THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Audit&Beyond

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Audit and Assurance Faculty

Audit Quality - the fundamentals

In the July/August issue of *Audit & Beyond* we summarised the outcome of the May *Audit Quality Forum* meeting and took a very brief look at the forward agenda for the *Forum*. The new prospectus has just been published, which sets out the broader agenda going forward, including examining relationships between shareholders, regulators and other stakeholders in the audit. This article therefore provides some more detail on the new projects.

Agency relationships and trust

The audit serves a vital economic purpose in helping to enforce accountability and promote confidence in financial reporting and trust in general. The relationship between principals and agents is of particular importance in understanding how audits have evolved over the centuries and continue to develop.

In the UK corporate reporting framework, tensions in the shareholder-director relationship with a separation of ownership and control and lack of trust provide a vital insight into developments in auditing. Auditors are appointed by and report to the shareholders of a company and the UK audit has an important stewardship role to play.

However, in the current economic environment, where financial information is in the public domain, other business and regulatory stakeholders also have an interest in the audit and the work of auditors and their expectations of an audit are not always aligned with those of shareholders or auditors. Auditors are also agents of the shareholders and trust becomes equally relevant in the shareholder/auditor relationship. These complexities and the role of audit are not easily explained by a simple agency model.

These issues will be explored in a background paper, *Agency theory and the role of audit*.

Current agenda

The *Forum* has four projects on its current work agenda.

Audit purpose

Only when the purpose of an audit is properly understood, can real progress be made towards aligning the interests of shareholders, auditors, boards and other stakeholders. This project will seek to articulate the purpose of an audit and will focus on the relationships and different interests that surround the audit role.

Principles-based auditing standards

This project will explore the perceptions of the nature of 'principles-based' or 'objectives-orientated' auditing standards and how they differ in practice from 'rules-based' standards. It will also consider implementation issues such as the ability of the standards to deliver improvements in audit quality and the need to balance the importance of professional judgement with the need for auditor accountability.

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'International' means everyone! Including you!

We believe that there are just a few practitioners who still believe that anything marked 'international' has nothing to do with them! This is just a timely reminder that International Standards on Auditing (ISAs UK and Ireland) will apply to all UK audits, regardless of the size of the client for accounting periods beginning on or after 15 December 2004, which means December 2005 audits. Time is running out for any audit practitioners who are not up to speed on this.

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Global auditing standards

The project will set out the challenges to implementing global auditing standards in the UK. The qualities necessary to facilitate high quality audits of large, medium-sized and small entities in the UK will be considered.

Auditor reporting

This project will consider the information that auditors should communicate and whether current auditor reporting, in particular the audit report, is helpful to shareholders and reflects audit purpose.

Third-party information to auditors

A further area identified as a priority was the extent of disclosure to auditors of third-party information and advice provided to the board. This project will explore the transparency of such information to auditors.

The *Audit Quality Forum* is convened by the Audit and Assurance Faculty of the Institute. It comprises representatives of the audit profession, investors, business and regulators who have an interest in high quality and confidence in the independent audit. Further information on the objectives and work of the *Forum*, downloadable copies of its reports and details of how to obtain hard copies are available at *www.icaew.co.uk/auditquality*.

The IFAC network consultation: will you have to be independent of your affiliates?

In common with all other main accountancy bodies that regulate audits throughout the world, the Institute is a member of the International Federation of Accountants (IFAC) and is committed to harmonisation towards global standards. In ethics, this is perhaps easier than in some other areas, as the recently revised IFAC *Code of Ethics* has adopted the principles-based approach to ethical standards long used by the Institute, rather than the US style that some argue has infiltrated other types of standard. IFAC has just completed a consultation on a change it proposes to make to the definition of network firms. When finalised, this is likely to impact on the Institute's guidance on Independence in Assurance Engagements and, as it is similar to that in the proposed revision to the EU 8th Directive, to the APB's Ethical Standards on Auditor Independence.

The key change in the proposed definition of network firms centres on how the firms present themselves. Whilst the traditional criteria of control or common control, ownership and management still apply, the proposal would also include an entity as a network firm of another if the two share a common name or share significant professional resources, profits, costs or expenses. Furthermore, if appearance suggests that a firm is part of a network firm when it is not, then firms should make appropriate disclosures to this effect when liaising with third parties.

The relevance of all this is that, if a number of firms are considered to be part of the same network for ethical code purposes, then if one has an audit client, not only will it have to be independent but so will the other network firms. Similar considerations apply when undertaking non-audit assurance engagements, though there is a lesser onus to search for independence issues. This is not a change to the current position but it may result in more firms being considered to be part of the same network than was previously the case.

The Institute's response supported the thrust of the proposed revision but raised a number of concerns in respect of the detailed definition and the explanation that is proposed to accompany it. These included, inter-alia:

- a recommendation that as the proposed definition is essentially the same as that in the draft 8th Directive, the same wording should be used;
- a note that it is not clear what the position is in respect of groupings where some firms use the same name but others do not, even though all other aspects of the relationship are the same;
- a concern that the requirement for a firm to describe the nature of its membership of an association by stating 'an independent firm associated with XYZ Association of Accounting Firms' may be interpreted as a black and white rule, with the unintended result that if this statement is not made, a firm will automatically be assumed to be a network firm;
- a suggestion that it be clarified what is meant by 'control'. Some networks and associations have an ability to control some aspects of member firms' behaviour (e.g. use of name) but not necessarily management control of the audit processes. We assume these are not meant to be included;
- a request that the IFAC Ethics Committee suggest to the IAASB that it expand on its brief comments in ISQC1 covering the extent to which firms need to pro-actively seek out independence threats in their network firms.

The Institute's full response is available at *www.icaew.co.uk/ethics*. IFAC is currently considering responses: watch this space for developments.

Is the information in emails capable of scrutiny under the Freedom of Information Act?

Most would agree and support the need for transparency and the wider public benefits that the Freedom of Information Act 2000 (the FOIA) brings about. However, are there potential areas where information that we provide could jeopardise the integrity and quality of the service being provided and the processes that are being followed?

Even though the FOIA does not apply directly to auditors of public bodies (except under contract to the NAO), it may still affect members in a number of ways, including where firms carry out work for public authorities or where reports issued by firms on private entities are held by a public authority. Members who deal with public authorities need to consider all aspects of their interaction with them, including email communication. Information may be conveyed to public authorities for a number of reasons and could be in many different forms. Emails are one of the ways in which information may be passed back and forth. The extent of the applicability of the FOIA to this information will obviously depend on the nature of the services provided.

In today's environment, information via email is often created, collected and received without being subject to the procedures and rules governing good record keeping. Consider how often you have been the unintended recipient of an email that was not meant to be for your information. Email communication is therefore possibly more fragile than paper communication and more thought is needed around how and what information is conveyed via email, especially when considering the impact of the FOIA.

Emails make it difficult to identify and keep track of information. They may not be consistently filed and managed and often cannot reliably demonstrate accountability. If mailboxes are not organised and managed properly, some types of information or decisions may effectively be lost. They can often be misunderstood because of the way in which they are written but, consider how many key decisions and actions are conveyed by email and how often they can take the form of 'loose' minutes?

Members need to be aware that, within a public authority, there will be records management policies and procedures for both paper and electronic communications. There will usually be no distinction in status between email communication and other forms of paper communication and therefore emails generated and received (including any attachments) in relation to the public authority's functions and services are likely to be considered to be public records and as a result are subject to the same records management policies and procedures.

Public authorities' electronic records management policies will instruct staff to retain any email or correspondence that forms part of a story, process or decision and file it with its electronic records system. The decision whether or not to retain the email and its contents will rest with the recipient within the public authority. All emails that form part of the public record system will be liable to disclosure and could potentially form part of civil, litigation and criminal proceedings.

Therefore, members who deal with public authorities that are designated under the FOIA need to consider the following if communicating information by email:

- Is sending an email the most appropriate method of communicating that particular piece of information?
- Any emails that are sent need to be constructed with care and with regard to the use that they may be put to. It is important to compose the message as if it were a formal business letter otherwise there may be a danger that the intended message will not be understood or acted upon in the appropriate way.
- Will the privacy and confidentiality of the message sent via email be guaranteed?
- Emails need to be kept short, polite and factual.
- Read them over carefully before pressing send.
- If the message is long, consider putting it into a more formal document and sending it as an attachment.
- Consider who the recipient of the email is and take care not to press the reply to all button in error.
- Avoid long distribution lists as you do not have control over the future use of data conveyed in an email.
- Only give personal comments/ judgements relevant to the issues at hand and only make comments that can be justified and backed up with evidence.
- Organise your mailbox so that information relating to a specific subject can be found quickly.

ICAEW survey on SME accounting and auditing issues

The ICAEW has carried out a research project as part of a larger survey organised by the Professional Oversight Board for Accountancy (POBA).

Background

There are three overall themes of the research by POBA:

- How effective is the support from accountants and others in helping managers of small and medium-sized enterprises (SMEs) to prepare and use financial information?
- How effective is the support from accountants and others in helping SMEs to achieve high quality financial reporting to external stakeholders?
- What are the needs of external stakeholders and how cost-effectively do SMEs' financial reports meet these needs?

This project asked practitioners for their views on the provision of accounting and auditing services to SMEs. POBA's research covers SMEs and other stakeholders in relation to the three themes.

Between 15 July and 5 August 2005, a cross section of ICAEW members in practice received an electronic questionnaire. 763 (11%) of members responded. The profile of the respondents is:

Type of respondents	%
A firm registered to carry out audits	69
A firm of accountants and/or tax advisors	30
Other (including a firm of bookkeepers)	1

Research findings

SME clients

74% of audit-registered firms have 50 or more small limited companies as clients. In comparison, the other firms of accountants have more of a mixed base of clients, ranging between '1-4' and '50 or more'.

Firms have a fewer number of medium-sized companies as clients. Just over half of the members who responded to the survey reported that their firms have less than 10 medium-sized companies as clients. However, 12% of audit-registered firms have more than 50 medium-sized companies as clients.

Audit exempt companies

68% of audit-registered firms estimate that less than 10% of their small limited company clients who are eligible for audit exemption currently have their accounts audited. Among other firms of accountants, 86% of respondents said that none of their clients who are eligible for audit exemption had their accounts audited.

Reasons for having audits

78% of audit-registered firms think that small companies continue to have an audit because it is considered useful for a bank or another lender, whilst 42% believe that it is because non-management shareholders consider an audit useful. 44% of these respondents think that small companies have audits because it gives 'management confidence in controls'.

Changes to the number of clients

According to respondents, an equal number of firms have seen either an increase or decrease in the number of small company clients they have as a direct result of increases in the audit exemption thresholds; three quarters have seen 'no change'.

Useful services for SME clients

When asked in which areas they believe small companies experience problems, over half of the respondents mentioned:-

- preparing statutory financial statements;
- understanding and interpreting the statutory financial statements;
- preparing tax returns; and
- management accounting including budgeting and planning.

The majority of practitioners provide services to these companies such as preparation of statutory financial statements, tax, general business advice, bookkeeping and management accounts and IT. In relation to IT assistance, whilst 59% of audit-registered firms provide IT-related services only 36% of non-auditing firms assist their clients with IT.

Respondents think that medium-sized companies have fewer areas where they experience problems. A majority of respondents raised only the preparation of statutory accounts and tax returns as areas in which medium-sized companies experience difficulties. The majority of audit-registered firms who responded assist medium-sized companies in preparing tax returns (96%), statutory financial statements (93%) and management accounting (53%). 81% of them also give general business advice. A lower percentage of non-auditing firms provide similar services.

The survey also asked what practitioners believed the accountancy profession could do to help small and medium-sized companies to enhance their effectiveness in meeting their accounting and auditing needs. From a review of the detailed responses to this question, common themes were identified. These included:

- lobbying for simpler regulations and less red tape;
- closer working relationship with clients, including regular visits and training; and
- being more proactive and understanding specific requirements of clients.

Further information on POBA's research findings will be provided in a future issue of *Audit & Beyond*.

Group audits guidance

The Faculty will shortly be issuing good practice guidance on group audits following the research carried out by Lighthouse Global earlier in the year (see the March issue of *True & Fair*). This new guidance will contain an eight point plan for firms to help them to enhance the quality of their group audits.

Objectives of the guidance

This guidance is based on the Lighthouse Global research and addresses the complex and topical issues surrounding the audit of groups. It is the latest in the Faculty's series of practical guidance on Audit Quality designed to help auditors deliver continuous improvement. The Faculty believes that firms of all sizes are keen to receive guidance on group audits as there is currently a limited amount of material available to them.

The publication highlights the crucial importance of good project management and establishing good communication with other auditors. Reviewing how firms use questionnaires is another area covered, as is how to deal with the growing complexity of accounting and auditing across the globe.

The eight point plan

1. Get organised
2. Analyse the group structure
3. Focus on the quality of other auditors
4. Focus the group audit on high risk areas
5. Understand internal controls across the group
6. Ensure staff understand the technical complexities of group audits and know when to bring in specialist help
7. Review other auditors' working papers
8. Review and update procedures, training and tools

The proposed revised ISA 600

In April of this year the APB issued an exposure draft of a proposed revised ISA (UK and Ireland) 600 '*The Audit of Group Financial Statements*' which adopts the text of proposed revised ISA 600 issued by the IAASB. The Institute's responses to the IAASB and the APB on their exposure drafts of the revised ISA 600 are available on the 'consulting you' section of the Faculty's website.

It is understood that it is now unlikely that the new standard will be effective until audits of periods beginning on or after 15 December 2007. However, the message from the Faculty is that auditors do not have to wait for the revised ISA 600 to come into effect to make any changes that might be needed to bring them in line with the recommendations in the new guidance.

The publication '*Promoting best practice in group audits*' will be available on the Faculty's website next month *www.icaew.co.uk/aafac*. Hard copies will be sent to members with the December/January issue of *Audit & Beyond*.

Time to declare your CPD

As the first year of CPD draws to a close, your thoughts should be turning towards making your mandatory annual declaration. In November you will be asked to tick one of three statements as part of the member profile, either in your subscription pack or online at *www.icaew.co.uk/profile*. The statements will be to the effect that:

- you have reviewed your CPD needs and taken action to meet any needs you have identified;
- you have not complied with the CPD requirements and request assistance; or
- you are exempt from CPD.

If you work in statutory audit, in a firm registered for audit with the Institute, you must comply with transitional arrangements for 2005. This means you need to spend 50 hours doing audit-related CPD, though the hours do not necessarily have to be entirely audit focused. For example, training on a new piece of software would count as audit-related CPD, provided it was relevant to your learning needs in your role as an auditor.

Though not counted as part of the 50 hours, you should also consider any other responsibilities you have outside of audit and whether you need to undertake any professional development in those areas.

From 2006, you will not need to reach a set number of hours and will need only to assess your development needs according to your judgement.

If you do not work in statutory audit, in a firm registered for audit with the Institute, you should comply with the normal CPD requirements. You need to reflect on your responsibilities, take action to meet any development needs and assess the impact of those actions.

A risk-based sample of members will be chosen to provide evidence of their CPD. As you work in a regulated area you are more likely to be sampled and will be reviewed as part of Practice Assurance. You may find it useful to keep a record of your CPD activities in case you are selected for review. You can create and submit records to the Institute on the CPD website, use the Audit and Assurance Faculty's CPD planner or a format of your own.

You can find out more about CPD and the transitional arrangements on the CPD website at *www.icaew.co.uk/cpd*. You can also see the wording of the declaration and suggestions for your CPD. You will need your member number and password to log in.

8th Directive on statutory audit

The European Parliament has voted to adopt the revised 8th Company Law Directive on statutory audit which completes a key stage in the EU legislative process.

This article explains what is covered by the Directive and what it means for auditors in the UK. The coverage of the revised 8th Directive includes the following issues:

- International Standards on Auditing (ISAs) to be used throughout Europe.
- Public oversight requirements which should be consistent with the changes made in the UK over the last few years.
- Auditor independence requirements, in particular for listed companies on provision of non-audit services and audit partner rotation.
- Listed companies to have audit committees or equivalent.
- The European Commission to present a report on auditor liability before the end of 2006.

The UK is already well placed regarding most of the requirements but the Institute will be taking a keen interest in the implementation of the Directive. More information about the coverage of the Directive and changes made since the publication of the proposal by the European Commission in March 2004 is provided below.

Chapter I: Subject matter and definitions

A number of favourable changes have been made to the definitions compared to the original Commission proposal, e.g. 'public interest entities' (PIEs), although there are issues to watch on implementation (see ICAEW policy statement from July). Definition of 'network' is relevant to the current consultation by the IFAC ethics committee.

Chapter II: Approval, continuous education and mutual recognition

A favourable change has been made to the conditions for approval as audit firms compared to the original Commission proposal, e.g. on control of firms. The education and training provisions are consistent with the existing regime.

Chapter III: Registration

There will be a bit more detail included, e.g. names of networks and affiliates.

Chapters IV and V: Professional ethics, professional secrecy and independence

This has been the focus of much debate, particularly Article 22 which covers non-audit services. The UK successfully resisted determined attempts to introduce outright bans. We now have compromise wording which might be difficult to interpret and our primary concern has shifted to the implementation of this in the UK (see ICAEW policy statement from July).

Chapter VI: Auditing Standards and audit reporting

This will bring in ISAs throughout Europe. We expect the APB pluses which we now have in the UK to reduce as the IAASB completes its ISA revision process. The Directive allows pluses for a period of two years beyond the normal transposition period of two years, i.e. four years.

Chapter VII: Quality assurance

Sets out the criteria which the quality assurance system must meet.

Chapter VIII: Investigations and sanctions

A European Parliament amendment commits the Commission to present a report on liability before the end of 2006 - the Institute is taking a keen interest in this (see ICAEW policy statement from July).

Chapter IX: Public oversight and regulatory arrangements between Member States

The 'new' arrangements in the UK are considered to be consistent with the requirements of the Directive. The original Commission proposal to not allow practitioners to participate in the governance of the public oversight system has been deleted.

Chapter X: Appointment, dismissal and communication

The DTI has attempted to ensure the draft company law clauses on auditor resignation are consistent with the likely requirements of the Directive.

Chapter XI: Special provisions for the statutory audit of public interest entities

This includes Article 39 on audit committees which has been the subject of much debate and lobbying, particularly from the UK (see ICAEW policy statement from July). Structurally, having this Chapter separate to the other sections is messy as it also picks up extra independence requirements for PIEs, e.g. on audit partner rotation. In addition it includes the requirement for a transparency report for any firm that audits PIEs.

Chapter XII: International aspects

There have been a number of favourable changes compared to the original Commission proposal, e.g. on the requirements regarding the registration of overseas auditors.

Chapter XIII: Transitional and final provisions

The final date of implementation is likely to be the middle of 2008 given the two-year transposition period.

The ICAEW policy statement referred to above is available at *www.icaew.co.uk /viewer/index.cfm?AUB=TB2I_83604*.

Internal audit lecture

Less than 10% of business risks are of a financial nature, according to PwC's analysis of the FTSE 100. If the overwhelming majority of risks derive from non-financial areas, there will be implications for an organisation's risk programme and for the type of judgments to be required from internal audit - not to mention the skills needed to make such judgments.

In September a PricewaterhouseCoopers panel facilitated a discussion among internal auditors about providing assurance over non-financial data.

The speakers, Paul Pilkington, director in non-financial assurance, Geoff Lane, partner in sustainability, and Phil Gerard, director in internal audit services, explained the topicality and importance of non-financial information and shared their views on how internal audit might approach the audit of such data.

Non-financial risks

The areas that typically give rise to non-financial risk can be classified into three types

- strategic, such as customer demand shortfall; competitive pressure; M&A integration problems; misaligned products and customer pricing pressure
- operational, eg cost overturns; accounting irregularities and management ineffectiveness
- hazard, including lawsuits and natural disasters

The audience spoke of non-financial risk areas specific to their organisations such as health and safety (e.g. fatalities and accidents), security, reputation (including lawyers' negligence and customer dissatisfaction) and relationships with providers.

The panel provided further illustrations from case studies involving telecoms' subscriber numbers, drug testing results and taxation policy.

Why bother?

The Operating and Financial Review requires directors to publish information on a range of matters going on across the business.

Moreover, organisations whose competitors or industry peers attempt reporting of non-financial information may face pressure to follow suit even if such reporting is not a legal requirement.

Finally, what stakeholders view as important is increasingly influencing the nature of published information. Non-financial information may well be subject to greater scrutiny than financial data because of less familiarity with its sources.

Whether published information concerns environmental matters, employee issues or social issues, directors will turn to internal audit for assurance thereon and to add value to the reporting process.

The challenges

PwC's experience shows that many organisations invariably falter when it comes to collating, measuring and reporting non-financial data and these challenges have implications for the auditor's work.

Furthermore, the frameworks around non-financial information are not usually as robust as the framework for financial data, making non-financial data easier to manipulate or override. What's more, there is often no third party information available to verify non-financial data and no audit trails.

Guidance for auditing non-financial information

The collective experiences of the internal auditors present suggested that, for many organisations, there is a strong case for:

- getting the risks surrounding non-financial data onto the audit committee's regular agenda
- encouraging business managers to accept that internal audit is a non-financial function and needs to take a holistic view of risk
- people from appropriate non-financial backgrounds to be integrated in internal audit teams - examples might include surveyors, industry experts, supply chain managers

The PwC panel outlined a systematic methodology for remaining alert to all business risks, including non-financial ones. This involves considering the organisation's:

- **market**, including the competition, regulation and macro-economic factors
- **strategy**, for example its goals and objectives and governance
- **value-creating activities**, such as customer service and policies
- **financial performance**, including its risk profile and segmental analysis

The speakers also provided some guidance for auditing non-financial risks:

Internal auditors should **prioritise** non-financial risks as they would financial ones.

They should ensure that the **scope** of audit work is sufficiently detailed and aligned to stakeholders' interests and that **tolerance levels** for errors are clearly stated.

Looking at the data alone is not enough and internal auditors should get to grips with the associated **reporting systems** and verify related processes and controls.

It may be helpful to coordinate internal audit's assurance work with that of **other assurance providers** in the organisation. This will stimulate discussion and ideas that can be escalated at board level.

At a higher level internal auditors should try and tap into what is troubling their **CEO** - often it won't be just the numbers. They should also keep an eye on future **regulation** and what implications it may have for non-financial data.

With the spotlight on the integrity of organisations' published information it will not be possible to ignore or be complacent about 'dodgy' HR or marketing systems. As a non-financial function, internal audit must ensure that all risks to the business feature on the risk register. And, in relation to information about non-financial business areas, internal audit is responsible for taking the lead in providing assurance.

bulletinboard

Faculty update

Fraud - the Internal Auditor's Toolkit

The Fraud Advisory Panel is hosting a full-day seminar, in association with the Institute of Internal Auditors - UK (IIA).

Date:

Thursday 1 December 2005

Costs:

IIA and FAP Members: £175 + VAT = £205.63
Non-Members: £275 + VAT = £323.13

Venue:

Chartered Accountants' Hall

Bookings via the IIA Training Department, tel: 020 7498 0101, *www.fraudadvisorypanel.org*

October issue of *Audit & Beyond*

Please note that the article on page 2 of the October issue of *Audit & Beyond* contained a factual inaccuracy. The reference to the audit exemption threshold of net assets over £2.8 million should in fact refer to balance sheet total (i.e. total assets).

Internal audit lecture series

A debate based on findings from PwC's survey of Audit Committee Chairs
Monday 5 December 2005,

Future dates for your diaries:

Monday 16 January 2006
Monday 6 March 2006

All lectures will start at 6pm and will be followed by wine and a finger buffet. The lectures will be held at Moorgate Place, London EC2P 2BJ. Tickets cost £32.50 plus VAT. For more information please contact Louise Thornton on 020 7920 8493.

CCH Professional Development events

Common reporting problems
Northern, 6 February 2006, £125
West Midlands, 20 February 2006, £125

Charities: audit, accounting and tax update
Devon and Cornwall, 7 February 2006, £125

Audit update - ethics and ISAs
West Midlands, 13 March 2006, £125
Salisbury, 16 March 2006, £125
Merseyside, 21 March 2006, £125
West Country, 21 March 2006, £125
East Midlands, 23 March 2006, £125
South Wales, 23 March 2006, £125

Pension schemes audit and accounting: introduction
London, 23 March 2006, £429

For further details on how to book any of the above events, please visit *www.cchseminars.co.uk* or call 01635 588898.

Faculty members receive a 10 per cent discount on the prices listed above for these courses, please mention *Audit & Beyond* when booking.

Audit & Beyond editorial information

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