



AUDIT &  
ASSURANCE  
FACULTY

## re:Assurance

Audit-exempt companies

# BEYOND THE THRESHOLD

ISSUES PAPER



# re:Assurance

An initiative from [the ICAEW Audit and Assurance Faculty](#)

Businesses, investors, government, tax authorities, market regulators and other stakeholders need to be able to rely on credible information flows to make economic decisions and policy. It is therefore vital that there is confidence in the quality of information; people need to have information they can rely on. Confidence diminishes when there are uncertainties around the integrity of information or its fitness for purpose.

Through the *re:Assurance* initiative, the Institute of Chartered Accountants in England and Wales (ICAEW) aims to establish a constructive dialogue on the role that assurance services can play in supporting markets and the economy by giving credibility to information flows. It seeks to explore the practical application of the International Auditing and Assurance Standards Board's Framework for Assurance Engagements and to develop guidance on assurance services to meet emerging market needs.

Further information on the *re:Assurance* initiative, its current work programme and how to get involved is available at [www.icaew.com/assurance](http://www.icaew.com/assurance) or telephone +44 (0)20 7920 8493.

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Audit-exempt companies  
**Beyond the threshold**

Issues paper

# Beyond the threshold

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## Executive summary

The ICAEW is interested in exploring the future needs of audit-exempt companies and is seeking to understand how chartered accountants can support these needs. This includes responding to shifts in the regulatory environment, public perception and market needs in order to help practitioners provide high quality, relevant services to such companies.

To articulate relevant issues and raise awareness, the ICAEW has developed this issues paper. Key issues include:

- the regulatory framework in which chartered accountants perform annual audits for smaller companies;
- the perceived costs and benefits of any further increase in the audit exemption threshold and the impact this could have on professional services that are offered to audit-exempt companies;
- the potential market for a new service for audit-exempt companies positioned between the voluntary statutory audit and accounts compilation; and
- the technical and practical support that the ICAEW should provide through its Audit and Assurance Faculty.

In addition, there are five specific questions on which we seek your comments. For details on how to provide feedback, please see pages 16–17.

This paper also describes the new ICAEW Assurance Service ('Assurance Service') set out in Interim Technical Release AAF 03/06 entitled *The ICAEW Assurance Service on Unaudited Financial Statements* and explains why the Audit and Assurance Faculty has developed the guidance in the current environment. The ICAEW has consulted, and will continue to consult with practitioners, users and preparers after the launch of the ICAEW Assurance Service and will review AAF 03/06 at the expiration of two years.

This paper is part of a series of publications that relates to the Assurance Service. Others in the series include:

- Interim Technical Release: AAF 03/06 *The ICAEW Assurance Service on Unaudited Financial Statements*;
- practical guidance: *Chartered accountant services*; and
- research report: *Company views on the ICAEW Assurance Service*.

The publications are available from: [www.icaew.com/assuranceservice](http://www.icaew.com/assuranceservice).

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# 1. Audit requirements and exemptions

The modern audit, performed by an independent and professionally qualified person, has evolved over the past century as a significant element of company law and governance. It is an extension of the idea of providing reports on stewardship for the benefit of owners that dates back to medieval times.

Audit is an important way of enhancing the credibility of reported information and thereby building confidence and stability in the economy. It is widely seen as enhancing the relationship between management and internal and external stakeholders and lowering the cost of capital.

These views are supported in the recent publication from the Professional Oversight Board (POB): *Review of how accountants support the needs of small and medium-sized companies and their stakeholders* (2006, hereafter 'POB Review'). POB reported that around 180,000 audit-exempt companies opted for a voluntary statutory audit in 2004/5 either for financing and taxation purposes or simply to provide management with additional comfort before filing their accounts (p.34, 2006).

## 1.1 Background

In the late 1970s, EU legislation provided Member States with an option of introducing what was known as an 'audit exemption threshold' whereby companies meeting certain size criteria became exempt from the legal requirement to have an audit. Three times in the 1980s, the Government considered introducing this option into the UK and on each occasion concluded that the audit requirement for all companies should be retained as the balance of costs and benefits appeared to support a legal requirement for companies of all sizes to be audited. However, after further consultations in 1993 and in 1997, the Government introduced an audit exemption threshold, relieving the smallest companies with turnover up to £350,000 from the need to have an audit although they still needed to file annual accounts at Companies House<sup>1</sup> (p.4-5, DTI, 1999).

Since the introduction of the audit exemption threshold, the Government has revised the threshold on two further occasions. In 2000, the turnover threshold was raised to £1 million after a Government consultation. In late 2003, the Government again announced its intention to increase the audit exemption and small and medium-sized company threshold. The latest regulations came into force on 30 January 2004, raising the turnover threshold to £5.6 million, i.e. the EU maximum<sup>2</sup>.

## 1.2 The role of audit for smaller business

When the independent audit was established at the end of the nineteenth century, it was primarily for the benefit of shareholders as a means of protecting their interests following the separation of ownership and control within companies. Clearly, financial information flowing from small business has changed significantly over this time, but the underlying governance framework, being one of accountability, has not. It is therefore reasonable to ask what changes have taken place in the past decades or so that would justify the introduction of, and continued rises in, the audit exemption threshold.

Part of the answer may lie in the fact that, for many smaller and sometimes larger companies, agency conflicts are mitigated through a majority shareholder who may also play a management role in the business, reducing the need for an audit. It may also be the case that the other stakeholders in audit, for example some external financiers, who have in the past claimed an interest in the audit, have become more sophisticated and can obtain, analyse and, in some circumstances, conclude on financial information with sufficient confidence to make their own business decisions. The regulatory cost of protecting the public interest through the statutory audit may also have started to outweigh the public benefits in certain market segments, and therefore a more pragmatic approach may be to allow the market, rather than the law, to drive demand for professional services.

<sup>1</sup> Between 1993 and 1997 audit-exempt companies were given the option of filing an audit exemption report in place of an audit report.

<sup>2</sup> The optional upper limit of small companies will be further raised by 20% resulting from the transposition of the 4th and 7th EU Company Law Directives.

## 2. Regulatory factors affecting chartered accountants

Over the last five years there have been significant changes to the regulatory environment within which chartered accountants operate including changes to the auditing and other professional standards they follow. In part, these changes stem from the desire to restore confidence in the capital markets after Enron and other corporate failures. These changes have often been driven internationally and may be perceived at times at odds with the UK's commitment to support innovation, diversity, growth and the creation of wealth through better regulation with a reasonable balance of costs and benefits.

This section highlights some of the implications of recent changes for chartered accountants and their clients.

### 2.1 Regulatory environment

In the UK, the Government has sought to provide better regulation whilst addressing the risk of major corporate failures, by way of a light-touch regulatory environment which supports the objective of growing the UK's economic strength in international markets. The idea is encapsulated further in the *Regulatory Philosophy* of the Financial Reporting Council (2004, FRC) which states that companies, supported by their professional advisers exhibiting professional judgement and encouraged by the investor community, have the primary responsibility for achieving high standards of reporting and governance. This philosophy views a well-informed market as the best regulator and supports a proactive, risk-based and proportionate role for the FRC, making effective use of regulatory powers when needed and having particular regard to the impact of regulation on small business through the use of regulatory impact assessments.

However, some believe that the most effective means of enhancing confidence in the capital markets is to tighten the regulatory requirements around the independent audit through more explicit and detailed auditing standards. Many recent measures are aimed at the auditors of large listed companies, which may impose disproportionate cost when applied to the audit of smaller business.

The UK accounting profession is an important member of the international accounting community. The ICAEW feeds in its views and experience of audit quality in the course of international standard setting. The UK and Irish Auditing Practices Board (APB) has adopted International Standards on Auditing (ISAs), issued by the International Auditing and Assurance Standards Board (IAASB), with the addition of some further requirements and guidance which the APB considers are appropriate for use in the UK and Ireland. Efforts are being made to deal with particular problems for the audit of smaller entities presented by ISAs, but the combination of audit exemption and increased regulation means that there is a real risk that over time, the range of professional services available to smaller companies will diminish. In the long run, this may mean that core audit skills are confined to larger firms and smaller practitioners withdraw from the audit market altogether<sup>3</sup>.

### 2.2 Auditing standards

In 2004, the APB released a suite of new auditing standards based on the published ISAs, known as ISAs (UK and Ireland). This was primarily in response to the early communication by the European Commission of its intention to adopt international auditing standards in the EU and to reflect new international thinking on auditors' responsibilities regarding risk and fraud.

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<sup>3</sup> There are a number of regulatory bodies and other organisations that require their members to retain the services of a registered auditor for specific regulatory purposes. This may be for the purposes of an audit or some other form of report, such as the Law Society's requirement, under the Solicitors' Accounts Rules, for an Accountant's Report on client monies by a registered auditor. Likewise, certain entities, whose activities are governed by law, are required to engage services of registered auditors such as charities, pension schemes and in grant applications.

While the new ISAs (UK and Ireland) are fairly similar to the previous UK and Irish Statements of Auditing Standards, the new requirements on risk and fraud involve greater probing by auditors and greater documentation of systems and processes. It was anticipated that these changes would be more significant for practitioners who had previously conducted mainly substantive audits. The first audits to be conducted under the new standards were mostly for December 2005 year ends.

Published surveys on the effects of the change have been limited to date. The extent of consequential impacts on the decisions of audit-exempt companies to continue having audits and on the decisions of practitioners as to whether to retain audit registration are uncertain. Anecdotal evidence suggests that, if presented in the right light, business has been generally receptive to the added value provided by audit because of its focus on business controls and the additional probing required under the new standards. Weaknesses in systems that clients were not previously aware of have been brought to light by the new procedures, for instance, and auditors may be able to take the opportunity to root out redundant audit procedures and replace them with ones that are more effective.

The main issues with ISAs (UK and Ireland) reported by smaller practitioners relate to the documentation requirements, and the way in which smaller entity considerations are dealt with. The ICAEW has made it clear to the IAASB that smaller entity considerations need to be dealt with in a much more holistic manner than they are at present. Papers have been presented to the IAASB by the APB making suggestions as to how the burden of documentation requirements for smaller entities might be dealt with. Moreover, regulatory impact assessments are being promoted to the IAASB and a guide to ISAs for SMEs is being developed by the International Federation of Accountants (IFAC).

Another area set to affect practitioners is the IAASB Clarity Project, which is generally expected to be one of the most important changes to auditing standards for many years. The IAASB is seeking to improve the clarity of standards and thereby enhance the consistency of their application as well as to address concerns about the length and complexity of standards and the way in which they are structured. However, in doing so, the IAASB may introduce what are perceived to be a considerable number of additional requirements. The Clarity Project's redrafting programme is expected to be complete by 2008.

The potential effect of the Clarity Project in terms of additional resource requirements for auditors, and, more importantly, the benefits for audit quality, is still unknown. There is general appreciation of the efforts made in order to achieve understandability and less complexity in some of the longer and more complex standards recently issued, but there is also concern that the balance will favour rules to the detriment of principles-based standards.

### 2.3 Auditor independence standards

As a result of Government recommendations in post-Enron reports published in 2003<sup>4</sup>, the responsibility for setting independence standards for statutory audits was transferred to the APB. Whilst the Government reports were broadly supportive of the existing guidance, the transfer of the standard setting process to the APB was believed to be important to maintain confidence in audited financial information.

The APB issued a series of Ethical Standards (ESs) on auditor independence in 2004 effective for periods commencing on or after 15 December 2004. These do not have direct statutory application but the professional bodies were required to adopt them under the provisions of the new Companies (Audit, Investigations and Community Enterprise) Act 2004. A number of concessions were made following extensive representations to the APB by the professional bodies as some of the originally proposed requirements were deemed inappropriate for the audits of smaller entities.

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<sup>4</sup> DTI, 2003, Statement to the House of Commons, *Final report of the co-ordinating group on audit and accounting issues*.

The ESs follow the principles-based approach to auditor independence pioneered by the ICAEW and many provisions are generally similar to the previous ICAEW professional guidance. While some specific non-audit services are prohibited in the ESs, there is no wholesale prohibition. In particular, the ESs usually permit the provision of accountancy services to audit clients other than to listed entities, provided there is a general threats and safeguards assessment.

However, the new requirements are more restrictive than the previous guidance in certain areas. There are a number of inflexible 'bright line' rules that will affect audits of smaller businesses. For example, the economic dependency rule states that a firm cannot act as the auditor where the total fees from a client regularly exceed 10% (for listed) or 15% (for others) of the fee income of the audit firm or relevant part thereof (ES 4) although its application is limited to the situation where such dependency occurs 'regularly' and 'from the client and its subsidiaries rather than from all connected parties'.

### 3. Implications of the audit exemption threshold

The services provided by chartered accountants to companies at the top end beneath the audit exemption threshold may be quite different to those required by smaller, owner-managed companies.

As noted above, the POB Review stated that 180,000 audit-exempt companies chose to invest in an audit in 2004/2005. Respondents told POB that they believed that most companies that were audited saw the audit as 'a cost-effective solution to their internal needs and those of their stakeholders, and wanted the audit to be done properly – meaning (according to these accountants) independently and thoroughly.' The POB Review also reported that directors were willing to invest more to use a firm with a strong local reputation (p.35, POB, 2006).

It is as yet unclear how recent regulatory changes will influence the cost and value of the audit. While many companies may perceive the additional requirements of the new auditing standards as valuable, there is a concern that others may drop the audit without fully appreciating the benefits. There also appears to be some confusion in the market as to the nature and benefits of professional services performed in connection with company accounts (p.2, POB/Open University, 2005) which raises question as to whether companies have all of the information they need to make decisions regarding audit. The POB Review recommended that the professional bodies should seek to provide clearer explanations, for use by practitioners when talking to clients, about the implications of filing abbreviated or full accounts and audited or unaudited accounts and also about how accounting information can aid good financial management.

Based on the DTI's report (DTI, 2005), approximately 883,000 audit exempt accounts were filed in 2004 – 2005. It is unclear whether these companies are fully aware of the implications of unaudited accounts, for example, in relation to the comfort taken by credit agencies from the audit and when loan covenants are due for review.

#### 3.1 Previous responses to audit exemption

Many countries have introduced, or have the option to introduce, audit exemptions. Other countries have responded in different ways: some by providing interpretative guidance on auditing standards for small company audits, some by maintaining the statutory audit requirement for all companies and some by introducing review-type engagements.

##### Interpretation assistance

The Institut der Wirtschaftsprüfer (IDW), a professional accounting body in Germany, has developed auditing guidance for small company audits *Special considerations in the audit of small and medium-sized entities* (2004). The guidance states that it 'highlights the special consideration facing the auditor in the audit of small and medium sized entities ... (and) is neither intended to establish any exemptions from the application of the IDW Auditing Standards for the audit of SMEs, nor is it intended to establish additional or different audit requirements' (p.2, IDW, 2004).

IFAC has approved a project to develop guidance materials on ISAs for use in SME audits for publication in early 2007. In the UK, the APB issued Practice Note 13 *The audit of small businesses* in 1997.

##### Statutory audit requirements

In the EU, under the 4th and 7th Company Law Directives, Member States have the option to exempt small companies from the audit requirement if they meet certain size criteria. Member States may tailor the scope of exemption to certain types of companies and set

local thresholds up to an EU maximum. Denmark, Finland, Greece, Italy and Sweden have, to date, retained the audit requirement for all companies (p.23, DG Internal Market, 2005). These Member States appear to be increasingly under pressure to exempt small companies.

### Review-type engagement

In the mid-1980s the Canadian Institute of Chartered Accountants introduced a review service. The service, positioned between the audit and accounts compilation, requires the accountant to issue a limited assurance report and is available to non-listed companies. It is similar to the review report issued as a result of accountants' work on the interim accounts of listed companies in the UK. The service is now well established in Canada. A review service has also existed in the US for many years. There is no audit requirement in company law in the US although the US Securities and Exchange Commission requires audited financial statements for listed companies.

In the EU, where the maximum audit exemption threshold is an option for Member States, a view is emerging that some form of review engagement could be introduced if the statutory audit requirement is removed for smaller companies.

### Independent Professional Review

In 2001, the APB field tested the Independent Professional Review (IPR) as part of the debate over the proposed increase in the audit exemption threshold included in the Company Law Review. At that time, it was suggested that the IPR be mandated in place of the statutory audit for companies with a turnover between £1 million and £4.8 million<sup>5</sup>. It was anticipated that, if the audit exemption threshold was to be raised, the statutory audit for eligible companies would be replaced by a lighter form of assurance. IPR procedures were restricted to analytical review and enquiry of management.

Field trials were performed by twenty accountancy firms on one of their existing audit clients. Although cost savings were identified, the trials indicated that firms experienced both technical and practical difficulties. They reported problems in performing the specific analytical procedures for small companies where detailed accounting information was not maintained, industry data was not available, and budgetary information was sparse. Where analytical procedures were performed, accountants often found it difficult to obtain satisfactory explanations for trends or variations. Accountants, directors and bankers also found the prohibition in the illustrative Statement of Standards on obtaining corroborative evidence a difficult issue. Furthermore, accountants were uncomfortable with the extent of reliance on directors' explanations.

Almost all accountants also reported that they were uncomfortable with the negativity of the review report, which was perceived as failing to communicate clearly the work performed and the level of assurance provided. Some bankers reported their reluctance to lose the audit, while some directors suggested that the potential cost saving could be used to purchase other services from their accountants.

On the basis of research findings published by the APB in late 2001, the Government concluded that the IPR was not a worthwhile replacement for statutory audit, in particular due to the concern at the lack of corroborative procedures (p.36, DTI, 2002).

## 3.2 Competition with unqualified accountants

Increases in the audit exemption threshold may result in smaller companies losing their historical association with professionally qualified accountants. Successive increases in the threshold may mean a greater number of small companies turning to non-qualified accountants who offer services at a lower cost.

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<sup>5</sup> The EU maximum at the time to which it was proposed the audit exemptions threshold would be raised in due course.

It may not be apparent to companies what a 'professionally qualified accountant' actually means. The general public may not understand the difference in the quality and nature of services provided by qualified and unqualified accountants. Nor may they realise that anyone can call themselves an 'accountant' without any qualification or technical expertise. The risk is that competition based on price introduced by unqualified accountants may cause the quality of financial information to deteriorate over time.

### 3.3 The ICAEW response

To help practitioners deal with the effects of the increase in the audit exemption threshold and other regulatory and market challenges, the ICAEW has lobbied for effective regulation that supports audit quality for all size of business in its responses to regulators and standard setters. In 2004, the ICAEW also researched the views of smaller businesses and its own members on the proposed increase in the audit exemption threshold and contributed to the POB Review by performing member research to identify key issues and the perceived needs of smaller business. It is also closely involved in European and international projects. Other areas where the ICAEW has been active include:

- encouraging the use of regulatory impact assessments in advance of significant change;
- specifically calling for an update of Practice Note 13 on smaller and less complex audits;
- providing practical information and services about new regulation and standards to members to raise awareness via articles, publications and events;
- providing technical and practical guidance on implementation of new standards, for example the recent publication for smaller firms on the policies and procedures required by International Standard on Quality Control 1 (ISQC 1) *Quality control in the audit environment* (2006) and the publication *£5.6 million – threat or opportunity?* (2004), raising the profile of the benefits of audit and considering opportunities for practitioners; and
- assessing its own role in response to the seven recommendations made by the POB Review (p.5, POB, 2006) including the recommendation that professional bodies should consider how, on an ongoing basis, the profession can give directors of small companies a clear explanation of the role of professional accountants, including their professional obligations and the services they offer.

#### Question 1: ICAEW support

What additional assistance should the ICAEW provide to its members to help them maintain their competitiveness in the market place, e.g.:

- a) further technical and practical support;
- b) development of new professional services to meet the needs of audit-exempt businesses; and
- c) literature to promote the qualities of ICAEW practitioners to small and medium-sized businesses?

## 4. Adopting a market approach

In addition to responding to proposed changes in legislation and regulation and updating members on technical and practical issues, the ICAEW also considers professional services other than audit that may be provided by its members in the public interest. Since the latest rise in the audit exemption threshold in 2004, the ICAEW has revised its guidance on accounts compilation and has developed new interim guidance on an assurance service positioned between the voluntary statutory audit and accounts compilation.

### 4.1 Accounts compilation

As early as 2002, the ICAEW commenced revision of its guidance on accounts compilation to communicate more effectively the nature of the work chartered accountants do when the audit exemption threshold was expected to rise again. The revised ICAEW guidance on accounts compilation was issued in 2004 and is consistent with the IAASB's standard.

The POB Review considered 'professional' accountants' involvement in the preparation of accounts and listed three factors which potentially limit the value of compilation reports (p.39, POB, 2006):

- very few sets of accounts on the public record include a compilation report;
- the wording of the compilation reports and the guidelines on which they are based vary across the professional bodies which might cause confusion were the reports to be more widely used; and
- the wording of the report gives users little useful information and does not set out clearly the nature and extent of the accountants' role.

The POB Review recommended a cross-profession compilation report with a straightforward explanation of the extent and relevance of the involvement of professional accountants (p.41, POB, 2006). It suggested the following steps:

- the compilation report could include a positive description of the accountants' obligations; and
- the report could broadly describe the scope of the engagement.

POB envisages that use of a compilation report would remain voluntary. However, it recognises a need for improved clarity and security surrounding reporting the involvement of professional accountants when accounts are filed at Companies House. This would enable the users of accounts to have confidence that, where the involvement of professional accountants is shown, this is genuine. The ICAEW is working with other UK professional accountancy bodies to consider these suggestions. The challenge is to develop a compilation report that users might find more useful without raising expectations that some form of assurance opinion is being given by the accountants and thereby expanding the expectation gap and exposing accountants to greater risk.

#### Question 2: Accounts compilation

- a) What improvements could be made to the existing illustrative report<sup>6</sup>?
- b) Should the guidance for chartered accountants include detailed procedures to follow when performing a compilation engagement?

<sup>6</sup> To view AUDIT 02/04 *Compilation of Financial Statements of Incorporated Entities*, visit [www.icaew.com/aaf](http://www.icaew.com/aaf) and see under 'Technical Releases'.

## 4.2 ICAEW Assurance Service

The concept of a service that involves practitioners issuing a report that conveys less assurance than an audit report is not a new idea. As mentioned earlier, a review service for audit-exempt companies exists in Canada and the US. The idea was once embodied in the concept of the IPR in the UK. Moreover, reviews of interim financial information are a long standing practice for UK listed companies. Building on these concepts, the existing standards in Canada and in the US, and the International Framework for Assurance Engagements issued by the IAASB, the ICAEW has developed an assurance service positioned between the voluntary statutory audit and accounts compilation which could be offered to audit-exempt companies on a voluntary basis.

### Explaining the new ICAEW Assurance Service

The upward trend in the audit exemption threshold was the main factor that prompted the ICAEW to consider an assurance service and to seek to address the issues that had negatively affected the IPR. It set about developing a new professional service that could be offered by members to audit-exempt companies on a voluntary basis.

The ICAEW Assurance Service ('Assurance Service') requires accountants to perform enquiries of management and analytical procedures and based on these initial procedures, to determine the areas where further work, including obtaining corroborative evidence, is required and to what extent. This approach contrasts with the proposed mandatory IPR where procedures were restricted to analytical review and management enquiry. The interim Technical Release AAF03/06 *The ICAEW Assurance Service on Unaudited Financial Statements* is available from the ICAEW website<sup>7</sup>.

The guidance underpinning the Assurance Service is based on the IAASB Assurance Framework that sets out the principles of assurance engagements. Accountants issue a report stating that nothing has come to the attention of them to refute the Directors' statement that confirms their compliance with the Companies Act 1985. The guidance is provided principally for annual accounts prepared in accordance with the Companies Act 1985 although practitioners may find the general principles useful when performing the service for accounts prepared under other legislation such as the limited liability partnership legislation. The form of the conclusion should be familiar to accountants as it resembles the conclusion provided on interim reviews of listed companies.

To help clients distinguish the Assurance Service from the voluntary statutory audit and accounts compilation, there is a practical guide published as part of the series which highlights the key differences. Accountants may find it a useful aid when helping their clients choose the service which would be of most value to their company. The Assurance Service is not an audit, hence the APB Ethical Standards do not apply. However, chartered accountants follow the ICAEW *Code of Ethics* and its independence requirements on assurance engagements<sup>8</sup>.

One of the benefits of the Assurance Service is that it may lend greater credibility than compilation reports to historical financial information to third parties to whom the chartered accountant may agree to provide an assurance report. It may also provide directors an additional degree of comfort on the accounts for which they are responsible.

<sup>7</sup> See [www.icaew.com/assuranceservice](http://www.icaew.com/assuranceservice).

<sup>8</sup> As part of the arrangements to adopt the APB ES, the ICAEW issued a Statement 1.201 *Independence on Assurance Engagements* (ICAEW, 2004) (to be replaced by Section 290 *Independence – Assurance Engagements* of the new Code of Ethics from 1 September 2006). Statement 1.201 (and Section 290 of the new Code of Ethics) sets out independence standards when carrying out assurance engagements other than audit including the Assurance Service.

### Question 3: Assurance Service

- a) As stated at the start of this paper, the ICAEW will seek views and experience on AAF 03/06 for the next two years to refine the guidance. What changes, if any, would you make to AAF 03/06 before it is issued in its final form?
- b) AAF 03/06 has guidance on how to manage professional liability. Do you find the information useful in managing the risks in this type of engagement, in particular in relation to shareholders and other third parties?

#### Views of external stakeholders

The POB Review (pp.37-38, POB, 2006) included the views of users of unaudited accounts. HM Revenue and Customs and the British Bankers' Association have reportedly indicated that an audit was not necessarily required for their own purposes, whilst the Institute of Credit Management stated that the audit would continue to be important in enabling the credit worthiness of a company to be assessed effectively.

Throughout 2005, the ICAEW consulted with key stakeholders including financial institutions on the Assurance Service. This process highlighted two views. Some commentators suggested that companies still had the option of a voluntary statutory audit if they needed assurance and questioned why another service was needed. Others welcomed the service and were supportive of the initiative in particular for companies that have already decided to opt out of an audit.

Some considered that the benefits of an audit were far greater than those provided by the Assurance Service. There are specific procedures in audits, such as tests on systems and internal controls, and work relating to fraud and non-compliance with laws and regulations. In contrast, chartered accountants performing the Assurance Service plan and perform procedures in relation to these areas by exercising their professional judgement. The Assurance Service is appropriate for smaller companies that have relatively straightforward business operations and not for companies that are highly complex or of high risk, for which a voluntary statutory audit may be more appropriate.

On the other hand, having reviewed the guidance, some commentators welcomed the initiative taken by the ICAEW. They considered that the Assurance Service will, on appropriate occasions, be useful to potential lenders when they are considering financial requests from their customers for expansion plans or the acquisition of capital assets. In particular, in the absence of audited annual accounts, the reports may help maintain and develop business relationships. It is likely that lenders would request specific information such as management accounts or on the day to day operation of bank accounts from their existing and potential customers. Even in that case, there would be additional comfort for lenders when the accountants' reports supported the information that had already been made available.

Some questions were raised on the available options where accountants doubt the validity of the annual accounts. The guidance is clear as to when and where accountants may resign from engagements or issue a modified conclusion. When accountants resign from the engagement, practitioners explain to the clients and other parties to the engagement their reasons for resigning, unless this would constitute a breach of legal or other regulatory requirements.

<sup>9</sup> See [www.icaew.com/assuranceservice](http://www.icaew.com/assuranceservice).

### Views of companies

The ICAEW commissioned independent research to understand the views of smaller companies on the Assurance Service and the nature of the potential market. About half of the respondents showed some interest in taking up the Assurance Service. The respondents also explained what potential benefits underpinned their interest in the Assurance Service and what were their concerns. The comments received during the interviews were considered in the refinement of the Assurance Service. The research report is available on the ICAEW website<sup>9</sup>.

This is the first in a series of research projects that we hope to undertake to monitor and consider the services available for the accounts of audit-exempt companies. We intend to carry out follow up research during the next two years.

### Enhancing market understanding

As explained earlier in this section, the ICAEW has developed a practical guide for companies articulating the involvement of chartered accountants in the annual accounts of audit-exempt companies. It is hoped that the brochure will help address the POB concerns around potential market confusion. Companies have been consulted for their views on the practical guide during the independent research, and the feedback was used to improve its content and presentation. The practical guide is available from the ICAEW website<sup>10</sup>.

#### Question 4: Practical guide

How useful do you find the practical guide *Chartered accountant services*? What suggestions do you have for its improvement?

#### Question 5: Support for smaller companies

Do you think the ICAEW provides sufficient support for smaller companies to help them understand the types of service suitable for their business? If not, what additional support should be provided?

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<sup>10</sup> See [www.icaew.com/assuranceservice](http://www.icaew.com/assuranceservice).

## 5. Action

### Asking for your views

The ICAEW welcomes your comments on the issues identified in this paper in particular your response to the six questions. Based on your feedback, the ICAEW will consider its next steps to assist members. Comments are also welcome on any additional matters that may be relevant but not covered in this paper.

### Invitation to feed in your experience

The ICAEW values your experience in performing the new Assurance Service and using the guidance and practical guide in practice. We would also welcome comments from companies and other stakeholders on any aspects of this issues paper or the Assurance Service. We expect to continue consulting with interested parties over the next two years and value your feedback. We are also interested in understanding your views on regulatory requirements, the APB independence standards, ISQC 1 and the recommendations from the review by POB.

### Roadshows

The ICAEW Audit and Assurance Faculty is holding a series of Roadshows in Autumn 2006 to inform members on current topics in relation to ISAs (UK and Ireland), ISQC 1 and accountants' services for smaller businesses.

Further information on the Roadshows *The Essential Audit and Assurance Services Update 2006: The pitfalls and potential benefits for your practice* is available from Tracy Gray on +44 (0)20 7920 8526 or visit our website [www.icaew.com/aaf](http://www.icaew.com/aaf).

### Events to debate the issues and feed into developments

From time to time the Faculty convenes events to discuss significant policy issues and their implications. Using your feedback we will consider the need for specific events.

## 6. How to comment...

Please email or post your comments to:

Email: [tdaf@icaew.com](mailto:tdaf@icaew.com)

Address: **Beyond the threshold**  
ICAEW Audit and Assurance Faculty  
Chartered Accountants' Hall  
PO Box 433  
Moorgate Place  
London EC2P 2BJ  
United Kingdom

Telephone: Jo Iwasaki on +44 (0)20 7920 8786

Unless otherwise stated, comments will be regarded as being on the public record.  
Please indicate specifically if you wish your response to be treated as confidential.  
Standard disclaimers in responses received by email will be disregarded for this purpose.

### **About the ICAEW Audit and Assurance Faculty**

The ICAEW Audit and Assurance Faculty is a leading UK authority on external audit and other assurance activities. It is recognised nationally and internationally by members, professional bodies and others as a source of expertise on all audit issues.

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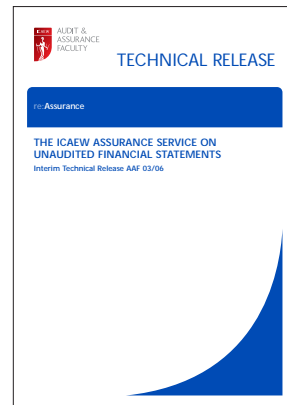
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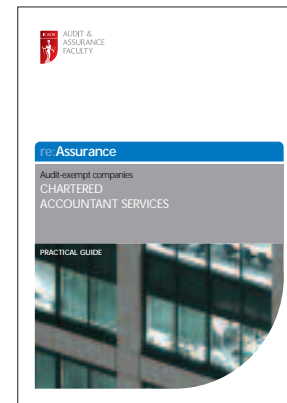
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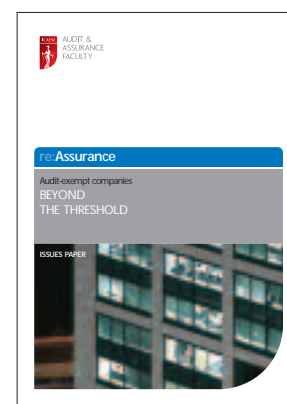
***The ICAEW Assurance Service on Unaudited Financial Statements***

*The guidance for practitioners wishing to offer audit-exempt companies the new ICAEW Assurance Service positioned between the statutory audit and accounts compilation.*



***Chartered accountant services***

*This guide explains to company directors the key benefits of accounts compilation, the ICAEW Assurance Service and statutory audit.*



***Company views on the ICAEW Assurance Service***

*This paper summarises the findings from in-depth interviews with audit exempt companies regarding possible demand for the ICAEW Assurance Service.*