Audit&Beyond

THE NEWSLETTER OF THE ICAEW AUDIT AND ASSURANCE FACULTY JULY/AUGUST 2006 NO.111

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Audit and Assurance Faculty

New Institute Code of Ethics: Why is it important?

As members of one of the world's leading professional bodies, chartered accountants are expected to demonstrate the highest standards of professional conduct. The Institute's new Code of Ethics (the Code) helps our members meet these obligations by providing them with ethical guidance. The Code will be effective from 1 September 2006.

Having read so far, some of you may be thinking some, if not, all of the following:

- Why is the Institute doing this? What was wrong with the previous Guide to Professional Ethics?
- Are we changing the auditor independence guidance?
- What relevance is the Code to audit engagements?

Why are we doing this?

The International Federation of Accountants (IFAC) issued a revised Code of Ethics for Professional Accountants in June 2005. The Institute (and other main accountancy bodies throughout the world, including the Consultative Committee of Accountancy Bodies (CCAB)) is under an obligation, from its membership of IFAC, to adopt the IFAC Code of Ethics requirements in its own Code of Ethics (the successor to the Guide to Professional Ethics).

In addition to meeting the IFAC requirements, there was also a need to rewrite the existing Guide to Professional Ethics. Feedback from members indicated that the guidance was sometimes difficult to find due to the piecemeal approach that had been adopted. For example, guidance on referral fees was included in three separate statements. Based on consultation with members, the Institute believes that the new structure and layout in the Code is more user-friendly and makes relevant guidance easier to find.

From the perspective of the accountancy profession, the other CCAB bodies have or will be adopting the IFAC Code of Ethics in its entirety or with additional guidance. The closer the professional bodies are to having similar codes based on IFAC, the easier it is for members and member firms to operate internationally.

Are we changing the auditor independence guidance?

According to the Companies (AICE) Act 2004, the Institute is required to adopt the Ethical Standards set by the Auditing Practices Board (APB). Hence, for audits of periods commencing after 15 December 2005, members conducting audit engagements in the UK and the Republic of Ireland have been required to comply with the Auditing Practices Board's Ethical Requirements for Auditors (*www.frc.org.uk/publications*). If performing audit engagements elsewhere, our Code clarifies that members should comply with Section 290 of the IFAC Code of Ethics (*www.ifac.org/guidance*).

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APB guidance on the audit of occupational pension schemes in the United Kingdom

The Auditing Practices Board is to issue a consultation draft of Practice Note 15 (Revised), *The audit of occupational pension schemes in the United Kingdom*, later this month or in early August.

PN15 was last revised in 2004. Since then there have been a number of developments, including substantial changes to the regulatory environment and the replacement of SASs by ISAs (UK and Ireland).

A summary of the main changes will be contained in the September issue of *Audit & Beyond*. In the meantime, copies of the Consultation Draft may be downloaded when it is published from the APB's website at *www.frc.org.uk/apb*.

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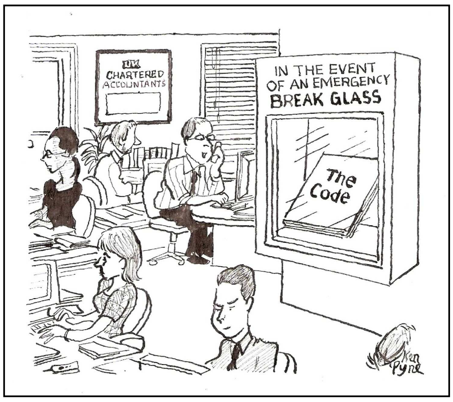
Whilst the Institute continues to provide feedback to the APB on aspects of concern in relation to their Ethical Standards (see *www.icaew.co.uk/ethics* for further information), authority to change the Ethical Standards rests only with the APB.



So, what relevance is the Code to audit engagements?

First, the generality of the Institute's Code applies to all activities, including audit. Audit engagements may involve ethical issues other than independence, for example conflicts.

Secondly, the scope of the APB's independence requirements is limited to audits. For other types of assurance engagements (e.g. grant claims), guidance is found in Section 290 of the Code.

Overview of Code

As mentioned previously, the Code is based on the IFAC Code of Ethics (issued in June 2005), which itself has adopted the principles-based approach pioneered by the Institute. Guidance additional to the IFAC wording has been included in the Code in italics. This is intended to be of assistance in respect of areas that have been found to be of particular relevance to our members or reflecting the particular environment in the UK.

The substance of the new Code is the same as in the existing Guide, but it has a new layout and structure. The Code includes a number of Sections covering situations that members might be likely to encounter and suggests, or in some cases requires, specific courses of action. For convenience, these Sections have been grouped into four parts, one covering general application to all members and the others dealing with situations most likely to be encountered by members:

- Part A: General application of the Code
- Part B: Professional Accountants in Public Practice
- Part C: Professional Accountants in Business
- Part D: Insolvency Practitioners

The new code can be downloaded from *www.icaew.co.uk/ethics*, as can an overview setting out the basic approach, ethical dilemma resolution framework, code contents and further sources of advice.

Part A of the Code establishes the conceptual framework and fundamental principles that all members must adhere to. The fundamental principles set out in the Code are:

Integrity

A professional accountant should be straightforward and honest in all professional and business relationships.

Objectivity

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

Professional Competence and Due Care

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

Confidentiality

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

Professional Behaviour

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Compliance with the fundamental principles may be threatened by a broad range of circumstances. Many threats fall into the following categories: self-interest threat, self-review threat, advocacy threat, familiarity threat and intimidation threat. Members are required to evaluate threats to the adherence to those principles and where these are significant, safeguards should be implemented. The Code discusses the types of safeguards which might be applied. Some of these safeguards are general, created by the profession, legislation or regulation. Others are created in the work environment, either by the organisation or the individual.

In evaluating compliance with the fundamental principles, a professional accountant may be required to resolve a conflict in the application of the fundamental principles. A professional accountant should consider the following as part of the resolution process.

a) Relevant facts
b) Relevant parties
c) Ethical issues involved
d) Fundamental principles related to the matter in question
e) Established internal procedures
f) Alternative courses of action

Having considered these issues, a professional accountant should determine the appropriate course of action that is consistent with the fundamental

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principles identified. The professional accountant should also weigh the consequences of each possible course of action. If the matter remains unresolved, the professional accountant should consult with other appropriate persons within the employing organisation for help in obtaining resolution.

It may be in the best interests of the professional accountant to document the substance of the issue and details of any discussions held or decisions taken, concerning that issue.

If a significant conflict cannot be resolved, a professional accountant may wish to obtain professional advice from the Institute or legal advisors, thereby obtaining guidance on ethical issues without breaching confidentiality.

If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant should, where possible, refuse to remain associated with the matter creating the conflict. The professional accountant may determine that, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organisation.

The sections in Part B of the Code are likely to be of most relevance to auditors. This Part applies the conceptual framework and fundamental principles to situations and circumstances that are likely to be encountered by members working in practice. The following guidance is included in Part B of the Code.

- Professional Appointment
- Conflicts of Interest
- Corporate Finance Advice
- Second Opinions
- Fees and Other Types of Remuneration
- Agencies and Referrals
- Marketing Professional Services
- Gifts and Hospitality
- Custody of Client Assets
- Objectivity – All Services
- Independence – Assurance Engagements

Existing guidance on corporate finance (Part B Section 221, formerly Statement 1.203) and insolvency (Part D Section 400, formerly Statement 1.202) has not been re-written but has been reformatted to align to the revised fundamental principles and changed numbering and references of the Code.

The Institute hopes that members will find this Code to be an improvement over the previous Guide. We welcome feedback on the new Code which can be sent to *tony.bromell@icaew.co.uk* or *anne.davis@icaew.co.uk*. For members with ethical queries, the Institute's Ethics Advisory Services is there to help. Ethics Advisory Services can be contacted by e-mail: *ethics@icaew.co.uk* or phone +44 (0) 1908 248258. Additional information on the Ethics Advisory Services can be found at *www.icaew.co.uk/ethicsadvice*.

Anne Davis, Manager, Accountancy Markets and Ethics – ICAEW

Faculty Roadshow – the essential audit and assurance services update

As previously mentioned in the June edition of *Audit & Beyond*, the Faculty's 2006 Roadshow will be visiting 15 locations across the country from September through to the beginning of December. The Faculty has already received many bookings for this event, and the 'early bird' scheme is again proving to be extremely popular.

The Roadshow will be focusing on the following subjects:

- Audit Quality and the practical implementation of ISQC (UK and Ireland) 1
- Accountants' services for the accounts of audit exempt companies
- Practical lessons from the first year of ISA (UK and Ireland) implementation – did we get it right?
- Update on ethical issues

More information is given in the enclosed flyer.

The Roadshow includes a Panel session and the Faculty is very pleased that a number of the key volunteers involved in the issues covered by the Roadshow have agreed to participate in this. They will be able to answer questions about quality control, accountants' services and ISA (UK and Ireland) implementation from their experiences, both from their perspective of being involved in the Faculty groups producing material for members and also from dealing with these issues within their firms. We expect that not only technical issues but also practical concerns, including those arising in smaller firms, will be picked up in these sessions.

The Faculty intends to ask attendees to provide some information regarding their experiences of the first year of ISA (UK and Ireland) implementation prior to the Roadshows. The information requested will include feedback on using the 'risk ISAs' and ISA (UK and Ireland) 240 on fraud. We would also like comments on the impact of the documentation and quality control requirements, and firms' experiences of determining the appropriate wording of audit reports. Finally, we are keen to obtain views on possible improvements to the ISAs (UK and Ireland) themselves and the material used by firms based on them.

In addition to the above, we expect the Institute's Quality Assurance Directorate (QAD) to provide feedback for participants, for example on ISA (UK and Ireland) compliance.

Clarity on group audits?

The International Auditing and Assurance Standards Board (IAASB) published its 'revised and redrafted' proposed ISA 600 *The Audit of Group Financial Statements* at the end of March, together with an Explanatory Memorandum. This new Exposure Draft has been drafted in the new style 'designed to enhance the clarity of IAASB pronouncements' and follows two previous consultations in December 2003 and March 2005. It reflects changes proposed in response to comments received on the last Exposure Draft.

The IAASB's Explanatory Memorandum includes a mapping document showing how the previous text has been reflected in the current Exposure Draft. The APB has produced a document (available in the 'IAASB Clarity Documents' section within 'Publications' on the APB website) which shows the source of the 'shall' requirements in the proposed ISA 600.

Text based on bold text requirements in the March 2005 Exposure Draft is shaded yellow and text elevated to a requirement from non bold guidance text is shaded green. Requirements introduced in response to comments received by the IAASB are also shaded green.

Best practice

The Institute supports a new ISA 600 on group audits and has been proactive in promoting improved quality of group audits through *Promoting best practice in group audits* which was issued last November. However, the Institute will emphasise the need for any likely increase in the costs of group audits to be proportionate to the intended increases in audit quality. It will be important for the IAASB to resolve the main issues (see below) in order to demonstrate this.

Related and unrelated auditors

The IAASB makes no distinction between related and unrelated auditors in the proposed ISA. What this means is that there would be no explicit difference in the procedures the group auditor performs in relation to the other auditor's work on the basis of whether or not the other auditor is 'related' to the group auditor (another auditor from the group auditor's firm or from a network firm complying with common quality control monitoring procedures) or is 'unrelated'. The IAASB considers that although it may be a relevant factor, the strength of the relationship varies and the distinction is not in itself a sufficient basis for determining the group auditor's work.

The application material in the proposed ISA does, however, outline the factors that may determine the nature, timing and extent of the group auditor's understanding of and involvement in the work performed by the other auditors. Networks might have common quality control, monitoring, methodology and organisational processes, and the Institute considers that due importance should be given to the range of relevant factors, for example where there are indeed effective common policies and procedures. There should be a greater degree of reliance on the other auditor in these situations.

There is also a concern that the lack of a distinction between related/unrelated could lead to a disproportionate increase in the work needed, especially for group audits carried out by the smaller networks. These networks might have common policies and procedures for audit work but these might not be formalised, therefore making it more burdensome to obtain an understanding of the other auditors and the work they have done in line with the proposed ISA.

Other auditor's memorandum

The proposed ISA has a number of fairly restrictive requirements related to the other auditor's memorandum or report of work performed. The Institute is concerned that there should be considerable flexibility regarding how the group auditor and other auditor should communicate.

Where there has been effective sharing of information during the planning and risk assessment stage, the emphasis should be on the other auditor providing information on the areas requiring the group auditor's attention. It should also be unnecessary for the other auditor to communicate matters that are only material to local reporting and not to the group.

Other auditor's responsibilities

The proposed ISA is written in terms of the requirements of the group auditor. The Institute would like the other auditors to have a professional obligation to co-operate with the group auditor, for example to provide appropriate access to information.

Single entity audit

The proposed ISA also applies where other auditors are involved in the audit of the financial statements of a single entity. The Institute hopes that the final ISA will be clearer in respect of this, for example by making a greater number of references to using the work of another auditor as well as to the audit of group financial statements.

The proposed ISA 600 is available from *www.ifac.org/EDs* and the APB document referred to above can be obtained from *www.frc.org.uk/apb/publications*.

The deadline for comments to the IAASB on the Exposure Draft is 31 July. Please send any comments to *chris.cantwell@icaew.co.uk*.

The Faculty's best practice publication on group audits is available from *www.icaew.co.uk/aaf*, and the final Institute response to the IAASB will also be available here once it is finalised.

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

New regulations affecting pension scheme audit appointments

1. Introduction

This article is to raise awareness of The Occupational Pension Schemes (Administration and Audited Accounts) (Amendment) Regulations 2005 which came into effect for pension scheme reporting periods commencing on or after 22 September 2005.

Although the amended regulations deal with various aspects of scheme administration, this article focuses on the changes to the requirements regarding the auditor's 'statement about contributions' and some changes to disclosure requirements for trustees of earmarked schemes.

2. Appointment of auditors

The basic mechanics of appointing an auditor to provide an audit opinion on the scheme accounts and/or to provide a statement about contributions paid to the scheme have not changed.

However, the exemption for the appointment of an auditor to certain earmarked schemes (previously known as relevant earmarked schemes) and certain Small Self Administered Schemes has been removed. Instead, the revised regulations allow exemptions for all schemes, both defined contribution and defined benefit, with less than 12 members where all members are trustees (or trustee directors). This is provided that they also meet the criterion of either (a) the provisions of the scheme provide that all decisions which fall to be made by the trustees are made by unanimous agreement by the trustees who are members of the scheme or (b) the scheme has an independent trustee who is on the approved list maintained by The Pensions Regulator.

3. The auditor's statement about contributions

The amended regulations deal with the frustration of auditors and their clients of having to qualify the auditor's statement about contributions for minor breaches of the schedule of contributions or payments schedule or where payments made are more than the amounts set out in the schedule.

The amended regulations now require the auditor's statement to provide an opinion as to whether contributions have '***in all material respects***' been paid '***at least***' in accordance with the schedule.

If there is no schedule in place then (as previously) the amended regulations require the auditor to provide an opinion with reference to the scheme rules and where applicable, the recommendations of the actuary.

4. Earmarked schemes

There is still a general requirement for trustees to appoint an auditor to an earmarked scheme to provide a statement about contributions for inclusion in the annual report of the scheme.

It should also be noted that because regulations exempt earmarked schemes from including audited accounts in their annual report, the amended regulations now place a requirement on trustees to provide on request a copy of the latest published accounts of the insurance company with which they hold the earmarked policies of insurance or annuity contracts.

Trustees are also required to provide each scheme member, within 12 months of the end of each scheme year, with a statement detailing the amount of contributions credited to the member during that scheme year.

5. Conclusion

Pension scheme trustees and their auditors should carefully review the amended regulations and the scheme rules to determine their respective responsibilities. In most cases it will be necessary to issue a new engagement letter.

Andrew Penketh, partner and member of the Pensions Group at Horwath Clark Whitehill LLP

Company Law Reform Bill

The Company Law Reform Bill was introduced in the House of Lords on 1 November, and a detailed report on the Bill was included in December/January's edition of *Audit & Beyond*.

By way of update, the Bill has now reached the House of Commons, having been debated in the House of Lords during 18 sessions, with over 1000 amendments tabled, nearly 500 of which were accepted. The Bill now contains more than 900 clauses and, as the Government has recently agreed to consolidate existing companies legislation into the Bill, is set to become much longer. The Bill will take several more months to pass through its remaining stages of Parliament, and is not expected to come into force before 2007.

In relation to the audit clauses, the Institute continues to call for greater clarity regarding the proposed criminal offence for auditors who 'knowingly or recklessly' provide an incorrect audit opinion. However, we welcome the Government's decision to change the accounting records part of the offence so that it relates to the auditor's statement that the accounts are in agreement with the records (rather than the accounting records being proper/adequate), which we feared would otherwise have been very onerous, especially for smaller practitioners.

A copy of the current version of the Bill is available on the UK Parliament website at *www.parliament.uk*.

Goodbye SASs

This article is an edited version of an article entitled *ISAs: The Great Leap Forward?*, which appeared in the May edition of *Accountancy*.

The vast majority of practitioners will by now have seen the changes in proprietary systems resulting from the introduction of ISAs (UK and Ireland) and most will have completed their first audits under the new standards. It is too early to make judgements about the overall impact of ISAs (UK and Ireland) because they will take time to bed in; we will be making further assessments in due course. However, the initial effects of implementation are beginning to show and the following issues have emerged from discussions between the Institute, practitioners, training providers and consortia and the producers of audit software.

Understanding and documenting controls for smaller audits

The impact of ISAs (UK and Ireland) on practitioners dealing with smaller and less complex audits has been mixed, and there are even quite significant variations from audit to audit within some firms. For some audits, it has proved necessary to make some significant adjustments to the way audits are performed in the company controls area. This often seems to be where audits were previously conducted on a largely substantive basis.

There are new requirements in the risk ISAs (ISAs (UK and Ireland) 315 and 330 in particular) for auditors to understand the design and implementation of controls. The old SAS 300 required auditors to obtain and document an understanding of the internal control system sufficient to determine the audit approach. The new ISAs require more. Among other things, they contain requirements to understand and document controls regardless of the intended audit approach. If work on systems in the past was very limited, the additional resources required to meet these new requirements may be needed.

For audits that did involve understanding and documenting systems in the past, the 'leap' required to fulfil the new requirements is not so great. Some firms are discovering that there have been more variations in the way audits were performed within the practice than they might have imagined.

Going forward, this issue may become even more important. Amendments to the Company Law Reform Bill may impact the 'proper accounting records' requirements. These may be accompanied by new 'offences' which could involve severe penalties for auditors who 'knowingly or recklessly' sign off audit reports disregarding accounting problems. The Institute is making representations on behalf of practitioners to ensure that any changes in the law are fully thought out and unintended consequences avoided. However, the likely effect of any change to the law on accounting records is that, in the future, some practitioners will need to look much more closely at records and the systems that produce them. ISAs (UK & Ireland) will help with this.

Dealing with the resource requirements

There have been a number of reports over the last two years on the additional audit resources that will be needed to implement ISAs (UK and Ireland). Reports to date have been estimates and it is always very difficult to predict the effect of the first year learning curve and teething troubles. There may be a tendency for practitioners feeling nervous to overestimate what might be involved.

What is important is that practitioners understand how they will deal with the new requirements and consider if additional resources will be required. Practitioners dealing with smaller and less complex audits may perceive that any additional costs will be difficult to pass on to clients. But the benefits of better audits are already coming to light. We have heard that some practitioners taking a positive attitude towards the changes have been able to justify fees increases for smaller and less complex audits on the basis of the enhanced value provided by the audit.

Some such practitioners have explained to clients that the new standards will require more effort, but have been delighted to discover that the additional probing and analysis required by the risk and fraud ISAs, for example, have, contrary to expectations, been appreciated by some clients. This seems to be partly because some clients welcome the opportunity to voice their fears about the vulnerability of their systems and because additional questioning and audit documentation help to identify how they can be made more secure, and partly because the changes have brought to light redundant audit procedures and documentation which can be replaced with more effective tests.

ISA CHANGES

- The greatest changes are likely to be needed for previously 'substantive only' audits
- Documentation of the understanding and evaluation of systems is now needed for all audits
- Do not assume that clients will react badly to the effects of the new requirements, some clients may welcome them
- Additional audit costs can be justified to clients who see the benefits of the new-style audit

Katharine Bagshaw is Secretary to the Institute's ISA Implementation Group.

Audit Quality Forum – update

We have provided a number of reports in *Audit & Beyond* on the recent work of the *Audit Quality Forum*.

The *Forum* is currently examining the relationships between shareholders, boards, auditors, regulators and other stakeholders in the audit. This resulted in the setting up of five working groups to consider:

- Audit purpose: what is the purpose of the audit?
- Principles-based auditing standards: What are principles-based (or objectives-orientated) standards?
- Making global auditing standards local: In practice how can auditing standards have global reach yet deal with local challenges?
- Auditor reporting: Is current auditor reporting, in particular the audit report, helpful to shareholders?
- Third parties: How does the extent of disclosure of third-party information and advice to the board impact on audit quality?

At its recent meeting in June, it tabled draft papers on Audit purpose and Principles-based auditing standards for fatal flaw comments. These papers will be finalised shortly and will be available from the website at *www.icaew.co.uk/auditquality*.

The *Forum* also received key issues papers on the Making global auditing standards local and Third parties projects.

The key objective of Making global auditing standards local is to identify the key criteria to drive the development of International Standards on Auditing so that those criteria can be promoted by the UK in the course of the standard-setting process. It has focused on four key issues.

- First year implementation and cost-benefit issues, such as the use of regulatory impact assessments to help audit quality
- APB, Europe and IAASB and communication with investors and corporate representatives
- The scope of standards to be adopted
- Greater consideration of smaller and less complex audits

Advice given to the boards and information held by third-party advisers is relevant to the content and reliability of financial statements. The Third parties working group is considering issues for directors, auditors and other advisors, such as lawyers and recommends that guidance be developed for directors regarding their responsibilities in preparing the financial statements.

Further information on the work of the *Audit Quality Forum*, downloadable copies of its key issues papers and reports and details of how to obtain hard copies are available at *www.icaew.co.uk/auditquality*.

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

Standardising sustainability reporting

A new discussion paper comparing existing European standards on sustainability assurance is published by the European Federation of Accountants (FEE).

Over the last few years, four countries in Europe: Sweden, France, the Netherlands and Germany, have published or are currently exposing sustainability assurance standards. There is, however, no equivalent standard in the UK. These standards and exposure drafts are all based on International Standard on Assurance Engagements (ISAE) 3000 *Assurance Engagements other than audits or reviews of historical financial information*. ISAE 3000 is the International Auditing and Assurance Standard Board's (IAASB's) current standard for assurance of non-financial information and became effective from 1 January 2005.

Through a detailed analysis of the standard and exposure drafts, FEE identified specific areas where different guidelines exist. These differences mainly arise from a lack of specific guidance in ISAE 3000 because it is written as an overarching high-level document.

In the discussion paper, FEE argues that ISAE 3000 is not sufficiently detailed for use in sustainability reporting, due to the complexity and specific nature of the subject being reported. Considering the wide range of readers of this type of report, any initiative from the IAASB to increase consistent practice is likely to be supported by the profession. The paper suggests to the national and international standard setters the areas where further guidance from them would be desirable. It will also support FEE's call for the IAASB to develop an international standard for sustainability assurance. The link to the FEE discussion paper is available from *www.fee.be*.

Response to GRI consultation

The March issue of *Audit & Beyond* provided a report on the consultation of the Global Reporting Initiative's (GRI's) reporting guidelines (G3 Guidelines). GRI is an independent organisation that promotes globally applicable reporting guidelines on economic, environmental and social matters and its reporting guidelines are used by many organisations as the basis for their reporting.

In response to this consultation, the ICAEW welcomed GRI's principle-based reporting framework which would help define the report content and quality. The ICAEW also agreed that there is a demand for improvements in the quality of sustainability reporting among the reporting community. However, the response also raised concerns about the extent of reporting and, in particular, the introduction of detailed lists of mandatory reporting items. The ICAEW's response is now publicly available on the website *www.icaew.co.uk/index.cfm?route=136281*.

Related parties

The audit of related parties is a thorny subject. The disclosure of the existence of related parties and transactions with them can be a sensitive area because of the possible implications of impropriety. The IAASB's press release accompanying the issue of its latest ED on the subject states that 'the involvement of related parties, such as directors, owners, and management, in major corporate scandals encouraged the IAASB to review its current auditing standard on the subject'.

The proposed standard is more risk-based than the existing standard and would require auditors to obtain an understanding of the nature and business rationale of related party relationships and transactions. It places greater emphasis on the difficult task of attempting to identify related party relationships and transactions not identified or disclosed by management.

Whilst the ICAEW is supportive of this more risk-based approach, we have concerns over a number of areas in the proposed standard.

- It should not raise expectations unduly about the ability of the auditor to detect undisclosed related party transactions, particularly where those transactions are intentionally hidden from the auditor. The standard should make it clear that the responsibility for the disclosure of such transactions rests with management, and not the auditor

- It should avoid giving the impression that the audit of related parties is a separate exercise to the audit of the financial statements

- It requires additional procedures where the risks relating to related party transactions are significant. It is therefore particularly important that the standards should not imply that all related party transactions represent a significant risk

- It requires auditors to identify the parties to which any identified dominant party is related and to understand the nature of business relationships between them. We believe that this exercise will be difficult at best, that the open-ended requirement may result in inconsistent application, and that the procedures, as drafted, are often unlikely to be effective

- It requires the evaluation of the effects of related party relationships and transactions on the financial statements, even in circumstances where the financial reporting framework does not establish related party accounting or disclosure requirements. This is not an issue in the UK. Nevertheless, whilst we believe that the intention of the proposed requirement is sound (the avoidance of misleading financial statements), the proposed means of achieving it appears to involve a de facto attempt to impose disclosure requirements regarding related parties in jurisdictions in which there are none. This is fraught with difficulty.

The comment period closed on 30 April.

Katharine Bagshaw, Manager, Auditing Standards (Policy and Practice), Audit and Assurance Faculty

Technical Releases and Help Sheets at a glance

Included with this issue is an update of the publication *Technical Releases and Help Sheets at a glance*.

The booklet was last updated in Spring 2005. The purpose of the publication is to provide Faculty members with an overview of the Audit and other Technical Releases and guidance that are available and relevant to their work. It is intended to serve as a 'signpost' to audit and assurance reference material published by the Institute, to enable members to find guidance quickly on specific topics. It covers the main Audit and Assurance Technical Releases, other Technical Releases and Members' Advisory Help Sheets that are available as at the beginning of June 2006.

The material is arranged into three main sections:

- Index of the Audit and Assurance Faculty publications (numbered from January 2006 onwards in a new 'AAF' sequence) and other Technical Releases relevant to audit
- Summary of the key features of the Audit and other Technical Releases
- List of Advisory Service and Ethical help sheets

The introduction to the booklet explains how the publications listed can be accessed on the Institute's website or, if they are not available on line, where they may be obtained. Members will normally have to log in to access the publications on line, although some of the Technical Releases are freely available to non-members.

As its title 'At a glance' suggests, the publication is intended as a quick reference summary, to save members time in finding guidance on specific subjects. It is not intended to be a substitute for reading the underlying publication. The printed booklet will not be updated very often, and as technical guidance is being formulated and updated all the time, members are strongly advised to check the Institute's website regularly for new guidance, and for updates to this summary.

Bank reports for audit purposes

In October 2005 the Auditing Practices Board published the Consultation Draft of Practice Note 16, *Bank reports for audit purposes (revised)*. The main changes proposed to the original Practice Note (PN16) were to:

- Recommend that auditors submit requests for information to banks earlier (one month, rather than two weeks) before the year end date
- Include the sort code and account number of the main account for the client named in the request for information
- Incorporate supplementary material from the Institute's Explanatory Note on bank reports for audit purposes, Audit 3/02

Respondents from the profession pointed out that, whilst auditors were expected to submit requests earlier, banks only undertook to 'endeavour' to reply on even standard information requests within a month of the confirmation date. They were also concerned that responses to requests for non-standard information could take up to two months. Many respondents considered that the quality of banks' responses was poor in terms of completeness, accuracy and timing. They argued that the proposed changes were unlikely to lead to significant improvements in the process.

On the other hand banking respondents considered that the current system was inefficient and did not recognise the changes to banking systems.

Representatives of the main clearing banks and of the CCAB bodies involved in audit have met to discuss a way forward. The meeting resulted in a good understanding of the issues, and agreement that a more fundamental review of the process set out in PN16 should be undertaken, subject to APB approval. Participants agreed to develop proposals for obtaining information from banks that would provide good, timely evidence for auditors whilst being efficient for banks to deliver, thus serving the best interests of their mutual clients. The CCAB bodies and banks will work on developing new procedures over the next two months.

In the meantime, to improve efficiency of the process, the Faculty encourages its members to:

- Provide the account number and sort code of the main account when they ask for bank reports for audit purposes
- Use the acknowledgement process set out in Audit 3/02
- Consider carefully if a client is likely to have any facilities other than those listed in the standard request. The banks find that the majority of requests for non-standard information result in a nil response. However, the search causes delay

The account information will enable better identification of related information by the banks, particularly across groups, which can have different names or names very similar to non-related clients of the banks. Since the auditor will take the account number and sort code from bank statements made available by the client, there should be no loss of audit value.

The assurance programme – update

We last informed you about the Faculty's Assurance Programme in the September 2005 issue of *Audit & Beyond*. This article provides an update on the latest developments.

The Faculty aims to establish a constructive dialogue on the role that assurance services can play in promoting credible information flows and supporting markets and the economy. It also seeks to explore the practical application of the International Auditing and Assurance Standards Board's (the IAASB's) Framework for Assurance Engagements and develop guidance on assurance services that practitioners may provide.

The Faculty intends to develop practical proposals and guidance on assurance services through stakeholder engagement and feedback, the sharing of experience and the discussion of expectations and practical problems. The Faculty regularly reviews its assurance programme to align it with market demand. As part of this programme, the Faculty recently issued AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties*. The guidance incorporates comments received from users, preparers of the report, and practitioners from the summer 2005 consultation. The guidance applies International Standard on Assurance Engagements (ISAE) 3000, issued by the IAASB. It is hoped that the new guidance may also provide a framework for the revision of FIT 1/94 *Reports on the Processing of Transactions by Service Organisations*. FIT 1/94 is currently based on agreed-upon procedures as was FRAG 21/94 (which was replaced by AAF 01/06).

As reported in previous issues of *Audit & Beyond*, we are also finalising guidance on an assurance service on audit exempt companies' annual accounts (SEAS guidance). Market research carried out by the Faculty indicated that there are companies that are interested in this type of service. The SEAS guidance will also form one of the topics at the Faculty's Roadshow.

Other areas that the Faculty intends to focus on include reporting on narrative information i.e. management commentary and third party assurance focusing on relationships where services are outsourced. We will update you as these projects progress further.

Evaluating internal audit effectiveness

The renewed scrutiny of the role of internal audit and its performance means it is increasingly important for the function to evaluate its effectiveness – after all, audit committees and organisations are already doing so. Forthcoming guidance from the Institute of Internal Auditors (IIA) is set to emphasise that self-assessment must consider the stakeholders and their needs.

Eileen Clarke, chair of the IIA's Technical Development Committee, gave a preview of the forthcoming IIA guidance on evaluating the effectiveness of internal audit during June's internal audit lecture.

The guidance, which is aimed at heads of internal audit and senior auditors, will have generic application and will help auditors:

- Decide what 'effective' means for them
- Keep professional standards in sight
- Determine good measures to use
- Use the measures for continuous improvement and to satisfy stakeholder requirements

The key message to internal auditors will be to **resist racing to identify and set measures**. Instead they should think about the key stakeholders and their requirements and integrate those needs in internal audit's performance management framework.

What is effective internal audit?

Effective internal audit is audit work for a reason, which delivers value in the eyes of the customer (stakeholder). It also:

- Meets the definition of internal auditing in relation to the audit work performed
- Addresses key stakeholder aims
- Complies with internationally recognised professional internal auditing standards

Why evaluate effectiveness?

Recent corporate scandals have resulted in internal audit being held to account and its performance scrutinised. Internal audit has a responsibility to manage its performance and to continuously improve it. Evaluating effectiveness is not a goal in itself, although it is a requirement of professional standards. Evaluation gives focus for performance and can satisfy stakeholders that the function is doing what it is supposed to. Evaluation is a way for internal audit to market itself, to raise its profile and to promote its work.

A practical approach to evaluating effectiveness

For whom?

Internal audit's role in governance means that a variety of stakeholders can hold the function to account.

Examples of stakeholders in internal audit include:

- Regulators
- Partners, who help provide the service
- Influencers, who can affect or have a say in how work is performed
- Customers, those to whom service is provided

Such a broad range of stakeholders invariably means that not all can be satisfied all of the time. Not all stakeholders are equal. The key ones should be identified and their requirements prioritised. Recognising a predominant stakeholder group will make it easier to manage conflicts of interest. It will also underpin plans for coverage, scope and quality of people needed to meet the predominant requirements.

What is evaluated?

One view is to evaluate the dimensions of internal audit's performance that are critical to effectiveness:

- Regarding **assurance**, is it provided to the right people in the right way? Does it generate the right actions?
- Regarding **other stakeholder needs** (consultancy, risk and control advice), it is important to assess specific training needs and to ensure quality.
- Concerning **current capabilities**, are the function's people and their expertise, resources and systems, partner arrangements and time and money constraints capable of meeting the organisation's requirements?
- To ensure **future capabilities**, can the function deal with new risks? What key skills will be needed?

Another evaluation method assesses:

- Outcomes (evidence of influencing the organisation)
- Delivery (reports, terms of reference, customer-focused)
- Foundation (audit remit, IIA standards)
- Coverage (resources, targeted, understood)

How to evaluate?

Evaluation is a continuous process. It begins with identifying the stakeholders, ensuring agreement with their needs and targeting service delivery.

Internal audit must think about which elements of its performance will be important in delivering that targeted service and identify and assess appropriate measures.

Deciding the baseline of performance and setting targets or standards may be made easier by comparing aspects of internal audit's performance with that of similar functions.

Measuring and evaluating are most meaningful when there are the means for reporting results to the right audience. This will also prompt improvements to the evaluation process, to targets, measures etc.

What measures?

It can be tempting to adopt measures just because they are widely used. If measures are to meet stakeholder needs it is important to ensure they meet tests of relevance, significance, stakeholder fit, measurability, costs effectiveness, driving behaviour, interpretation and driving improvement.

The effectiveness of internal audit will continue to be topical among its key stakeholders. A thoughtful approach to evaluating effectiveness will help internal audit face that scrutiny.

Acting as a trustee to a trust holding shares in an assurance client

It is not unusual for a principal or member of staff in a firm to act as trustee for a trust holding shares in an audit and non-audit assurance (hereafter 'assurance') client. Typically the trust's sole or principle asset will be the shares. So when can such positions be held and by whom? The principles are:[1]

- The trustee cannot be a beneficiary of the trust
- The interest in the assurance client cannot be material to the trust
- The trustee cannot have significant influence over the investment decisions involving the interest in the assurance client
- The trust cannot exercise significant influence over the assurance client

It is the last point which is sometimes overlooked. Does that mean that for these trusts the firm's staff cannot hold the position of trustee under any circumstances? No. However, the trustee cannot be in a position to influence the assurance engagement or team. So the trustee cannot be a member of the assurance team, in its chain of command or otherwise in a position of influence. A partner will rarely be able to be a trustee for such a trust. For non principles holding such positions safeguards may include use of different teams, hot or cold file reviews (as appropriate to the threat) of the assurance engagement, consultation with the ethics partner or equivalent or audit committee or equivalent governance vehicle within the client.

For more information regarding independence generally or trusteeships specifically please refer to *www.icaew.co.uk/ethicsadvice* or the ethics advisory services on 01908 248258 (or *ethics@icaew.co.uk*).

[1] For audit engagements – APB Ethical Standard 2 (Para 17), for other assurance engagements – Statement 1.201 Para 4.9.

Professional Oversight Board consults on public reporting of the results of the monitoring of audit quality

The Professional Oversight Board, a part of the Financial Reporting Council, has issued a consultation document on the form and content of public reporting on the work of its Audit Inspection Unit (AIU). The AIU is responsible for the direct monitoring of the quality of the auditing of listed and other major public interest entities.

The existing approach (that the AIU does not publish inspection reports on individual audit firms, or identify audit firms by name in its Annual Report) was laid down in 2003 by the Group under the auspices of the Government which oversaw the implementation of the Government's 'post-Enron' reforms to the UK audit regulatory regime. The Oversight Board has had it in mind to look again at this issue once the new inspection arrangements had been in operation for a reasonable time and decided in May to consult publicly.

This issue was raised in the House of Lords during the debate on the Company Law Reform Bill. Several peers argued that the publication of reports on individual audit firms would provide valuable information in particular to audit committees. Lord Mackenzie of Luton, who spoke for the Government, noted that the Oversight Board would be consulting on this issue.

The Oversight Board took the view that it would be helpful to consult whilst the Company Law Reform Bill was still before Parliament, thus helping to ensure that Parliamentarians considering this or related issues have all the relevant information and considerations in mind.

The consultation document sets out the advantages and disadvantages of extended public reporting of the results of AIU inspections. It also identifies a series of possible options.

The consultation document is available at *www.frc.org.uk/pob*. The deadline for comments is 22 September 2006. If you have any comments on the document, please send them to *chris.cantwell@icaew.co.uk*.

bulletinboard

Faculty update

Revised 8th Directive

The final version of the statutory audit (revised 8th) Directive was published in the Official Journal of the European Union on 9 June. The effective date is 29 June 2006 which means that Member States have until 29 June 2008 to adopt and publish the provisions necessary to comply with the Directive.

An update on the Directive is available at *www.icaew.co.uk*, under 'Technical & Business Topics', 'Audit and assurance'.

Internal audit lecture series

A Chief Executive's view on internal audit – past, present and future

Monday 11 September 2006, Richard Bowker, Chief Executive, Partnerships for Schools

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 contact Louise Thornton on 020 7920 8493.

APB work programme

The APB has published the final version of its work programme for 2006/07. In 2006/07, the APB will focus on:

- Remaining influential internationally, in particular contributing proactively to the work of the IAASB
- Responding to IAASB exposure drafts arising from its Clarity Project
- Active involvement in the process for the adoption of auditing standards within the European Union
- Participating in the FRC project to develop a common view of audit quality, focusing in particular on the audit of listed companies
- Updating the industry specific Practice Notes

The work programme and a feedback statement on the APB's consultation on the draft work programme are available from *www.frc.org.uk/apb*.

FRC Annual Report

The FRC has published its Annual Report for 2005/06. The Annual Report describes the way in which the FRC has contributed to high quality corporate reporting, auditing and governance and the integrity, competence and transparency of the accountancy profession during 2005/06. The Annual Report also explains how it has incorporated the Better Regulation Executive principles of good regulation in the way it works.

The Annual Report is available from *www.frc.org.uk*.

IFAC news: support for SMPs and SMEs

IFAC has provided details of what it is doing to support SMEs, in particular a project to develop guidance materials on ISAs for use in SME audit engagements. IFAC has also issued its Annual Report for 2005. More information is available at *www.ifac.org*.

CCH professional development events

Audit and Assurance – emerging issues

Delegates will be given clear, practical and authoritative guidance on dealing with current audit problems. In particular, delegates will have the opportunity of asking questions of experts and well informed speakers.

Various locations between September and December – £125. For more details go to *www.cchseminars.co.uk* or call 01635 588898.

Audit & Beyond editorial information

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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*
ISSN 1748-5789

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