

Audit & Beyond

THE NEWSLETTER OF THE ICAEW AUDIT AND ASSURANCE FACULTY JULY/AUGUST 2005 NO.101

Building blocks for the future



Dear Faculty Member

I am pleased to report to you that on 8 June 2005 Council approved a new Constitution for our Faculty, which I believe represents a positive step towards evolving the activities of the Faculty.

You may be aware that the Faculties are central to the ICAEW's long term strategy. Under ICAEW plans, the Faculties are to move centre stage to display properly the specialist areas. To contribute to the strategy, the Faculties are to build on their established reputation for delivering technical excellence, influence and recognition for their members and to expand the nature of their activities in line with the ICAEW's strategic aspirations to include greater thought leadership, research and consideration of post qualification needs within their areas of expertise. We also believe that there are opportunities not only in extending the Faculties to existing ICAEW members, but also to promote them to non-members. By growing the activities and membership in this way we aim to develop a solid foundation for greater influence and improve the resources available for service development and

delivery to you.

The Constitutions of all five faculties have been updated to reflect the broader range of activities the faculties plan to pursue. This is an exciting time for the Faculties and we should embrace the freedom to explore these new areas. The vision for the Faculties is as follows:

'The Faculties provide and are recognised throughout the world both for technical excellence and thought leadership in the public interest, and for support to members in their careers through the delivery of high quality member service, networking, influence and recognition for Faculty members in their individual fields.'

The Faculty has already started to rise to the challenge through the Audit Quality Forum which brings together the audit profession, investors, business and regulators and has generated a number of policy proposals aimed at further enhancing confidence in the independent audit. This is a good example of the type of thought leadership the Faculty should pursue and I believe the revised Constitution will enable us to explore other opportunities which will further benefit our members.

If you would like to know more about the Constitution you can visit the Faculty website at www.icaew.co.uk/aafac and select 'about the Faculty', where you will find a link to the Faculty Constitution.

Andrew N Ratcliffe
 Chairman, Audit and Assurance Faculty

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Coming up next...

Look out for the next issue of *Audit & Beyond* which will include articles on the following:

- Introduction to the incoming Faculty Chairman, Gerald Russell
- Questions and answers on the APB's ethical standards
- Turnbull update

Audit liability: claims by third parties

As a result of a number of high-profile legal cases involving claims by third parties against auditors, firms have become increasingly aware of the need for a 'risk management' mentality to allow them to consider the potential pitfalls they might be facing given their particular circumstances.

The Faculty has been responding to this situation by providing practical guidance to members, most notably through the work of the Special Reports of Accountants Panel (SRAP). We are now issuing a review of the relevant legal cases (with references to the appropriate Institute/Faculty guidance) which has the advantage of bringing all these cases together in one document for the first time and which provides members with a single point of reference for the relevant risk management guidance issued by the Faculty/Institute. The text for this review has been provided by the lawyers Simmons & Simmons, to whom we are extremely grateful.

Duty of care

The review highlights the tests used by the courts to determine whether auditors owe a duty of care arising from the *Caparo v Dickman* case and covers the way in which these principles might be applied to a wide variety of factual situations, the main categories of third parties being as below.

Investors

The cases highlight how auditors might assume a duty of care to potential investors, e.g. by giving information or advice directly to them. The publication also emphasises the need to always define the scope and responsibilities of an engagement in an agreed engagement letter or to obtain a 'hold harmless' letter from the third party.

Creditors and lenders

The same principles apply to those who lend to (rather than invest in) companies on the basis of audited accounts. The

review covers the recently appealed *Bannerman* case (see below) which led to the publication by the Faculty of Technical Release Audit 01/03 '*The Audit Report and Auditors' Duty of Care to Third Parties*'. The importance of the disclaimer recommended in Audit 01/03 and avoiding actions inconsistent with it is emphasised.

Regulators and trade bodies

The cases highlight the importance of the Faculty's guidance, e.g. in Audit 1/01 '*Reporting to Third Parties*', to meet the needs of regulators/trade bodies through tripartite engagements which are separate to the statutory audit engagement, and to avoid any duty of care to these third parties for the audit. SRAP has now issued a number of Technical Releases dealing with reporting arrangements for particular regulators/trade bodies which are listed in the text.

Affiliates/associates of the client

This is where auditors may owe a duty of care to entities affiliated or associated with the audit client. The review concludes that auditors of a company in a group need to exercise caution in their dealings with auditors of other group companies. It notes that a new ISA (600 revised) is being developed on group audits and that the Faculty plans to issue practical guidance on this topic later in the year (see article '*Group audits research*' in the March issue of *True & Fair*).

Obtaining copies of the guidance

The guidance is included with this issue of Audit & Beyond. It is also available to Faculty members on the Faculty's website

www.icaew.co.uk/aafac.

Summary of Bannerman appeal

The *Audit Liability: Claims by Third Parties* guidance includes information about the *Bannerman* appeal. The Inner House of the Scottish Court of Session (equivalent to the Court of Appeal) has dismissed the appeal by the accountants against the judgment given in 2003 refusing to strike out a claim brought against them.

At first instance, the accountants had argued that, in order for them to be found to have assumed a duty of care to the bank in relation to their audit, it would have to be shown that they had intended that the Royal Bank of Scotland should rely on the audited accounts for a known purpose.

That submission was rejected at first instance and it has been similarly rejected on appeal. The Court of Session has said that, to establish the relevant duty of care, it may be sufficient in some circumstances that the provider of the information or advice knows that it will be passed to the third party recipient for a specific purpose and that the recipient is likely to rely on it for that purpose.

Whilst intention, if present, may support the existence of proximity between the auditors and the third party, the Court of Session has stated that intention should not be seen as essential 'in every case'. Following *Caparo*, what really matters is not the intention of the auditor, but its actual or presumed knowledge that the information or advice was likely to be relied on by the third party.

At first instance, the Court had stated that the absence of a disclaimer by the

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auditors could be taken to indicate that they had assumed responsibility to the bank in relation to the audited accounts. Following that statement, the Institute issued Audit 01/03 which includes appropriate wording to be included in audit reports disclaiming liability to third parties.

On appeal, the Court of Session has confirmed that a failure to disclaim against a third party can, in appropriate circumstances, be a factor pointing to an assumption of responsibility on the part of the auditor.

The Court also confirmed that there is

nothing in section 310 of the Companies Act 1985 to prevent an auditor from disclaiming liability to third parties.

Chris Cantwell
Manager, Practice Regulation (Policy and Practice)

Audit quality - the forward agenda

The *Audit Quality Forum* was set up in December 2004 and since then we have carried numerous articles covering its initial work programme, policy proposals and their inclusion in the Government's White paper on Company Law (see March, April and May issues). This article provides background on the outcome of the last meeting of the Forum in May and takes a look at the forward agenda for promoting audit quality.

Four policy proposals

In late May, the Institute brought together key stakeholders at the third meeting of the *Audit Quality Forum* to discuss progress on the four policy proposals that were passed to the DTI and FRC earlier in the year and to receive an interim update on the project considering competition and choice in the audit market. It also set its sights forward and considered eight potential new projects to get our teeth into.

Four policy proposals

- Auditor resignation statements
- Questions to auditors
- Disclosure of contractual terms
- Identifying the audit partner

At the meeting, participants were informed by the DTI that draft clauses on the four policy proposals, see right,

will be available before the summer break, with outline plans to introduce the measures in the Company Law Reform Bill due this Autumn.

Competition and choice

The working group tasked with the difficult issue of competition and choice summarised the key matters identified by their work including the effects on competition of globalisation, networks, pricing, risk and reward and, in particular, real or perceived choices in the market and interactions between these factors. The group highlighted that the differing perceptions of the nature and purpose of an audit was also a key concern. At this stage, the primary recommendation of the group is the need for independent research into this complex area and the Forum is working with the DTI and FRC to identify the most appropriate way to take this forward.

Potential future projects

Finally, the Forum received a presentation on eight potential projects which were derived from a consultation exercise with stakeholders performed in April/May 2005. After discussion and debate, the Forum proposed that there be a new work stream which should consider the purpose of audit in modern society across entities of all sizes. Our discussion summarised that within this

work stream we should encompass three interrelated and interdependent projects of *audit purpose, principles based global auditing standards and audit reports*.

The Forum also backed a late runner in the form of a project to consider the nature and availability of *third party information to auditors*, which means that we have a rather busy forward agenda.

Now the dust has settled we have turned our attention to working with stakeholder groups to determine the next practical steps, including more detailed scoping and clarity around the nature of the output from each of these projects.

To find out more detail about the May meeting, the potential projects or more general information about the *Audit Quality Forum* visit the website at www.icaew.co.uk/auditquality.

New projects

Purpose of audit work stream

- Audit purpose
- Principles-based global auditing
- Audit reports

Other

- Third party information to auditors

Audit and Assurance Faculty celebrates tenth anniversary

To celebrate the Faculty's tenth anniversary we have taken a look back at the last ten years to see what the major achievements have been for the Faculty.

Leap back in time

First, let us take a leap back in time to 1995, when the Audit and Assurance Faculty was launched. At that time we had a Tory Government, the average house price was £61,369, the average gross pay was £17,487.60 a year, a pint of lager cost £1.63, a litre of petrol cost 53p and Robson and Jerome held the number one spot for seven weeks with their version of *Unchained Melody*. It was also the year when we saw the collapse of Barings. At the time we had the Big Six accountancy firms made up of Price Waterhouse, KPMG, Coopers & Lybrand, Deloitte & Touche, Ernst & Young and Arthur Anderson, and in that year Deloitte & Touche created Deloitte Consulting.

The Faculty began operating with a staff team of four to service a membership of 5,765. The team has since evolved to a dedicated team of ten, consisting of the Faculty Head, six technical managers, an operations manager, a services manager and an administrator, servicing the needs of more than 9,000 members both in the UK and overseas. Indeed, the remit of the Faculty has also developed and we now cover assurance matters, an area of increasing relevance where there is little practical guidance.

Thought leadership

The Faculty has always been at the forefront of debate on audit-related matters and has risen to the challenge of delivering outstanding thought leadership over the years. In the very first edition of the Faculty's newsletter (*True & Fair*), Gerry Acher, then Chairman of the Faculty, advocated standards with international

acceptability. Ten years later, on 1 January 2005, we have seen the introduction of the International Financial Reporting Standards (IFRS). Back in 1995 the ICAEW was also lobbying for auditor liability talks and an amendment to section 310 of the Companies Act. Now, ten years on, we are finally seeing some serious progress in this area. Back in 1995 concerns were also being raised about the relationship between auditors and investors. In 2005 we have seen the formation of the *Audit Quality Forum*, which brings together the audit profession, investors, business and regulators to work together to generate policy proposals that will further enhance confidence in the independent audit by promoting transparency and accountability.

Ten years of unprecedented change

Over the last ten years the audit profession has been through a period of unprecedented change. We have witnessed major corporate reporting scandals both in the US and Europe, which have put the profession under intense scrutiny. We have also seen the audit exemption threshold rise three times - now fixed at £5.6 million, the implementation of a suite of new auditing standards, the arrival of the Auditing Practices Board (APB) ethical standards for auditors and developments in the technical underpinnings of assurance engagements. The Faculty has had a crucial role to play in representing member's interests and providing timely guidance to assist members through these critical periods of change. To date, more than 50 Technical Releases have been issued and numerous publications have been produced addressing a wide range of topical issues.

Publications

In 1997, the Faculty published *The Value of an Audit* to highlight the importance

of an audit to the owners of a company and other users of the audited financial statements. The Faculty view was that good audits would create stronger businesses. Undoubtedly, the Faculty's most popular publication of 1997 was *Audit Committees: a Framework for Assessment*. This publication was so popular that the Faculty had to arrange a second print run to keep up with demand. It also received global recognition for helping directors understand the role of audit committees and was reprinted for the Australian Institute of Chartered Accountants.

In 2002 the Faculty produced *Audit Quality*, which brings together leading edge thinking from a wide range of acknowledged practitioners and identifies vital ingredients that contribute to audit quality. This publication forms part of the overall strategy of the Faculty to continue to help members perform quality work. Following on from this in 2003 the Faculty published *Fraud: Meeting the Challenge of External Audit*, which provides a ten-point action plan for audit firms, their partners and staff to take the initiative in developing their audit procedures to respond to fraud risk in the light of increasing public expectations. More recently, the Faculty has undertaken research into aggressive earnings management and investor confidence in audited information to gauge perceptions in the aftermath of major corporate scandals.

Roadshows

In addition, the Faculty has delivered timely and practical advice to members through the nationwide Roadshows. We have run 11 roadshows in 10 years, visiting up to 28 locations nationwide. The recent Roadshows have covered issues such as ISA implementation and the implications of the movement in the audit exemption threshold.

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A special thank you

To mark this very special anniversary the Faculty felt it would be appropriate to recognise selected individuals who have been with the Faculty since its creation in 1995 and have consistently supported the Faculty in its endeavours to provide technical excellence, thought leadership, influence and recognition for members.

Gerry Acher

Gerry was instrumental in establishing the Audit and Assurance Faculty back in 1995. He worked tirelessly as the first Faculty Chairman to establish the Faculty's reputation as the leading voice on all audit related matters.

Tony Bingham

As Chairman of the Technical and Practical Auditing Committee for the last ten years, Tony has played a crucial role in TPAC's representational work and in leading the debate to ensure the timely delivery of practical and effective technical guidance and publications on topical auditing and assurance matters for firms of all sizes.

Stella Fearnley

Stella has consistently supported the Faculty since 1995, providing timely academic insight on a wide range of technical issues.

Tracy Gray

Tracy is the only member of staff who has been with the Faculty since its creation in 1995. She has enjoyed ongoing success in the delivery of the full range of member service activities, particularly the extremely popular Faculty roadshows.

Clive Jones

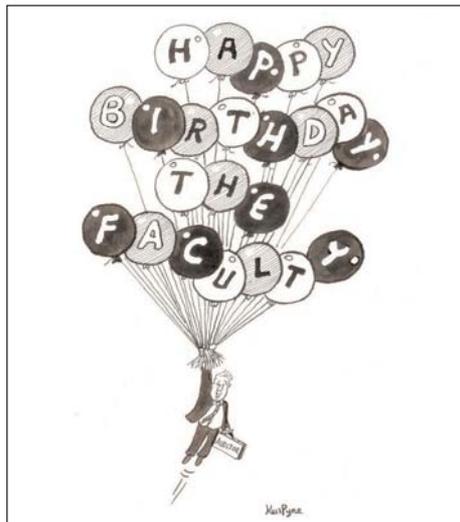
Clive has been Chairman of the Practitioner Services Committee since its creation in 1995. He is dedicated to meeting the needs of smaller practitioners through timely and appropriate practical support and advice. His Committee is responsible for the roadshows and Clive has taken an active personal interest in the latest roadshow on the APB ethical standards.

Martyn Jones

Martyn is Vice-Chairman of the Technical and Practical Auditing Committee. He is Chairman of the International Standards on Auditing (ISA) Implementation sub-group. His dedication to the work of the Faculty shines through in the number of times he has volunteered to contribute his technical expertise on a wide range of technical issues. He even has his own post in-tray at Moorgate Place.

John Moss

John has been a member of the Practitioner Services Committee since its creation in 1995. Over the years he has provided invaluable support to members through his work on the committee.



Andrew Ratcliffe

Andrew took over the chairmanship of the Faculty from Gerry Archer in 2001. Over the years he has made significant contributions to the Faculty's thought leadership programmes, including audit quality. He has played a key role in developing the strategy and direction of the Faculty.

Michael Sheasby

Michael has been a member of the Internal Audit Committee since its creation in 1995 and became Chairman of the Committee in 2002. Michael has always given freely of his time to support the Faculty and often chairs the extremely popular Internal Audit Lecture Series.

Tony Upton

After ten years of unwavering service, Tony has recently retired from the Technical and Practical Auditing Committee. His technical expertise and pragmatic insight on a wide range of technical issues have played a crucial role in our technical successes.

The Faculty is proud of what it has achieved over the last ten years and is very grateful for the continued hard work and support of Faculty members, the large number of volunteers who give freely of their time and Faculty staff. To conclude, we have a few words from the Faculty's first Chairman, Gerry Acher.

"When in the early 1990s I was appointed Head of Audit at KPMG I found it difficult to believe that there was no Audit Faculty already up and running yet the tax and other faculties were all supplying a need. Few needed to be convinced and I think many felt a sense of relief when we got the show on the road in 1995. That need manifested itself exponentially as each year went on. First internal audit was pulled in and then public body auditing. The need for support for practitioners from the faculty knew no boundaries.

Since I passed on the mantle to Andrew Ratcliffe the challenges have only got greater but the bar has been set continually higher. The Enron/Worldcom fall-out and the Sarbanes-Oxley regime have reduced the room for auditors to manoeuvre. But the need for good auditing backed up by a strong audit faculty is even more necessary now than it was ten years ago. The future of the audit and assurance faculty is assured and every practitioner owes a debt of gratitude to all the permanent staff and the strong body of volunteers so ably led by Andrew.

I wish the Faculty every success in its celebration and look forward to toasting its health when it truly comes to age in a further 11 years time!"

Norma Jones (Faculty Operations Manager) and Louise Matthews (Faculty Administrator)

Subcontracting out audit work - issues to think about

This is an area where the Institute has received a number of complaints that could be avoided. In this article, the ICAEW's Professional Conduct Directorate provides some background on potential pitfalls and guidance on procedures for practitioners to follow.

Do you subcontract out audit work?

Complaints are often received in relation to members subcontracting audit work or having similar arrangements where work of third parties is relied upon. Members need to be aware that there are potential disciplinary implications arising from their responsibilities as a Responsible Individual signing an audit report based on the work of subcontractors. What follows may seem like common sense, yet all too often this is what is missing from such agreements.

A firm of Registered Auditors may be liable to disciplinary action in respect of accounts which fail to comply with Accounting Standards or the Companies Act. The Responsible Individual cannot wholly rely on any opinion supplied by the subcontractor, but must consider whether he has discharged all his obligations and satisfied himself that all Auditing Standards and Audit Regulations have been complied with. Audit Regulation 3.06 deals with undue influence on the Responsible Individual and Audit Regulation 3.08c deals with the arrangements that have to be made by an audit firm which uses a subcontractor to perform some of the audit work.

However, essentially the position is no different from any other audit whereby Responsible Individuals must be fully satisfied before they sign any audit report.

Common pitfalls and procedures to follow

Most members who come to the attention of the Professional Conduct

Directorate have made a genuine attempt to meet the Auditing Standards and Audit Regulation requirements prior to signing the audit report in their own firm's name.

However, Responsible Individuals and firms who subcontract audit work need to ensure that all Auditing Standards are met. For example, they should:

- issue the engagement letter to the client directly; and
- check the independence and competence of all subcontracting staff.

The Responsible Individual needs to gain adequate knowledge of the client to fulfil his duties. Usually this would require him meeting the directors to obtain an appropriate understanding.

Whilst a subcontracting firm may perform the planning and field work, it is the Responsible Individual's responsibility to review and sign off the planning and field work in the same way as an audit performed by his own firm. Indeed often more care is needed if work is subcontracted as the methodology for documenting the working papers may be different between the two firms.

Audit regulation 3.06 states that the Registered Auditor must make arrangements to prevent anyone who is not the Responsible Individual from having any influence which would be to the detriment of the firm's independence or integrity.

Audit Regulation 3.08c also stipulates that arrangements must be in place whereby all audit papers created by the subcontracting firm are sent to the Registered Auditor and that the subcontractor has allowed the Registered Auditor unrestricted access to the working papers.

Finally, it is the Responsible Individual and his firm's responsibility to ensure that any subcontractors are not acting contrary to any ethical guidelines.

Example 1

A potential client contacts you and states that the due date for filing his company accounts is only a short time away. He has found an accountant to do the audit, but at the last moment he realised that the accountant was not a Registered Auditor and he is becoming desperate. He passes you the unregistered firm's working papers and asks if you can review the papers and sign the audit report.

What procedures should you perform prior to signing the report?

In this situation it is highly unlikely that you can place sufficient reliance on the work which has already been performed. The overall direction of the audit and exercise of judgement should always be in the hands of the Responsible Individual. Merely reviewing the work which has been performed by the subcontractor and signing the audit report is insufficient and will not comply with Audit Regulation 3.06.

Before accepting the audit you need to consider money laundering obligations and also gain an understanding of the client. You will then need to understand if the subcontractor was suitably qualified, had the appropriate audit experience and in this case there is a risk that the contractor has inadequate experience as they are not qualified to sign the audit report. As the Responsible Individual signing the audit report you will still need to plan your audit and as part of this planning assess the extent to which work undertaken provides the assurance required and ensure that further work required has been completed. You will need to record this process.

Example 2

E Limited is an existing client. However, you have moved from the area, but wish to retain the client. You decide to use a

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subcontractor, T & Co, Chartered Accountants, who are still local to E Limited. You decide that you will perform a desk-top review of all the planning and working papers. You will also hold several telephone meetings with the subcontractor prior to, and during, the planning and completion phases of the work to ensure that key risk areas have been considered and that judgmental areas have been audited and reasonable conclusions drawn. You will

use e-mail to send and review key documents such as the planning document and management letter.

Is this arrangement acceptable?

This arrangement does not seem to address adequately the need for you to update your knowledge of the client. Best practice would be to ensure that you visit E Limited and meet with the directors together with T & Co to hold at

least a planning and a clearance meeting.

Where in doubt, the principal auditor should consider taking advice, including technical assistance, from the Institute. Technical assistance or help in respect of any issue is available to Institute members by contacting the Institute's Advisory Services (Technical Enquiries Service on 01908 248025 or Ethics Helpline on 01908 248258).

The new audit reports

APB has recently published a Draft Bulletin on Audit Reports (Bulletin 2005/4 *Auditor's Reports on Financial Statements* available at www.frc.org.uk/apb). The guidance is effective for audits conducted in accordance with International Standards on Auditing (ISAs) for periods commencing on or after 15 December 2004.

The Bulletin consists of a short introductory section dealing with the reasons for its issue and longer appendices which give a considerable number of example audit reports. The Bulletin has been issued to deal with a number of recent developments which impact on the audit report:

- the use of ISAs in the conduct of audits;
- the use of IFRS in some company accounts;
- changes to the Companies Act 1985 and corporate governance requirements; and
- the use of 'emphasis of matter' paragraphs in the place of 'fundamental uncertainty' paragraphs.

The Bulletin updates the example reports given in SAS 600 and subsequent Bulletins and is the first edition of the Bulletin referred to in ISA (UK and Ireland) 700 *The Auditor's Report on Financial Statements*. Example opinions have been taken from current IAASB documents and adapted to the UK situation, except where the UK wording is considered more relevant. The Bulletin does not cover summary financial

statements and SI 2005/1011 which will require a positive statement that the directors' report has been prepared on a basis consistent with the financial statements (required for financial years beginning on or after 1 April 2005).

These changes relating to the use of IFRS in particular have resulted in some complications for auditors, but there are three flowcharts which help with working out which example applies. Clean reports for companies that are not publicly traded are relatively straightforward. It should be emphasised that whilst APB has done its best to cover all of the more common situations, not all permutations have been covered simply in order to keep the length of the Bulletin manageable, for example, there is no example dealing with an unlisted entity that decides to adopt IFRS. It should also be emphasised that with the exception of the introduction of ISAs, the cause of most of the changes is beyond APB's control!

The most significant apparent change in the look of audit reports is the references to UK Generally Accepted Accounting Practices (GAAP) and/or IFRS.

Non-publicly traded companies

In order to establish what type of report to issue for non-publicly traded companies, the auditors have to ask three main questions:

- are group accounts required?
- has the FRSSSE been used?

- is there 'surround' information other than the directors' report?

The example given for group accounts assumes a simple situation: that UK GAAP is used for both group and parent company accounts, that group and parent company accounts are presented together and that the S230 exemption from the publication of the parent's own profit and loss account has not been taken.

Where surround information other than the directors' report is provided there is an additional paragraph within the paragraph dealing with the responsibilities of directors and auditors covering the auditor's duties in relation to that information.

Where the FRSSSE has been used, the reference in the opinion paragraph is to UK Generally Accepted Accounting Practice applicable to Smaller Entities.

Publicly traded companies

The main complications arising here derive from the fact that group and parent company accounts can be prepared under different accounting regimes (UK GAAP, EU-adopted IFRS and full IFRS), that many such companies take advantage of the S230 exemption from the publication of the parent company's profit and loss account, and that as a result of further complications relating to IFRS, many companies may wish to present group and parent company accounts separately.

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So the main questions that need to be asked for these companies are:

- are group accounts required?
- are parent company accounts prepared under EU-adopted IFRS?
- has the S230 exemption been taken?
- are the group and parent company accounts presented separately?

Further questions that need to be asked include questions about the location of the corporate governance statement and the Directors' Remuneration Report (group or parent company financial statements).

References in the opinion paragraph

where IFRS are used are to 'those IFRSs adopted for use in the European Union'. Where a company complies with full IFRS, an additional opinion is required.

Modified audit reports

Emphasis of matter paragraphs are back. Generally, they replace fundamental uncertainty paragraphs. The example given relates to the possible outcome of a lawsuit. This aside, the familiar format of qualified ('except for'), adverse and disclaimers of opinion remain. The only other 'changes' relate to:

- multiple significant uncertainties: rather than issuing a string of emphasis

of matters paragraphs, in some extreme circumstances, auditors may issue a disclaimer of opinion;

- going concern opinions: complications arise here because of the interaction of accounting standards (UK GAAP and IFRS) and auditing standards. This area is complex and gives rise to different reports depending on the accounting framework used.

Whilst some of the issues that give rise to complications in this Bulletin are likely to resolve themselves in the not-too-distant future, it seems that some of them are likely to be with us for some time. It is therefore worth getting to grips with this document!

Third party reporting on financial service organisations

The Audit and Assurance Faculty is exposing draft guidance, *Assurance reports on internal controls of service organisations made available to third parties to replace the existing guidance FRAG 21/94 Reports on internal control of investment custodians made available to third parties*.

Critics of FRAG21/94, revised in 1997, raised questions about the usefulness of the reports prepared under the guidance and suggested that the reliance placed by users on such reports was more than the assurance in fact conveyed. The proposed guidance is designed to help accountants to issue *opinions* in their reports on the control procedures of financial service organisations, such as investment managers and custodians.

The working party that developed the guidance includes representatives from the National Association of Pension Funds, the Investment Management Association and other service organisations. The draft guidance includes sets of control objectives for different types of service, primarily for reporting accountants to evaluate and

conclude on internal controls of service organisations. Criteria are also expected to assist users to understand how the reporting accountants have evaluated the internal controls to reach their conclusion.

The working party has sought to address the following issues which were raised in respect of the existing guidance:

- Scope.** The scope and content of reports prepared under FRAG21 can vary widely and this reduces their comparability and consistency. Under the proposed guidance accountants would state the basis of their work and responsibilities for their opinion in line with the guidance.
- Improved transparency.** Under the proposed guidance the respective responsibilities of management and reporting accountants would be more clearly stated in the accountants' report.
- Provision of conclusion.** Under the proposed guidance reporting accountants would give an opinion as to the adequacy of the control description and the design and

operation of controls. In contrast FRAG21 reports reported factual details only.

- Agreed control objectives.** The working party agreed on minimum components of control objectives expected from financial service organisations. These are intended to provide a standard basis for service providers preparing the report and to ensure greater transparency of the criteria on which reporting accountants base their opinion.
- Usefulness of the guidance.** The draft guidance provides a reporting framework that can be applied to different areas of outsourced activities, if appropriate control objectives can be developed.

A series of questions accompanies the exposure draft, asking for comments on matters such as the level of assurance and the use of control objectives as criteria.

The exposure draft and related questions is available from www.icaew.co.uk/aafac. Please send your comments and response to the questions by e-mail to: tdaf@icaew.co.uk.

Internal audit: managing the risk of fraudulent financial reporting

Take three ingredients: opportunity, a situation of personal or business pressure and the ability to justify something that is wrong and you have the perfect circumstances for a finance executive to commit financial reporting fraud.

Moreover says Alex Plavsic, head of fraud services at KPMG, competitive highflyers who are hardworking and well-respected have a greater ability to commit fraud and effect a cover-up because they are trusted. And the more senior the executive the larger the sums usually involved.

Alex, who also sits on the board of the Fraud Advisory Panel which was founded by the ICAEW, was examining internal audit's increasingly greater role in challenging the way their organisations manage the risk of fraudulent financial reporting during May's internal audit lecture. He described many examples of financial reporting fraud which were committed by the 'good guy' in finance. In most cases, focus on the risk issues or the data was overshadowed by perception of the individual.

How those frauds came about commonly stemmed from the fact that opportunity arose during a situation of personal or business pressure and the finance executive succeeded in rationalising (or

justifying) the fraudulent numbers.

It is understandable how fraud can come about in even the most sophisticated organisations. Behavioural or performance indicators may be ignored just because of who the person portraying them is. In some organisations there is often a lack of understanding or focus on hotspots (incidents or allegations occurring in one function, office or region). Yet in others the IT environment is far from robust.

Internal auditors should be aware that *best anti-fraud practice* requires robust fraud governance with challenge from the audit committee and a fraud detection system that is proactive with the ability to drill down into the detail, thereby providing a systematic response to fraud. Fraud awareness should be adapted to the organisation's circumstances, championed by people with credibility and cascaded immediately and locally.

Detecting fraud or investigating

allegations can be difficult for management internal auditors or investigators for a number of reasons, such as not wanting to ask questions which indicate a lack of knowledge or the inability to spot deception in those whom they know and like. Alex Plavsic says that internal auditors should encourage scepticism.

Internal auditors should seek or revisit the anti-fraud policy and whistleblowing arrangements and check how widely known their existence is in the organisation.

Their wider role should comprise

- review and challenge of the governance of financial reporting (responsibilities, policies and controls, management supervision and audit committee oversight)
- testing of key risks and analysis of data (e.g. manual journals)
- promotion of awareness and scepticism throughout the organisation

CPD planner - ACA puts you ahead CPD keeps you there

As you will know, the Institute introduced new arrangements for continuing professional development in 2005 and, towards the end of each year, members of the Institute will be required to complete an annual declaration that they have undertaken their CPD for the year.

On an ongoing basis, members are required to **reflect** on what is expected of them in their roles and take **actions** to meet these expectations. Having completed relevant learning, members need to consider the **impact** by assessing whether the reading, meeting or course has helped them meet their needs and consider

action points for further development. An annual return will need to be completed and CPD evidence will need to be made available where requested by the Institute.

In order to help members with this process, the Faculty has developed a CPD planner (included with this issue of *Audit & Beyond*) which provides information about the new scheme, how it works and the transitional rules. The planner provides an illustrative example of a CPD planning and recording document, which follows the 'reflect, act and impact' approach, to help members to familiarise themselves with the requirements. A logbook of development

activities to record CPD is also provided in the planner, alongside examples of useful articles and resources in the Faculty which can help members to meet their CPD needs.

Further information on other resources available, professional challenges, case studies on ethical dilemmas and members' experiences can be found on the CPD website at www.icaew.co.uk/cpd.

The planner (and a word version of the logbook) can also be downloaded from the Faculty's website at www.icaew.co.uk/aafac.

Changes to the audit regulations

The Institute has amended the audit regulations to reflect changes such as the adoption of international standards on auditing and other matters.

- Adoption of ISAs
- APB Ethical Standards
- The Companies (Audit, Investigations and Community Enterprise) Act 2004

This article highlights some of the changes. Audit News number 40 (sent to firms in June) should be referred to for all the changes, which are effective from 1 August 2005. Firms can download a copy of the Audit Regulations incorporating the changes from www.icaew.co.uk/auditnews.

Definition of audit

The Companies (Audit, Investigations and Community Enterprise) Act 2004 gave the Audit Inspection Unit (AIU) a wider remit to monitor 'company audit functions' which includes corporate governance matters contained in an audit report. The AIU also has a remit to look at other types of audited entities. To deal with this, the definition is now drafted in terms of specific legislation and other regulatory requirements that require audit reports and includes open-ended investment companies, unit trusts, Lloyds' syndicates and mutual life offices.

New APB statements

The definition of auditing standards was amended to refer to international auditing standards. New definitions were added for quality control and ethical standards. Where appropriate, regulations have been amended to refer to the new items.

Definition of monitoring unit

The new definition replaces that for the Joint Monitoring Unit and includes the AIU.

Regulation 3.08c - working papers

This regulation requires a firm to have access to working papers where it subcontracts work to another firm, e.g. a stock-take visit at a remote location. The regulation was amended to clarify that it does not concern the working papers of a subsidiary auditor, where 'access' is governed by company law and SAS 510

(now ISA (UK & Ireland) 600).

Regulation 7.06 - requests for information

The changes are to clarify what types of information can be requested.

Regulation 7.07 - disclosure of information

This was a lengthy list about when confidential information could be disclosed and was to become longer! Instead, adopting a principles basis has shortened the regulation. Information is still kept confidential but can be disclosed to assist others in undertaking their regulatory, disciplinary or law enforcement responsibilities.

Regulation 8.01 - conditions

The change was to clarify that conditions do not apply just to individual audits but can be used to ensure that all audit work is undertaken, supervised and managed effectively.

Regulation 8.07 - withdrawal of registration

This change makes clear that the Audit Registration Committee can withdraw a firm's audit registration if it fails to honour a promise given to the committee.

The Audit Regulations were rewritten in 1995 to make them clearer. Since then there have been a number of changes and the original cohesion of the regulations may have diminished. Therefore the Institute is considering whether to look at this again, although any changes are not expected to be as extensive as the 1995 project. If you have any matters that you think should be considered, could you send them to Peter Burton, Head of Regulatory Policy at the ICAEW, Silbury Court, 412-416 Silbury Boulevard, Milton Keynes, MK9 2AF or by email to peter.burton@icaew.co.uk.

International standard on quality control - reminder

The APB issued a new auditing standard with the rather long title of 'International Standard on Quality Control (UK and Ireland) 1 - Quality controls for firms that perform audits and reviews of historical financial information and other assurance and related services engagements'. As this standard relates to overall firm procedures rather than individual audits, the implementation of the standard is different to other auditing standards which are implemented by reference to audits of accounting periods. Firms were therefore required to have in place the various systems detailed in the standard by 15 June 2005. Hopefully this has not posed too many problems as most of the requirements are matters that firms are likely to be dealing with anyway.

As a reminder, the Standard covers similar material to that included in Chapter 3 of the Audit Regulations. However, it is more detailed and covers a wider range of issues. In a small number of cases the standard has put into 'bold type' requirements matters that the

Audit Regulations deal with in guidance. These are as follows:

Independence - paragraph 23 of ISQC 1

This requires a written confirmation from all principals and staff about their independence at least on an annual basis. The Audit Regulations only dealt with the frequency of confirmation in guidance after Regulation 3.02.

Acceptance and continuance of client relationships and specific engagements - paragraph 28 of ISQC 1

When considering accepting an audit appointment or reappointment the standard (at sub-paragraph a) requires the integrity of the client to be considered. This is not an issue specifically mentioned in Audit Regulation 3.04.

Consultation - paragraph 51 of ISQC 1

This paragraph deals with consultations on 'difficult and contentious' matters,

which can be regarded as the ethical and technical matters that Audit Regulation 3.09 refers to. Whereas the Audit Regulations mention the need for documenting such consultations, the standard (at sub-paragraph c) elevates this to a bold type requirement.

Monitoring - paragraph 82 and 85 of ISQC 1

These paragraphs, like Audit Regulation 3.15, are about how a firm should monitor its compliance with the Audit Regulations and Auditing Standards. The regulation notes that the outcomes of the review should be communicated within the firm. Again, the standards raise this to a bold type requirement.

The above are those instances where there is a direct linkage between the standard and the Audit Regulations. Firms should consider the entirety of the standard and check that they are in compliance with the other matters included in the standard.

Institute responds to White Paper

The Institute has called on the DTI to make fundamental changes to outdated capital maintenance rules that impose limits on company distributions. In its response to the Company Law Reform White Paper, the ICAEW argued that the regime is too complex and no longer reflects the needs of companies and their creditors.

The reform is particularly urgent because the rigid link which the present law imposes between company balance sheets and the amount of company distributions 'fails to achieve the objective of protecting creditors, imposes unwarranted burdens on business and impedes the development of financial reporting' the Institute said in its response.

The ICAEW favours a solvency-based regime. Such an approach would determine contributions by reference to the effect on company solvency and the need to preserve the company as a going concern. It would be simpler and more cost-effective, whilst also protecting creditors and allowing investors appropriate returns.

The Institute supports measures to improve shareholders' rights and ensure a strong, competitive and high quality audit market and the proposals for liability reform, but called for changes to the wording of the accompanying new criminal penalties for auditors. The Institute is concerned not with the underlying purpose of the new offences, but with the detailed wording.

The White Paper also enshrines the principle of 'Think Small First,' which aims to make the law simpler and more accessible for smaller private companies.

Commenting on this, Eric Anstee said:

'We hope that the Government's proposals on smaller companies will provide a significant step towards reducing the regulatory burden on this sector, further encouraging competitiveness and growth.'

'We now have an excellent opportunity to implement these measures, and we will seek every opportunity to work with Ministers and MPs to ensure their successful passage through Parliament.'

bulletinboard

Faculty update

Library & Information Service Summer closure

The Library & Information Service will be closed from Monday 8 August until Monday 29 August 2005, re-opening on Tuesday 30 August. During this time LIS staff will be working on essential development projects to ensure they can continue to improve the high quality service they provide to members.

While the Library is closed you can still:

- Use the extensive online information services on the LIS website at www.icaew.co.uk/library
- Return books by post or leave them with the Security staff at the Copthall Avenue entrance to Chartered Accountants Hall
- Get help with *urgent* information needs by leaving a message on 020 7920 8620 or emailing library@icaew.co.uk. These will be checked twice daily by LIS staff.

For more information about alternative business information services you can use while the Library is closed visit www.icaew.co.uk/library.

APB issues draft guidance

APB has issued the following draft revised guidance:

- A consultation draft of a revision of Practice Note 10 (Revised), Audit of Financial Statements of Public Sector Bodies in the United Kingdom (deadline for comment is 16 September 2005)
- A consultation draft of a revision of Practice Note 14, The Audit of Registered Social Landlords in the United Kingdom (deadline for comment is 7 September 2005).

Copies of the consultation drafts may be downloaded from the Publications section of the APB's website at www.frc.org.uk/apb. The Institute will be responding to these consultations. For more information see Consulting You on the Faculty website at www.icaew.co.uk/aafac.

Internal Audit Lecture series

Future dates for your diaries:

Monday, 12 September

Monday 24 October
Monday 5 December

All lectures will start at 6pm and will be followed by wine and a finger buffet.

The lectures will be held at Moorgate Place, London, EC2P 2BJ. Tickets cost £32.50 plus VAT. For more information please contact Louise Matthews on 020 7920 8493.

CCH Professional Development events

New auditing standards - implementation & issues for technical and compliance partners
London, 22 September 2005, £429

Practical auditing problems
London, 02 November 2005, £199

Audit Roadshows
Newcastle, 8 November, £229.00
Leeds, 9 November, £229.00
Liverpool, 10 November, £229.00

For further details of these events please visit www.cchseminars.co.uk or call 01635 588898.

Audit & Beyond editorial information

Comments should be addressed to the Audit and Assurance Faculty, ICAEW, PO Box 433, Chartered Accountants' Hall, Moorgate Place, London, EC2P 2BJ
Tel: 020 7920 8493; Fax: 020 7920 8754;
E-mail: Tracy.Gray@icaew.co.uk
Website: www.icaew.co.uk/aafac

Audit & Beyond is produced by Wolters Kluwer (UK) Limited on behalf of the Audit and Assurance Faculty
Tel: 0870 777 2906
E-mail: customerservices@cch.co.uk

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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