this regard.

## Impact on the profession

What is the impact on audit firms and other entities that still require an audit or the services of a registered auditor?

Audit firms may have mixed views on a decision to raise the threshold. Some may

believe that an increase in the threshold will result in declining audit work and will impact on firm's revenue. A further reduction in the number of audits will make it that much harder to continue to train staff in the audit field and to service those remaining audit clients and other entities that require a registered auditor. Others may, however, see opportunities arising. No longer bound by such strict ethical requirements these firms might consider that they are better able to serve their clients through other services that would have been restricted if they had been performing an audit (this would include becoming directors and investing in these businesses).

Alongside this we need to think about those entities who continue to require an audit or the services of a registered auditor (e.g. solicitors and charities). A further increase in the threshold might mean that some audit firms choose to come out of the audit market and this could adversely impact competition and choice in the market place at a time where there are calls to encourage more competition in the audit field so as to create more choice for businesses.

## Next steps?

These are difficult issues for the Government to consider and they require further research. Before raising the limit a further time, it will be important to try to assess the cumulative effects of previous increases to the audit exemption threshold.

Where will this end? If the EU continues to review and raise the thresholds on a regular basis, at what threshold level do we stop at in the UK? Policy in this area needs to be evidence-based – the benefits of further relaxation clearly need to exceed the less quantifiable costs.

If you have comments to make that might help the ICAEW to formulate its reaction over the coming months to a potential change to the thresholds please send them to [louise.maslen@icaew.co.uk](mailto:louise.maslen@icaew.co.uk).

# Companies Act 2006 receives Royal Assent

After much widely publicised controversy over some of its key provisions, the Companies Act (originally the Company Law Reform Bill) was finally passed by Parliament on 8 November 2006.

It is the longest Act ever, running to 1,300 sections, introducing many reforms and consolidating virtually all existing companies legislation. It is written in simplified language, with a particular focus on small businesses. The Government claims that the Act will help businesses save £250 million a year, including up to £100 million for small businesses.

## Specific legislative changes affecting smaller businesses

In addition to provisions affecting all companies (below), the Act includes the following measures that will benefit private companies:

- It will be easier to take decisions by written resolutions, requiring a simple majority for ordinary resolutions and 75 per cent for special resolutions rather than unanimity. The auditors must be informed of such resolutions, which cannot be used to remove a director or auditor during their term
- No need to hold an annual general meeting, nor to have a company secretary unless the company wants one – if one is appointed, he/she will have the same rights and responsibilities as currently apply
- Separate and simpler model Articles of Association for private companies
- The rules prohibiting financial assistance are abolished and there is a new 'solvency statement' mechanism for private companies to make capital reductions
- The provisions on accounts and reports are simplified and made clearer

There are also some implications for private companies:

- The deadline for filing accounts will be reduced from ten to nine months
- The Act removes the specific medium-

sized group exemption from preparing group accounts

- Whilst SMEs will continue to be able to file abbreviated accounts, the Government's intention is that they be required to disclose turnover (consultation on form of accounts will follow in 2007)

The Government will supplement the legislation with clear guidance so that smaller companies will be able to easily identify the requirements placed on them. Existing companies may need to make amendments to their articles to take advantage of some of the deregulatory measures, and the DTI intends to issue guidance on these in Spring 2007, including checklists and draft resolutions/articles. There will also be a separate, comprehensive 'code' of accounting and reporting requirements for small companies, and Companies House will provide a wider range of web-based guidance, better links to related websites and online access to up-to-date companies legislation.

## Measures affecting all companies

- New provisions on auditor liability, directors' duties and narrative reporting (see below)
- Easier electronic communication with shareholders. Electronic communications with shareholders by email, or via a website with notification, will be permitted provided the individual shareholder consents. If no response is received, consent to website communication (with notification) can be implied if authorised by the articles or shareholder resolution. Shareholders always have the right to subsequently request a hard copy.
- Directors may not approve accounts unless they give a true and fair view of the financial position of the company
- Directors and shareholders may file a service address on the public record rather than a private address
- Annual accounts and reports need not be sent to persons for whom the

company has no current address

- Company names will be easier to change, allowed to contain symbols, and opportunistic registration or 'cyber squatting' made more difficult
- Records of board and shareholder resolutions and meetings will need to be retained for ten years (rather than indefinitely)
- Companies will no longer be required to specify their objects
- The company memorandum will become a formal document recording the position at the point of registration, with just the articles being the continuing constitutional document
- Filings with the registrar can mostly be made electronically
- The concept of 'authorised share capital' is abolished
- Shareholder engagement will be promoted through enhancing the powers of proxies and making it easier for indirect investors to be informed and exercise governance rights in the company

## Audit-related provisions

### Criminal offence

The Act includes a new criminal offence, punishable by an unlimited fine, for 'knowingly or recklessly' including misleading, false or deceptive matters in an audit report. The Government's view is that 'recklessness' has a very high hurdle and would only catch an auditor who is *'aware that an action or failure to act carried risks, that they personally knew that the risks were not reasonable ones to take, and that, despite knowing that, they went ahead'*.

The new criminal offence for auditors in relation to accounting records was originally linked to the statement as to their being proper/adequate. To address concerns that this would have been especially onerous for smaller practitioners, this new offence in the Act was changed to relate to the statement that the accounts are in agreement with the records.

### Provisions protecting auditors from liability

The Act allows auditors to contract annually with shareholders to limit their liability to a 'fair and reasonable' amount. These provisions are widely drawn, permitting proportionate liability, capping and formulae, and so to avoid initial confusion it is important that guidance on what is 'fair and reasonable' is developed in consultation with investors and the profession. These provisions also allow the Government to mandate/preclude terms, in particular to avoid any distortion of competition, and make it clear that no account should be taken of the ability of other parties to pay for the loss.

### Signature of audit reports

Audit reports must be signed by the 'senior statutory auditor' in his/her own name (on behalf of the firm). Guidance is to be issued on who is a 'senior statutory auditor', who must also be named in the published accounts, with an exception where there is a risk of violence or intimidation.

### Resignation statements regime

For unquoted companies, the requirements for a statement of circumstances are essentially unchanged, but quoted company auditors will now *always* need to make a statement of circumstances surrounding their ceasing to be auditors. There is also a new regime to notify the audit authorities. Auditors of listed companies and public interest entities must notify the audit authorities whenever they cease to hold office. Auditors of other companies only need to notify the authorities if the auditor ceases to hold office before the end of their term. The notice to the audit authorities must be accompanied by the statement of circumstances or – where there is no such statement – a statement of 'reasons' for ceasing to hold office. Companies will also have notification duties when they change auditors, i.e. there is a dual notification regime.

### Statutory auditors

To achieve more consistency of regulation of auditors, the existing regulatory regime

for 'company auditors' is extended to cover auditors of building societies, banks and insurance undertakings (including those that are industrial and provident societies or friendly societies), all of which will now register as 'statutory auditors'. There are also minor changes to the eligibility/independence regime.

### Directors' duties

The Act contains a statutory statement of directors' general duties, which are currently established in case law rather than statute. The Government will be issuing guidance for directors on what these duties mean, based on the statements made in Parliament.

### 'Enlightened shareholder value'

The 'enlightened shareholder value' duty, which broadly replaces the existing fiduciary duty to act in the company's best interests, has been controversial. It imposes a duty to '*promote the success of the company for the benefit of its members as a whole*' having regard to various factors including the longer term, the interests of employees, suppliers, consumers and the environment. However, it is important to note that this is a *single* duty to work for the benefit of shareholders, rather than a separate set of duties in relation to the stakeholders represented in the list of factors. It is important to remember that the director will only be liable to the company (or its shareholders on behalf of the company) for breach of this duty if the company can demonstrate that it has suffered loss as a result of the breach. The codified '*derivative claims*' provisions makes the criteria and procedure for minority shareholders to make a claim in the name of the company clearer, but includes protections to ensure that unmeritorious suits are quickly dismissed with costs falling to the person bringing the claim.

### Conflicts of interest

The Act changes the rules on directors' conflicts of interest by allowing independent directors to authorise a director's conflict of interest arising in respect of any property, information or opportunity that conflicts or may conflict with the interests of the company.

### Narrative reporting

A new statutory liability regime will be introduced, effectively incorporating a safe harbour, for information in directors' reports and directors' remuneration reports. The requirements for a business review in the directors' report were revised and – for quoted companies only – the content requirements extended significantly, to include for example information on environmental impacts and the main factors likely to affect the company's future business.

### When will the Act come into effect?

All parts of the Act will be in force by October 2008, but some aspects will be implemented earlier. The provisions facilitating electronic communication between companies and their shareholders will be introduced in January 2007, because the Government believe they will lead to 'many millions of pounds of savings to business'.

### What next?

The DTI will be consulting in February on when the various changes should be implemented and on whether existing companies should need to change their articles to take advantage of the deregulatory measures. A link to the Act is available on the DTI website ([www.dti.gov.uk/bbf/co-act-2006/index.html](http://www.dti.gov.uk/bbf/co-act-2006/index.html)) where further information on the changes brought in from January 2007 will become available during December and explanatory notes (and derivation and destination tables, to facilitate cross referencing with existing legislation) will be available in the new year. Further guidance on the implications of the Act, in particular for private companies, should become available in Spring 2007.

The Faculty will also be developing a short publication which signposts the audit-related changes brought in by the Act. This will be mailed out to members in the New Year. More information on the Act is available in the 'Modernising UK Company Law' section of the Institute's Law and Regulation pages ([www.icaew.co.uk/lawandregulation](http://www.icaew.co.uk/lawandregulation)).

Liz Cole, ICAEW Business Law Manager

# Launch of the Faculty's *re:Assurance* initiative

The Faculty has just launched its *re:Assurance* initiative which seeks to promote dialogue about assurance services. The objectives of this initiative are:

- To find out where new services could strengthen markets and support economic confidence by making information flows more credible
- To ask how the International Framework for Assurance Engagements can be applied and developed
- To answer demands for practical guidance to meet emerging market needs

Businesses and other stakeholders need to be able to rely on credible information flows to make economic decisions and policy. Where businesses or stakeholders identify a need to build confidence in information and reinforce relationships of trust, external assurance can play a valuable role.

There is, however, a lack of understanding of what is meant by assurance and there are differing expectations of the role that assurance

can play in building business confidence. This is why this dialogue on the role of assurance is so important.

## Getting started

The Faculty has already published an issues paper, *Beyond the threshold*, which looks at the financial reporting needs of audit-exempt companies. It also sets out the new ICAEW Assurance Service in ICAEW Interim Technical Release AAF 03/06, *The ICAEW Assurance Service on Unaudited Financial Statements*. Other papers in the series include a practical guide to chartered accountant services and a research report highlighting company views on the new service.

We are also planning a series of publications which set out to explain and discuss the International Framework for Assurance Engagements. This series will seek to stimulate policy debate on practical implementation issues, to understand the assurance needs of stakeholders and to identify areas where further development is needed.

A third stream of work is envisaged on the practical application of the

Framework to additional new assurance services. We will be looking at narrative reporting and third party assurance. We have already published Technical Release AAF 01/06 which provides the latest guidance on reporting on internal controls of service organisations.

Finally, to support these work streams we have been developing guidance on the management of risk and liability on assurance engagements (see page 9 for further information).

More information on the Faculty's work on assurance is available at [www.icaew.co.uk/assurance](http://www.icaew.co.uk/assurance).

Without credible information flows, people are unable to make economic decisions with confidence. Through the *re:Assurance* initiative, the ICAEW will explore the role that assurance services can play in promoting economic prosperity by reinforcing confidence in business reporting.

*Louise Maslen, Manager Audit Practice Issues, Audit and Assurance Faculty*

## Transparency reporting by firms: Institute responds to the POB

The September issue of *Audit & Beyond* reported on the consultation document issued by the Financial Reporting Council's (FRC) Professional Oversight Board (POB) on statutory transparency reporting by auditors of UK public interest entities. This article summarises the Institute's key comments included in our response.

### Purpose of the proposals

The Institute welcomes the consultation document which will (by following the requirements of Article 40 of the EU's Statutory Audit Directive) formalise and expand on the initiative the Institute supported on annual transparency reporting by major audit

firms following the report of the Coordinating Group on Audit and Accountancy issued in January 2003.

The Institute agrees that such reporting has a significant role to play in encouraging audit quality. Firms should be encouraged to comply with the Directive's requirements in spirit as well

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as in form and the Institute's view is that this will be best achieved by firms having as much freedom as possible to communicate as appropriate in their specific circumstances.

#### **Institute position**

In broad terms the Institute supports the approach proposed by the POB, in particular limiting the scope to firms auditing fully listed companies, e.g. not including AIM or Ofex companies, and restricting the requirements for the content of the report to those in the Directive. Given the need for choice in the audit market it is important to limit the scope of 'public interest

entity' for this purpose and to avoid the requirements becoming overly burdensome for firms. It could be helpful to provide clearer wording on some of the requirements but only where it can be demonstrated that the revised wording will make it easier for firms to understand and comply.

#### **Need for effective coordination**

The Institute believes it is vital that there is effective coordination at EU level and calls on the FRC/POB to play a leading part in discussions to ensure as much consistency of implementation as possible across the EU. For example, one of the smaller international 'networks' of

firms might get caught by the requirement to describe the network even if just one of its member firms is auditing one 'public interest entity' in one EU Member State. It is important for market reasons that unduly burdensome requirements are avoided for the smaller and more informal international accounting/auditing associations.

*The Institute's response to the POB is available from the 'past consultations' section of the Faculty's website at [www.icaew.co.uk/index.cfm?route=143162](http://www.icaew.co.uk/index.cfm?route=143162).*

*Chris Cantwell, Manager Practice Regulation (Policy and Practice), Audit and Assurance Faculty*

## **Managing risk and liability within assurance engagements**

**Clients are increasingly asking accountants to provide assurance on specific operations/functions within their organisation or on information prepared by the client in order to provide comfort to other third party organisations (for example, customers of the client). A convenient way of doing this may be for clients to seek to engage the accountants to issue an assurance report.**

Recently, the Audit and Assurance Faculty has provided guidance on limited assurance engagements in AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties* and AAF 03/06, *ICAEW assurance service on unaudited financial statements*. Both sets of guidance use the International Auditing and Assurance Standards Board's (IAASB) International Framework for Assurance Engagements ('the International Framework'). This sets out the principles of assurance engagements. The International Framework is applicable to a wide range of services, including historical financial information.

Both sets of guidance highlight issues that accountants need to consider in

seeking to manage their liability and risks effectively. Future guidance in other areas where specific assurance frameworks will be developed will also need to consider these issues.

The Faculty takes a keen interest in liability issues and has, for a number of years considered engagement acceptance, duty of care and liability issues within each piece of guidance that it issues. In doing so, it has always required firms to use their judgement in assessing the risks that they are taking on (for each particular engagement) and in line with their own internal risk management policies and the level of professional indemnity insurance that they have in place.

The Faculty has now published separate guidance, AAF04/06, *Assurance Engagements: Management of Risk and Liability* for assurance engagements (developed under the IAASB's framework). When providing these reports, accountants will need to be clear about why the report has been requested, the purpose for which it will be used, and who may obtain access to the report and assert rights against the accountants. The guidance therefore considers the steps that accountants

may take to manage the risks associated with such reporting. It raises the thought processes that accountants need to consider and provides overarching principles to accountants seeking to manage their risk and liability in future assurance engagements, whilst the practical steps will be considered in the development of separate technical releases for specific topics and areas. In particular, new assurance technical releases will cross refer to the guidance and suggest how it can be applied to the particular circumstance.

The technical release provides links to other existing guidance e.g. Audit 1/01, *Reporting to third parties*, and the Members Handbook Statement 9.1 *Managing the Professional Liability of Accountants*.

*Sumita Shah, Manager, Audit and Assurance Faculty*

# Project Assurance – from compliance to challenge

At the October internal audit lecture, Philip Hendriks and Qadir Marikar, who lead the project assurance practice within PricewaterhouseCoopers, discussed the role of internal audit in project risk management.

Projects are a feature of every business; they can be defined as an activity with a pre-defined start and end date, with the expectation of deriving business benefit. For some, such as construction and IT companies, it may be the reason for being in business, for others it will be part of business change, and will include activities such as acquisition integration, restructuring, outsourcing, product development and IT and systems improvements.

Research indicates that projects are increasing in size and complexity (more than 79 per cent of businesses say projects are increasing in size, complexity and spend – KPMG 2005). However, failure rates are high (25 per cent of projects fail completely, 50 per cent are late or over budget – PwC 2005). According to a recent *Computer Weekly* survey only 16 per cent of IT projects achieve all their targets.

Given the increasing frequency of projects in the current business environment, consistent under-performance in the delivery of projects will erode a business's competitive advantage. Consequently project governance has become an important area of focus for internal audit.

## Internal audit's approach

Given that projects are dependent on time and vary in complexity, the involvement of internal audit can carry its own reputation risks. Where internal audit has carried out a review and a project has failed, questions may be asked as to why the issues were not predicted. In the case of significant project failure where internal audit was absent, queries may be raised as to why the project was not being looked at by internal audit. In order to maintain and enhance the credibility of internal audit,

the approach to projects needs to focus on challenging performance and assumptions rather than looking for compliance with internal project guidance. We believe reviews should take place at intervals throughout the project's life-cycle and be particularly heavily focused at the pre-execution stages when the project is being defined and the scope is being set.

The ability of internal audit to make an impact on projects will be dependent on how well the review team understand the root causes of project failure and is able to identify how they feature in the project being reviewed.

## The root causes of project failure

Research on root causes of project failure would suggest that the primary causes of project failure centre around poor scoping and change control, ill defined project delivery and contracting plans, inadequate stakeholder support and involvement, failure to link back to business benefits as the project progressed and poorly skilled teams.

There are many conceptual models which can be used to assess project risk and consequently predict likely project performance. The 'Six Pillar' model suggests that reviewers assess projects across the six dimensions of risk management, scope realism and management, work and schedule, team structure and skills, stakeholder commitment and benefits realisation.

The value gained from using a conceptual model such as the 'Six Pillar' model will depend on the skill and experience of the reviewer. For example, stakeholder needs should be identified but they should not necessarily define the solution. As Henry Ford once said, "If I asked my customers what they wanted I would have built a faster horse".

'Perspective Convergence' is another feature of projects; a group of people involved in a project over a period of time

can develop a 'view' of the project which can blind them to potential issues or solutions. Independent reviews are an invaluable way of challenging the dominant view.

## The project portfolio

Taking a step back, projects are rarely carried out in sequence and often there are a number of projects running in a business. The ability to understand the 'Project Portfolio' provides the internal auditor with the ability to assess how overall project risk is managed and whether resources are being optimally applied. In particular, are there conflicting projects in an organisation (not rare) and is the project portfolio sufficiently risk balanced? Portfolio risk management is particularly relevant for those entities involved in delivering projects, an excessive concentration of high risk projects can lead to cashflow issues and business failure.

The sequence in which projects are implemented can also be an indicator of likely project success or failure. For example, despite the proven benefits of 'lean construction' techniques in improving margins, the UK construction industry has generally failed to adopt lean construction as a working methodology despite some attempts among the major contractors. This is primarily due to the scepticism of construction workers towards changing their work habits. A project to change perception and culture system is essential in preparing fertile ground for a 'lean construction' implementation.

## Getting going

A combination of using subject matter experts and asking simple questions such as 'why' and 'how' can prove very effective in project reviews, but this all depends on internal audit having the right role being equipped with the adequate authority and resources.

# RICS Regulation – next steps

On 17 October 2006 a member vote of 97 per cent paved the way for a major overhaul of the Royal Institution of Chartered Surveyors (RICS) regulatory regime. Gillian Charlesworth, RICS Head of Regulation Policy, previews the year ahead.

Change is afoot in the way that Chartered Surveyors are regulated and it is likely that RICS' new regime will have a major impact on the role of accountants. At an EGM on 17 October, RICS members voted overwhelmingly in favour of root and branch reform. The principles of Better Regulation that will underpin and define the new regime: proportionality, targeting, consistency, accountability and transparency. In practice this will mean short, principles-based rules and a risk-based approach to enforcement that concentrates on rooting out problems rather than on penalising every tiny breach.

The main changes are aimed at those operating in firms, either as sole practitioners or in larger concerns,

especially those firms holding clients' money. The risk-based approach to enforcement should, over the next few years, bring a marked reduction in the cost and administrative burden of compliance as these firms develop their clients' money systems to suit their business needs and those of the clients. RICS' plan is to develop a risk profile for every firm that will inform the compliance monitoring framework.

RICS sees that its major challenge now is to create efficient tools for the task of assessing risk. These tools fall into three categories: smart IT, the right people and clear, efficient processes. It aims to reduce the number of times members and firms must communicate with the Institution by bringing all regulatory compliance information together into a single, web-based annual return. Instead of Departmental staff handling thousands of pieces of paper a year, firms' submissions on matters such as clients' money, complaints handling and PII will be assessed and risk-rated electronically. Finite staff resources can

be diverted towards helping and advising those firms that need it.

The Institution says that it expects a new regulatory culture to emerge in which help, assistance and good practice are the watchwords rather than zero tolerance and strict liability. Once the initial information gathering exercise is complete towards the end of next summer, firms should begin to see how the new light touch, simplified system brings business benefit.

In terms of clients' money compliance the plan is to move to an in-house compliance approach and to dispense with the need for firms to provide an independent accountant's report. The accountancy profession's role should therefore change from reporting to assisting with systems and implementation. RICS' stated aim is to achieve high standards, consistently applied, by helping and advising its members on how best to handle clients' money.

## Competition 2: word search

15 of the 16 words/publication titles can be found in the wordsearch below. Can you spot which word is missing?

APB  
AUDIT  
AUDIT AND BEYOND  
ASSURANCE  
AUDIT QUALITY  
BULLETIN  
ETHICS  
EXEMPTION  
FACULTY  
FRAUD  
ICAEW  
INTEGRITY  
REGULATION  
ROADSHOW  
STANDARDS  
TECHNICAL UPDATE

A	A	P	U	Y	T	I	L	X	E	A	A	Y	E	T
N	U	J	B	K	T	N	O	I	T	P	M	E	X	E
O	D	D	R	E	G	L	D	P	W	B	W	T	M	C
I	I	U	I	X	A	R	U	T	S	E	H	I	P	H
T	S	Y	Y	T	T	S	M	C	N	X	A	R	S	N
A	S	S	U	R	A	N	C	E	A	E	S	C	N	I
L	U	Y	B	E	C	N	R	S	I	F	A	G	I	C
U	N	D	A	G	I	O	D	S	N	Q	U	R	T	A
G	O	D	I	D	A	O	R	B	T	A	D	B	E	L
E	I	L	D	D	S	H	O	W	E	C	I	D	L	U
R	P	R	S	X	U	A	R	F	G	Y	T	U	L	P
T	R	H	S	E	P	T	A	R	R	O	O	A	U	D
W	O	S	C	I	H	T	E	U	I	N	R	N	B	A
W	A	Q	U	A	M	F	C	E	T	D	O	R	D	T
S	D	R	A	D	N	A	T	S	Y	S	P	Q	U	E
Y	Y	T	I	L	A	U	Q	T	I	D	U	A	S	P

Answers to be sent or faxed to the Faculty\* to be received no later than 30 January 2007. The draw will take place on 31 January 2007. £30 Marks and Spencer vouchers will be sent to the first correct entry drawn.

\*Audit and Assurance Faculty, Institute of Chartered Accountants in England & Wales, Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ or fax: 020 7920 8754.

# bulletinboard

## Faculty update

### UK News

The APB issued a new Ethical Standard for Reporting Accountants (ESRA) applying to reporting accountants undertaking a public reporting engagement on historical financial information in connection with an investment circular. Independence standards for audit and investment circular reporting engagements are closely aligned. Further information is available at [www.frc.org.uk/apb](http://www.frc.org.uk/apb).

### International and European News

In October, the International Federation of Accountants (IFAC) sought proposals for the development of an explanatory guide on implementing International Standard on Quality Control (ISQC) 1 for use by small and medium-sized practices ([www.ifac.org/smp](http://www.ifac.org/smp)).

The World Federation of Exchanges (WFE) formally endorsed the processes for establishing International Standards on Auditing (ISAs), viewing ISAs as key to the development of a globally uniform financial reporting system. The WFE represents 57 securities and derivative markets that account for more than 97 percent of world stock market capitalisation.

The European Federation of Accountants (FEE) hosted a high level conference in Brussels in October 2006, which addressed key issues in audit regulation in the EU. FEE also announced the appointment of Olivier Boutellis-Taft as Chief Executive. See [www.fee.be](http://www.fee.be) for further information.

### Internal audit lecture series

#### Empathy and Understanding – The New Role for Internal Audit

Monday 22 January 2007, Simon Darcy, Associate Director of Audit Services at the Portman Building Society and Vice President of the IIA

The lecture will start at 6pm and will be followed by wine and a finger buffet. The lecture will be held at Moorgate Place, London EC2P 2BJ. The cost of this lecture is £34.04 + VAT. For more information please call Louise Thornton on 020 7920 8493 or visit [www.icaew.co.uk/aaf](http://www.icaew.co.uk/aaf) where you can now book online.

#### Guidance on Packaging Waste (PRNs/PERNs)

The Faculty is working on developing a framework and guidance for the next round of PRNs/PERNs. However, there

is a legal issue that it is trying to resolve with the Environment Agency's lawyers. As soon as the Faculty has a clear way forward, guidance will be published.

### Pension Trustees – Conflicts of Interest and new Money Purchase toolkit module

It is common for a Finance Director to also act as trustee to the employer sponsored pension fund, and issues can often arise which cause discomfort and conflict for those carrying out this dual role. Ethics Advisory Services have issued a new helpsheet with practical and helpful suggestions to assist in managing the conflicts which can arise. [www.icaew.co.uk/helpsheets](http://www.icaew.co.uk/helpsheets).

The latest module of the trustee toolkit, relevant to defined contribution schemes (or sections of schemes) is now available at [www.trusteetoolkit.com](http://www.trusteetoolkit.com). This looks at DC scheme funding and investment choices, the contribution structure, the design and management of DC schemes, how to improve administration and how changes in the UK's tax regime may impact on the scheme.

### Audit & Beyond editorial information

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If you have enjoyed reading *Audit & Beyond*, please pass this copy to one of your colleagues or associates who may be interested in joining the Audit and Assurance Faculty. All enquiries should be directed to the Faculty address above.

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