



## How you sign your name has never been more important!

A number of practitioners have expressed concerns about a recent change in company law regarding who may sign the auditor's report. In particular, questions have been asked regarding the actions that should be taken if the senior statutory auditor is indisposed when the auditor's report is required to be signed. This article seeks to clarify when it is necessary for the senior statutory auditor to sign the auditor's report and what practical steps might be taken when the senior statutory auditor is not in a position to sign the report.

Under the provisions of s. 503 of the *Companies Act 2006* (CA 2006) the audit report (for financial years starting on or after 6 April 2008) must state the name of the auditor and be signed and dated. Where the auditor is an individual, the report must be signed by him/her. Where the auditor is a firm, the report must be signed by the 'senior statutory auditor in his/her own name, for and on behalf of the auditor'.

The Secretary of State, as permitted by s. 504 of CA 2006, has appointed the Auditing Practices Board (APB) to issue guidance with respect to the meaning of the term 'senior statutory auditor'. The APB's Bulletin 2008/06 *The 'Senior Statutory Auditor' under the United Kingdom Companies Act 2006* **R** provides that guidance and states that the term 'senior statutory auditor' has the same meaning as the term 'engagement partner' when used in International Standards on Auditing (ISAs) (UK and Ireland).

Therefore, the senior statutory auditor is the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm. The senior statutory auditor must be a member of a recognised supervisory body and be eligible for appointment under the rules of that body.

### Meaning of signing the auditor's report under section 503 of CA 2006

The requirement for the senior statutory auditor to sign in her or his own name applies to the auditor's report that is provided to the company by the auditor upon completion of the audit. It also applies in respect of voluntary revisions of annual accounts and reports, and on the special auditor's report relating to abbreviated accounts.

Under s. 503(3) of CA 2006, the senior statutory auditor must sign the auditor's report that is provided to the company. Another partner or responsible individual is not able to sign for and on behalf of the senior statutory auditor. This requirement

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did not exist in the *Companies Act 1985* which permitted the audit report to be signed in the name of the firm by a person authorised to sign on the firm's behalf. Therefore, if the engagement partner was indisposed, it was permitted for another partner or responsible individual to sign the auditor's report on behalf of the firm.

It is important to note that the requirement for the senior statutory auditor to sign the auditor's report does not apply with respect to the authentication of accounts and reports filed with the Registrar of Companies. These requirements are dealt with in SI 2007 No.3495 and require that the auditor's report delivered with the company's accounts to the registrar of companies for filing:

- must state the name of the auditing firm and the name of the person who signed the report as senior statutory auditor, and
- must be signed by the auditor (or where the auditor is a firm) be signed in the name of the firm by a person authorised to sign on its behalf (for example, the report must have the name of the senior statutory auditor as it appears on the register 'Andrew Smith for and on behalf of XYZ Plc' typed in, but they can be signed as a 'A Smith' or 'XYZ Plc').

This means that the senior statutory auditor, ie the engagement partner, does not need to sign the auditor's reports that are required to be delivered to the Registrar of Companies. However, the original copy for the client must be signed before the authenticated copy is sent to Companies House. The authentication is that the original has been signed and that the copy is an accurate copy. The SI 2007 No. 3495 requires the authentication to state the 'name of the person who signed it as senior statutory auditor'. Paragraph 10 of Bulletin 2008/6 refers to this. However, it would seem sensible if the same partner signed the copy filed at Companies House.

Where the auditor is an individual, the report must state their name and must be signed by them.

### Engagement partner unable to sign the auditor's report to the company

Concerns have been raised about what should happen when the engagement partner is indisposed and not able to be present at the time that the auditor's report needs to be signed. Whilst it is easy to plan for most situations, eg ensuring that the audit is closed as quickly as possible after the work has been completed and managing the clients' expectations, there are some instances which cannot be anticipated and therefore cannot be planned for, eg sickness, accident or even death.

### APB guidance

The APB Bulletin provides some helpful guidance in paragraphs 13 to 15 of actions that may be taken

where the senior statutory auditor is unable to be present to sign the auditor's report:

'13. In circumstances where the senior statutory auditor is unable to continue to take responsibility for the direction, supervision and performance of the audit, the audit firm appoints a replacement senior statutory auditor...'

Where the senior statutory auditor is changed during the reporting period the new senior statutory auditor reviews the audit work performed to the date of the change. The review procedures are sufficient to satisfy the new senior statutory auditor that the audit work performed to the date of the review had been planned and performed in accordance with professional standards and regulatory and legal requirements.

'14. ...where the senior statutory auditor is absent but is still able to, and does, take responsibility for the direction, supervision and performance of the audit, the senior statutory auditor may sign the auditor's report using electronic means (e.g. e-mail or fax).'

This means that even if the engagement partner is ill or overseas, she or he can still sign off electronically if they have completed their work.

'15. ...where the auditor's report needs to be signed by a certain date (e.g. for listed entities and other public interest entities) it would be pragmatic for the audit firm to have a contingency plan as to who would succeed as senior statutory auditor in the event that the audit is at an advanced stage, but the senior statutory auditor is unable to sign the audit report...'

If another audit partner is actively involved in the audit engagement, a suitable contingency plan may be for that other partner to work in parallel with the senior statutory auditor. This recommendation is

intended as a practical suggestion for those circumstances where more than one audit partner is actively involved in the audit. It is not a recommendation from the APB that all audits need to have partners working in parallel with one another.

The APB Bulletin also recognises that there may be exceptional circumstances whereby these options may not work and it outlines that, 'it is permissible for the engagement quality control reviewer (EQCR) to be appointed as the replacement senior statutory auditor where...the EQCR has completed his or her review...and ...the audit is at an "advanced stage". However, once an EQCR has been appointed as a replacement senior statutory auditor, he or she can no longer act as the EQCR...'. If the review has been completed, there will not be a need to appoint another EQCR to review that year's audit again.

### Faculty view

It is useful to recognise that this new requirement has been implemented through legislation. It is therefore not possible to make any changes other than through legislation. The law states that the senior statutory auditor is required to sign the audit report. The APB guidance provides a means to change the senior statutory auditor in circumstances where the engagement partner is not available, for whatever reason. The faculty's view is that the exceptional circumstances will be rare and in the vast majority of cases the situation can be planned and managed so that difficulties do not arise.

It is down to firms to use their judgement and put the appropriate contingency plans in place, taking account of the following:

1. Where there is an EQCR:
  - Both the audit engagement partner and EQCR roles must be performed properly
  - The audit engagement partner must review what she or he needs to review under auditing standards

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- The EQCR must provide challenges as required by ISA 220
  - If the engagement partner is unavailable, the EQCR is normally best placed to carry out the engagement partner level of review as she or he has already carried out reviews of significant judgements and key working papers, and this would be the most efficient option
  - If the EQCR has not completed her or his work in that role, by stepping up into the role of the senior statutory auditor, they will be reviewing their own work, therefore a new EQCR would be required
  - However, by signing the auditor's report, the EQCR would be unable to act as independent reviewer in the future as their objectivity may have been impaired by assuming a role as a senior statutory auditor.
2. Where there is no EQCR:
- If the senior statutory auditor is ill, it may be better to wait until he/she is better or use the option of electronic signature, or
  - If the senior statutory auditor is unable to continue as an engagement partner, then a new one should be appointed.

In accordance with paragraph 11 of the APB Bulletin 2008/06, where a new senior statutory auditor is appointed, she or he will need to 'review the audit work performed to the date of change'. This review is carried out so that the new senior statutory auditor can be satisfied that 'the audit work performed to the date of the review had been planned and performed in accordance with professional standards

and regulatory and legal requirements'. However, this does not mean that the new engagement partner needs to re-perform everything that the previous engagement partner had carried out, but their review needs to be sufficient to be able to satisfy themselves that the work to date has been planned, carried out and reviewed in accordance with standards, regulatory and legal requirements. This could be carried out by having a discussion with the audit team on various aspects of the audit as appropriate.

The faculty will be interested in whether firms encounter any practical difficulties when signing audit reports relating to 30 June 2009 to 31 December 2009 year ends and, if there are difficulties, ascertain how the firms handled them. If there are any conclusions drawn that would benefit members of the faculty more generally, we will provide an update in a future edition of *Audit and Beyond*. If we find evidence of wide-scale difficulties we will discuss our findings with the APB and, in conjunction with them,

seek to meet with the Department for Business, Innovation and Skills to see what can be done to ameliorate the specific problems that have been encountered.

As ever, the moral of the story (particularly for public interest entities subject to rotation rules), is to plan the timetable, and manage the clients' expectations (making sure the client knows what information you are depending on them to deliver to you and by when) in order to issue an opinion when they require it. Also consider what contingencies need to be in place for when a partner may be unexpectedly called away.



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**The faculty would like to thank Steve Leonard of the APB for his help in the drafting of this article.**

### Extract from *Audit News* (Issue 45)

#### Signing audit reports

#### Tell us about changes – as they happen

As you may know from reading *Accountancy*, for a firm to allow (either by design or accident) an individual who is not a responsible individual to sign an audit report has consequences. In some respects, those consequences are now raised a few notches, given the imminent arrival of the public audit register. Members of the public (and other firms) will be able to check that an individual, who now has to give his or her name on the audit report, is properly authorised to sign the report.

So please, as required by audit regulation 2.11, notify us of changes of responsible individuals as these happen (within 10 business days). For new appointments, the responsible individual cannot be in charge of audit work and sign audits reports until the Institute has confirmed the appointment. Telling us of changes on the annual return is too late!

#### How you should sign

At the moment, an audit report simply gives the printed name of the audit firm, as it appears on the register. The responsible individual then signs the

report in the name of the firm. For audit reports on accounting periods starting after 6 April 2008, the name of the responsible individual in charge of the audit must be given and the report has to be signed in his or her own name, not in the name of the firm. This individual is known as the 'senior statutory auditor' and this phrase must be added to the signature block.

We have started to receive queries about how the name should be signed. These are typically of the type 'my name is William, but I sign myself as Bill - what should I do?'

The printed name must be as it appears on the register which will be in the format: first name, surname. This is taken from the membership details we already hold. There is no need to include your designatory letters (they will

be on the register) but you worked hard for them! Then you sign your usual signature. So an individual with the name of William Smith may have a usual signature of:

- William Smith
- W Smith or
- Bill Smith.

Any of these are acceptable on the basis that it is your usual signature. So an audit report signature block may look like this:

<<usual signature>>  
William Smith FCA

Senior Statutory Auditor  
for and on behalf of  
<<Audit firm name>>

Statutory Auditor  
Chartered Accountants

<<Address>>  
<<Date>> **R**.

# The APB issues revised standard on audit reports

For some time, institutional investors, preparers and users of audit reports and some auditing firms have expressed support for a shorter audit report. The APB has sought to address this by making significant changes to the basis of opinion and to the description of the auditor's responsibilities.

## Scope of audit

The Auditing Practices Board (APB) issued the International Standard on Auditing (UK & Ireland) 700 (Revised) *The Auditor's Report on Financial Statements* in March 2009 **R**. This includes a significant change in the 'basis of opinion' which is now renamed 'Scope of the audit' and allows some alternatives for auditors to choose what to include within the 'Scope of audit':

- Cross refer to a 'Statement of the Scope of an Audit' on the APB's website
- Cross refer to a 'Statement of the Scope of an Audit' that is included elsewhere within the Annual Report
- Include a prescribed description of the scope of an audit within the auditor's report.

## Auditor's responsibilities

The APB has, in the revision of ISA 700 (UK & Ireland), reduced the description of the auditor's responsibilities in length and re-positioned it to the second part of the auditor's report to be included under 'other reporting matters'.

## Effective date

This ISA (UK & Ireland) is effective for the audits of financial statements of:

- UK companies, except for those that are charities, for periods commencing on or after 6 April 2008 and ending on or after 5 April 2009, and
- All other UK entities for periods ending on or after 15 December 2010.

The APB has also published Bulletin 2009/2 *Auditor's Reports on Financial Statements in the United Kingdom* in April 2009 **R** which auditors may wish to refer to. This bulletin includes updated examples of unmodified and modified auditor's reports, for audits of financial statements of companies incorporated in the UK, for periods beginning on or after 6 April 2008 and ending on or after 5 April 2009.

## Bannerman wording within audit reports

Auditors are reminded of the Institute's guidance to include additional wording within audit reports as outlined in the faculty's technical release Audit 1/03 *The Audit Report and the Auditors' Duty of Care to Third Parties* **R**. The revisions to ISA 700 (UK & Ireland) (Revised) do not affect the faculty's guidance in relation to the need to include the additional wording in relation to their duty of care to third parties.

There is no revision to the wording outlined in Audit 1/03 except in relation to the new *Companies Act 2006*, (which was effective for accounting periods starting on or after 6 April 2008) through which the duties are spread across s. 495 (truth and fairness, proper preparation of accounts in accordance with

applicable framework, preparation in accordance with the law), s. 496 (directors' report consistency) and s. 497 (directors' remuneration report for quoted companies). The additional wording therefore is:

*This report is made solely to the company's members, as a body, in accordance with [ss. 495 and 496/ss. 495, 496 and 497\*] of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.*

*\*Include reference to s. 497 if the company is quoted (see s. 385).*

Auditors are reminded that the guidance recommends that the additional wording be included within the first or second paragraph of the audit report.

**Sumita Shah** *Manager, Audit and Assurance Faculty.*

## Technical Q&A

### Access to information by successor auditors

**Q. The financial year end of the company is 31 May 2008. The auditor appointed for that year carries out the audit and resigns in September 2008. Assuming new auditors are appointed straight away, in September 2008, for the year commencing 1 June 2008, would these new auditors be able to request access to the audit information from the auditors resigning?**

**A.** Yes, the new regime applies as the new accounting period starts on 1 June 2008 (even though the auditor is not appointed until September 2008).

Audit regulation 3.09 applies to accounting periods starting on or after 6 April 2008.

When the new accounting period starts on 1 June 2008 and the auditor then resigns, the new auditor can invoke the regulation as the accounting period started after 6 April 2008. Therefore the new auditor is able to request access to the audit information from the resigning auditors who would have to comply with the request.

For more information and clarification, auditors are reminded to refer to Technical Release AAF 01/08 *Access to information by successor auditors* **R**. Auditors are also reminded that they can contact the technical enquiry service on +44 (0)1908 248025.



# Financial reporting and auditing: chicken and egg?

Changes in financial reporting in recent years have presented challenges for auditors. Kathryn Cearns, chair of the *Audit Quality Forum* working party discusses the forthcoming publication *Changes in Financial Reporting and Auditing Practice*.

The *Audit Quality Forum* (the *Forum*), hosted by the ICAEW, has completed its suite of reports under the heading 'Evolution' **R**. The final report in the series is entitled *Changes in Financial Reporting and Auditing Practice*. It looks at the often complex relationship between financial reporting and auditing, particularly how changes to the financial reporting environment, which have been significant in recent years, have, and should in future, affect audit practice.

The report begins by looking at some of the key recent changes in financial reporting and also considers the future of financial reporting. Estimates, which require the application of judgement, are an inherent part of financial reporting and will continue to be so even in a predominantly historical cost situation. The report points out that using current values in financial reporting is not new: banks and other financial institutions have been using them for a long time, as have property companies. In many cases, these current values were demanded by the market, with the discipline of accounting standards lagging behind. Nevertheless an increase in the use of current values, including for bespoke over-the-counter derivatives, has caused greater uncertainty in financial reporting in the context of ranges of possible values.

The development of the new conceptual framework of the IASB was considered to be important as the move to focus on 'relevance' and downplay 'reliability' is of concern to many. It will be a challenge for preparers of financial statements, who need sufficient information to enable them to make the proper judgements in relation to their financial statements. The acceptability of the extent of uncertainty created by these changes should ultimately, however, be a matter for users of financial statements.

The report also examines the challenges of more voluminous disclosures and the greater focus on narrative reporting. To some extent increased disclosure is a direct result of increased uncertainty, but it reflects greater inherent complexity in corporate affairs. The role of narrative reporting is still developing and there are issues about whether, and how, it satisfies the needs of users of financial information beyond the statutory financial statements.

Turning to the impact of these developments on audit practice, the working party was clear that auditing practices have had to adapt, and they have generally done this well. In that context, we took the opportunity to look at some of the reports arising from the credit crunch, as much can be learned from looking at any system when it is under extreme pressure.

The question of what is sufficient, appropriate audit evidence is fundamental when considering the audit of any element of financial statements. What is sufficient will be a matter of judgement. Guidance in auditing standards has also developed, with one of the major developments being a much greater focus on audit risk as well as standards in specific aspects, such as fair values.

What do we see as the major adaptation challenges going forward for audit practice? We think that liaison between standard setters should continue in order to reduce the time lag between the development of financial reporting and auditing standards. The cost-benefit implications of auditing new financial reporting requirements should also be considered; in some cases, it may be that new financial reporting requirements are excluded from the scope of the audit if the additional auditing cost cannot be justified.

We discussed whether the different levels of 'reasonable assurance' over different elements of the financial statements should warrant different opinions, but the *Forum* took the view that it is still valid to have one opinion on the truth and fairness of the financial statements. There were nevertheless other questions about the scope of the audit, and the fact that some information,

such as key performance indicators, is of great interest to users but is not directly audited. Obtaining assurance on such additional information may or may not be within the skill set of a financial statement auditor. The report discusses the competencies that ought to be core for an auditor.

Finally, the report considers whether auditors can improve the situation as regards complexity, by taking a more proactive role in advising on the structure and clarity of financial statements, as part of their overarching opinion on truth and fairness.

Comments on the report (addressed to Kathryn Cearns) are very welcome, although there is no specific deadline.



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The *Audit Quality Forum* brings together representatives of auditors, investors, business and regulatory bodies.

Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue about transparency, accountability, reporting and confidence in the independent audit.

To find out more, visit:  
[www.auditqualityforum.com](http://www.auditqualityforum.com).

# Walking the tightrope of control



Jane Howard and Catherine Elford reflect on the key issues raised during their recent seminar on global network risks and ways of managing them.

There are a number of cases relating to international networks currently before the courts, and this trend looks set to continue. The claims, all of which have so far been brought in the US, involve various different networks. Some have been progressing through the courts for years (the *Parmalat Securities litigation*<sup>1</sup> is a case in point); others are relative newcomers on the scene (such as the claim against *BDO International*<sup>2</sup>). One issue arises time and again: namely the extent to which the international 'umbrella' organisation controls, or could be said to control, the member firm responsible for the engagement in question.

## Why is the issue of control so important?

A finding of control is a critical requirement of many of the allegations made against the international entities, both under common law and statute. For a finding of agency under common law, claimants must show not only a relationship between a principal and an agent (ie the international organisation and the member firm responsible for the work in issue) but also evidence that the principal controlled the actions of the agent.

Claims brought under statute, most notably the US securities legislation and, in particular, s. 20(a) of the *Securities Exchange Act 1934*, also require a finding of control. Requirements for a finding of liability under s. 20(a) are set out in the box on page 7.

## The meaning of control

In spite of its importance to both common law and statutory claims, 'control' remains a nebulous and therefore flexible concept. Several courts have grappled with the type of control required in order to succeed with a claim of agency or under s. 20(a). Some courts have concluded that actual control is required, others (and this appears to be the current trend) have ruled that the potential to control is

sufficient (at least in the context of an application for dismissal or Summary Judgment). In addition, some courts require evidence that the international organisation exercised control over the particular engagement in question, as well as exercising general control over the actions of member firms.

## What amounts to control?

From the outset, it is important to appreciate that none of the cases considered below are determinative of the issue as to what conduct could constitute control, as they are all judgments arising from interim applications rather than a full trial of the issues of law or fact.

In some cases, it seems that the court has not needed to look too far to find evidence of either control or the potential to control. In the *BDO International* case, the court found that the network's constitutional documents contained a persuasive indication of control. Indeed, it was alleged that BDO International's Articles of Association included, as one of the entity's objectives, 'the management and control' of the member firms. Similarly, the agreements governing the relationships between the international organisations and the member firms included certain mandatory obligations, rather than being restricted to recommendations or guidance.

Other cases, notably the *Parmalat Securities litigation*, are less clear-cut, forcing the court to consider whether the international organisations exercised control over the actions of member firms in areas such as marketing, quality reviews, and the audit of *Parmalat* itself. For both umbrella organisations, Grant Thornton International (GTI) and Deloitte Touche Tohmatsu (DTT), allegations that they directed how the member firms should refer to themselves in their marketing literature, and requirements on member firms to use professional standards and general auditing procedures promulgated by them, seemed to persuade the court that the issue of control should, at the very least, be considered further at a full trial.

In respect of the *Parmalat* audit itself, it was alleged that DTT had exercised control and influence when it intervened in, and arbitrated, a dispute between the Brazilian and Italian audit partners. It was alleged that the Brazilian auditor expressed some concerns regarding the transfer of inter-company debt within *Parmalat* and the lack of documentation generally on *Parmalat's* files, and wanted to qualify his audit opinion. He is alleged to have discussed this with the Italian auditor, who did not agree with his views. Apparently DTT 'removed' the Brazilian auditor from office, rather than let his concerns come

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to light. GTI allegedly exhibited control over the Parmalat audit in a different way. It is alleged that, after Parmalat's collapse, GTI suspended the Italian audit partners involved in the audit and then, a few weeks later, expelled the Italian member firm from the network (actions which one might regard as entirely understandable in the circumstances). Nonetheless, the court seemed to find the evidence persuasive, such that the claimants were allowed to pursue their claims to trial.

This control of, or ability to control, the particular engagement in question appears to be especially important. It is notable that it was the lack of such specific evidence which led the New York Court to dismiss a claim against RSM<sup>3</sup>. In that case, whilst there was evidence of RSMi exercising quality control over member firms, there was no evidence that it had been involved in the audit in issue (that audit having been performed by one of its independent member firms). Accordingly, the court released RMSi from the action.

### Staying the right side of the controlling line

At face value, the case law suggests that any control by an international organisation should be discouraged. Such a conclusion would, however, be somewhat naïve, as a degree of control is necessary in order to enable the network organisation to fulfil its various roles. Without it, it is difficult to see how the network would operate at all. So how can the risks associated with control be managed such that the rewards of network membership can still be enjoyed?

It is difficult to say with any finality, given that the courts have not conclusively determined what type of conduct would be deemed too controlling.

However, some points to bear in mind are:

- When issuing guidance to member firms, international organisations should emphasise (save where there is a genuine need for strict compliance) that the guidance is not mandatory, rather it is merely a recommendation which member firms could adopt
- Independence statements (which should also clarify the role of the umbrella organisation) should be included in member firms' domestic terms of business
- Member firms and international organisations should avoid any suggestion (express or implied) that they are working either as a joint venture or in partnership with one another
- Member firms should be encouraged to sign off opinions in their own name and there should be no direct interference by the international organisation
- Where quality reviews of member firms are being carried out, these should be confined to historic (as opposed to open or live)

matters – thus removing the potential to influence the work in question.

It remains to be seen exactly what factors will ultimately determine the outcome of the cases currently progressing through the courts. Some control of member firms by umbrella organisations is, of course, necessary and/or desirable. Moreover, quality control and monitoring is arguably one of the best ways to seek to ensure that 'mistakes' are not made in the first place. Given the current economic climate, network organisations will be walking a tightrope for some time, seeking to balance the risks and rewards of network status.

### Notes

<sup>1</sup> *In re Parmalat Securities litigation* [04 MD 1653 (LAK)].

<sup>2</sup> *Banco Espirito Santo International Ltd v BDO International* [2008] No. 3D07-599.

<sup>3</sup> *Star Energy Corporation v RSM Top-Audit and RSM International* [08 Civ 00329 (DC)].



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## Requirements for a finding of liability under s. 20a of the Securities Exchange Act 1934:

- A violation by a primary violator (ie a mis-deed by the member firm carrying out the engagement)
- Control, either direct or indirect, of the primary violator by a third party (the international organisation).

## The ICAEW Assurance Service consultation – report released

The faculty has issued a report **R** to share its experience and findings based on a two-year consultation reviewing the needs of audit-exempt companies in relation to the ICAEW Assurance Service. The consultation, which was launched in 2006, considered the needs of the increasing number of companies that were taking advantage of a legal option not to have an audit.

The environment has changed dramatically in the UK and internationally. There is far more interest in the

topic of possible alternatives to audit and the subject is now of global concern to business, regulatory and professional accounting communities. It is also on the agenda of the IAASB.

Against this background and to share our experience, and to participate in a global debate, we have published this report. The

report describes our findings of how professional accountants approach alternatives to audit, how external users including banks and credit reference agencies use financial information of SMEs and the challenges of establishing new approaches.



# Can auditors do more to build confidence in financial services?



'Our report does not conclude that auditors failed in their duties. However, the banking crisis has raised some serious questions about the usefulness of financial audit' said Chairman of the Treasury Committee John McFall MP when issuing the Committee's third report on the banking crisis.

The role of auditors is given extended coverage in the June and July/August editions of the Financial Services Faculty's magazine, *FS Focus*, **R** which features two articles by Christopher Humphrey from Manchester Business School, and Margaret Woods and Kevin Dowd from Nottingham University Business School. The authors aim to encourage debate on the subject of audit practice and pose questions for practitioners, including:

- What is the relationship between auditors and banking regulators?
- When do auditing standards stop and prudential standards start?
- To what extent have regulations forced auditors to focus on compliance and process issues at the expense of a broader view of the overall organisation and underlying business model?
- What audit issues are raised by the complexity of arriving at certain fair values and how are these resolved in practice?
- When does auditing work best and how could it develop?

The academics are keen to learn more about how auditors in practice deal with a range of issues, including:

- the way in which they have dealt with valuing complex instruments
- what auditing considerations arise when market conditions are difficult and
- how auditors respond to going concern issues in the current economic climate.

They argue that greater visibility of audit practice could enhance confidence in the audit through making auditors' work and achievements known by the public at large.

The authors highlight the fact that recent press coverage of fair value accounting has been focussed on accounting practice, rather than on the implications for audit practice. This, they argue, is despite the fact that a key problem for auditors is the verification of the valuation of illiquid assets, particularly given the consequential impact of such valuations on the reported profits (or losses) of major banking institutions. Whilst the auditor's role is to attest that the financial statements are true and fair, they argue that volatile markets which require significant adjustments within short timeframes present a challenge. As the academics outline how some valuations are highly sensitive to changes in the underlying assumptions, they ask: 'How meaningful is the term "true and fair" when applied to values of complex and illiquid assets?'

Their discussion of the role of auditors is timely, as this has also been explored by the Treasury Committee, with the ICAEW's Chief Executive Michael Izza and the Director of Technical Strategy, Robert Hodgkinson giving evidence on this subject. At the request of the Treasury Committee, the ICAEW's Financial Services Faculty subsequently convened a discussion of audit firms to identify where the role of auditors could change, with particular reference to the relationship between auditors and the Financial Services Authority (FSA). The faculty developed five ideas which aimed to contribute to enhanced public confidence in banks by increasing trust in the information that banks report to the public and to the regulator. Specifically, the ideas were that the role of the auditor could be extended to include more work on:

1. Financial information outside the accounts
2. 'Pillar 3' risk disclosures
3. Regulatory returns to the FSA
4. Control activities chosen by the FSA
5. Bank-specific meetings with the FSA.

The Financial Services Faculty's ideas are taken up in full by the Treasury Committee, which said:

'We are grateful for the response by the ICAEW in bringing together audit firms and drawing up some suggestions to strengthened links between the FSA and auditors. We recommend that the FSA should respond to each of the five suggestions made by the ICAEW.'

To summarise, the views expressed by the academics in *FS Focus* and by the members of the Treasury Committee in their report on the banking crisis, illustrate that the role of banks' auditors merits further discussion. The *Audit Quality Forum* convened a debate in early June to look at systemic risk and the role of auditors. This is likely to highlight further issues around the role of auditors of both financial and non-financial businesses...watch this space for more news!



**Claire Stone**

*Audit and Reporting Manager, Financial Services Faculty.*



# Overhaul of the EU Accounting Directives – the ICAEW viewpoint

As part of an ongoing programme to reduce EU administrative burdens on SMEs, the European Commission published in February 2009 a legislative proposal to exempt micro-entities (defined as businesses with less than ten employees, balance sheet total and annual turnover below 500,000 euro and 1 million euro respectively) from the scope of the EU Accounting Directives (the Fourth and Seventh Company Law Directives) and a consultation to review the Directives for the companies that would remain within their scope **R**.

The proposal on micro-entities is of major significance as it could potentially exempt 5.4 million companies (75 per cent of EU companies) from all EU financial reporting requirements. The UK Government has been among the leading supporters of the exemption. As it would be a national option, it is possible that a number of Member States would continue to require these businesses to comply with requirements in the Directives, even if the exemption is adopted at EU level. It is expected that the adoption of the proposal will be subject to intense debate in the European Parliament and EU Council, not least given the sensitivity from an internal market perspective and the variety of viewpoints apparent among Member States.

The ICAEW has welcomed the opportunity to have a European-wide debate on exempting micro-entities from the Directives, taking into account the significant simplification potential of the proposal and also the systemic implications for the EU as a whole. We consider that the exemption can provide the flexibility needed for each Member State to instigate a comprehensive debate as to the financial reporting regime that most appropriately meets the needs of its very small businesses. If the proposal is adopted, the ICAEW would support an exhaustive debate in the UK on the future financial reporting regime for micro-entities, with due consideration of the reporting obligations that remain necessary for the protection of the public interest and those that could be removed.

Meanwhile, the recent consultation exercise on the Accounting Directives focused on the modernisation and simplification of the EU financial reporting framework which would be applicable to large, medium and small companies, other than

micro-entities. The consultation addressed the overall nature and structure of the Directives, as well as the various specific requirements for each company category on the preparation and publication of the annual accounts. The consultation also explored the possibility of merging the two Directives into one EU accounting text.

In its submission, the ICAEW called for a root-and-branch review of the Directives on the basis of the bottom-up approach and the 'think small first' principle. Following this methodology, the ICAEW argued that the minimum EU requirements for small companies should be the preparation of a balance sheet, a profit and loss account and a deemed minimum of supporting accompanying notes. Further requirements would be added for medium and large companies, such as the preparation of a cash flow statement and the requirement for a statutory audit.

The response strongly supported including in the EU legislation a set of fundamental requirements and EU principles, rather than prescriptive material as this could be best addressed at the standard-setting level. Such an EU framework would provide the best possible opportunity to deliver real simplification to small and medium-sized enterprises (SMEs) as it would give Member States flexibility to implement the common EU principles in the manner most appropriate to their national environment.

The ICAEW response also stressed the importance of having

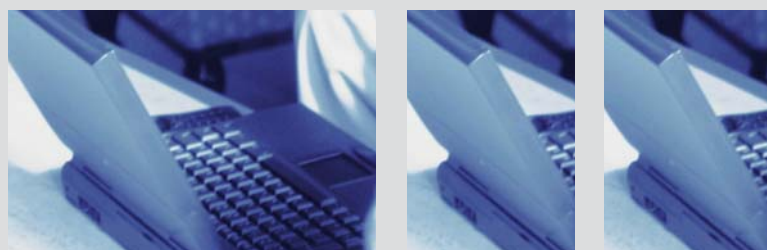
consistency with the fundamental principles and conceptual approaches in international accounting as developed in the broad IFRS framework. In particular, the Directives should be fully compatible with the proposed simplified IFRS for non-publicly accountable entities, therefore making the adoption of this standard at the national level an appropriate route to comply with the Directives' requirements.

Following the analysis of responses **R**, it is expected that the Commission will publish a legislative proposal and an impact assessment in the autumn of 2009. Although the review of the Accounting Directives and the proposed exemption for micro-entities have been pursued by the Commission as two parallel work streams, it is likely that the new group of MEPs – following the 2009 European elections – and the EU Council will consider both proposals together as a package for reforming the EU financial reporting framework for SMEs.



**Pablo Portugal**  
European Union  
Affairs Manager,  
Brussels Office.

# Auditing complex financial instruments – this means you!



Complex financial instruments are now ubiquitous. They are no longer the preserve of the larger company or auditor, and our response to the APB on its proposed revisions to Practice Note 23 on that subject reflects the need for the guidance to work for smaller audits.

The ICAEW responded to the APB's December 2008 consultation on PN 23 *Auditing Complex Financial Instruments* (PN 23) on 27 March 2009 **R**.

The current PN 23 was issued in April 2002 to provide guidance on auditing derivative financial instruments and was based on an International Auditing Practice Statement. The proposals:

- widen the scope of PN 23 to cover other complex financial instruments, as well as derivatives
- deal with the implications for valuations, and disclosures about risks and uncertainties, of the current difficult financial market conditions. They draw on the IAASB Staff Audit Practice Alert *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment* issued in October 2008. The proposals supplement Bulletin 2008/01, *Audit Issues When Financial Market Conditions are Difficult and Credit Facilities may be Restricted*
- deal with changes to UK financial reporting frameworks including amendments to accounting standards to permit the reclassification of certain financial assets.

While the Institute welcomed the consultation, we noted that complex financial instruments are now ubiquitous and that while the current economic climate renders challenges to the audit thereof acute, such instruments are likely to remain important regardless of the economic climate. We suggested that the effort involved in further improving draft PN 23 was worthwhile in terms of improved audit quality, and that the document risked failing to meet its objective of providing useful guidance to auditors otherwise.

Specifically, we noted that the document is more relevant than ever to smaller firms and their clients. Many smaller firms might read the title of the document as being irrelevant to them. Some very

small pension funds may nowadays be exposed to highly complex instruments. Both small companies and pension funds may now enter into interest rate or currency swaps to hedge their investment returns. The issue is not the low value of the instruments but the risk that they may become big if markets move – just because the current carrying value is immaterial does not mean that it will continue to be so. Therefore, this guidance is relevant even if the financial instruments are not complex or large and we suggest that some mechanism should be found to make it clear that the value of some complex instruments may be very low indeed.

We also noted that many financial instruments now display some complexity and that a definition or description of financial instruments that excludes *simple* instruments that function as, and have simple characteristics such that they closely resemble, cash, debtors or creditors, should be developed.

The proposals contain new material on areas such as marking to market in illiquid markets, and we commented on the problems associated with the blanket use of emphases of matter in some jurisdictions, such as the US. We suggested that PN 23 should note that emphases of matter should not be used as a matter of course and are only likely to be appropriate in unusual circumstances, where valuations are exceptional in the context of the market as a whole, for example.

We noted that while the existence of illiquidity in the marketplace is relevant to going concern uncertainties, more could be made of the possible link between the use of complex financial instruments and the adequacy of liquidity and going concern disclosures. Potentially large future losses on complex financial instruments need to be considered as part of the review of liquidity and going concern disclosures and inadequate cash reserves and lines of credit or parental support are relevant, particularly where financial markets are difficult.

We noted some duplication and omission of material and the need for a through edit, more use of cross-referencing and the need for additional material explaining the ISA rather than simply repeating the ISA material. We suggested that there might be more material on the complexity of accounting judgements, the need to consider using experts, materiality and estimation uncertainty, professional scepticism and the inherent limitations involved in auditing complex financial instruments.

The proposals contain a separate section on considerations when financial markets are difficult and, while this is helpful, we suggested the information be incorporated into the main body of the material so as not to lose it when, or if, the current conditions persist and the label 'difficult' loses its potency.

**Katharine Bagshaw** *Manager, Audit and Assurance Faculty.*

# Reporting on government grant claims

Organisations receive government support for a wide range of initiatives from charitable, voluntary, environmental and sustainability projects to funding for innovation and to help businesses to develop, grow and succeed. This funding can be a major source of finance for business, charities, voluntary organisations and academia. As a condition of the grant, recipients are often asked to obtain an independent accountant's report on how they have used their grant funding.

The faculty is currently drafting a framework document which seeks to review the current framework for accountants who report to grant paying bodies on whether grant monies, which have been allocated to organisations, have been spent for the purpose for which the funding was intended and in accordance with the terms and conditions of the scheme. The framework document is intended to help all parties involved in the grant reporting process.

In particular:

- accountants will find the framework useful as it outlines reporting practicalities (from planning to reporting stage) that they will need to consider when they are asked to take on such an engagement
- grant funders will have access to good practice principles to enable them to consider, when they design a new grant scheme or review existing ones, how to make the arrangements practicable and cost effective for all (including discussion of the proposed scope of work and reporting requirements with accountants at an early stage)

- grant recipients will gain a better understanding of the reporting requirements and their accountants' ability to meet them at the grant acceptance stage.

If you carry out such work, look out for the framework document which will be published for consultation on the faculty's website by early August 2009. Comments will be invited from relevant stakeholders and practitioners by 30 October 2009.

Please send your comments on the consultation draft to [sumita.shah@icaew.com](mailto:sumita.shah@icaew.com) by the response deadline.

## Bulletin Board

### Faculty update

#### Autumn Roadshows

**Topic:** Are You Clear On Clarity?

**Speaker:** John Selwood

Dates:	Location:
01 September 2009	Bury St Edmunds
04 September 2009	Durham
08 September 2009	Bristol
10 September 2009	Colchester
11 September 2009	Stafford
14 September 2009	Croydon
16 September 2009	High Wycombe
22 September 2009	Liverpool
23 September 2009	London
24 September 2009	Southampton
13 October 2009	Luton
04 November 2009	Derby
05 November 2009	Preston
06 November 2009	Manchester
12 November 2009	Birmingham
16 November 2009	Maidstone
20 November 2009	London
23 November 2009	London
03 December 2009	Sheffield
04 December 2009	Leicester
14 December 2009	Wakefield
15 December 2009	Cardiff
17 December 2009	Exeter

For more information, and to book online, go to the faculty website [www.icaew.com/aaf](http://www.icaew.com/aaf).

The faculty roadshows, this year, are more important than ever as they will provide you with key information to enable you to start planning, training and implementing the Clarity ISAs. Some of the

standards contain new requirements and it is essential that you are up to date with these major revisions to help you plan and manage implementation efficiently. The roadshows will cover some hot topics including:

- the new audit report
- Companies Act 2006
- Ethical Standards
- Access to working papers

Places are going fast. Don't miss the opportunity to book yourself onto this crucial update.

#### Last chance for direct entry to the IIA Advanced Diploma

The Institute of Internal Auditors – UK and Ireland (IIA) readily acknowledges the valuable experience and expertise that chartered accountants working within internal audit have.

As a consequence, qualified accountants have enjoyed exemptions from parts of the IIA's professional internal auditing qualifications, including a direct entry to the IIA Advanced Diploma in Internal Auditing and Management. This exemption will be concluding on 31 August 2009.

Log onto the IIA website for more details: [www.iaa.org.uk/en/Qualifications\\_and\\_CPD/Qualifications\\_Portfolio/Advdiploma/direct-entry-for-ccab-holders.cfm](http://www.iaa.org.uk/en/Qualifications_and_CPD/Qualifications_Portfolio/Advdiploma/direct-entry-for-ccab-holders.cfm).

#### FRC publishes discussion paper on reducing complexity on corporate reporting

The paper, *Louder than Words: Principles and actions for making corporate reports less complex and more relevant* – is intended to remind all of those involved in corporate reporting that it is what we all do in practice that affects the quality and readability of corporate reports. Go to: [www.frc.org.uk](http://www.frc.org.uk) to view the discussion paper.

#### Internal Audit Lecture Series

**Date:** Monday 7 September

**Topic:** How Do Your Ethics Measure Up?

**Speaker:** Simon Culhane, Chief Executive of the Financial Securities & Investment Institute  
With the public's trust in MPs at an all time low and the financial services industry suffering from a global lack of trust, are you fit to conduct business?

Dates for 2009 lectures (topics to be confirmed):

Monday 19 October  
Monday 30 November

For further details, and to book online, visit [www.icaew.com/aaf](http://www.icaew.com/aaf).



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3	Technical Q&A	Technical Release AAF 01/08 <i>Access to information by successor auditors</i>	<a href="http://www.icaew.com/aaf">www.icaew.com/aaf</a>
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*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](mailto:customerservices@cch.co.uk)  
ISSN: 17748-5789

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TECPLM8182 July/August 2009