

'If something sounds too good to be true, then...'

Does anyone remember Barlow Clowes? Described in an article a few years ago as, 'the biggest financial crash in what some say was the greediest and most cash-obsessed decade of the century: the 1980s'. Imagine that quote in 20 or 30 years; only change the name to Madoff (and any others please?) and change the decade!

Recipe for a successful fraud:

- Take one highly reputable and trusted establishment figure, who with hindsight seems to have been a little short of ethics
- Be in an environment where many people, both rich and poor, are looking for the secret of becoming wealthy or more wealthy
- Offer returns which are excellent but also steady (presumably therefore less risky than other alternatives?)
- A monitoring and regulatory process which appears to lack some rigour
- Stir gently, sit back and wait

What did Madoff do?

It may be some time before it is completely clear what happened but essentially Bernie Madoff's fraud was handled within his asset management companies. Word of mouth and his extensive connections and reputation, led investors, personal and institutional, to approach his business and invest very large sums. The returns offered were solid and particularly regular, year in and year out. The very regularity actually made some people suspicious, but this was such a reputable and well connected person (ex chairman of NASDAQ) that most investors had no doubts as to the astuteness of their investment decisions.

Eventually pyramid schemes and Ponzi schemes (see box on page 2 for descriptions of these) inevitably crumble, but how long might it have taken if sub-prime loans/credit and so on had not made investors both worry about the safety of their investments, and also need substantial sums back to be able to cope with other needs? The moment it became clear that Madoff would have to pay out large sums, is when the crisis hit. It is known that in early December Madoff told his own sons that the asset management arm of his firm was one big lie.


It does seem extraordinary that such a huge fraud can be carried out over a long period of time – at the US Bankruptcy Court filing in early February 2009 a listing of 162 pages was provided with the names of at least 13,500 clients and some estimates have suggested that the losses may be as high as \$50bn. It is still early days, but investigators have recently suggested that there may have been no actual purchases of securities for the last 13 years or so. That seems unimaginable but...

How did it happen?

This is a good question; sadly it is a question that seems to have been asked many times in the past – Robert Maxwell, BCCI, Enron, Worldcom, and of course the previously mentioned Barlow Clowes among many many examples. Apparently the US

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CCAB Voluntary Code of Practice on Disclosure of Audit Profitability



In September 2008, the Consultative Committee of Accountancy Bodies (CCAB) published an exposure draft of guidance to audit firms on the voluntary disclosure of the financial results of their work on statutory audits and directly related services **R**.

The guidance was developed in response to a request from the Financial Reporting Council (FRC), which hopes that the Code will lead to greater consistency in firms' published reports, as to the definition of the audit segment and the way overheads are allocated to that segment, and thus lead to greater comparability between firms' financial performance. The overall aim is to provide greater transparency for potential entrants to the audit market, resulting in more choice for market participants.

The exposure period ended on 31 December, and the CCAB Working Group, delegated with the authority to issue the Code, was reviewing the comments as *Audit and Beyond* went to press. Publication of a final Code was expected by 31 March 2009.

The draft Code:

1. Defined the reportable audit segment to include all fees for any statutory audit (ie, not just companies) plus fees in respect of work that 'fits

naturally' with the auditor's statutory responsibilities – that is, work either required to be, or in practice tending to be, carried out by the auditor. Examples include, preliminary announcements, regulatory reporting and so on.

2. Required that overheads, as measured and recognised in the firm's financial statements, should be allocated to the reportable segment. The impact of material non-recurring costs should also be disclosed, in order to highlight their effect on profitability.

The exposure draft suggested that the Code should apply to any UK audit firm that is a 'transparency reporting auditor'. This is any statutory auditor with a 'public interest' client – one which has its securities traded on a regulated market. The effect would be to capture approximately 40 audit firms, some of which audit only one public interest entity.

However, application to the smaller firms might be unduly onerous, and the Working Group considered narrowing the scope. Disclosure would be allowed in either the firm's Transparency Report or its Annual Report.

As *Audit & Beyond* went to press, it was announced that the Code will apply to 'major firms' – ie, those with more than ten 'major audits' as defined by the Public Oversight Board. There are currently nine major firms. The Code will apply in respect of accounting periods beginning on or after 6 April 2009.

Desmond Wright *Senior Manager, Technical Strategy Directorate*

'If something sounds too good to be true, then...' *cont'd from page 1*

Securities and Exchange Commission (SEC) investigated Madoff Securities LLC eight times over a 16 year period but came to no clear conclusions. There have been numerous rumours that some advisors somewhere suggested Madoff should be avoided, but their comments don't seem to have been taken too seriously elsewhere. Concerns were raised several times privately to the SEC (and were not widely publicised) that models failed to duplicate the returns and consistency that Madoff was apparently achieving, but again the effect was limited. Some justifiable doubts have also appeared about the abilities and resources of the small US firm of accountants, Friehling & Horowitz, who audited Madoff's empire, but again there is as yet no clear evidence or findings.

Could regulators have done a better job? Should investors and their advisors have done a better job?

Should the auditors have done a better job? Answers will emerge, but, no doubt by then there will have been even more examples of such wide scale frauds. (Did someone mention the name Stanford? No I imagined it! And of course anyone dealing with someone like him will have carried out appropriate due diligence I assume?)

Andrew Guntert *Lecturer with the Mercia Group Ltd and member of the Technical and Practical Auditing Committee*

Postscript:

12 March 2009, Madoff pleads guilty to 11 charges and says he is sorry; so that's alright then...

Ponzi scheme: a fraudulent investment scheme which pays investors returns out of money paid in by other investors rather than from real profits earned. The origin of the name was Charles Ponzi who developed and used the technique in the US in the 1920s.

The term is different from pyramid selling in that individuals tend to invest with the same person rather than bring in ever more people.

Audit quality is important – now more than ever

In the current market when the world's financial markets are in disarray and the global economy has been destabilised, there is an increasing amount of interest in assurance reports that accountants provide. Independent accountants play a vital role in enhancing the reliability of financial information prepared by businesses of all sizes and in all sectors. Now more than ever they are in the limelight, and this creates challenges given the commercial reality of likely pressure to keep fees low.

It is, however, all too easy to blame the accountant when things start to go wrong in business, or when corporate scandals are being unveiled every few weeks. It is also just as easy to misunderstand what the purpose of the assurance report is and what the accountant's role is, and isn't, when providing an assurance report on any aspect of the business.

Reports to third parties

The issue of providing reports to third parties hasn't always been clear cut. Accountants are often asked by a client (or by a third party) to sign a special report that will be used by a third party as part of its decision making process. The accountant is often under pressure from the client to comply with the request as soon as possible as the client's business might be critically dependent on providing the right answer. For example, the client might need a license to carry out a certain type of business, a credit listing or a new loan, and will be unable to receive this until the signed report has been returned to the third party. The problem is that assignments like this, if not managed properly, can prove to be open-ended and accountants may end up unintentionally owing a duty of care to the third parties in certain circumstances.

By signing such reports, misunderstandings may arise that accountants may become the equivalent of insurers or guarantors of the clients' obligations to third parties. However, firms should not agree to do extra work for an extra fee without thinking through the consequences. Before advising clients on the subject, accountants may want to consider their risk management policies and working practices, as they may be taking on a level of risk for a fee that is a

small fraction of the premium that insurers would charge for the same level of risk. With the increase in the audit exemption threshold, assurance and other engagements have become an increasing percentage of smaller firms' work, so firms need to ensure that their approach to this work is in line with best practice.

Guidance issued by the CCAB, *Audit 4/00 Firms' Reports and Duties to Lenders in Connection with Loans and other Facilities to Clients and Related Covenants* **R** was published in 2000 and is based on the law governing duty of care. The Faculty published *Audit 1/01, Reporting to Third Parties* **R** in 2001 which provides guidance to accountants when they receive requests for these special reports.

Request for reports on future income or future solvency

Further guidance can also be found in *Audit 2/01, Requests for References on Clients' Financial Status and their Ability to Service Loans* **R** which provides guidance to firms that receive requests from third parties (for example, banks, building societies, insurance companies and letting agents) for a reference on the financial status of their clients when they intend to obtain a loan or enter into some other obligation.

Accountants should only provide these where there is no need to perform any work, research or investigation to produce the

reference and no fee should be charged. Where lenders are asking for an accountant's opinion or report on pre-printed forms on whether the client will have sufficient income to service a proposed loan, firms should explain to lenders that they are unable to provide such an opinion and are, 'unable to report in positive terms on future income or future solvency' and, 'no amount of enquiry can provide accountants with the assurance needed to enable them to confirm that a client will have sufficient income to service a loan or other obligation'.

The faculty continues to prioritise its work in relation to special reports. More information can be found on its website www.icaew.com/aaf.

Sumita Shah *Responsible for the development of the faculty's policy in relation to risk management*

For the full article see *Accountancy Magazine, April 2009*.

Forthcoming ethics attractions

What new attractions are we expecting on the ethics rollercoaster in 2009/10? Believe it or not, we are likely to see the further consultations and changes to auditor independence requirements and the ICAEW's Code of Ethics. Two engine drivers for these forthcoming attractions are the:

- Auditing Practices Board (APB) and
- International Federation of Accountants (IFAC)

Want to find out more about the key features of the ethics rollercoaster? Read on...

APB Ethical Standards

The APB issued revised Ethical Standards on auditor independence on 4 April 2008 which applies to audits in the UK and ROI for periods commencing on or after 6 April 2008 **R**.

As well as issuing the revised standards, the APB announced in its feedback paper that it intended to undertake further work in the following areas:

- Appropriate period for the rotation of the audit engagement partner and engagement quality control reviewer on listed entity audits
- Managers with a long association with an audited entity becoming key partners involved in the audit
- Independence issues which arise from using internal audit staff to work directly for the audit team
- Possible conflicts of interest arising from the same firm providing auditing services and restructuring services as well as other related issues raised in the Treasury Select Committee report on Northern Rock
- Prohibition on financial interests of new partners joining the firm arising from previous employment
- Amendments to align with the IFAC's revisions to independence requirements included in
- Section 290 (Independence – Audit and Review Engagements)
- Alignment of APB's affiliate definition with that used in the IFAC Code

The APB has now completed this work and published a consultation paper for comments by 15th June 2009 **R**. If you would like to submit your views for inclusion in the Institute's response, please send your comments to ethicspolicy@icaew.com by 30 April 2009.

IFAC's Code of Ethics

All the main accountancy bodies in the world are required to comply with the principles in the IFAC Code of Ethics. So what loops, swoops and crossovers are likely to affect the ICAEW's Code of Ethics?

The first curve stems from the IFAC's Ethics Standards Board (IESBA)'s drafting conventions project. The intention is to remove inconsistencies or ambiguities in the IFAC Code (and therefore the ICAEW Code), but not to change the substance of the Code or the requirements. The key proposed changes include:

- Replacing should with shall
- Replacing ambiguous words such as consider with more specific action words such as evaluate or determine
- Including a temporary departure from meeting specific requirement of the Code, or part of the Code, in exceptional and unforeseen circumstances
- Revising the description of each of the five categories of threat, and clarifying the relationship or circumstance where threats arise
- Replacing the concept of clearly insignificant threats with threats that are not at an acceptable level

IESBA is hoping to finalise the revisions to the Code.

The second curve relates to IESBA's numerous consultations on independence requirements (Section 290 and Section 291 of the IFAC Code). These are summarised on our ethics website pages. It is our understanding that the proposed changes to independence requirements will be included as final and not subject to further consultation in the re-drafted IFAC Code of Ethics. There are a number of changes in this area, but perhaps the most significant relates to the independence requirements for audit and review engagements. Currently, in the UK and ROI, audits must be conducted in accordance with the APB Ethical Standards and review engagements

(Section 290, ICAEW's Code of Ethics). Going forward, IFAC has deemed that review engagements should comply with the same independence requirements as audits. Since the APB's remit is only audit engagements, the ICAEW is considering whether the revised ICAEW Code of Ethics should include an additional section for independence requirements relating to review engagements.

So, potentially, there could be three sets of independence requirements depending on the type of engagement being conducted:

1. Audit (follow APB Ethical Standards)
2. Review engagements (section in the ICAEW Code derived from IFAC Code Section 290) and
3. Non-audit, non-review engagements (section in the ICAEW Code derived from the IFAC Code Section 291)

Have your say

We welcome your views on whether this is an appropriate way to proceed, or whether it would be sensible to have two sets of independence requirements, one for audit and review engagements (follow APB Ethical Standards) and the other for non audit, non-assurance engagements (section in the ICAEW Code derived from the IFAC Code Section 291). Please send your comments to ethicspolicy@icaew.com.

Further developments on these forthcoming attractions and other ethical matters are available at www.icaew.com/ethics.

Anne Davis Ethics Manager, ICAEW

EU debate on choice in the audit market



The impact of the ownership and control requirements of audit firms on concentration and choice at the large company end of the audit market has become an important area of focus in the EU arena. The European Commission recently launched a consultation process **R** which will form the basis of a forward-looking European debate in this area. The current financial crisis and the potential risks of the unintended withdrawal of a major player in the audit market are perspectives considered in the Commission's consultation document.

The adoption of the Statutory Audit Directive represented a considerable step forward in the 'Europeanisation' of the regulatory landscape in relation to the ownership and control rules of audit firms. By requiring audit firms to be owned by a majority of registered auditors approved in any EU Member State, the Directive paved the way for an audit firm registered in one Member State to own an audit firm in another Member State. In recent months certain large audit firm networks have begun rearranging their international structures, making use of the possibilities available under this regime.

The Directive did not, however, introduce changes to the actual thresholds of the ownership and control requirements. As with the antecedent 8th Company Law Directive, the revised Directive requires the voting rights and composition of the administrative or management body to correspond to 'a majority' of registered auditors. The manner in which this provision has been implemented into national legislation can vary across the EU.

A main question explored in the consultation is whether a relaxation of existing ownership rules to allow more external investment (ie capital from non-auditors) into audit firms would have a positive impact in terms of concentration and choice. The Commission notes that a relaxation of ownership rules could allow a number of firms and groupings of firms to raise the external capital to facilitate

organic growth. One of the main conclusions of an independent EU study, undertaken in October 2007, **R** was that audit firms might require significant investments over the years beyond their operating capital in order to enhance their international capability.

In approaching this debate, the Commission appears to recognise that the regulatory framework in which firms and their clients operate can have a significant impact on the evolution of the audit market. What possible 'catalysts' could be pursued to widen the pool of audit service suppliers for the largest global companies?

The consultation focuses attention on a number of possible factors at play. The Commission study, for instance, concluded that the reputation of firms, the differences among firms in international outreach, firms' expertise and human capital, and liability risk were also key elements potentially impacting on concentration and choice. A firm, or grouping of firms, will undertake a holistic assessment of all factors to determine whether there is commercial advantage in expanding its international capability.

Debating the way forward will also demand looking at the overall impact of the Internal Market legislative framework. It is worth noting that the Statutory Audit Directive aims at high-level – though not full – harmonisation of statutory audit requirements. One of the key questions in the present debate is whether an enhanced level of regulatory integration in the EU would remove some of the perceived barriers to international expansion and the costs associated with those barriers. Reducing differences in national

requirements may be relevant in the current debate; in this regard, the Commission notes that further converging or harmonising independence rules and the definition of 'network' within the EU could be aspects for consideration to allow the entry of new players, as they would consolidate cross-border networks and make the profession more attractive.

Auditor independence is seen as a critical part of this debate. It is worth noting that the 2007 study concluded that auditor independence in practice is unlikely to be impaired by alternative ownership structures, and that safeguards could be put in place to address specific conflicts of interest.

Given the various interrelated matters to consider, the EU-wide debate launched with the consultation may have to be approached as part of a broad reflection on the future Internal Market framework for the regulation of audit services and the long-term sustainability of the audit market in light of globalisation.

Pablo Portugal *European Union Affairs Manager, Brussels Office*

Audit conduct and training



CCAB project on audit conduct and training

The project was set up following an earlier initiative by the Financial Reporting Council (FRC) on *Promoting Audit Quality* **R**. The steering committee for the CCAB project is chaired by the Faculty Chair Gerry Murphy, and the purpose is to understand more about the detailed processes behind key audit judgements. For example, how individual members of the audit team are trained and communicate with each other to ensure key issues are identified and appropriate judgements are made by properly qualified people. The final output is expected to be a report to the FRC later this year with recommendations and suggested actions. The detailed terms of reference for the project were previously outlined in the July/August 2008 issue of *Audit & Beyond*.

We have obtained detailed feedback from audit firms on three questions covering:

- How they define a 'significant audit judgement'
- Who in the firm makes these judgements
- The role of junior staff in this process

Key themes identified from firms' responses

There was little difference on matters of principle between the answers from large and small firms and between the approaches taken for different sizes and types of audit. This is probably unsurprising given that all audits are carried out in accordance with International Standards on Auditing (ISAs).

Key themes arising from what firms have told us include:

- Following auditing standards should mean that all significant issues come to the attention of the audit engagement partner who takes full responsibility for the judgements on these issues. Clear documentation is needed to support these judgements including on the planning of the audit, and the supervision and review of the work carried out by junior team members. Significant

judgements include accounting, ethical and pure audit judgements. Good communication within the audit team is an essential part of good judgements being made and should happen within a framework of review, quality control and culture in the firm as a whole that complies with requirements for firm-wide procedures.

- Professional scepticism is key to good judgements and firms say they give as much emphasis to developing this in junior staff as they do to training staff to acquire the necessary technical knowledge and experience.
- Firms aim to put together audit teams with a balance of fresh blood and continuity, ensuring sufficient knowledge and experience of the client. Firms believe that it is important that juniors play their part in audit teams and excluding them from involvement in real audits would be detrimental to the quality of the profession and the development of future audit professionals.
- The technical resources within firms and other help available for smaller firms, eg from the Institute's technical helplines, play an important part in dealing with complex issues. Processes are in place for dealing with disagreements on

significant judgements, eg between the engagement partner and the engagement quality control reviewer.

- There is little awareness within firms of International Education Standards (IESs) including IES 8 *Competence Requirements for Audit Professionals*. However, the view is that these requirements should be met through the professional bodies' qualifications and CPD programmes. There is also a perception of inconsistency (which the steering committee might raise with IFAC) between the collegiate audit team approach taken by following ISAs and IES 8 which seems to focus more narrowly on the competencies of individual audit professionals. The steering committee understands that IFAC intends to develop additional guidance related to IES 8 in the form of a practice statement, although this is at an early stage of consideration. The normal timescale for this type of document to be issued is up to two years.

Initial conclusions and possible actions

The steering committee has identified some initial conclusions and possible actions in response to these key themes, including:

1. Firm-wide quality control (and compliance with ISQC 1 *Quality Control for Firms that*

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Audit conduct and training *cont'd from page 6*

Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements) is vital to ensuring quality on individual audits. The FRC's *Promoting Audit Quality* initiative has resulted in other outputs of relevance to this including the FRC's *Audit Quality Framework* **R**.

2. Having the best people is vital to achieving audit quality and a principles-based approach to the audit will not only lead to concentrating on the most important issues, but will also make the profession more attractive to the best people.
3. The work that firms carry out on the competencies of audit staff needs to be in line with developing standards. Firms should ensure staff are sufficiently independent and approach the audit with a mindset of professional scepticism. The challenge of developing auditors of the future with this mindset needs special emphasis and is related to point 1 above about attracting the best people.
4. Good audit planning at the right time is vital to the efficiency and effectiveness of audits. There should be good communication with the client as part of the planning process.
5. It is important for firms to carry out post audit reviews and to take forward learning points for the next year's audit, other audits and for the development of the individuals involved. Post audit appraisal reviews for individuals should link into firms' overall annual appraisal processes.
6. There could be value in further practical audit quality guidance being issued, eg by the

ICAEW. In addition to the challenge of developing professional scepticism (as above), it could also cover issues such as firm-wide quality control, audit planning, achieving balanced audit teams, post audit reviews and the role of technical departments and engagement quality control review.

7. International considerations are becoming more important and international regulation and standards are being enhanced to reflect this. All relevant parties in the UK, including the regulators, professional bodies and network firms, need to play an active part in helping to achieve good quality global standards.
8. The profession needs to maintain a good dialogue with stakeholders with an interest in the audit process and to deal as needed with concerns they express. There is a need for more to be done to explain the practicalities of auditing to these stakeholders and the reasons why firms operate as they do.

Views of other stakeholders

The steering committee is also obtaining the comments of various other stakeholders on these matters and discussing any particular concerns they have on the issues already identified or any other audit conduct matters arising from their experiences. These stakeholders include the Audit Inspection Unit (AIU), the Institute's Quality Assurance Directorate (QAD), preparers, audit committee members and investors. The AIU and the QAD are providing their views on the firms' responses based on their audit inspections. Investors have emphasised what they see as a vital role played by audit committees in ensuring that high audit quality is maintained.

Chris Cantwell *Manager, Audit and Assurance Faculty*

Bulletin Board

Faculty update

Internal Audit Lecture Series

Monday 20 April 2009

Speaker: Michelle Dixon, 192.com Business Services

Topic: Fraudster's Modus Operandi – inside the minds of convicted fraudsters

Dates for 2009 lectures (topics to be confirmed):

Monday 15 June	Monday 19 October
Monday 7 September	Monday 30 November

For further details, and to book online, visit: www.icaew.com/aaf.

Annual General Meeting

Notice is hereby given that the Annual General Meeting of the Audit and Assurance Faculty is being held on 8 May 2009, commencing at 2.00pm, at the Institute of Chartered Accountants in England and Wales Chartered Accountants' Hall, Moorgate Place, London EC2P 2BJ, for the following purposes:

1. To receive the report and financial statements for the year ended 31 December 2008
2. To answer questions about the activities of the faculty

The Annual Report will shortly be available from the website at: www.icaew.com/aaf

FRC publications

The APB issues a Bulletin containing Illustrative examples of Charity Auditor Reports, see: www.frc.org.uk/apb.

The FRC publishes an Update on Going Concern for Directors of Smaller Companies, available at: www.frc.org.uk.

Institute Representations:

The Institute's representation to the G20 London Summit was launched on 18 March 2009.

See the live webpage at: www.icaew.com/g20.

CAA guidance (AAF 02/09):

Audit & Beyond February referred to forthcoming guidance on changes to the CAA accountants' reporting arrangements. The guidance has been delayed and discussions with the CAA are currently ongoing. The CAA will be announcing new reporting deadlines once discussions are finalised.

RELATED			
Page	Article	Document(s) mentioned	Get a copy
2	Voluntary Code of Practice on Disclosure of Audit Profitability	CCAB's Exposure Draft – <i>Voluntary Code of Practice on Disclosure of Audit Profitability</i>	www.ccab.org.uk/documents.php
3	Audit quality is important – now more than ever	CCAB, <i>Audit 4/00 Firms' Reports and Duties to Lenders in Connection with Loans and other Facilities to Clients and Related Covenants</i> Audit 1/01 <i>Reporting to Third Parties</i> Audit 2/01 <i>Requests for References on Clients' Financial Status and their Ability to Service Loans</i>	www.ccab.org.uk/documents.php?subaction=showfull&id=991300509&archive=&start_from=&ucat=2& www.icaew.com/aaf www.icaew.com/aaf
4	Forthcoming ethics attractions	Integrity in organisations – next steps, June 2008 <i>Audit & Beyond</i> (page 3) APB's consultation on <i>Revised Draft Ethical Standards for Auditors</i>	www.icaew.com/aaf www.frc.org.uk/apb/press/pub1886.html
5	EU debate on choice in the audit market	European Commission's – <i>Audit firms: Commission consults on ways to help create more market players</i>	http://ec.europa.eu/internal_market/auditing/market/index_en.htm
6	Audit conduct and training	FRC's <i>Promoting Audit Quality</i> project FRC's <i>Audit Quality Framework</i>	www.frc.org.uk/about/promotingauditquality.cfm www.frc.org.uk/documents/pagemanager/frc/promoting_audit_quality_responses/Audit%20Quality%20Framework%20for%20web.pdf

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