AUDIT & ASSURANCE FACULTY

re:Assurance

ALTERNATIVES TO AUDIT

Report on the ICAEW Assurance Service consultation

re:Assurance

An initiative from **the ICAEW Audit and Assurance Faculty**

All types of business, public and voluntary bodies, investors, governments, tax authorities, market participants and their stakeholders need to rely on credible information flows to make decisions. Confidence suffers when there is uncertainty about the integrity of information or its fitness for purpose.

The Institute of Chartered Accountants in England and Wales' (ICAEW) Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance.

Through the *re:Assurance* initiative, the ICAEW Audit and Assurance Faculty is promoting dialogue about external assurance: finding out what new assurance services could strengthen markets and enhance confidence by making information flows more credible; asking how the International Framework for Assurance Engagements can be applied and developed; and answering demands for practical guidance to meet emerging business needs.

Further information on the re:Assurance initiative, the current work programme and how to get involved is available at **www.icaew.com/assurance** or telephone +44 (0)20 7920 8493. We welcome comments on this publication or related issues. If you have any specific feedback or comments, please email or contact Jo Iwasaki at jo.iwasaki@icaew.com or telephone +44 (0)20 7920 8786.

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Report on the ICAEW Assurance Service consultation

Alternatives to audit

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In August 2006, the ICAEW Audit and Assurance Faculty began a two-year consultation on a new assurance service (the ICAEW Assurance Service), an alternative to audit based on the idea of limited assurance introduced by the International Auditing and Assurance Standards Board (IAASB). This report presents findings from practical experience of providing the ICAEW Assurance Service over the subsequent two years and views of users of financial information that help in assessing the relevance of the service to their needs.

Prior to 1993, all UK companies had their financial statements audited as required by company law. By 2006, however, an increasing and substantial majority of companies were taking advantage of a legal option for smaller companies not to have an audit. Against this backdrop, we decided to instigate a debate on whether a new alternative to audit was needed in the UK market by reference to a specific service.

AAF 03/06, the technical guidance which underpins the ICAEW Assurance Service, draws on the IAASB *International Framework for Assurance Engagements* rather than the existing International Standard on Review Engagements (ISRE 2400). Our initiative met with considerable scepticism based on doubts about demand for a new service and concerns about variability in the procedures followed by practitioners applying professional judgement.

The environment changed dramatically over the two-year consultation period in the UK and internationally. There is now far wider acceptance of the need to look at new assurance services. There have also been questions about the economics of auditing private limited companies, in particular small and medium-sized enterprises (SMEs). The topic of alternatives to audit is now of global concern to the business, regulatory and professional accounting communities and is on the agenda of the IAASB.

Against that background, the ICAEW is publishing this report to share its experience and participate in a global debate. We seek to identify and discuss issues identified through our consultation, where possible, in a way that is relevant beyond the UK. We also describe our experience of how professional accountants approach alternatives to audit, how external users use financial information of SMEs and the challenges of establishing new approaches.

Since the South-East Asian economic crisis at the end of 1990s, there has been growing acceptance of the need to implement high quality and internationally consistent accounting and auditing regimes to encourage international capital flows. One of the consequences is the spread of International Financial Reporting Standards (IFRS). Another is support for a shared global understanding of what a financial statement audit is, summarised in the phrase ‘an audit is an audit’. Nevertheless, recent moves to enhance International Standards on Auditing (ISAs) have drawn attention to the economics of what we refer to as the ‘universal audit’ approach.

The ‘universal audit’ approach, which requires all companies to prepare accounts for their shareholders, to have them audited and to file them at a public registry, is not prevalent or accepted where it once was. The U.S. has never adopted it. In Europe, where the approach was once favoured, deregulatory pressure for increased international competitiveness has led the European Commission and national governments to continually raise audit exemption thresholds. The UK is no exception to the trend. A growing realisation of this has been the key trigger to the ICAEW in exploring voluntary alternatives to audit. There is also a great deal of recent work on the concept of assurance which should be taken into account.

Reflecting on past and current developments, this report supports the need for a comprehensive reappraisal of alternatives to audit, including not only review and assurance services but also agreed-upon procedures and compilation engagements. In doing so, we also consider other possible priorities. These include: agreeing on internationally consistent SME financial information; rethinking SME audit; and simply updating existing standards for review and accounts compilation engagements.

While there are growing signs of engagement within the profession at an international level to consider alternatives to audit, we are also conscious of the need to engage a wide diversity of stakeholders and their different views. The central proposal of this report is that there should be a properly informed international debate led by the IAASB made accessible to a wide range of people. The objective of such a debate should be to develop a common understanding of the issues and language for talking about alternatives to audit, allowing people to communicate effectively across different jurisdictions, reporting regimes, traditions and markets. Rather than leading to new phrases such as ‘a review is a review’ based on uniform global adoption and implementation, standards could be used as a frame of reference by businesses, professional accountants and regulators in different markets and countries.

We believe that the basic purpose of audit and other assurance services is important in enhancing the confidence placed in financial information. This position is supported by the views of external users of financial information. We strongly support the need for professional judgement in providing audits and other assurance services, allowing professionals to exercise a degree of discretion which cannot simply be reduced to the application of written standards or the completion of a predefined set of procedures. In such engagements, the engagement partner will need to show leadership and take responsibility for the report that is issued.

A properly informed global debate will bring benefits, for example: sharing learning and knowledge; allowing choice and diversity; and supporting economic development. There are also a number of significant challenges, including: demonstrating the benefits of assurance; dealing with the concepts of limited and moderate assurance; recognising the limits of standards in codifying activities such as the exercise of professional judgement; and establishing reporting conventions. These should be addressed through an inclusive and comprehensive international debate in which we believe the IAASB is best placed to play the leading active role.

1. THE IMPORTANCE OF ALTERNATIVES TO AUDIT

In August 2006, the ICAEW Audit and Assurance Faculty began an extended consultation on a new assurance service, an alternative to audit based on the idea of limited assurance as introduced in pronouncements of the International Auditing and Assurance Standards Board (IAASB).

The ICAEW Audit and Assurance Faculty launched its Assurance Service as part of the *re:Assurance* thought leadership initiative. The Faculty's work has subsequently attracted interest from around the world. It deals with a topic that affects the overwhelming majority of businesses in the world and is vital to many accounting firms. This report presents findings from practical experience of providing the ICAEW Assurance Service and from research with banks and credit reference agencies to help assess the relevance of the service to their needs.

Throughout this report, we have used grey boxes to indicate consultation findings. We have also used grey boxes to incorporate briefings on historical and technical background information. The use of these boxes has enabled us to focus on setting out a consistent narrative while providing supporting information where applicable.

1.1 Background

The result of an audit is a report in which a professional accountant expresses an opinion on the truth and fairness of financial statements. Prior to 1993, all UK companies had their financial statements audited because this was required by company law. Therefore in the UK there was little demand for other types of professional opinion, although there was some practice of giving other types of report which described compilation work or the results of performing agreed-upon procedures on financial information. However, by 2006 an increasing and substantial majority of companies were taking advantage of a legal option for smaller companies not to have an audit. Against this backdrop, the ICAEW decided to instigate a debate on whether a new alternative to audit was needed in the UK market by reference to a specific and tangible service that people could discuss.

The ICAEW launched a new assurance service and, to enable its members to offer it to clients, it issued guidance in the form of Interim Technical Release AAF 03/06 *The ICAEW Assurance Service on Unaudited Financial Statements* in August 2006. This was supplemented by: an issues paper, *Audit-exempt companies: Beyond the Threshold*; a practical guide for distribution to clients with comparisons to accounts compilation and audit, *Chartered Accountant Services*; and a research paper, *Company Views on the ICAEW Assurance Service*.

The new service was not a UK application of the existing International Standard on Review Engagements (ISRE) 2400. In the period since it originally issued ISRE 2400, the IAASB had published its *International Framework for Assurance Engagements*. The IAASB framework contained some new thinking which the ICAEW drew on in developing the new assurance service described in Briefing 1.1 below.

Briefing 1.1: Description of the ICAEW Assurance Service

The ICAEW Assurance Service was aimed at companies that qualify for exemption from statutory audit but where directors and shareholders still want some independent work done on the statutory accounts to give an additional degree of comfort. It enables companies to present the accounts with greater credibility to third parties to whom chartered accountants providing the service agree to provide their report.

In providing the service, chartered accountants discuss the results shown in the accounts in greater depth with directors and company staff than would be the case if they were simply compiling the accounts. They also compare information in the accounts with other relevant information to see if it is consistent and makes sense.

Any necessary further work is tailored to the company involved and is planned and performed in accordance with ICAEW guidance. Although it is less extensive than the work involved in an audit, it is designed to address significant risks of material misstatement that come to the chartered accountants' attention.

If chartered accountants have any unresolved doubts about the validity of the accounts or if there is a material limitation in the scope of the work, then they should not issue a report or allow their name to be associated with the accounts concerned. Otherwise they issue a report which says that nothing has come to their attention to refute the directors' confirmation that the accounts give a true and fair view.

Chartered accountants are subject to the Code of Ethics and additional independence requirements for assurance services issued and enforced by the ICAEW.

We announced a two-year consultation period and planned, if there was evidence of demand for the service, to issue final guidance that would reflect feedback from delivering the service in practice. In the UK, the ICAEW initiative met with considerable scepticism from many ICAEW members, other professional bodies, the Auditing Practices Board (APB) and the Professional Oversight Board for Accountancy (POBA), later renamed the Professional Oversight Board (POB). This was principally based on the belief that it was more important to agree on the standards and guidance that should be applied in performing and reporting on the two services that were already offered in the UK market, namely the audit and the compilation service. It was argued that until this was done, it was impossible to know if there was a gap for the new assurance service, there would be no demand for it, and it would simply generate market confusion.

Commentators also referred to the failure of a UK initiative in 2002 to launch a new mandatory review service, the Independent Professional Review, and argued that this showed there was no demand for a new service. Furthermore, a technical objection was that the ICAEW Assurance Service relies too much on the exercise of professional judgement and, specifically, does not provide detailed prescriptive guidance to professional accountants about the procedures that they might need to apply in providing the service. In this respect, the ICAEW guidance contrasts with ISRE 2400 which has an appendix containing some 90 illustrative procedures. Consequently, the APB and the POB continue to believe that there will be unacceptable variability in the procedures followed by different professional accountants in similar circumstances.

1.2 International developments

The environment changed dramatically over the two-year consultation period. In the UK, there is now far wider acceptance of the need to look at new assurance services. The issue of alternatives to audit has also become an international one and the subject has featured at a number of conferences and forums around the world. Along with changes in relevant legislation, a number of European countries have introduced or extended audit exemption for companies below certain size thresholds. Internationally, there are major economies including the U.S. where only publicly quoted companies are required to file audited accounts. More recently, there have been questions about the economics of auditing many private limited companies, in particular small and medium-sized enterprises (SMEs). The topic of alternatives to audit is now of global concern to the business, regulatory and professional accounting communities and it is on the agenda of the IAASB.

Although our experience indicates that the interim guidance AAF 03/06 for the ICAEW Assurance Service is fit for purpose even in a changed international environment, the ICAEW thinks that issuing final guidance at present might send a wrong signal that, in our view, debate on the subject of alternatives to audit is over. That is why we are keeping the interim guidance in place. We are however publishing this report to share our experience and participate in a global debate that still has some way to run.

We are issuing this report to surface and discuss key issues in the debate so that different options can be understood. Participants in the debate may be hindered either by unfamiliarity with the relevant technical and policy considerations or by a natural tendency to discuss them purely on the basis of the environment with which they are most familiar. In this report, we seek to identify and discuss these issues, where possible, in a way that is relevant beyond the UK. We also present our own current views, drawing on the Audit and Assurance Faculty's experience in developing and consulting on the ICAEW Assurance Service and other professional services related to financial information of companies for which no mandatory audit is required.

We also wish to contribute to the global debate by sharing our experience of how professional accountants approach alternatives to audit, how external users use financial information of SMEs and the challenges of establishing new approaches. The issues being discussed now at an international level are ones on which we have been engaged for many years.

1.3 Consultation process

This report uses evidence gathered over the course of the ICAEW's two-year consultation period, and subsequently, to support views expressed about the future development of alternatives to audit. Our evidence gathering was strongly influenced by the scepticism referred to earlier among regulators and others about the discretion allowed to professional accountants by the ICAEW Assurance Service. The basis on which we sought input from professional accountants is summarised in Briefing 1.2 below. The selection methods used do not purport to be random and the findings may not be representative of all professional accountants. Nevertheless, we think that they are appropriate for the purpose of understanding practical issues arising on implementation of the ICAEW Assurance Service.

Briefing 1.2: Evidence gathered from professional accountants

ICAEW staff attended numerous meetings across the UK to discuss the ICAEW Assurance Service with groups of professional accountants and interacted with professional accountants at roundtables, interviews, local practitioners' meetings, and national training roadshows which discussed the guidance and practical implementation issues. Staff also reviewed individual engagements.

In total, between September and December 2008 we looked at 27 engagements of volunteers who performed the Assurance Service over the consultation period, by reviewing files and talking to the practitioners involved. They covered a wide range of industry sectors and locations across the UK and were the responsibility of nine engagement partners who generally supervised one or two other team members. Of the predominantly owner-managed companies covered by the 27 engagements:

- 18 had turnover of up to £1 million and only two had turnover over £3 million;
- 24 had a balance sheet total of no more than £1 million; and
- 18 had 20 or fewer employees.

The engagement partners whose engagements we reviewed were volunteers identified through contact with ICAEW staff supporting ICAEW committees and performing quality assurance reviews of ICAEW-registered firms. The engagements reviewed were selected by the partners involved.

Prior to the launch of the consultation, we conducted in-depth interviews with a small number of audit-exempt companies to understand their views on non-audit assurance services. From this exercise, we learnt that their interest in a potential new service depended on the views of external users of accounts, including banks and credit reference agencies. This insight prompted a further focus in our evidence gathering on credit decisions as summarised in Briefing 1.3 below.

Briefing 1.3: Evidence about credit decisions

During the two-year consultation, the ICAEW contacted banks and credit reference agencies (CRAs) to understand: how they make decisions over their SME customers; how they use SME financial information, in particular focusing on entities that are not audited; how they obtain comfort over financial information; and the role of external assurance.

We met people who make decisions relevant to SMEs in various capacities. These include: making risk assessment decisions in banks; setting up credit and banking policies in banks and CRAs; SME market research; trade credit decisions; and providing credit insurance.

We conducted interviews with staff at three of the four major UK banks that were identified as accounting for 80% of the UK SME market and they were involved, or had extensive experience, in credit management of SMEs, including making credit risk assessments and decisions, setting up credit and banking policies, SME market research, and communication with SME customers. The interviews were carried out between June and November 2007 before the recent economic downturn accelerated.

During the same period, we also conducted interviews at all the major UK CRAs with staff involved in trade credit, credit policy setting and credit insurance.

2. THE CURRENT SITUATION

To understand recent international interest in alternatives to audit, it is helpful to trace recent developments in audit-related standard setting in response to changing economic circumstances and events.

By 1995 there was a body of international standards produced by the International Auditing Practices Committee (IAPC) for services provided by professional accountants on financial statements covering audit, review, compilation and agreed-upon procedures engagements. Broadly speaking, these international standards accommodated the relevant and varied standards of the major national auditing standard setters but were themselves adopted only by countries that did not have their own standard setter.

2.1 Changes in auditing standards

Over the past decade, there has been continuing and significant development of International Standards on Auditing (ISAs) relating to financial statement audits, but virtually no changes to international standards for other types of financial statement engagements. This development of ISAs has been a response to changes in business, in investor and regulator expectations, and in audit practice and thinking. Now, the recent development of ISAs is prompting a similar need to revisit and develop standards for alternatives to audit and this is reflected in the *IAASB Strategy and Work Program, 2009-2011*.

It was the South-East Asian economic crisis at the end of the 1990s that highlighted a need for countries to implement accounting and auditing regimes that were consistent with, and comparable to, the best in the world. Unless they did, they could not expect to attract international capital into their securities markets and to benefit from financial globalisation. These messages were further reinforced by the global reaction to Enron and other corporate collapses in 2001 and 2002 and pressure for improvements in auditing standards.

These crises provided impetus to the improvement and adoption of international accounting standards which were relaunched as International Financial Reporting Standards (IFRS) by a reformed and renamed International Accounting Standards Board (IASB). Crises similarly raised the profile of ISAs and prompted initiatives to make them more demanding and to reform the standard setter which as the IAASB, rather than the IAPC, is still part of the International Federation of Accountants (IFAC) but is now overseen by the Public Interest Oversight Board (PIOB).

Furthermore, there has been growing acceptance of the need for a shared global understanding of what a financial statement audit is, summarised in the phrase 'an audit is an audit'. The case for this is summarised and supported in IFAC Policy Position 2 *IFAC's Support for a Single Set of Auditing Standards: Implications for Audits of Small- and Medium-sized Entities*. A further strengthening of auditing standards is due to take effect as a result of the IAASB's recently completed Clarity Project which is designed to identify the auditor's overall objectives when conducting an audit in accordance with ISAs, clarify the related obligations imposed by the requirements of the ISAs and thus eliminate ambiguities about those requirements. The needs of international capital markets now have an important influence on what constitutes an audit.

That is not to say that ISAs are only suitable for listed companies; this is evidenced by the adoption of ISAs by the APB for all audits in the UK and Ireland from 2005 and the APB's recent support for Clarified ISAs. ISAs also do not follow the model of an integrated audit of financial statements and internal control over financial reporting followed by the Public Company Accounting Oversight Board (PCAOB), the U.S. auditing standard setter for publicly traded companies registered with the U.S. Securities and Exchange Commission (SEC). It is therefore not a surprise that ISAs have also been chosen as the basis for the current and future work of the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) which continues to set auditing standards for U.S. private companies.

Nevertheless, the influence of securities market participants and regulators is seen by some as disproportionately increasing the cost of doing audits of the financial statements of smaller companies. This concern is also addressed by *IFAC Policy Position 2*. Working with the IFAC Small and Medium Practices Committee, the IAASB strives to ensure and demonstrate that ISAs are not unnecessarily burdensome for SMEs and to help professional accountants apply ISAs to them. Nevertheless, recent moves to enhance the clarity of auditing standards and their uniform application have drawn attention to the economics of an approach to financial reporting and audit reflected in many company law regimes, including EU company law directives. We refer to this as the 'universal audit' approach.

2.2 Universal audit under threat

In broad terms, the universal audit approach requires all companies to prepare accounts for their shareholders, to have them audited and to file them at a public registry where they can be accessed by parties who might do business with the company.

It is particularly important to bear in mind that the U.S. has never adopted the universal audit approach. To this day, there are no requirements for the public filing of audited financial statements under state corporation law. The U.S. instead developed its own quite distinct capital markets model of audit. In the U.S., audit is principally a requirement for publicly traded companies registered with the SEC which was established through the federal securities legislation introduced in the 1930s after the 1929 Wall Street Crash.

Globalisation has created pressure for more demanding accounting and auditing standards. It has also put pressure on national governments and international bodies such as the European Commission to reduce administrative burdens so that their economies remain internationally competitive. One area for scrutiny is accounting and auditing where comparisons are made with the U.S. and countries adopting a similar model.

EU company law directives have, however, long departed from the principle of universal audit and contain options for member states to incorporate into national law various size thresholds for companies below which an audit is not required. Deregulatory pressure to relieve private companies of administrative requirements has led both to a continual raising of thresholds and member states' increased willingness to incorporate exemptions into their national law. The result has been that companies that meet primarily size-based criteria have been relieved of audit requirements as national governments attempt to meet the political goal of deregulation. The removal of audit requirements in regimes that still require the public filing of statutory accounts will mean that there is a growing number, in the millions, of unaudited accounts publicly filed across the EU.

The UK had already been facing challenges to the universal applicability of audit partly as a result of introducing more demanding auditing standards and independent monitoring of their application in the 1990s. 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. Yet, for most small owner-managed companies this is not an issue. In 1993, the UK took the first of several steps to make use of options in EU law to exempt smaller companies from audit. By 2006, there were just over one million companies, or about two-thirds of all UK companies, publicly filing unaudited accounts. This helps to explain why members of the ICAEW Audit and Assurance Faculty felt the need to explore voluntary alternatives to audit.

Although the accounting profession is rightly keen to try and ensure that the economics of auditing standards do not unnecessarily restrict the availability of audit to all companies, the increasing number of unaudited accounts indicated that there is a public interest issue to consider. A growing realisation of this has been evident to the ICAEW and its members during the development of the ICAEW Assurance Service and subsequent consultation. In the U.S., for example, review engagements as an alternative to audit for private companies had become well-established over time and standards for them were introduced in 1978. Practitioners and their professional bodies also appear to be moving their position from denying the potential need for alternatives to audit and accepting them as not only inevitable but also desirable.

Briefing 2.1: FEE survey of EU assurance and other services

Following recent developments in Europe, particularly increases in the audit exemption thresholds in 2007 and 2008 and various proposals to introduce new services for audit-exempt companies, the Fédération des Experts Comptables Européens (FEE) decided to look at alternative assurance and related services in EU member states.

FEE sent out a survey to professional accountancy bodies, most of which are national standard setters, to develop an inventory of the different alternative assurance and related services for smaller entities that are available or under development. The survey took place between January and April 2009 and received responses for 26 of the 27 EU member states and two other countries. The survey predominantly covers voluntary services and there was some degree of subjective interpretation of the survey questionnaire by respondents which is reflected in the following summary.

Briefing 2.1: FEE survey of EU assurance and other services (continued)

The types of services provided and planned are broadly classified as accounts compilation and agreed-upon procedures services (non-assurance engagements), moderate level or limited assurance services (eg, reviews) and reasonable assurance services. They covered not only services related to the historical financial statements of private companies but also other subject matter such as internal controls and other types of preparers including listed companies, charities and partnerships.

In relation to the financial information of private limited companies that are audit-exempt, eight countries reported having standards or guidance on agreed-upon procedures and nine on accounts compilation services. These are broadly based on the standards issued by the IAASB, namely ISRS 4400 and ISRS 4410.

There is a wide variety of moderate level and limited assurance services. Ten countries have adopted ISRE 2400 and nine have standards or guidance for other types of moderate level or limited assurance services. In one country there are limited assurance engagements based on the IAASB Assurance Framework, and in two of them there is assurance reporting on the underlying records which the practitioner subsequently uses to compile accounts.

There are three types of engagements that involve the provision of a positive opinion that appears to express reasonable assurance. One of them is a service based on ISRE 2400 but with a conclusion that is positively worded. A second involves detailed examination of accounting records culminating in a positive assurance opinion and a third involves continuous examination of internal controls on the basis of which a positive assurance opinion is issued.

Despite the importance of legislative requirements for the audit of published financial statements, it also needs to be recognised that auditing standards are also applied in other areas. For example, audits are often required under contractual arrangements or by industry regulators or trade associations. In these cases as well, there are increasing economic pressures to develop cost-effective alternatives to audit that meet the needs of the parties involved.

Recent changes also have important ramifications for developing economies across the globe. For example, the World Bank in its Reports on the Observance of Standards and Codes (ROSC) takes ISAs as the benchmark standards against which national practices are assessed. However, ROSC work on auditing primarily focuses on entities of significant public interest because of their business, their size, their number of employees or because their corporate status is such that they have a wide range of stakeholders. SMEs are not covered even though, as a whole, they are vital to economic development. If ROSC work addressed financial reporting by SMEs, it might be able to make a more thorough assessment of a country's development needs. In this context, it seems clear that international agreement about benchmark standards for alternatives to audit would be very helpful.

2.3 A new agenda

The IAASB now faces real challenges in relation to alternatives to audit. It has a suite of quite old standards for review, agreed-upon procedures and compilation engagements (ISRE 2400, ISRS 4400 and ISRS 4410) which accommodate a range of national practices and services. In this respect, they are similar to the ISAs of the mid-1990s. The IAASB also has a more recent framework for the provision of audit and other assurance services which is inconsistent in some aspects with the standards for alternatives to audit that predate the framework. And, the IAASB faces a range of national initiatives to develop new services to respond to the needs of audit-exempt companies and their stakeholders. There is acceptance that the IAASB needs to demonstrate that it is committed to serving the needs of its SME stakeholders by taking the lead on alternatives to audit.

In revisiting its standards on alternatives to audit, the IAASB needs to bear in mind that it and its predecessor, the IAPC, have done a great deal of work on the concept of assurance since its non-audit standards were last revised. Much of this work was driven by a desire to address increasing demands for information on a broad range of subjects, not just financial statements, and the consequent, perceived need for services to enhance the credibility of such information.

This work is summarised below in Briefing 2.2. It has implications for alternatives to audit related to financial statements even though its extensive consideration of the determination of appropriate subject matter and criteria is largely irrelevant in the context of historical financial information produced according to established financial reporting frameworks.

Briefing 2.2: A short history of assurance

The IAPC issued an exposure draft *Reporting on the credibility of information* in 1997 which introduced the concept of a continuum of assurance with the level of assurance being determined by the interrelationship of four variables: subject matter; reporting criteria; nature, timing, and extent of procedures; and quantity and quality of evidence available. However, many commentators said that the concept of assurance as a continuum would be difficult to apply in practice and to report with the necessary precision. A further exposure draft *Assurance Engagements* in 1999 retained the concept of the continuum, but restricted the levels of assurance provided to two levels: high and moderate. Respondents generally agreed with the concept of a high level of assurance but found the explanation of moderate assurance insufficient and difficult to communicate.

The two levels of assurance subsequently appeared in 2000 in ISAE 100 *International Standard on Assurance Engagements*. The standard provided the definition and requirements for a high level of assurance but left the determinants of a moderate level of assurance to subsequent research. At that point, two views were presented as to how a moderate assurance engagement could be conducted. These two views were the so-called 'interaction of variables' view, found in the 1997 and 1999 exposure drafts, and the 'work effort' view. On the latter view, the subject matter, reporting criteria and availability of evidence all needed to have certain minimum characteristics for an assurance engagement to be performed at all. Consequently, only variations in the nature, timing and extent of procedures (ie, the work effort) would affect the level of assurance.

To help resolve the issue of levels of assurance, the IAPC commissioned research. In 2002, the results were published in *Determination and communication of levels of assurance other than high*. The paper reviewed the relevant academic literature and attempted to substantiate the concept of the moderate level of assurance by conducting a survey of companies and other stakeholders to identify their expectations. The study supported the interaction of variables view and analysed the practical problems associated with establishing conventions for communicating levels of assurance.

The IAPC also sought external input to assist in its work and in 2003, FEE published an issues paper entitled *Principles of Assurance: Fundamental Theoretical Issues with Respect to Assurance in Assurance Engagements*. The FEE paper explored the concept of assurance and introduced the concepts of reasonable and limited assurance. Reasonable assurance was seen as a relative concept which depends on the circumstances, and may vary over time and across different subject matters and criteria, engagement processes and jurisdictions. The paper also argued that professional accountants do not 'provide assurance' but instead use assurance reports to convey the assurance the professional accountant has obtained so that the user can obtain their own assurance. Anything less than reasonable assurance was by definition limited assurance and it was for professional accountants to communicate the way in which the assurance they had obtained was limited thorough their reports.

The FEE paper had a significant impact on standard development. The IAASB separated ISAE 100 into two documents in 2004. The fundamental elements of an assurance engagement are defined and described in *International framework for assurance engagements*, intended to apply to all assurance engagements including audits and provide a frame of reference for preparers, users and professional accountants. Basic principles and essential procedures for the performance of assurance engagements are set out in *ISAE 3000 Assurance engagements on subject matters other than historical financial information*.

These documents introduced the terms reasonable assurance and limited assurance in place of high and moderate levels of assurance. The number of specific standards and pieces of guidance developed based on the IAASB Framework and ISAE 3000 remain limited to date although an explicit aim of the ICAEW *re:Assurance* thought leadership programme has been to test the practicality of the IAASB Framework, for example in the development of the ICAEW Assurance Service.

Reflecting on past and current developments, this report supports the need for a comprehensive reappraisal of alternatives to audit. Before setting out a vision for that reappraisal and considering both the potential benefits and the challenges that it will need to surmount, we consider other views that we have taken into consideration as possible alternatives to the one adopted in this report:

- reaching agreement on SME financial information (2.4);
- reclaiming the audit for SMEs (2.5);
- updating current review products (2.6); and
- enhancing compilation services (2.7).

We conclude that all these alternatives raise important issues that need to be considered, but that this will best be achieved within a broader reappraisal of alternatives to audit.

2.4 Reach agreement on SME financial information?

Don't we first need to decide what SMEs should report? It can be argued that a wider conclusion is needed on the use of financial statements, particularly SME accounts, before deciding what type of alternatives to audit might be appropriate to assess the reliability and enhance the credibility of such financial information. In short, it can be argued that the debate on alternatives to audit should await the finalisation and implementation of the IASB's deliberations on the IFRS for SMEs and other potential reforms such as the European Commission's simplification proposals exempting micro entities from accounts filing requirements and revision of the Accounting Directives and their implementation in member states. Some may argue that other national initiatives should also take precedence before discussing assurance needs. It might also be appropriate to consider the effect of widening accounts preparation exemption to all non-quoted companies as in the U.S. and in Canada. Some might see this as a public interest issue, in particular where filing requirements for limited companies currently exist.

However, in our view, the issue of alternatives to audit is relevant globally and the solutions should be generally applicable to all forms of financial reporting. We therefore think that it is unconvincing to argue that progressing this issue should await some particular reform of financial reporting, no matter how important that reform might be to the SMEs and other parties affected by it.

It is also important for the accounting profession to appreciate the sheer variety, volatility and variability across sectors and countries of the financial and non-financial information available to those who make financial decisions about SMEs, such as banks and CRAs. Financial and non-financial information needs are driven by users and change because market needs change. The variety, volatility and variability are likely to persist and are logically distinct from questions about whether and to what extent decision makers should give extra weight to particular pieces of financial information depending on whether they have been subject to audit or some alternative to audit.

The financial information that is available on SMEs matters to economic decisions and those taking part in the debate on alternatives to audit need to understand not just what information is used but also how it is used. For example, Finding 2.1 below summarises how information is used in the UK market to assist with credit decisions.

Finding 2.1: A wide range of information impacts credit decisions affecting SMEs

Banks and CRAs use accounting and non-accounting information in making decisions affecting SMEs. However, the use and extent of reliance on each type of information differ between these two types of stakeholders and according to the size and other characteristics of SMEs.

Banks request financial information to make initial lending decisions and to perform subsequent monitoring. Profit and loss, balance sheet, cash flow (for larger companies) and aged debtor information is relevant. Management accounts, ideally quarterly, are also used if available.

Banks also use non-financial information including market prospects and key risk indicators. Such information is not company-specific but provides a framework against which to assess the way in which the company operates. This is the same for new or existing customers. In the recent past, information about the availability of readily realisable security has not been very important as banks considered lending to asset-poor businesses if the cash flow was thought to be dependable.

CRA and credit managers use a variety of information in their predominantly automated decision-making process. Some information is routinely collected, sometimes by external data processing agencies, whereas other information is collected manually and used by exception. Generally, the more information is available, the greater the confidence that an accurate credit risk assessment can be made. In contrast, limited information leads to greater prudence in decision making. The information typically extracted from publicly filed annual accounts and used for automated processing includes: turnover; profit/operating profit; net assets; liquidity; form (eg, incorporated) and type of business; length of time in business; number of staff; and number of branches.

Information is primarily extracted from the annual return filed at Companies House and is incorporated into the scoring card, weighted and classified to calculate the credit rating for a business. If a company files a set of abbreviated accounts, the rating may not be calculable as a result of insufficient information being available and this adversely affects the company's credit status. When additional information such as a change in management becomes available or a new annual return is filed, the information is fed into the system to revise the rating. Scoring models are usually revised every few years based on historical trends. When there are macroeconomic issues, risk analysts may obtain further information (eg, sector specific information) and provide manual, additional notes for customers. Directors' information is also extracted from annual returns along with their history of directorships at previous companies.

CRAs also regularly collect information from sources such as trade gazettes, trade body membership lists, VAT registrations and consumer credit licence listings. Information such as credit payment history from suppliers (eg, utility companies) may also be used to understand the cash flows of businesses. Information on matters filed at County Court, charges on assets, use of abbreviated accounts and accounts being unaudited or qualified all have a negative impact on a rating.

Sometimes, automated systems return a rating which is insufficient for a potential trading partner and the business may try to improve their credit rating. In these circumstances, additional information may be sourced, including management accounts, director records and profiles, interviews with management, references, and involvement of professional accountants both internal and external. This type of information is however not generally collected due to cost constraints.

It is also clear that regulatory decisions regarding the availability of financial information in particular do have potentially major impacts on the granting of credit. We summarise our evidence in Finding 2.2 below. As a consequence, discussion about the future of SME reporting is vital, even if it can be dealt with separately from the debate over alternatives to audit.

Finding 2.2: Non-availability of information reduces credit availability

There are situations where regular accounting information is unavailable from companies for various reasons. These situations are dealt with differently by banks and CRAs, but in some cases negative decisions for businesses may follow.

Where full statutory accounts are not available, banks may use other types of information which enable them to work around the problem, such as detailed year-end management accounts, internal examination or limited scope external due diligence. Some banks have systems, for example of behavioural scoring, to assess companies without a set of accounts if they have operated banking arrangements for the companies for some time. These systems will not, however, provide a sufficient basis for decisions to be made about those wishing to switch banks, start-ups or relatively large companies.

Finding 2.2: Non-availability of information reduces credit availability (continued)

Even if the UK follows the U.S. model and audit requirements on non-listed companies are progressively removed, bank respondents believed that they should be able to rely on their own information sources and retain the ability to ask for full accounts. They also thought that the skill and experience of their own staff would be sufficient to make banking and lending decisions. However, they acknowledged that if publicly available financial information becomes limited, there may be an impact on the robustness and cost of external credit ratings which is one of the information sources that banks use.

The record of transactions and the use of bank accounts can also be used to assess credit-worthiness, financial stability and liquidity for most companies. In five years' time, this approach may be applied to an even larger segment of customers and may reduce the use of manual credit assessment. The approach has been in place in the U.S. where unlisted incorporated companies do not file accounts. UK banks may follow suit and accounts might therefore become less relevant.

CRA representatives thought that the impact of deregulation is likely to be more severe for them than for banks that have an on-going relationship with customers and can obtain other sources of information. CRAs rely on publicly available information in the first instance, and the usefulness of the annual return is significantly limited for them when companies file abbreviated accounts. Time and again, businesses contact CRAs when they do not see any improvement in their score and rating despite improved profitability. It often turns out that they have filed abbreviated accounts with Companies House which make no reference to the profitability of the business. CRA representatives argue against the perception that annual accounts are of limited use because they are historical. Accounts provide CRAs with a track record and give an overview of the business and disclosure notes are also regularly used in scoring.

If information from publicly available sources is limited, reliance on other types of information will increase. Manual analysis of individual information is costly, so the use of revolving credit and payment history information provided by suppliers which can be automatically processed is increasingly used to understand the cash flows of businesses. The process is more costly than using publicly available information, but if the trend to deregulate the SME sector continues, the importance of other types of information will increase. Today, other information, such as trade, bank and other references, is increasingly used to help assess a business's ability to repay borrowing.

CRA representatives cautioned against potential legislative changes to exempt micro entities from filing annual accounts because it would lead to a significant reduction in publicly available information and have an impact on SME credit rating. CRAs would be reluctant to address the increased credit risk because they would need to collect additional information at a cost which CRAs do not feel they can pass on to their clients. Furthermore, the current economic slowdown means that businesses and credit decision making will come under greater scrutiny. CRAs are undoubtedly conscious of the importance of providing more accurate scores and ratings with better information than before. The implication of this for businesses is that if they choose to file less information, it is likely to make CRA decisions harder and thus more expensive or less timely.

An interview-based rating process may be used for sole traders and partnerships where no statutory filing requirement exists. The scoring model is different from incorporated entities and the credit required for these types of business tends to be relatively small. A new company will also only be able to provide limited information and CRAs will make pragmatic decisions based on what is available.

2.5 Reclaim the audit for SMEs?

Shouldn't the SME community be reclaiming the audit? Some people argue that audit should be economic for all businesses regardless of size and that it may be possible to obtain reasonable assurance other than by following the procedures prescribed in ISAs. However, such arguments ignore a wide variety of initiatives to ease the application of ISAs to SME audits, such as IFAC's 2007 *Guide to Using ISAs* and the APB's *Practice Note 26* on documentation.

In addition, it needs to be understood that the IAASB is not going to produce a set of SME auditing standards or base its auditing standard setting on a philosophy of 'think small first' since this would mean downplaying the needs of listed company investors and securities regulators. It is also not particularly practical, in the immediate aftermath of the completion of the Clarity Project, to expect ISAs to undergo another massive overhaul in the near future.

Therefore, without in any way wishing to question the potential value of ISA audits for SMEs or the importance of efforts to minimise the costs of performing them, we think that work on alternatives to audit is important on pragmatic grounds. It should also be noted that the economic argument for a cost-effective alternative to audit can be seen even in the listed company sector. Regulators generally only require audits of annual financial statements and permit or require reviews, rather than audits, of quarterly or interim information.

2.6 Update current review products?

Shouldn't we just endorse the review services currently available in many countries? The U.S. and other countries have widely used standards for review engagements and it would be difficult for these countries to move to international standards if they did not accommodate the continuation of such engagements under a successor to ISRE 2400. The past and present examples are summarised below in Briefing 2.3.

Briefing 2.3: Existing services based on ISRE 2400

ISRE 2400 was originally issued in 1988 and was subsequently revised in 1990 and reissued in 1994 as AS 910. It defines a review engagement as one which provides a moderate level of assurance that the information subject to review is free of material misstatement and this is expressed in the form of a negative statement that nothing has come to the professional accountant's attention that causes them to think otherwise. Under ISRE 2400 professional accountants perform management enquiry and analytical review procedures and issue a review conclusion supported by additional work if necessary. ISRE 2400 is accompanied by a list of some 90 detailed procedures consisting of management enquiry, analytical review and some substantive tests.

A number of national standards and guidance materials follow the ISRE 2400 model. These include review engagement standards issued in Canada, the U.S., New Zealand and Australia. The Canadian and American institutes have also issued supplementary guidance to assist the performance of review engagements. This relates in particular to analytical review procedures and management enquiry which form the core of reviews.

In 2001 in the UK, the APB field trialled a form of review engagement based on international standards on behalf of the UK government. The Independent Professional Review (IPR) consisted of management enquiry and analytical review procedures but, unlike ISRE 2400, disallowed the performance of any additional substantive work. The approach was taken to clearly differentiate the review from an audit. Field trials were performed by 20 accountancy firms and, based on the findings, the proposal was withdrawn.

UK experience of the abortive IPR showed that there was limited acceptance of a procedures-driven approach that limits the assurance that can be obtained by arbitrarily limiting the procedures performed. Nevertheless, the experience in the UK with the procedurally-based Independent Examiner's Review (IER) for charities shows that such engagements can work within specific sectors. The IER originates from the 1990s and revised guidance was issued to coincide with the implementation of the Charities Act 2006. The work procedures of an IER involve: a review of the accounting records kept by the charity and the comparison of the accounts presented with those records; and a review of the accounts and consideration of any unusual items or disclosures. The Charity Commission provides 12 Directions accompanied by explanatory guidance and detailed procedures to help independent examiners. The guidance and detailed procedures help to fulfil specific charity accounting requirements and are also particularly intended to assist examiners who do not hold a professional accountancy qualification.

There are issues with ISRE 2400-type services which need to be addressed and which might affect the willingness of countries moving from a universal audit approach to adopt ISRE 2400 outright. Some of these are referred to in the ICAEW response to the IAASB's September 2008 consultation paper *Matters to Consider in a Revision of International Standard on Review Engagements 2400, Engagements to Review Financial Statements*. This paper, prepared by standard setters from Australia, Canada, New Zealand and South Africa who have existing review standards, shows the limitations of such standards because they effectively do not take into account some of the technical developments of the past decade, including those that are reflected in the IAASB *International Framework on Assurance Engagements* and the ICAEW Assurance Service.

A fundamental question with review engagements is the extent to which they are seen as prescribing required procedures. One of the fundamental characteristics of an assurance engagement is the provision of an independent opinion, supported by sufficient evidence gathered by the professional accountant. Where prescriptive mandatory procedures are seen as a complete list of the work required, this can lead to a blurring of review engagements and agreed-upon procedures engagements performed under ISRS 4400. The results of prescribed procedures alone do not necessarily give sufficient appropriate evidence needed by a professional accountant expressing an assurance opinion. In other words, where the nature, timing, and extent of procedures are too prescriptive in an assurance engagement, there is a risk that the task of drawing conclusions from the procedures and findings is transferred to the users of the professional accountant's report as in an agreed-upon procedures engagement.

This is in fact a distinguishing characteristic of an agreed-upon procedures engagement: professional accountants carry out procedures as agreed with relevant parties and report on factual findings. It is a basic assumption in an agreed-upon procedures engagement that the users of the report are able to assess for themselves the procedures performed and the findings reported by professional accountants to draw their own conclusion. As agreed-upon procedures engagements are well-established in the market place and are regularly used in particular in regulatory reporting, we consider that the revision of ISRS 4400 *Engagements to Perform Agreed-upon Procedures Regarding Financial Information* is an increasingly urgent task.

2.7 Enhance compilation services?

Should we just issue revised standards on compilation services? The IAASB plans to revise the International Standard on Related Services (ISRS) 4410 *Engagements to Compile Financial Statements*. The standard states that the objective of a compilation engagement is for the professional accountant to use accounting expertise to collect, classify and summarise financial information and that users of the compiled financial information derive benefits as a result of the professional accountant's involvement because the service has been performed with professional competence and due care.

Some people argue that the value of compilation services is underappreciated and correcting this could severely limit the appeal of other alternatives to audit. Developments in the UK during our consultation on the ICAEW Assurance Service showed that we need to recognise the confidence that could and should be engendered even by non-assurance services such as compilations because of the need for professional accountants to comply with quality control standards and certain ethical requirements, for example in relation to their association with financial information. These developments are summarised below in Briefing 2.4.

Briefing 2.4: Recent UK work on compilation reports relevant to revision of ISRS 4410

In 2006, the POBA, conducted research to assess how the accountancy profession supports the needs of small and medium-sized companies and their stakeholders in the light of the overall importance of the sector and the significant changes made in recent years to the financial accounting and reporting arrangements for these companies. The report *Review of How Accountants Support the Needs of Small and Medium-sized Companies and their Stakeholders* considered a number of key issues relevant to the UK SME sector, including the needs of company directors, the use of full or abbreviated accounts, and perceptions about the value of audited and unaudited accounts.

The report considered the use of unaudited accounts and the implications of filing abbreviated accounts and making use of audit exemption. The report noted that filing abbreviated accounts had negative commercial implications (eg, less favourable credit arrangements and difficulty in winning business) even though it may save businesses from divulging sensitive information. In relation to increases in the take-up of audit exemption, the report concluded that while users such as tax authorities and banks may not change their conduct, other users including trading partners do have an interest in the reliability of financial information. It was suggested this could be addressed by clearly indicating the involvement of professional accountants in the preparation of accounts. A survey commissioned for the report found that around 85% of small and medium-sized companies used some form of external support for accounting. Furthermore, in nine out of ten cases, this support was provided by professional accountants, with around 30,000 professional accountants working in around 18,000 accountancy practices supporting small and medium-sized companies. This involvement of professional accountants was often not apparent from filed SME accounts.

In the light of the findings, the POBA issued a series of recommendations. One of them was that members of the institutes belonging to the UK Consultative Committee of Accountancy Bodies (CCAB), which includes the ICAEW, should consider issuing a cross-profession accounts compilation report, which would include a very broad description of the scope of the engagement together with a positive description of professional accountants' obligations.

The POBA objective in encouraging the CCAB to develop a cross-profession accounts compilation report was not only to achieve consistency but also to increase the use of accounts compilation reports which signal the involvement of professional accountants to users and to make the professional accountants who help prepare the financial statements more conscious of their responsibilities.

In particular, the principle of integrity is one of five Fundamental Principles within the IFAC Code of Ethics and specifies that professional accountants should not be associated with information where they believe that it contains a materially false or misleading statement, contains statements or information furnished recklessly, or omits or obscures information required to be included when such omission or obscurity would be misleading. Because of this obligation, professional accountants engaged to compile financial statements based on information made available to them, often undertake other procedures, although currently this is only required in circumstances where the professional accountants become aware that management has provided information that is incorrect, incomplete, or otherwise unsatisfactory.

The CCAB bodies finalised their recommended draft report in February 2009 and will publish a final report based on the results of consultation. The POB has, however, expressed the view that the principles underlying its original recommendation are most likely to be met if the lessons learnt from the work performed by the CCAB are considered and taken forward as part of a broader FRC project to assess the impact on SMEs of the regulatory framework for accounting and auditing and related services.

Although there is anecdotal evidence that the public appear to take a level of comfort from a professional accountant's involvement in accounts compilation, the primary distinguishing feature of assurance engagements is the provision of an overall conclusion or opinion by the professional accountant. This distinguishing feature is, however, unlikely to be removed as a result of any forthcoming revision of ISRS 4410 and therefore there seems to be little basis for saying that enhanced compilation services should be the sole alternative to audit and thereby obviate the need for a more comprehensive consideration of alternatives.

3. A WAY FORWARD

In this section we discuss some of the key conclusions we have drawn from our consultation exercise on the ICAEW Assurance Service and the benefits we see in an international approach.

The issues raised by alternatives to audit are as important from a public interest standpoint as those addressed in recent years in relation to audit. Yet, the challenges involved in making progress are, if anything, more difficult. While there are growing signs of engagement at an international level within the profession, there is a wide diversity of stakeholders to be engaged. There are also different views as to what extent an international solution is desirable.

3.1 The need for open debate

Our experience of the ICAEW Assurance Service, summarised in Finding 3.1, indicates that in the UK market there is a place for at least one new alternative to audit.

Finding 3.1: SMEs and the users of their accounts value limited assurance

The ICAEW Assurance Service was released in 2006 and, as it is voluntary and no filing requirement exists, we have few means of knowing how many engagements have been completed in total. To support its members, the Audit and Assurance Faculty initially made promotional material and technical guidance available on-line and over 1,000 professional accountants learnt about the Assurance Service through the faculty's roadshows. However, there was no active marketing or promotion to potential users of the service. This caution was understandable given the scepticism of regulators and some commentators and the consultative nature of the initial launch. The approach seems to have been vindicated as members were gradually won over to the extent that strong support for the Assurance Service was expressed by the ICAEW Council in July 2008 during a debate on the future of audit. However, it is not surprising that our interviews with bank and CRA representatives indicated that these ultimate users of SME accounts were generally not aware of the availability of the new service.

Upon discussion, a bank respondent thought that the limited assurance report could be comparable to the 'Home Buyer's Report': a property survey more detailed than a mortgage valuation, but less detailed than a full structural survey. Whether the new Assurance Service is widely used or not will depend on competitive market demand. Audit-exempt companies may decide that the money they might spend on the service could be better spent on software to improve forecasting and financial management and such decisions are best left to companies. Another respondent thought that the new service can add confidence in certain circumstances, such as on leveraged lending and where the reliability of information is called into question. Depending on the risk and size of lending, a service that offers less comfort than an audit may be sufficient. The provision of the Assurance Service and the availability of an assurance report could also increase confidence in company management.

In the long run, whatever the level of audit-exemption thresholds, some companies will continue to file audited accounts on a voluntary basis if they need larger banking facilities. A bank representative thought that the Assurance Service may facilitate lending decisions for comparatively small loans of up to £100,000 secured or £50,000 unsecured, whereas a voluntary audit might be needed for larger loans.

Take-up of the service will, however, also depend on how businesses and other interested parties assess the value that the limited assurance service delivers. The benefit might be that it provides some comfort over the business as a whole: ie, 'this business is at least trustworthy enough to ask for and get a clean assurance report.' In this respect, there is encouragement from the engagements we reviewed.

Companies choosing the ICAEW Assurance Service thought that limited assurance was sufficient for the needs of directors and external users including funding providers, outside owners and customers. On one of the engagements we reviewed, the company specifically asked for the service after hearing about it from another company. Some clients covered by our reviews had the service for more than a year which indicates some degree of satisfaction. Feedback from the engagement partners also indicated that clients were happy with the report content and there was no criticism of the negative assurance wording. It appears that other users of the report had no issue with companies providing the assurance report in place of an audit report as in the past.

Even where the conduct of the service was relatively formalised and made use of commercially developed audit software and fully documented analytical review and substantive procedures, there was a saving against the cost of an audit because of reduced documentation and an enhanced focus on specific risk areas. An engagement partner said that his client thought that the substantive work procedures were thoroughly discussed between them and the engagement team and that the engagement was very focused on their specific circumstances.

As discussed in Section 2.2, there are over a million UK companies that have chosen not to have an audit and it seems appropriate in the public interest for there to be some market alternative, as in other countries, which involves a professional accountant providing an overall conclusion or opinion on the quality of financial information. We acknowledge that the task is not specific to the UK and we propose to learn from and contribute to wider international discussions.

The central proposal of this report is that there should be a properly informed international debate led by the IAASB on the alternatives to audit that professional accountants can provide in relation to financial statements. This debate needs to be accessible to a wide range of people, not just professional accountants and standard setters who are immersed in the technical aspects of these services. It needs to involve people across the business, public policy, regulatory and professional accounting communities with an interest in the quality and reliability of financial information produced by SMEs.

The case for international harmonisation is not as strong as for auditing standards which are applied to internationally traded listed companies and large entities of public significance. The absolute uniformity of the 'an audit is an audit' approach may not be needed in markets for alternatives to audit. There are nevertheless benefits which mean that we should not give up on harmonisation as being too difficult. Fragmentation is not good for business or confidence in the accountancy profession and everyone benefits from being able to understand each other and learn from each other. There are important issues to be considered. For what type of entities would an internationally harmonised approach be beneficial? How far does harmonisation need to go? Could the aim be to harmonise principles, thereby allowing different vehicles to be used which suit the local environment but which can be understood internationally? Or does harmonisation have to mean applying detailed standards and sets of procedures consistently?

Our view is that the objective of the debate should be to develop a common understanding of the issues and a common language for talking about alternatives to audit which allows people to communicate effectively across different jurisdictions, reporting regimes, traditions and markets. This language should cover the complete range of services including audit, review, limited assurance, agreed-upon procedures, compilation and any other related services that are currently performed in different jurisdictions. Also, a vigorous discussion of alternatives to audit will help the profession and key stakeholders in companies that are not subject to audit to be engaged in a broader debate over deregulatory moves and developments in auditing standards that will be important in building confidence in financial information. Initiating debate also encourages the profession to become champions of change rather than defenders of existing practice.

The output of the proposed debate would be a set of high quality international standards. However, rather than leading to new phrases such as 'a review is a review', based on uniform global adoption and implementation, standards could be used as a frame of reference by businesses, professional accountants and regulators in different markets and countries. It would not preclude the development of specific solutions for local needs but it would allow such services to reflect and benefit from a high quality international frame of reference. In particular, it would allow different national public authorities to choose, rather than developing from scratch, different policy options in relation to alternatives to audit and allow stakeholders in SMEs, including those involved in credit and financing decisions and possibly tax authorities, to choose services that best meet their particular circumstances and needs. Maintaining a knowledge base of what is done in different countries and for different regulators would also help in this regard.

Pending what emerges from the international debate, we will continue to support members providing the ICAEW Assurance Service as set out in our Interim Technical Release AAF 03/06 and to promote ICAEW guidance on compilation services and various types of agreed-upon procedures engagements developed in conjunction with trade bodies and industry regulators. Meanwhile, in the remainder of this section we set out our views on the principles that should underpin the international debate about alternatives to audit and the benefits that we see such a debate bringing.

3.2 Assurance enhances confidence

As a matter of principle, we believe that assurance is important and that there is a central role for external assurance to play in inspiring confidence. A number of traditional commentators on audit are dismissive of references to assurance on the basis that it is an ill-defined concept compared to audit and because it is a difficult English word to translate into some languages. However, the concept is important if we are to recognise that the basic purpose of audit and other assurance services is to enhance the confidence placed in financial information.

This is the principal reason for engaging the services of a professional accountant and it is by obtaining a degree of assurance about financial information through the provision of a service that the professional accountant enhances confidence among users of that information. In the case of credit decisions, this is backed up by Finding 3.2 below.

Finding 3.2: Decision makers value independent professional involvement

Banks and CRAs thought SMEs should be more aware of the negative impact of not having any independent assessment of the credibility of their accounts. CRAs see independent opinions as important in strengthening third-party confidence in financial information. If more SMEs understood the value of having an independent assessment, some companies which do not currently have an independent assurance opinion – regardless of whether it is audit or assurance – on their financial statements may switch back to having one.

Bank respondents said that voluntarily audited accounts also give a positive 'soft' signal, ie, a good sign that the company is exceeding the bank's expectation for its internal monitoring. It may also indicate that the business and its management have aspirations and a forward-looking attitude. This is particularly so when management voluntarily seeks such a service in contrast to merely fulfilling a mandatory requirement.

Although it is not an audit, respondents appeared to think the ICAEW Assurance Service gives comfort. Notwithstanding that few people in banks and CRAs currently know that there is an alternative to an audit in the UK, they thought that having the Assurance Service would indicate that a company was duly concerned about the quality of its accounts. Audited accounts are seen as more desirable but given that audit exemption is a reality, a focus on the cost of any voluntary service is understandable. It was seen as better to have the Assurance Service than nothing because it indicates that the company is going in the right direction. Currently, the existence of an assurance report is unlikely to be recognised in scoring models, but some CRA respondents suggested that it could be incorporated in the their models in the future. Whether ICAEW technical guidance is issued as interim or final would not fundamentally affect this.

For CRAs, the audit has historically provided confidence that areas such as internal controls are looked at, and from that view point the audit is still a valuable service. Through an audit, CRA respondents thought that professional accountants historically acted as business advisors and brought in specialist business knowledge as well as 'practical common sense' on issues such as segregation of duties. CRAs see that the ICAEW Assurance Service may play a similar role. However, in their view, the real value of the new service will depend on whether professional accountants can act flexibly as a business advisor assessing companies by understanding the business, applying a broader business sense, and providing objective views and advice. The new service was seen as making sense in principle.

However, CRAs pointed out that they would only become aware of an assurance report (or any other reports including a voluntary audit report or an accounts compilation report) if it was attached to the publicly filed accounts. Otherwise, they would only find out about it if they requested further information from companies but, for reasons of cost-effectiveness, such requests are rare.

3.3 Practice matters

As a matter of principle, we think that the norms and conventions that apply to a practice matter as much as written rules and requirements. This applies as much to assurance services as to any other activity.

Therefore, in determining the value and effectiveness of a professional service, such as the ICAEW Assurance Service, it is necessary to look beyond written standards and guidance and consult professional accountants or those who are familiar with what professional accountants do or are expected to do in particular circumstances. This means that in comparing current different alternatives to audit, it is important to look beyond what the relevant standards say and study what professional accountants do in practice. Different services may be more similar in practice than they seem on paper. Conversely, apparently very similar services may be carried our very differently in different national, legal or industry settings.

Some, including the APB, consider it a major weakness of the ICAEW Assurance Service that it permits different amounts of work to be performed in similar circumstances. They are not reassured by Finding 3.3 below which shows that despite the absence of detailed procedural requirements in the ICAEW Assurance Service, professional accountants appear to perform substantive procedures that are responsive to the circumstances of their client to obtain sufficient assurance to provide a limited assurance report.

Finding 3.3: Assurance Service providers choose to do substantive testing

The engagement documentation on the engagements reviewed by ICAEW staff included documentation of the reasons for approaches taken. Typically, engagements included a range of substantive procedures to support accuracy and existence and were reviewed by the engagement partner. They included third-party confirmations, testing of reconciliations, physical inspection, agreeing to supporting documentation, recalculations, cut-off testing of transactions around the year-end and so on in relation to material and high risk balances, including cash, stocks, fixed asset additions, debtors and turnover. In four engagements, the engagement team attended the year-end stockcount.

Additional work in relation to profit and loss account expenses was also carried out in response major fluctuations. This area also appeared to concern engagement teams because of their potential tax implications and this meant that engagement teams appeared to lower their materiality threshold in line with the approach taken by the tax authorities. In addition, engagement teams almost always carried out additional substantive work on accounting for balances with group companies. They also often re-performed calculations and identified incorrect entries and omissions.

Based on the discussion with engagement partners, clients were happy with the work effort, comfortable with the application of risk judgement, and liked the approach that professional accountants concentrated on key risks rather than comprehensively working through line items. An engagement partner thought that the work procedures could be a little more streamlined, but reasoned that no business is static and that in subsequent years there would be discussions with the client on the approach to be adopted.

In light of our experience, it would be interesting to perform a similar exercise in relation to review engagements performed under ISRE 2400, which allows but does not require substantive procedures, to see whether a similar pattern emerges.

3.4 Professional judgement is needed

On principle, we support the need for professional judgement in providing audit and alternatives to audit. Whenever a professional service is provided, some degree of professional judgement will need to be applied. This is a further reason why audits and alternatives to audit cannot simply be reduced to the application of written standards or the completion of a predefined set of procedures. Nor should this be seen as a way of allowing professionals a degree of discretion which compromises the quality of their work. It is instead a fundamental and demanding expectation that is rightly held by users of professional services.

In Finding 3.4, we summarise how the exercise of professional judgement was found to be pervasive throughout the performance of the assurance engagements that we reviewed.

Finding 3.4: Professional judgement is pervasive in performing assurance engagements

Professional judgement is exercised throughout the various stages of an assurance service engagement: planning, management enquiry, analytical review, substantive procedures and drawing the assurance conclusion. Professional judgement relates to different aspects of engagement procedures from determining the engagement approach and materiality to deciding which member of the engagement team carries out what procedure.

Depending on the nature of professional judgement required, different members of the engagement team made decisions. These decisions were generally documented for review by a senior member of the team or the engagement partner. The documents were either signed off or comments to that effect were added. The most significant types of professional judgement related to the determination of the engagement approach, the extent and breadth of management enquiry and analytical review, and what additional procedures to perform and to what extent.

The high level engagement approach was usually decided at the planning stage. All engagements involved a discussion with management and staff members of the entity as part of planning to obtain and update knowledge of the business and its operations. This meeting was used to obtain knowledge of accounting records and to consider applicable accounting principles and materiality. The type of work carried out at this stage depends on the existing knowledge of the entity, the size of the business and the firm's experience of the service. Where the client provided financial information prior to, or at the planning meeting, the engagement team queried management on major points, thus performing high level management enquiry and analytical review. Planning meetings were normally attended by the engagement partner, sometimes accompanied by the senior member of the engagement team.

Two years' experience of the Assurance Service shows that professional accountants in practice are very keen and quite able to make judgements about the type of work that is most effective in reaching a level of assurance. This shows that there is a potential role for an assurance service of the type that we envisaged. This is also economically more efficient than trying to limit assurance purely by limiting the tools that are available to the professional accountant.

Engagement teams exercised professional judgement in designing the extent and breadth of management enquiry and analytical review. The extent of management enquiry depends on: the formality of the business operation; the size of the entity (primarily based on the number of employees); and the firm's previous relationship with the client. In less formalised engagements, management enquiry was sometimes conducted as part of the planning meeting where the engagement partner and often the senior member of the engagement team met the client. The extent of analytical review procedures depended primarily on the type of business and the availability of comparable information.

Different members of the engagement team determined the nature and extent of substantive procedures. In most cases, junior members of the team compared the financial statements with underlying accounting records. There were also a number of areas in which the engagement team would perform substantive procedures. The nature of areas identified and the type and extent of additional work performed reflected the understanding of the entity at the planning stage as well as the outcome of management enquiry and analytical review procedures.

3.5 Leadership is expected

A principle that underpins audits and all the alternatives to audit that we are considering, including the ICAEW Assurance Service, is that the engagement partner is expected to show leadership and take personal responsibility for the report that is issued. Under the IFAC Assurance Framework, professional accountants who perform not only audits but also other assurance engagements are governed by the IFAC *Code of Ethics for Professional Accountants* (the IFAC Code) and *International Standard on Quality Control 1* (ISQC1). Finding 3.5 below shows this ethos being transferred to the new service through leadership shown by engagement partners. However, the ethical requirements placed on professional accountants who are associated with financial information also enhance user confidence even when the service provided is not, as in the case of a compilation or agreed-upon procedures engagement, actually classified as an assurance service.

ISRS 4410 explains that while no assurance is expressed, users of compiled financial information derive some benefit as a result of the professional accountant's involvement because the service has to be performed with professional competence and due care. A professional accountant performing a compilation under ISRS 4410 is required to comply with ISQC 1 and, while not required to be independent, ISRS 4410 nevertheless requires the professional accountant to comply with the ethical principles embodied in the IFAC Code, for example, acting with integrity and objectivity. The same responsibilities apply where agreed-upon procedures are performed under ISRS 4400.

Finding 3.5: Engagement leadership is vital to assurance

As discussed in Finding 3.4, professional judgement is pervasive throughout assurance engagements. Consequently, engagement leadership is also vital. The role of the engagement partner as a key decision maker is evident at the outset of each stage of an ICAEW Assurance Service engagement.

In all cases, the engagement teams started the engagement by discussions with management and members of staff who were responsible for accounting. The discussions generally involved engagement partners or senior members of the engagement team. Matters covered typically included business performance during the period and future prospects, material transactions, special matters to note and year-end concerns such as debtor provisions.

In all cases, the engagement partners made key decisions on engagement procedures as to what level of formality was required including holding team meetings and using standard forms for documentation. The engagement partner's role was most visible at the outset of the engagement and the engagement planning although they appeared to maintain relatively close control throughout the course of the engagement.

The engagement partners' close involvement with the engagement appears to be related to the size of engagement teams. They mainly consisted of two to three members including the engagement partners. In small engagement teams, the engagement partners directly coached junior staff and reviewed their work. This degree of involvement may also be related to engagement partners' own decision to maintain control over this new type of engagement. Discussions with some of the engagement partners indicated that they were consciously trying to assess how the Assurance Service differed from an audit. Some engagement partners said that they reviewed the way they conducted the engagement and considered areas where they did too much work in order to make changes in the following year.

Some engagement partners decided to use commercial software and tailored the programmes to document the engagement. Other engagement partners set out their own minimum procedures for the Assurance Service based on their knowledge of their clients. In simpler engagements, the engagement partner might instruct the engagement team on the procedures to perform subsequent to the planning meeting.

3.6 Learning and knowledge benefits

There are three main ways in which a properly informed global debate on alternatives to audit will bring benefits under the heading of learning and knowledge:

- We should be able to avoid potential duplication of effort that results from diversified international thinking on alternatives to audit. This is clearly visible in the emerging proliferation of alternatives to audit services around Europe in response to legislative moves to exempt companies from audit. This proliferation is evidenced by the results of the FEE survey summarised in Briefing 2.1. This shows the need to encourage greater sharing of experience and practice. Maintenance of information on different countries' practices would help mutual learning even in an area where there is no compelling international trade argument for absolute consistency. However, clear leadership by the IAASB of a truly global endeavour to debate the issues and then develop an international frame of reference would be even more productive. Different requirements for alternatives to audit could still benefit from the learning and development that flow from shared core standards.
- There is a need for an ongoing research agenda which would be helped by a more harmonised international approach. Our experience in recent years in developing the ICAEW Assurance Service indicates a need for more academic research into alternatives to audit. Such research appears to be hampered by the national specificity of such services, when set against the advantages of performing research work in other areas of greater international interest

which can draw on a wider range of experience and prior research. In a similar vein, there is also less evidence of the development of international methodologies and sharing of experience, learning and people within accounting firms in relation to alternatives to audit.

- The debate that we propose would enhance the credibility of professional accountants by forcing resolution of the uncertainty at the heart of the IAASB literature with respect to its Framework. It is more recent than the IAASB's various standards for alternatives to audit and the IAASB can now set about resolving differences between these two bodies of literature. The Framework was developed after a long phase of research and so it would be helpful to clarify whether that research is now thought to have been superseded by practical experience or whether it will be used to inform future standard setting.

3.7 Choice and diversity benefits

There are three principal means by which an international debate that leads to an agreed range of alternatives to audit will bring benefits in terms of choice and diversity:

- A shared frame of reference with a common international set of standards and language holds out the prospect of allowing the exercise of market choice and effective competition between different legislators, regulators and professional bodies. It should also respect differences in national and market circumstances while avoiding confusion and lack of comparability. The ability to require and regulate the provision of certain services, to set and enforce standards and to provide redress to buyers of services needs to be exercised within national structures established by appropriate public authorities.
- The proposed range of alternatives should help the market to work in the case of individual businesses that would be better able to choose the service that most closely met their needs from a range of services set out in international standards. Similarly, private businesses that perform rapid mass processing of publicly filed SME accounts, such as CRAs, could understand professional accountants' services well enough to determine the relative impact of audit and alternatives to audit on their credit scoring systems. Public authorities would also be able to adopt policy positions that are seen as respecting the interests of their constituencies, national sovereignty and differences between market and reporting environments, while still operating within a framework that facilitates international comparisons and the mobility of professionals.
- Ultimately, by accommodating most existing diverse practices while putting them under some pressure to align with an international frame of reference, a range of alternatives would not force supporters of these practices to resist international standards in the interests of saving particular alternatives to audit which enjoy local market acceptance and familiarity. Most existing regulatory requirements can be accommodated provided they can be presented under the flexible auspices of an agreed-upon procedures engagement with the regulator specifying required procedures.

3.8 Economic development benefits

Under the heading of economic development, there are three paths by which an inclusive international debate on alternatives to audit can bring benefits:

- A range of alternatives to audit enables professional accountants to provide services that support the contribution that SMEs make to the prosperity of all economies by enhancing confidence in the financial information SMEs produce. Such services are particularly needed to allow developing economies to build a basic level of confidence in the quality of their financial information, to attract investment and credit and to support economic development.
- A range of alternatives to audit will also help to develop and sustain an accounting profession that is trained to be professionally sceptical and questioning about financial information even in an economy where audit ceases to be widely practised. This is not just something that is in the interests of the accounting profession. It has wider benefits in terms of the overall quality of professional work and it enables professional accountants to enhance the quality of all the information with which they are associated. Again, this is particularly important in developing economies seeking to create human capacity and infrastructure to support economic development.
- Furthermore, the credit crisis shows that there is a potential need for services other than audit if banks are to reflect an appropriate assessment of the risks involved in relation to commercial lending to entities that are not required to have an audit. These could affect not only their lending decisions but also their own capital adequacy requirements.

Further details in relation to the last of these benefits are set out under Finding 3.6 below.

Finding 3.6: Assurance engagements on borrowers help banks

A bank respondent commented that for banks, there are three major competing pressures to consider when dealing with SMEs in addition to their own desire for efficiency and speedy decision making:

- confidence that comes from having reliable financial information about the SME which might be reflected in a statement in a facility letter that audited accounts are required;
- external pressure to reduce the burdens on SMEs so that banks feel that they cannot seek full audited accounts where companies are not statutorily required to produce them;
- conformance with the requirements of Basel II to have external assurance, taking account of all available information, which may include requesting a set of audited accounts from a company seeking to borrow a large sum.

In respect of Basel II, the motive is not to protect against default but to achieve a lower regulatory capital requirement. The necessary external assurance may be obtained through a CRA but it could also potentially be provided through an alternative to audit such as the ICAEW Assurance Service. Consequently, in the UK the Banking Code Standards Board and the Financial Services Authority (FSA) may be able to issue some sort of guideline or instruction for banks to accept the new type of assurance service. For instance, if the ICAEW Assurance Service was seen as achieving the right balance between rigour and cost, it could be included among the list of reports that may be requested and signal how this will help demonstrate responsible lending. Furthermore, where audited accounts are only requested in a facility letter as a standard requirement for Basel II conformance rather than being necessary for monitoring performance, the bank's back office may be satisfied with accounts that have been subject to another form of assurance.

We conclude this section with the principal benefit that could accrue from a thorough consideration of alternatives to audit, namely more cost-effective ways of increasing the flow of credit to SMEs. As is explained in Finding 3.7 below, the contributions of different types of professional involvement in accounting information is not reflected in a particularly systematic way and so a clearer menu of alternatives to audit could be very helpful.

Finding 3.7: Audit and alternatives to audit improve credit terms

One of the key themes that consistently came up in our discussions was the value stakeholders attached to an independent professional accountant's professional opinion over the truth and fairness of financial information of audit-exempt companies. The application of professional judgement is particularly valued. Our discussions with users of SME financial information show that they want the comfort of knowing that an independent and professionally qualified accountant has been involved in the production of SME accounts. However, current scoring methodologies are not particularly sensitive to different levels of professional involvement in financial statements.

Banks see that the audit enhances confidence in SME financial information. While having professional accountants involved in accounts preparation adds robustness to the accounts, external audit provides an independent perspective. This is particularly important when a bank is dealing with highly leveraged lending and historically unreliable management information. Where external assurance is needed in relation to specific areas, banks may commission due diligence work. Audited annual accounts are also seen as supplementing ongoing management information. In other words, if a company never provides audited accounts, a bank will have little to support the trustworthiness of management accounts.

Banks will also encourage businesses to get professional accountants involved in their business beyond the preparation of annual accounts. In relation to the need for external assurance, there is a limit on the usefulness of historical or annual information. Banks may be more interested in seeing customers bring in external support for more current and regular information such as management accounts and forecasts.

Finding 3.7: Audit and alternatives to audit improve credit terms (continued)

CRA respondents told us that published statutory accounts are regularly used and these are best if audited. However the cost of having audited accounts should not be prohibitive. For CRAs, the credit rating may be unaffected if accounts are unaudited, but the company's credit limit may be set lower than that of a company that files audited accounts. The value of external assurance comes from the fact that the professional accountants' opinion is independent and is based on professional expertise.

Qualified auditor's reports would certainly always have a negative effect on a credit rating. There are however no general rules as to how different types of qualifications and report modifications are classified and impact on scoring because the reasons for qualification are diverse. In any case, it would be wrong to assume that CRAs only look at the name of the firm and do not read the audit report.

The scoring models of CRAs generally appear to be unaffected whether professional accountants are involved in the preparation of accounts or not. However, if small company accounts are submitted without involving professional accountants, some CRAs may take this into account and lower the credit limit in a manner similar to where accounts are unaudited. Generally speaking, CRAs say that they cannot do a great deal to increase the quality of information because of time and cost constraints. CRAs generally take accounts at face value. Where management accounts are used, credit analysts would need to compare three or four sets of accounts to establish whether trends are reasonable and raise queries with the management if necessary. It is therefore a costly process.

4. CHALLENGES AHEAD

Progress on alternatives to audit depends on reaching a better shared understanding of the benefits of assurance, the concepts involved, the role of standards and how assurance is reported.

There are a number of significant challenges that flow from the analysis of the way forward presented in the preceding section which are discussed below. These should be addressed through an inclusive and comprehensive international debate.

4.1 Demonstrating the benefits of assurance

Despite the positive things that representatives of banks and CRAs have said to us during our consultation, users of unaudited financial information will still need to be persuaded of the benefits of various alternatives to audit that professional accountants can perform, for example if they are to recognise them in credit scoring exercises.

Yet, it is very difficult for a variety of reasons to obtain convincing evidence that alternatives to audit enhance the quality of financial information. In particular:

- Some measures of quality that are readily apparent (such as clerical errors, inconsistencies and departures from mandatory disclosure requirements) do not seem to be appreciably different between accounts with either some or no identified external professional involvement. These measures also tell us nothing directly about the presence of errors that are not readily apparent or that were eliminated as a result of professional involvement.
- If professional accountants and their clients are not aware of the potential benefits of indicating their association with a set of financial statements, perhaps because they don't know how disclosure will affect credit decisions, they are unlikely to be able to assess the extent of benefits attributable to that association and the services that they have provided.

The result of the above difficulties is a potentially vicious circle whereby the provision of alternatives to audit is not publicly disclosed by professional accountants because they can only see risk to themselves in reporting publicly rather than benefit to the company. As a result, it is not possible to correlate the provision of the assurance service with the quality of financial statements and therefore few think that there is any upside in disclosure.

4.2 Dealing with limited and moderate assurance

The principal technical issue for resolution in the area of assurance arises in understanding the practical difference, if any, between the concepts of moderate assurance (as reflected in ISRE 2400) and limited assurance (as reflected in the IAASB Framework). As briefly discussed in Briefing 2.2, both these concepts are contained within the IAASB's literature but are they distinct, useful and sustainable concepts that could support different types of engagement which require separate international standards?

In principle, moderate assurance should be contrasted with high assurance and limited assurance with reasonable assurance. Since reasonable assurance is the concept that is actually applied to audits performed under ISAs, it would appear appropriate to propose that an assurance alternative to audit should be based on the concept of limited assurance. However, as a practical matter, a limited assurance engagement on financial statements would require the identification of how professional accountants limit their work by comparison with an audit. This could be done in a multitude of ways and it is not clear how a standard could meaningfully choose between the various alternatives.

One possibility would be for the limited procedures to match the implicit limitation in the current review standard ISRE 2400. This would involve relying primarily on enquiry and analytical review procedures which are illustrated in an appendix to the standard. In this case ISRE 2400 might remain largely unchanged but for a change in terminology from moderate to limited assurance.

It would also be possible to specify further additional types of limited assurance on the basis of a limitation of the types of audit-type testing that may be performed. Nevertheless, this approach is unattractive because it seems perverse and inefficient and gets us close to an agreed-upon procedures engagement as observed in the experience of the IPR. However, some may say that it is a clear way of getting to a lower level of assurance and making it relatively easy to monitor compliance by professional accountants.

The approach taken to limited assurance in the ICAEW Assurance Service is different. The limitation implicit in AAF 03/06 does not only focus on some of the testing procedures required in an ISA audit. Indeed, professional accountants are not expected to rule out applying any particular type of procedure in circumstances where they are aware of a significant risk of material misstatement identified through management enquiry and analytical review. The assurance that they should aspire to is framed in terms of mitigating such risks. They are expected to adopt a risk-based approach comparable to an audit but once again without being required to perform any of the required procedures set out in the relevant ISAs.

There are different perspectives about what professional accountants really want: a set of mandatory procedures so that they don't have to think and can keep costs down; or few mandatory procedures so that they can exercise and develop professional judgement and avoid becoming box-tickers? There are different business models for professional accountants with different positions in the value chain and different levels of supporting infrastructure which might make both approaches valid in different circumstances. There is no need for a 'one-size-fits-all' solution.

The reality is that practical examples of the ICAEW Assurance Service exhibit the dynamics of an audit but performed to reach a lower level of assurance. This is illustrated in Findings 4.1 and 4.2 below. It is worth exploring whether, in reality, review engagements based on standards like ISRE 2400 are conducted in a similar manner, notwithstanding a literal understanding of the relevant standards. There is an assumption in some discussions that the ICAEW is seeking to develop an additional alternative to the review engagement set out in ISRE 2400. However, we regard it as an open question whether the old review engagement just needs to be comprehensively updated or a new standard needs to be drafted from scratch.

Finding 4.1: Iterative risk identification takes place throughout assurance engagements

Engagement teams identified areas to perform substantive procedures based on the outcome of three prior engagement steps: planning, management enquiry and analytical review procedures. The outcome of the planning work or management enquiry indicate the areas that are significant and readily identified such as, material fixed assets acquired during the year. Analytical review procedures identified anomalies. Matters identified through analytical review procedures were followed either by further management enquiry, substantive procedures or by both.

The outcome of each step indicating the risk of material misstatement was reviewed by a senior member of the engagement team, which may be the engagement partner in a small engagement team. The outcome was documented with different levels of details, sometimes accompanied by comments from the reviewer. In most of cases, it was observed that the engagement partner thoroughly reviewed the working papers.

Matters that typically prompted additional procedures were identified at an early stage because they were: risks known to the engagement partner based on his existing knowledge of the client; of concern to the client; of tax significance; related to business risks; vulnerable to fraud; technically challenging to the client; or subject to errors (eg, cut-off).

Matters were identified at a later stage because they were: material to the financial statements or, in one case, material to an assertion; not in line with the engagement team's expectation; identified as potential risk areas in earlier procedures; unusual items; areas where substantive work was proposed by engagement software.

Analytical review procedures were conducted in all engagements, but to different degrees. They typically included:

- overall review of the trial balance/accounts for reasonableness;
- prior year comparison of balances and profit margins;
- reasonableness of items (eg, expenses) based on the understanding of the entity and business;
- month on month fluctuation against the understanding of the entity and business; and
- key ratios (eg, creditors versus cost of sales, debtors versus sales, debtor/creditor/stock days).

Finding 4.1: Iterative risk identification takes place throughout assurance engagements (continued)

Based on these comparisons, the engagement teams reviewed items that 'stood out'. In a small number of cases, the engagement teams used very limited analytical review procedures upon completing management enquiry and performed mainly substantive procedures. The examples of these cases occurred on:

- a holding company with no commercial transactions; and
- a trading company with a very small number of transactions whose income was accrued based on the cost of sales, so that the completeness of income could be established through testing the accuracy and completeness of cost of sales.

Even in these cases, the decisions were practically based on comparison between the understanding of the entity and transactions during the year, which is a high level analytical review procedure.

Engagement teams primarily used analytical review procedures to consider if the high level view obtained from management enquiry was in line with the findings from analytical review procedures.

Engagement teams also used analytical review procedures to meet the objective set out in the ICAEW guidance, to identify inconsistencies and unusual items based on reviewing the trial balance and, where available, the profit and loss account and balance sheet. Analysis of major items and transactions were also often used. Analytical review procedures were conducted either by the engagement partner or by a senior member of the engagement team, depending on when the analytical review procedures were performed. Their comments were documented for follow-up management enquiry or substantive work.

In some cases engagement teams conducted further management enquiry subsequent to analytical review to address inconsistencies. This was often supplemented by inspections of supporting documentation. There was no example of the use of complex analysis using statistical techniques.

Finding 4.2: Client diversity leads to substantial differences between assurance engagements

Case studies appeared to indicate that the quality and extent of accounting and reporting performed by entities vary considerably. This affected every aspect of engagement procedures, in particular planning, management enquiry, analytical review procedures and substantive procedures.

Where an entity's accounting records were informal or an entity was unable to provide a trial balance, it affected the nature of discussions at the initial meeting. In such a case, the engagement partner would concentrate on a high level discussion of the business performance and matters that concerned management. In contrast, where a client provided a trial balance or even a draft profit and loss account, the engagement team and the client had in-depth discussions at the initial planning meeting, focusing on specific matters that the engagement partner or team identified prior to the meeting. Where the entity was new to the firm, professional accountants conducted detailed research using the internet, obtained previous years' accounts, and contacted internal or external accountants involved in the book-keeping of the entity.

The extent of planning work varied considerably according to the existing relationship and knowledge of the entity and the type of business. In all cases, the engagement partner, sometimes accompanied by a senior member of the engagement team, met with management before the engagement commenced. In some cases, engagement partners also met client management before the year end to discuss the business performance and operations based on management accounts. Subsequent to these meetings, engagement partners set out key objectives for the main financial statement assertions and, in some cases minimum procedures. In two larger engagements, the engagement partner brought together the entire engagement team to discuss risk areas.

Entities' ability to provide relevant financial information also affected the analytical review procedures. Where the engagement team helped an entity write up the disclosure notes, the engagement team might also query the entity to explain the make-up of items, sometimes requesting supporting evidence. While the information might be subsequently compared against the prior year information, the work procedures already involved what may be generally considered additional substantive procedures.

Entities' ability to provide relevant financial information did not appear to be directly related to the size of the business. For example, one owner-managed company with a turnover below £1 million with fewer than 10 employees employed an external, qualified accountant to keep books and prepare accounts.

4.3 Recognising the limits of standards

There are clearly limits to what can be achieved through standards covering different alternatives to audit. It would be helpful to develop some measure of agreement on the following issues if the way forward suggested in this report is to be a success:

- Are there substantive differences between what professional accountants do in providing different types of alternative services and what it says in the standards? For example, how do professional accountants exercise professional judgement and discharge their responsibilities as professionals who are associating themselves with financial statements in the absence of any words in the standards to guide them in this?
- Do such considerations mean that there is much more convergence in practice between different alternatives to audit than would be apparent from simply reading the standards and guidance for different services?
- Is it possible to codify activities such as the exercise of professional judgement more explicitly in standards and guidance? If not, should the scope for such judgement be reduced, for example through greater prescription of required or minimum procedures, so as to make it easier to verify and monitor performance to expected standards? Or should this tendency be resisted since the desire to be more specific means that all services for which there are standards, including ISAs, can end up as regulator-driven agreed-upon procedures engagements which, in the long run, weaken the tradition of professional judgement and ultimately the reputation of professional accountants?
- As well as considering standards for the performance of alternatives to audit, what other standards and regulation are necessary in order to build confidence in these services and to reduce contracting costs between the parties involved in such services? In particular, what expectations should there be regarding the independence and expertise of service providers and related monitoring and enforcement?
- How do we avoid independence dilemmas? We need to address clearly the risk that alternatives to audit become inaccessible in the same way that audits become inaccessible because of a 'one-size-fits-all' approach to independence. This is one of the issues a current AICPA initiative on reliability is looking at.

One of the areas that requires particular consideration is the extent to which the willingness of professional accountants to provide services and the way that they perform them in practice are affected by their perceptions of their own litigation and reputation risks given the legal environment in which they operate. For these reasons, the take-up and conduct of alternatives to audit can be as much affected by the internal policies of practising firms and their perceptions of risk as by external standards.

Professional accountants' risk management could lead to an unwillingness to provide alternatives to audit. There is a need for a risk and liability environment for alternatives to audit that professional accountants find acceptable. The overall emphasis should be on creating a space in which professional accountants can operate. Risk management issues need to be considered on a jurisdiction basis rather than being dealt with in international standards as judicial traditions in each jurisdiction will differ. However, high level principles can be set at an international level about establishing an environment in which alternatives to audit can flourish.

4.4 Establishing reporting conventions

There has been a long quest to find better solutions to reporting on different types of alternatives to audit so as to communicate what professional accountants have done and the strength of the assurance that they have obtained. Compilation and agreed-upon procedures assignments which are not assurance engagements have historically resulted in simple statements of what has been done and in the latter case a statement of findings.

In the UK, at the urging of the POB, the CCAB bodies have recently been looking to amend the accountant's report on compilation services to try and provide more information about the benefits of engaging a professionally qualified accountant with the intention of enhancing the confidence of the reader in the financial information to which the report is attached. Is this a trend that should be considered for inclusion in international standards? It is likely that widespread communication by standard setters and providing access to websites through accountant's reports are more important than trying to find a 'silver bullet' solution within the accountant's report.

Currently, both moderate and limited assurance engagements lead to a form of double negative report. In the case of the ICAEW Assurance Service this results in a report that 'based on our work, nothing has to come to our attention to refute the directors' confirmation that the financial statements give a true and fair view.' This contrasts with a positive audit opinion to the effect that 'in our opinion, the financial statements give a true and fair view.' Does the long-standing use of such approaches to reporting mean that they are satisfactory formulae which acquire meaning through familiarity and custom rather than what they actually say? Even if this is so, would it be appropriate to use the same form of negative opinion for both moderate and limited assurance engagements if it was decided that there was a useful and sustainable distinction between the two types of assurance?

Our experience during the consultation period on the ICAEW Assurance Service is that negative reporting is not a substantive issue. Nevertheless, the prospect of being able to express a positive opinion even when assurance is moderate or limited remains attractive and might be worth continued effort.

4.5 Supporting the IAASB

The IAASB needs to play the leading active role in the debate that we envisage. It is the body that should set the relevant standards for alternatives to audit and ensure that they are complementary to and consistent with the principles of International Standards on Auditing. Moreover, it is in a position to publish standards that have an impact in practice. This is because it is established under the auspices of IFAC and the member bodies of IFAC are required by IFAC Statements of Membership Obligations to support implementation of IAASB standards as are the transnational audit firms that are members of IFAC's Forum of Firms. Its standards for alternatives to audit are also likely to be endorsed and promoted by other organisations such as the World Bank.

However, there may be a need for other bodies to play a leadership role in bringing together all the parties who need to be involved and ensuring that issues are addressed in a way that engages those without a specialist technical grounding in the services provided by professional accountants. The relevant parties will not necessarily be the same as the stakeholders who are most closely interested in the IAASB's audit standard setting role. Indeed, some stakeholders may have little appreciation of the importance of alternatives to audit or wider issues related to assurance.

Leadership will also be important in setting a tone for dealing with different traditions and approaches to alternatives to audit. For example:

- To what extent should all present forms of existing service including review, limited assurance, agreed-upon procedures and compilation services, be preserved but explained better so that public authorities and SME stakeholders can make better informed choices?
- Alternatively, is there scope for a radical simplification, for example based on a view that all services that are alternatives to audit require the specification of audit procedures that should or should not be performed?
- What other new types of service, if any, might be encouraged?

We need a genuinely open debate to be led by the IAASB which is inclusive and encouraging of market solutions and learning. We therefore welcome the establishment of the IAASB's Task Force to review ISRE 2400 and ISRS 4410. We are committed to contributing to its work and will welcome any moves to broaden its remit to include ISRS 4400 on agreed-upon procedures engagements.

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