

The audit of related parties – draft guidance

The faculty has recently issued for comment a draft paper which seeks to provide some practical guidance on the audit of related parties and related party transactions.

Background

The faculty has, over recent years, produced a number of publications offering practical guidance to members in several areas to help auditors to deliver continuous improvements in audit quality. This draft paper is the latest step in the faculty's programme of work aimed at promoting audit quality.

There is little existing guidance in the area of auditing related parties and related party transactions. Given the introduction in the UK at a future date of the International Standard on Auditing 550 (Revised and Redrafted), *Related Parties* (ISA 550 (Revised and Redrafted)) which has just been issued by the International Auditing and Assurance Standards Board (IAASB), the faculty considers that the audit of related parties is an area where further improvements in audit effectiveness can be delivered. ISA 550 (Revised and Redrafted) will require a significant shift in focus of work carried out by auditors in this area.

The draft guidance provides a summary of the ISA requirements that will come into effect and incorporates these in its suggested five-point action plan. In particular, it seeks to provide guidance to members on planning and consideration of risk, understanding the company's internal controls, designing procedures to respond to risks and documentation of work in this area. It highlights common pitfalls and issues and provides suggestions to strengthen audit quality in this area.

The paper has been issued as draft on the basis that it is, as yet, unclear when revised ISAs, including ISA 550 (Revised and Redrafted), will be implemented in the UK. The faculty felt, however, that it might be helpful for those members and training organisations who may wish to start to plan for implementation of the ISA now. It also provides members with an opportunity to comment on the draft guidance before it is finalised.

The audit of related parties


The audit of related parties and related party transactions is an important part of the overall audit of the financial statements but it poses particular challenges for auditors.

Auditors often see related parties and related party transactions primarily as financial reporting issues requiring disclosure under IAS 24 or FRS 8 and they may therefore focus on confirming that the disclosure requirements have been met rather than responding to the risk of material misstatement as a result of fraud and error.

Related parties and related party transactions are not easy to identify and auditors normally place significant reliance on management to identify all related parties and to have effective internal controls in place for authorising, recording and tracking of related party transactions. Auditors of smaller companies face particular issues because management may not fully understand the disclosure requirements required for

cont'd on page 2

In this issue...

02. **Is your practice assured?**
Sandra Higgins comments on her recent Quality Assurance Directorate (QAD) Practice Assurance visit
03. **Leading the trend – Audit and Assurance Faculty's projects in external assurance**
04. **European auditing developments**
Chris Cantwell summarises recent European developments including an update on the implementation of the Statutory Audit Directive
05. **The audit of charities in the United Kingdom**
A summary of the Institute's response to the Auditing Practices Board (APB) on Practice Note 11, *The audit of charities in the United Kingdom (Revised)*
06. **Achieving business excellence through the audit function**
Lorna Webley reports from the June Moorgate Internal Audit Lecture
07. **IFRS implementation**
07. **Bulletin Board**
08. ** Related**
Links to briefings and guides mentioned in this issue

Is your practice assured?

Life can get a bit blurred in January. It might be the recovery process after the previous month's festive celebrations for Christmas and New Year, but I think it has more to do with the mass influx of apologies from clients saying how sorry they are that they didn't get their records in sooner, like they promised last year, but they'd be really grateful if we could please do their tax return by the end of the month.

Despite the hectic January rush, I do recall receiving a letter from the QAD saying how much they would like to come and see me in the third week in January. I think the mere fact I remember it so clearly reflects the panic I felt at the QAD wanting to come and see me...let alone in January. I quickly telephoned the contact and explained that January was particularly busy, and that while they were welcome any time, deferring their arrival would mean that we could give them more attention while they were here. The lady was very nice, and said that this was the response she had received quite a lot, and would a visit in April suit me?

As the date for the visit drew near, I wondered why I had felt that momentary panic. I have been in practice long enough to have had two Joint Monitoring Unit (JMU) visits, and by all accounts the QAD are there to help. From my work with the Audit and Assurance Faculty roadshows I have also had the opportunity to meet and talk to a few QAD Inspectors. But this was Practice Assurance. What did that really mean? I know I am not alone in this because I decided to Google 'ICAEW QAD' and there are others out there asking the same question.

The letter informing us of the visit arrived with a questionnaire and document lists, along with a rather helpful ICAEW publication *Your Practice Assurance Visit* **R**. This publication was found to

be a very useful helpsheet and quickly dispelled any panic arising from the unknown.

The Inspector called, as indicated, a couple of weeks prior to the visit to see if we had any queries, and on the day we had a good opening meeting where we all felt relaxed and able to discuss the important, and sometimes difficult, issues of running a commercial practice under increasing regulation. As expected, the Inspector reviewed a sample of files covering a variety of types of client and services, and he also looked at our office records and procedures. At the end of the second day we had the closing meeting, and it was interesting to hear what he had to say. Communication by email followed and we were given plenty of time to respond to the findings. Overall, not an unpleasant experience, and we have made a few positive changes as a result of the visit.

Looking back now, I see that compared to the JMU, the QAD is a whole firm visit. This was reflected in the involvement of a wider range of staff having a greater appreciation of what it means to work in a regulated industry. All of our staff wanted to be involved in making sure that

we complied with the regulations, and wanted to hear about the feedback from the visit and how we had got on as a practice. With staff who understand their responsibility for the quality of their work, both in technical and administration departments, there is no need to fear a visit from the QAD – indeed it should be welcomed as helpful for the practice.

Having just had my QAD visit, I was interested to hear that the quality of audit files was to be the topic of the next faculty roadshow. I am also pleased that this event will include direct feedback from the QAD about their visits, including practice assurance matters, about which I believe many practitioners are still a little vague in their understanding. With the wider remit of the QAD, this roadshow is not just for principals, but also useful for staff to get an appreciation of how their work is regulated and what issues the QAD are currently focusing on. It doesn't matter if your next visit is next week, next year, or in five years' time; to get a better understanding of what is expected now, book your place. Visit the faculty's website for further details **R**.

Sandra Higgins | Chairperson, Audit and Assurance Faculty Practitioner Services Committee

The audit of related parties – draft guidance *cont'd from page 1*

related parties and related party transactions and their importance. Whilst larger companies might have a better understanding of the importance of disclosure and some controls in place in this area they may be dealing with more complex transactions that might be more difficult for auditors to understand.

Practical guidance

The draft paper highlights the critical importance of planning the audit of related parties and related party transactions. It is important to involve the entire audit team in this and to ensure that related party issues are considered or reviewed by suitably experienced staff. Discussions at an early stage with the client to identify related parties are highly recommended.

A key part of the planning process is assessing the risk

that there might be material misstatements associated with related parties and related party transactions. This draft paper provides some indicators of related parties and related party transactions and highlights some of the problem areas.

The draft guidance also looks at understanding the procedures in the company to identify related parties and record related party transactions, the design of audit procedures to respond to risks identified and the associated documentation requirements.

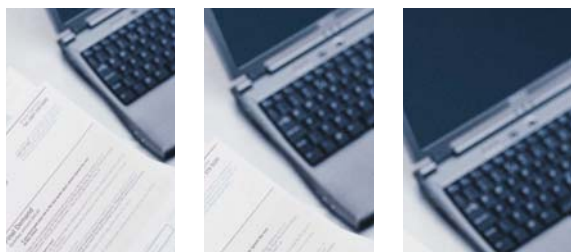
How to access the draft guidance

Members who are interested in reading the draft guidance and starting to plan for the introduction of ISA 550 (Revised and Redrafted) may download a copy from the faculty's website at www.icaew.com/aaf.

Louise Sharp | Manager, Audit and Assurance Faculty

If members have any comments on the draft guidance please send them through to tdaf@icaew.com by 19 December 2008.

Leading the trend – Audit and Assurance Faculty's projects in external assurance



The *Re:Assurance* initiative is the overarching project title the faculty gave to summarise its various projects in the area of external assurance. The initiative, first introduced in 2006 along with the launch of the ICAEW consultation on the needs of audit-exempt companies, has grown in its scope over the past two years. Various projects grew out of the initiative and many of them lead the way in their respective fields.

In this article we set out what we have achieved and how we intend to continue with our lead in this field as we review various projects that have been launched over the past two years.

Market-driven approach

All the projects relating to the external assurance services are fundamentally market-driven. Where there is demand, the faculty will take an action. This does not mean that the faculty will wait until government and regulators issue legislation and requirements. The faculty believes that looking at public debates, statistical trends and having direct discussion with its members and other practitioners provides valuable foresights into what is likely to become the future agenda.

This is not always easy as what can appear as a remote issue becomes a crucial topic in a very short time. Debate over the potential need to consider a non-audit assurance service for SMEs was hardly heard of when the faculty first looked into the issue. The faculty issued AAF 03/06 *The ICAEW Assurance Service on Unaudited Financial Statements* in August 2006 along with the issues paper *Beyond the Threshold* which set out the context and issues arising as part of the ICAEW consultation on the needs of audit-exempt companies.

Now the subject is being discussed by the International Audit and Assurance Standards Board within its Strategy and Work Program 2009–11, along with the revision of International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Financial Statements*.

The ICAEW consultation on the needs of audit-exempt companies came to an end in August. The faculty is working on summarising a number of discussions we have had with various stakeholders which include banks, credit reference agencies and practitioners during this period. The final report, due to be launched towards the end of this year, is receiving interest from a wide range of audiences including the profession and other stakeholders within the UK and overseas.

Working together

We are working with stakeholders who are directly affected by the work of practitioners. In 2006, for example we issued AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties*, initially to revise FRAG 21/94 which had a limited scope and did not reflect the increasing interest in the corporate governance environment. The three parties that were directly affected by the provision of assurance reports on internal controls were involved: practitioners, service organisations, and the user organisations including pension trustees. The resulting guidance AAF 01/06 has a far-wider scope than FRAG 21/94, and is relevant to a wide range of financial service organisations. Furthermore, those involved in the development of AAF 01/06 will continue to monitor the industry trends and intend to address any further emerging needs.

The faculty also maintains regular contact with international standard setters and professional bodies in other countries to exchange ideas and share

experiences. These activities help the faculty to develop practical guidance, sometimes based on learning already tested elsewhere, in a manner that is consistent with international standards. AAF 01/06, for example, reflects practical learning from existing standards and, in turn, has influenced the development of the recently exposed International Standard on Assurance Engagement 3402 *Assurance reports on controls at a third party service organization*. This way, we intend to provide our members with practical guidance on a timely basis and achieve as much consistency as possible with forthcoming international standards.

Staying ahead of the game

In December 2007 the faculty published three papers called *Perspectives on Assurance* to stimulate debate on the market need for assurance and with the July/August issue of *Audit & Beyond* we delivered *Assurance on non-financial information: Existing practices and issues*. These are high-level papers which seek to explore existing practices and consider what we need to do to enhance the quality and consistency of the work of our members. We are actively seeking feedback from key stakeholders of practitioners' services to identify further opportunities. It may be that your experiences would guide us in deciding what the next actions should be.

Jo Iwasaki | *Manager, Audit and Assurance Faculty*

European auditing developments

Statutory Audit Directive implementation

The European Union (EU) Statutory Audit Directive was due to be implemented by Member States by 29 June 2008. The European Commission has issued a scoreboard which outlines the state of implementation in Member States based on information provided by the Member States. The scoreboard highlights that the UK is one of only 12 countries (out of 27) that believe they have completed the implementation process [R](#).

The position regarding UK implementation of the Directive was summarised in the March issue of *Audit & Beyond* and more information on certain issues is provided below. The Institute has provided a more detailed update on the Directive on the website which includes related links [R](#).

Regulation of non-EU auditors

The Professional Oversight Board (POB) has consulted on proposals for reducing the burdens for the regulation of third country auditors, i.e. audit firms from outside the EU [R](#). Those third country firms with audits of companies listed in the EU are subject to the regulation of EU authorities in accordance with Articles 45 and 46 of the Directive. The POB document anticipated a Decision from the European Commission on transitional arrangements that should reduce the regulatory burden on firms from a number of countries until 1 July 2010. This Decision has now been issued by the Commission [R](#).

The Institute has responded to the POB on these proposals [R](#). We are in broad agreement with the actions proposed by the POB and in particular support the use of common format application forms with other Member States as this would avoid undue burdens being placed on firms. The European Commission has now published common application forms along with the Decision and the target is for the system to be up and running for third country firms to register with the POB from 1 October. The third country auditor register (maintained by the POB) needs to be operational well in advance of the earliest accounts subject to these provisions (financial periods starting on or after 29 June 2008).

Auditor liability

The European Commission issued a Recommendation on Auditor Liability on 6 June

2008 [R](#). This calls for Member States to limit liability in their jurisdiction but leaves them free to determine the most appropriate way of doing this. As far as the UK is concerned, the FRC recently issued guidance on Auditor Liability Limitation Agreements as provided for under the Companies Act 2006 [R](#).

Clarity ISAs

The European Commission has commissioned two studies to analyse the impact of a possible adoption of International Standards on Auditing (ISAs) in the EU. The completion of these studies is not expected until early 2009 and the forthcoming APB consultation on possible adoption of clarity ISAs in the UK will cover the possible impact of European developments on what might be proposed for the UK on adoption of these standards.

Auditor independence

The European Commission has referred France to the European Court of Justice over its national independence rules relating to international networks of audit firms. The Commission considers that the French rules to restrict the provision of services by the networks unduly restrict the freedom of firms to provide services and go far beyond the requirements of the Directive.

Auditor oversight and external quality assurance

Audit firms in all Member States should be subject to a system of external quality assurance and public auditor oversight which is independent from the auditing profession. The European Commission issued a

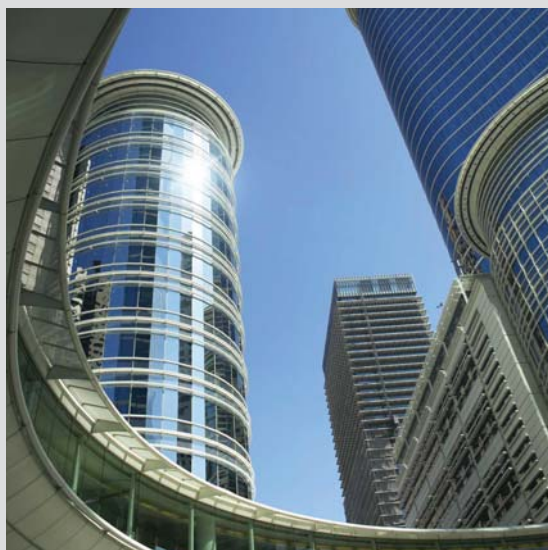
Recommendation in May seeking to strengthen the position regarding those audit firms that audit public interest entities (PIEs) [R](#). In the UK the Audit Inspection Unit has responsibility for the monitoring of the audits of PIEs and the Recommendation is likely to have a greater impact in countries where this type of independent arrangement has not yet been established.

Ownership and control of firms

The Directive has raised the possibility of firms moving away from a jurisdiction-specific nature towards a more European approach. An example of developments in this area is the recent formation of KPMG Europe LLP, a UK limited liability partnership, which is a holding company of a number of KPMG firms in the EU. Ernst & Young has also recently announced the establishment of a similar arrangement. The issue of ownership and control of firms is part of a broader debate on concentration and choice in the audit market and a public consultation by the European Commission is expected shortly. In the UK the FRC has its Choice in the UK Audit Market project and this is being monitored in Europe [R](#).

Chris Cantwell | *Manager, Audit and Assurance Faculty*

The audit of charities in the United Kingdom



The Auditing Practices Board (APB) published the consultation draft of Practice Note 11, *The audit of charities in the United Kingdom (Revised)* **R** on 10 April, with a deadline for responses of 10 July. This article summarises the key points made by the Institute in its submission to the APB.

The Institute considers that the proposed revised Practice Note will be very useful. It brings into a single document essential guidance that is currently contained in three separate publications: the special considerations relating to the application of general auditing standards in the context of charities ('old' PN11); guidance on the application of the 'risk based ISAs' to charity audits (Bulletin 2005/01); and charity audit report examples (published for members by the Institute in November 2006).

The Institute is very concerned, however, that the changes introduced by the Companies Act and Charities Act of 2006 are far from straightforward and that the transfer of audit provisions for small charitable companies to charities legislation has not been as clean cut or final as paragraphs 20 and 21 in Appendix 1, of PN11 (*Revised*), suggests. There are different regulations concerning accounting and audit provisions for charities in England and Wales, and in Scotland, which add to the complexities for cross border charities in general, and small charitable companies operating in both jurisdictions in particular.

We believe that the example audit reports relating to small charitable companies (2, 4 and 6 in Appendix 4) are wrong as to content and legislative references. There are also some errors in relation to changes effective for accounting periods beginning

on or after 6 April 2008. The term 'Registered Auditor(s)' will be replaced by the term 'Statutory Auditor(s)' in all audit reports. Whilst the Companies Act 2006 reports should be signed by the Senior Statutory Auditor, reports on (charity) audits not carried out under the Companies Act should continue to be signed by the Firm, so the 'sign-off' in examples 3 and 5 is wrong.

It is very important to note that the report examples in the draft Practice Note will not apply until accounting periods starting on or after 1 April 2008. In the meantime, auditors should continue to use the examples on the ICAEW website, (and it is hoped to update these shortly) or refer to Technical Enquiry Service if they have queries on the wording of reports for periods commencing between 27 February 2007 and 31 March 2008 inclusive.

Apart from expressing serious concern about the proposed revised Practice Note's treatment of the legislative changes and transitional period, the Institute has recommended a number of practical changes to make the document more user-friendly.

In the first place, at 150 pages the document is hardly an easy read. Given that it is most likely to be used for reference on particular points, and is not intended as a comprehensive guide to doing a charity audit, the Institute recommended that there be a subject index at the end of the Practice Note, as well as the list of contents at the beginning.

The Institute also commented on the inconsistent level and treatment of detail in the proposed revised Practice Note.

For example, there are some references to accounting principles which are not sufficiently detailed to be complete, but which go well beyond a simple cross reference to other data. Some paragraphs on the application of individual ISAs contain material that is neither comprehensive, for the non-specialist auditor, nor selective, for reference on a particular question. There is also a lot of general material that could apply to the audit of an entity operating in any sector. We recommended that the draft Practice Note should focus on high level, charity-specific points, and avoid referring to issues that would apply to the audit of any entity.

So far as the practical points for auditors are concerned, an important point to note concerns whistle-blowing. Auditors of charity companies in England and Wales now have a duty to report to the Regulator under the Charities Act 1993, s. 68A as amended. Previously there was only a right to report to the Charity Commission.

While the Institute response to the APB expressed serious concern about the treatment of legislative changes in the proposed revised Practice Note. We consider that the proposed revised guidance is generally helpful and practical, and we encourage its implementation by members.

Mary-Lou Wedderburn |
Consultant, Audit and Assurance Faculty

Achieving business excellence through the audit function

In today's economic climate, the internal audit function is required to play a greater role than ever before. By carrying out the right audits at the right time, and making the most of other intelligence and insights, internal audit can deliver important improvements to organisations.

During the June Internal Audit Lecture, James Paterson, Vice President of Group Internal Audit at AstraZeneca PLC, shared his views on how to optimise internal audit efficiency and business impact. James highlighted best practice in several areas including audit planning, assignment management, having the right key performance indicators and the importance of clear and timely communication with senior management and the audit committee.

James stressed that it's vital from the outset to engage with senior management and the audit committee to consider the optimal role of the internal audit function, taking into account an 'assurance map' for the organisation. Having created an optimal role for the internal audit function to work on areas in addition to financial controls and compliance, an 'acid test' of internal audit's effectiveness is to demonstrate clear evidence of real organisational impact, including improvements to the management of more business critical risks, including delivery of change, or work to improve the mitigation of potential reputational risks.

Levels of assurance

Optimising the role of internal audit could be assisted by using the 'three lines of defence' model when thinking about effective risk and control. The three lines are: the effectiveness of line management to manage key risks and controls on a day-to-day basis; performance management measures and reviews, and specialist functions, to oversee and monitor the activities of the first line (and re-enforce the need for good control as part of business as usual); and then finally internal audit, which could act as an independent assurance and advisory function in relation to the effectiveness of the first two lines of defence.

These three lines of defence provide a helpful perspective to allow organisations to see more clearly where risk and control improvement

opportunities might lie. They help to focus attention at the right level in the organisation to ensure effective embedding of control, since invariably improvements are not solved by carrying out an internal audit, but by embedding the right risk, control and management disciplines in the business itself.

Quality control

By signing up to effective quality management systems and standards, the internal audit function will ensure it is dealing with issues consistently, and that add value to the business. However, for internal audit to add the most value, James explained that measures and standards should move beyond conventional measures, such as the speed of issuing audit reports, to questions such as: 'What is the percentage of key risks addressed by internal audits annual plan?'

In addition, reporting on the mix of skills and capabilities of the function is helpful since this is needed to look at more challenging, business critical, risks. James told delegates that one of the achievements he was most proud of with regard to the AstraZeneca internal audit function was the fact that a substantial proportion of staff were from a non audit/non-financial background.

James shared some of the most recent insights he and his team had gained after six years of driving and building the AstraZeneca internal function. He focused on the different ways to drive efficiencies in audit assignments without sacrificing

quality. For example, effective intelligence gathering in advance, a degree of remote auditing and the use of 'working hypotheses' with regard to key risks in processes in which likely 'failure points' and high risk areas, identified through pre-work and intelligence gathering, are reviewed early on.

He concluded by stating that in several instances audits conducted in this way have delivered the impact of findings in only half the time originally planned. This required more experienced auditors, who could exercise greater judgement during audits, optimising the depth of audits, rather than gathering more and more facts on the same issue.

The discussion concluded by obtaining a range of inputs from delegates on other best practice ways of optimising the impact of internal audits, particularly the need for regular independent effectiveness reviews of the internal function.

Lorna Webley | Independent Consultant

IFRS implementation

In October last year the new Financial Reporting Faculty published a major study prepared for the European Commission on EU implementation of IFRS by listed companies [R](#). That study provided the basis for the Commission's formal report on IFRS implementation, submitted to the EU Council and Parliament in April 2008.

The faculty's study concluded that IFRS implementation had been challenging but successful; there was an absence of any general loss of confidence in financial reporting and IFRS implementation was generally seen as a positive development for EU financial reporting. It also reported that at roundtables held to test the draft conclusions, participants – who included auditors, preparers and regulators – expressed concern about the complexity of the standards and over the likely increase in the pace and direction of change in IFRS, referring in particular to the greater use of fair values. These concerns were reflected in a general lack of appetite at the time for any wider application of full IFRS.

For financial periods commencing on or after 1 January 2007, companies listed on AIM, comprising over 1,600 UK and overseas companies, were also required to comply with IFRS. So how did things go?

It is still too early to assess the outcome with any certainty, but it would appear that, like many companies listed on the Main Market, a significant number of AIM companies started their preparations for switching to IFRS at a late stage, but that, even so, the process ran remarkably smoothly, with reporting deadlines met consistently. AIM companies are however often listed owner-managed businesses, with fewer resources available, and consequently many are thought to have found the challenge of IFRS implementation particularly daunting.

AIM companies did enjoy some advantages over the first wave of UK IFRS adopters. Firstly, they were helped by the greater familiarity of the whole community with IFRS concepts and vocabulary, and in particular with the greater familiarity of the auditors, gained since 2005. Thus

advisors were able to anticipate where the problem areas would be. Secondly, the transactions entered into by many AIM companies are relatively straightforward and in particular, they are likely to have needed to account for fewer complex financial instruments.

The Financial Reporting Faculty is currently preparing a major report for the United Nations on the UK experience of moving to IFRS. It hopes to publish this in November 2008.

Dr Nigel Sleight-Johnson | *Head of Financial Reporting Faculty*

The Financial Reporting Faculty expects to open its doors to members later this year once development work is complete. For more information, see www.icaew.com/frf.

Bulletin Board

Faculty update

APB Practice Note 16

PN16, *Bank Reports for audit purposes (Revised)*, becomes fully effective for accounting periods beginning on or after 26 December 2007. This means that requests sent to banks for December 2008 year ends will need to conform to the new procedures. The faculty has updated its practical guidance for auditors on obtaining bank reports (www.icaew.com/index.cfm/route/109630) to encourage members to use the new procedures for all clients on which they have the necessary bank account details. Members are reminded to check the BBA website or the banks' own websites for details of where to send the requests and what forms to use.

Access to information by successor auditors

Technical Release AAF 01/08, *Access to information by successor auditors* has been finalised and is now available on the faculty's website under technical releases www.icaew.com/index.cfm/route/159730. A hard copy is enclosed with this edition of *Audit & Beyond*. If you have any queries please refer to the technical enquiries helpline on 01908 248025.

CCH Audit Conference

Developments in the fields of fraud, audit risk, quality control and auditors' liability are all set to shape the UK audit market over the forthcoming months - The ICAEW Audit and Assurance Conference 2008 will offer participants the opportunity to hear what is involved in all these areas and how it will affect the work they do.

The benefits of attending are to:

- Understand the changes to the Audit regulation
- Learn how to improve audits and win new business
- Receive a practical guide to quality control in the audit environment

This event is in partnership with the faculty and will be of interest to auditors in both small and large firms.

For more information visit www.cchpd.co.uk/audit, call 01635 588 898 or e-mail customerservices@cchpd.co.uk.

An Essential Guide to Auditor Independence in the UK

This podcast provides a summary of the Auditing Practices Board's approach to independence and highlights key policies, procedures and documentation that the Ethical Standards require auditors to consider.

The podcast is available at www.icaew.com/index.cfm?route=158296.

Guide to Public Sector Bodies in the UK

The revised Guide to Public Sector Bodies in the UK has been published and is available on the faculty website under public sector www.icaew.com/index.cfm/route/135283.

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5	The audit of charities in the United Kingdom	Consultation draft PN11 <i>The audit of charities in the United Kingdom (Revised)</i>	www.frc.org.uk/apb/publications/pub1586.html
6	IFRS implementation	EU implementation of IFRS by listed companies	www.icaew.com/index.cfm?route=145392

Audit and Assurance Faculty
PO Box 433
Moorgate Place
London EC2P 2BJ
T: +44 (0) 20 7920 8493
F: +44 (0) 20 7920 8754
E: tdaf@icaew.com
DX 877 London/City
www.icaew.com/aaf

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
T: +44 (0) 20 7920 8493
E: tracy.gray@icaew.com
W: www.icaew.com/aaf

Audit & Beyond is produced by Wolters Kluwer (UK) Limited on behalf of the Audit and Assurance Faculty
T: 0870 777 2906
E: customerservices@cch.co.uk
ISSN: 17748-5789

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