What is the purpose of an audit? This overarching paper seeks to articulate the purpose of an audit, in the context of the interests of shareholders who appoint and monitor boards and, ultimately control the companies they own. Attention has been given to responsibilities, relationships and the benefits of audits of both quoted and unquoted companies.
The Audit Quality Forum brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of government and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

The initial focus of the Forum was to improve audit transparency and support shareholder involvement in the audit process. At its meeting in May 2005 the Forum agreed to explore a broader agenda which examines the relationships between shareholders, boards, auditors, regulators and other stakeholders in the audit.

Anyone interested in providing feedback on this paper should send their comments to louise.maslen@icaew.co.uk.

Further information on the Audit Quality Forum, the current work programme and how to get involved is available at www.icaew.co.uk/auditquality or telephone 020 7920 8493.
AuditQuality®
Fundamentals – Audit purpose
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Executive summary

This paper focuses on articulating the purpose of the statutory audit of companies in the UK. In response to concerns raised at the Audit Quality Forum by Forum representatives about the differing perceptions among stakeholders of the purpose of the audit, a working group (‘the group’) was set up to consider its purpose. In so doing, the group has considered how the audit has developed in response to agency risks, the legal requirements for a statutory audit and what auditing standards and case law say. Where relevant, the group has also considered international developments but has been keen not to lose sight of the underlying purpose of the paper which is to articulate the purpose of the audit in the UK.

The framework for the statutory audit

The purpose of the statutory audit is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements, whether they have been properly prepared in accordance with the Companies Act 1985, and to report by exception to the shareholders on the other requirements of company law such as where, in the auditors’ opinion, proper accounting records have not been kept. Directors are delegated responsibility for managing the affairs of the company and the audit is an important mechanism that helps owners of companies assess the stewardship of directors, and in so doing provides an important stimulus for directors to place a proper emphasis on their fiduciary responsibilities.

The purpose of financial statements

In seeking to articulate the purpose of the statutory audit, it is also important to consider the purpose of financial statements. Having considered the current UK legal framework, the group would support a definition which is founded on stewardship. The International Accounting Standards Board’s Framework for the Preparation and Presentation of Financial Statements, however, places greater emphasis on decision usefulness and whilst further consideration of this is not within the remit of the group, the group believes that this would be an issue for further consideration by an appropriate body or forum. In view of the joint Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) project to agree a common conceptual framework, the group believes that this is an important issue.

Other stakeholders and their interests in the audit

Whilst the group recognises that other stakeholders have interests in the audit and the audit has a clear public interest role, the purpose of a statutory audit, as defined in law, is clear – it is conducted for the benefit of the shareholders. Potential investors, creditors, employers and other sectors of the business community, as well as government and the public at large, rely on the soundness of reporting and its impact on the economic well-being of the community and country. However, the interests of other stakeholders and any assurance/value that they gain from the audit must be seen as consequences, rather than the primary purpose, of the statutory audit, albeit they are valuable ones with important public interest and social benefits.
**EXECUTIVE SUMMARY**

**Expectation gaps**

We recognise that there are expectation gaps between what some stakeholders want or believe to be the purpose of the audit and what auditors are providing to existing shareholders by way of assurance. It is not within the scope of the group to resolve these differing expectations. However, in its discussions, the group looked at expectation gaps in three specific areas: internal controls, fraud and going concern. Whilst these areas are considered by the auditors in forming their opinion on the truth and fairness of the financial statements, no specific assurance is required to be provided by auditors on the effectiveness of internal controls, the detection of fraud and the future viability of the business.

Whilst some members of the group were interested in more explicit and direct communication and information provided to the shareholders about the audit, the group agrees that these are not expectations that the current purpose of the statutory audit is designed to meet. The group also noted that shareholders might want additional information about difficult, sensitive or contentious matters and discussions with audit committees, though such information needs cannot necessarily be satisfied by the auditors. It was suggested that the Audit Quality Forum’s Auditor Reporting working group consider further the issue of what additional information could be provided by auditors to the shareholders.

One particular area of focus for the group on the issue of expectation gaps was auditors’ responsibilities on accounting records. Auditors currently are required to report to shareholders, by exception, where they consider that proper accounting records have not been kept. At the time of writing, the new Company Law Reform Bill proposes that auditors consider whether adequate accounting records have been kept. The group highlights the need for greater clarity and understanding of directors’ and auditors’ responsibilities regarding accounting records. The group understands that the Government has already been considering this issue and the group believes that the development of guidance on directors’ and auditors’ responsibilities would be helpful.

**Reasonable assurance**

The group also considered what is meant by the term ‘reasonable assurance’, its use in auditing standards and its applicability to the UK audit. The group concludes that reasonable assurance is the level of confidence the auditors, by exercising professional skill and care, are expected to attain from their audit that the financial statements are not materially misstated. It believes that objectivity, professional scepticism and judgement are integral to the concept of reasonable assurance and are fundamental requirements of auditors when carrying out an audit. The group also emphasised that there are key enablers of audit quality that underpin the capacity of the audit to provide reasonable assurance and these include the recruitment of quality people, relevant training and experience, continuous professional development and effective quality control measures, both at firm and engagement level.
Introduction

Background

In May 2005, the Audit Quality Forum agreed to explore a broad agenda, which would examine the relationships between shareholders, boards, auditors, regulators and other stakeholders in the audit. All of these stakeholders have an interest in high-quality audit that is performed by a strong audit profession, which, amongst other things, demonstrates integrity and objectivity, professional judgement, scepticism and expertise. One of the key issues raised at the Forum was concern over the differing perceptions among stakeholders of the purpose of the audit and the impact this therefore has on the development of principles-based global auditing standards and on reporting by auditors.

In the light of these concerns, working groups were established to take forward a project to understand and articulate the purpose of an audit and other closely related projects on auditing standards and reporting.

This overarching paper seeks to articulate the purpose of an audit in the context of the interests of shareholders who appoint and monitor boards and, ultimately, control the companies they own.

Key objectives of the group

The objectives of the group were:

> to research, debate and articulate the fundamental purpose of an audit in view of the legal backdrop and related regulatory frameworks, and the various stakeholder interests and perceptions; and to discuss whether the current model appropriately reflects this; and

> to set the context for the other projects within this work stream of the Audit Quality Forum relating to auditing standards and auditor reporting.

Against the Forum’s background paper titled Agency theory and the role of audit, the project has considered and discussed a number of key issues, including:

> the background to the development of the audit and the role of the principal-agent relationship in determining audit purpose;

> the UK legal requirements and responsibilities, including consideration of the relevant provisions of the new Company Law Reform Bill;

> the key stakeholders with an interest in the audit and their expectations;

> auditing standards and the term ‘reasonable assurance’.

Where relevant, the group has considered international developments such as the new EU Directive on the Statutory Audit of Annual Accounts and Consolidated Accounts, whilst not losing sight of the fundamental objective of the project which is to articulate the purpose of the audit in the UK.

The focus of this project is on the purpose of the statutory audit of companies. The group has not sought to look at the purpose of the audit of other entities such as charities, pension schemes or audits in the public sector.
The paper takes account of the current legal framework and that proposed in the Company Law Reform Bill.\(^1\) It does not take account of potential changes to reporting mechanisms, for example as a result of the use of extensible business reporting language (XBRL). In view of the impact that such changes may have on reporting, further consideration may be needed at a future date.

The key conclusions of the group and issues for further consideration are highlighted in this paper. These have been arrived at after consideration of a number of issues, many of which have been summarised in papers covering expectation gaps, the legal framework and case law and the use of the term ‘reasonable assurance’. Working papers of the group may be downloaded from www.icaew.co.uk/auditquality.

\(^1\) References to the Company Law Reform Bill, including to section numbers, are to those relevant at the time of writing.
The framework for the statutory audit

Agency relationships

Audits serve a fundamental purpose in helping to enforce accountability and promote confidence in financial reporting. Relationships between principals and their agents are of particular importance in understanding how audits have evolved and continue to develop. The statutory audit has developed over at least a century in response to agency risks. Directors are delegated responsibility for managing the affairs of the company by the owners and the financial statements therefore became a primary mechanism for shareholders to hold the directors to account.

In effect, directors act as trustees for shareholders. They are bound by certain fiduciary duties that are established in common law and under statute. These include responsibilities in respect of the company accounts and administration of the company. As a result of the separation of ownership from control, problems with information asymmetries and differing motives, there may be tension in the shareholder-director relationship.2 The statutory audit is a mechanism for shareholders to help ensure that the directors are acting in the company’s best interests and it therefore plays a fundamental stewardship role.

Some companies may not, however, have a divorce of ownership from control. For example, the shareholders in many private companies are also the directors. Stewardship may not always, therefore, be present as the driving factor for an external audit as the owner-managers already have access to the information necessary to make informed decisions about the financial position of the company. The exemption from audit available to some small companies perhaps addresses some of the related concerns which arise as to the purpose of a statutory audit for such entities, and it does take some owner-managed companies out of the requirement for a statutory audit. However, many private companies may have minority shareholders who are not part of the management team. For others, the audit may be deemed necessary in order that the members may benefit from the perceived consequential benefits gained by other stakeholders, particularly creditors.

The legal framework

The purpose of the statutory audit, as set out in law, reflects the stewardship role and is backed up by case law. The legal framework for preparing financial statements and an audit thereon is contained in the Companies Act 1985 and is also set out in the Company Law Reform Bill which, at the time of writing, is going through due process in Parliament.

The Companies Act prescribes clear statutory responsibilities for directors in respect of the accounts and administration of the company. The duty on the directors to prepare individual accounts is covered under Section 226 of the Companies Act (Section 376 of the Company Law Reform Bill). Section 375 of the Company Law Reform Bill sets out a specific requirement that accounts should give a true and fair view. This is a new section which does not directly replace any section of the Companies Act 1985 but states that directors must not approve the accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company. It also adds that the auditors of the company in carrying out their functions in relation to the accounts must have regard to this duty of directors.

2 The background paper, *Agency theory and the role of audit*, which builds on a presentation delivered to the *Forum* in March 2005, looks at agency relationships in more detail.
Sections 235 and 237 of the Companies Act 1985 (Sections 485 to 488 of the Company Law Reform Bill) clarify what a statutory audit is and who it is for.

In law, the auditors are appointed by the shareholders of the company to provide them with an independent report. The report is required to state whether in the auditors’ opinion the annual accounts (which are prepared by and are the responsibility of the board of directors) give a true and fair view in accordance with the relevant financial reporting framework. Alongside this, auditors have further responsibilities, which include:

> the provision of an opinion on whether the financial statements have been properly prepared in accordance with the Act;
> consideration of whether the company has kept proper accounting records (adequate accounting records under the Company Law Reform Bill);
> whether the accounts agree to the underlying financial records; and
> whether information given in the directors’ report is consistent with the accounts.

Where, in the auditors’ opinion, these requirements have not been met, the auditors must state this fact in their report.

Case law reiterates this primary purpose of a statutory audit. As the Caparo case confirmed, auditors are directly accountable and owe a duty of care to the company’s existing shareholders as a body. According to Lord Oliver of Aylmerton:

> It is the auditors’ function to ensure, so far as possible, that the financial information as to the company’s affairs prepared by the directors accurately reflects the company’s position in order, first to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company’s affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.

In addition, other statute confers certain rights and duties to auditors in relation to ‘whistle blowing’ and other reporting to regulatory bodies such as The Pensions Regulator and the Financial Services Authority (FSA). These rights and duties arise in part from the statutory position of auditors, but are not directly related to the audit itself. As such the group has not sought to conflate into this discussion these related responsibilities.

**Auditing standards and objectives**

The Auditing Practices Board (APB) has issued International Standards on Auditing (UK and Ireland), which provide standards and guidance on the objectives and general principles governing an audit of financial statements. The ISAs (UK and Ireland) are the ISAs as issued by the IAASB, supplemented, where necessary, by standards and guidance from the UK auditing standards previously in issue (‘pluses’). ISA (UK and Ireland) 200 sets out the objectives of an audit as follows:

> The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. [Paragraph 2]

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3 In the Company Law Reform Bill, the report must give a true and fair view and have been properly prepared in accordance with the relevant financial reporting framework.

4 At the time of writing, Section 368 of the Company Law Reform Bill requires directors to keep adequate rather than proper accounting records and the auditors’ responsibilities under Section 488 are to consider whether adequate accounting records have been kept.

5 *Caparo v Dickman* [1990] 2 AC 605.
'The applicable financial reporting framework’ comprises those requirements of accounting standards, law and regulations applicable to the entity that determine the form and content of its financial statements.’ [Paragraph 2-1]

‘An audit in accordance with ISAs (UK and Ireland) is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement.’ [Paragraph 8]

ISA (UK and Ireland) 700 states ‘In the UK and Ireland, the auditor ordinarily is required by law or regulations to evaluate whether the financial statements give a true and fair view’.

As a result, the ‘applicable financial reporting framework’ embodies the requirements of law and regulations.

The purpose of the statutory audit

In considering what the purpose of the audit is, the group has considered agency relationships, the legal framework, case law and auditing standards. Whilst the group accept that auditing standards do not determine the purpose of the audit they do explain and provide guidance and principles on how to perform an audit and so it is important to consider what they say and what expectations may be generated from them.

The group considers that the statutory audit is conducted for the benefit of shareholders and that the auditors are appointed to provide an independent report to the shareholders on the truth and fairness of the financial statements, whether they have been properly prepared in accordance with the Companies Act, and to report by exception to the shareholders on the other requirements of company law such as where, in the auditors’ opinion, proper accounting records have not been kept.

In coming to this conclusion, the group has considered other stakeholder interests in an audit and the potential expectation gaps that arise around the purpose of the audit. These are covered in the following sections of this paper.

Conclusion:

The purpose of the statutory audit is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements, whether they have been properly prepared in accordance with the Companies Act and to report by exception to the shareholders on the other requirements of company law such as where, in the auditors’ opinion, proper accounting records have not been kept.
Purpose of financial statements

In articulating the purpose of an audit it is critical to clarify and understand the purpose of financial statements. Though this was not one of the group’s objectives, members of the group felt that it would be difficult to consider the purpose of the audit without looking at the purpose of financial statements.

The Companies Act 1985 and the Company Law Reform Bill provide no statement of purpose but Section 375 of the Company Law Reform Bill does say that:

‘The directors of a company must not approve accounts… unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss …of the company.’

The group discussed this issue and believes that the following definition provides the best and most succinct description of the purpose of financial statements in the UK:

‘The primary purpose of the financial statements of an entity is to provide its owners – the shareholders – with information on the state of affairs of the entity and its performance and to assist them in assessing the stewardship exercised by the directors over the business that has been entrusted to them.’ [Paragraph 1, Auditing Practices Board Ethical Standard 1 – Integrity, Objectivity and Independence]

The group believes that under the current UK legal framework, the purpose of both financial statements and the audit is founded on stewardship of the company by directors on behalf of owners. The group notes, however, that the IASB’s Framework for the Preparation and Presentation of Financial Statements (adopted April 2001) places greater emphasis on decision usefulness rather than stewardship:

‘The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.’ [Paragraph 12]

It also notes that there is a joint project of the FASB and the IASB to agree a common conceptual framework.

Further consideration of these potential differences in definition and how they may impact in the UK is beyond the scope of the group but the group believes that this is an important issue, which could benefit from further consideration and monitoring by an appropriate body or forum.

Issues for further consideration:

The group believes that further consideration of the potential differences between International Financial Reporting Standards as a reporting framework and the purpose of the audit under the current UK legal framework (and future framework) by an appropriate forum would be helpful in understanding these differences and what the likely implications may be. In view of the joint FASB/IASB project to agree a common conceptual framework, this is a matter of some importance.
Other stakeholders and their interests in the audit

Whilst the explicit purpose of the statutory audit is to provide a report to shareholders, the statutory audit is of value for many different purposes to other stakeholders, such as directors (or those charged with governance), management, employees, creditors, potential investors, shareholders in other companies and regulators. The legal framework and case law recognise that, in normal circumstances, the auditors owe no duty of care to these stakeholders. However, financial information in the accounts may be a material source of information to many of these stakeholders and they will take assurance or derive value from the fact that an audit has been performed on the financial statements. Likewise, certain rights and duties to report to regulators may arise out of the performance of the audit, albeit they are not the primary purpose of the statutory audit (see page 9). The statutory audit helps to reinforce confidence and trust in financial reporting and to promote a well-ordered and active economy.

Whilst the group recognises that these stakeholders have interests in the audit, the purpose of the audit as defined in law is clear; the audit is conducted for the benefit of shareholders. These other interests must therefore be seen as consequences of the statutory audit – albeit valuable ones with significant public interest and/or social welfare benefits. Some of these consequences also have indirect benefits for shareholders. For example, an audit, and in particular, a management letter or report to the board or to the audit committee, can be valuable in identifying issues in the business. If directors and/or management are gaining benefit from the advice and work of auditors, then indirectly shareholders must benefit too.

Conclusion:

The interests of other stakeholders in the audit are consequences, rather than the primary purpose, of the statutory audit, albeit they have significant public interest and/or social welfare benefits.
Expectation gaps

Shareholder expectations

The previous section highlighted some of the benefits obtained by other stakeholders as a consequence of audited accounts. Except in relation to existing members of the company as a body such assurance is not the primary purpose of the audit. Other stakeholders may not fully appreciate this distinction and as a result have expectations of the audit that it is not designed to meet. Expectation gaps may also arise in respect of what the existing members of the company believe to be the purposes of the audit when compared with the actual nature of the assurance reported to them by auditors.

Fraud, internal control and going concern

The group considered expectation gaps in three specific areas: internal controls, fraud and going concern. It is recognised that expectation gaps may exist in these areas and the group explored these issues but has not given consideration to how such expectation gaps may be addressed.

In formulating an opinion on the financial statements for the benefit of shareholders, the auditors consider the appropriateness of management’s use of the going concern assumption in the preparation of the accounts. In order to help determine their audit procedures, auditors also evaluate internal controls and the potential existence of fraud in terms of the risk that there may be material misstatements. However, no specific assurance is expressed by the auditors on the future viability of the business, the detection of fraud or the effectiveness of internal controls, notwithstanding that some shareholders may want or expect assurance in these areas.

In the context of such expectation gaps, the group discussed the auditing standards in these areas and the use of the term ‘reasonable assurance’ in the UK to explain what audit evidence is needed to support the provision of an audit opinion. The concept of reasonable assurance takes account of the need for professional judgement and scepticism when carrying out an audit and the fact auditors cannot obtain absolute assurance because of the nature of financial statements and the audit. The nature of reasonable assurance is considered in more detail on page 16. Likewise the group identified issues that would benefit from additional clarification in relation to the auditors’ opinion on proper accounting records, which are also highlighted below.

In terms of expectation gaps in the area of fraud, the group notes that fraud, and in particular collusive fraud by senior management is extremely difficult to detect. In 1998 the APB published a discussion paper, Fraud and Audit: Choices for Society. This explored the issue of management fraud, its costs and the practical difficulties associated with auditors detecting management fraud. The paper asked whether the current balance between avoiding unnecessary constraints on business and preventing/detecting fraud was appropriate or whether changes should be sought to current auditing practice, law and governance. The overwhelming response from users, preparers, regulators and auditors at the time was that the APB should not extend the scope of the audit, as has for example now occurred in the USA with the passing into law of the Sarbanes-Oxley Act, and in particular Section 404 of that Act relating to internal control over financial reporting.
To increase audit costs for all companies in an attempt to increase the likelihood of deterrence to or detection of a limited number of cases of management fraud was seen as creating an unacceptable regulatory burden and this would still appear to the group to be the broad consensus in the UK today. The group has not, therefore, given any further consideration to expectation gaps in this area.

**Conclusion:**

The group recognises that there may be expectation gaps between what some stakeholders believe to be the nature of assurance that results from the audit and the actual purpose of the audit. It is not, however, the objective of the group to attempt to resolve these differing expectations beyond clarifying what the purpose of the audit is and how this impacts upon the nature of the assurance that is actually being expressed.

**Wider ranging information for shareholders**

Based on the group’s discussions, it is believed that some shareholders (and other stakeholders) would like to have wider ranging and/or more explicit assurance or information on aspects of the company’s operations not explicitly covered by the financial statements.

Whilst some members of the group were interested in more explicit and direct communication and information provided to the shareholders about the audit, the group agrees that these were not expectations that the current purpose of the statutory audit is designed to meet.

The group notes that shareholders may also want greater disclosure of information on material areas of judgement and difficult, sensitive or contentious matters that have been discussed by the board, or its audit committee, with the auditors. However, it notes that the auditors have no responsibility to share this information with the shareholders except through the medium of the board of directors, and in particular its audit committee, which fulfils the governance role of acting in such matters as a proxy for the shareholders. The group suggests that the issue of what additional information could be provided by auditors to the shareholders is a matter for further consideration by the Audit Quality Forum Auditor Reporting working group.

**Conclusion:**

Whilst the group recognises that some interested parties would like more explicit and direct communication and information about the audit, the group agrees that these are not expectations that the statutory audit is designed to meet, having regard to its primary purpose.

**Issues for further consideration:**

The group suggests that the issue of what additional information could be provided by auditors to shareholders is a matter for further consideration by the Auditor Reporting working group.
Proper accounting records

Under current UK law (Section 237 of the Companies Act 1985), a company’s auditors shall, in preparing their audit report, carry out such investigations as will enable them to form an opinion as to whether proper accounting records have been kept by the company. The audit report therefore may contain an opinion on both the results and financial position of the business (something that is mainly numerically presented and essentially quantitative), and the state of its records (something that is more qualitative). The ‘proper accounting records’ test applies throughout a whole reporting period and not just as at the year-end date. In the event that the auditors can still come to a positive opinion on the presentation of the accounts, the auditors must, if applicable, still flag the fact that proper accounting records have not been kept.

Auditing standards applicable in the UK cover the work required by auditors to obtain an understanding of the entity and its environment, including its accounting system and internal control, but do not specifically address what work should be done to comply with the UK requirement for auditors to form an opinion as to whether the company has kept proper accounting records. The working group questions whether it is clear enough what auditors should do in order to be able to form an opinion on the accounting records, and what and when they should report if they are not satisfied.

At the time of writing, the Company Law Reform Bill requires directors to keep adequate records (Section 368) and auditors’ responsibilities in this respect (Section 488) are also expressed in terms of adequate accounting records.

In terms of the current and prospective law, the group highlighted the following questions where clarification would be helpful:

> What practical guidance will be available to directors to enable them to discharge their responsibilities regarding accounting records that are set out in the Company Law Reform Bill? The group notes that FRAG 5/92, Accounting Records, which was issued by the ICAEW, provides guidance on the requirement of companies to keep accounting records under Section 221 of the Companies Act 1985 but this would need revision to address the requirements of the Company Law Reform Bill.

> What level of work is (will be) needed by auditors to satisfy themselves that proper (or adequate) accounting records have been kept?

> What is the interaction between proper (or adequate) accounting records and the true and fair view opinion given on the accounts? For example, if there is a qualification of the opinion on the accounts due to a limitation of scope, is there an automatic need to report that, at least in some respects, proper (or adequate) accounting records have not been kept?

Conclusion:

The group has identified the need for greater clarity and understanding of directors’ and auditors’ responsibilities in relation to proper or adequate accounting records. The group understands that the Government has been looking at this issue, alongside the current wording of the Company Law Reform Bill in order to provide clarity in this area. The group believes that the development of further guidance, which would update existing guidance for companies and provide new guidance on auditors’ responsibilities, in due course is likely to be helpful.
Reasonable assurance

Background

The Audit Quality Forum recommended that the group look specifically at the concept of reasonable assurance. The group considered the term from a UK perspective, researching what is meant by reasonable assurance that the financial statements as a whole are free from material misstatement and its link with the current legal responsibilities of auditors, as defined in law and identifying the concerns which have been raised by some Forum representatives about its use and meaning.

What is meant by reasonable assurance?

Reasonable assurance is not a concept in UK law. Sections 235 and 237 of the Companies Act 1985 (Sections 485 to 488 of the Company Law Reform Bill), which deal with auditors’ responsibilities, do not include the concept of reasonable assurance. Case law has not attempted to set predetermined thresholds of assurance for audit. The concept does, however, appear in auditing standards. Of particular relevance is paragraph 8 of ISA (UK and Ireland) 200 which says:

‘An audit in accordance with ISAs (UK and Ireland) is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.’

The paragraph does not, however, specify whether and to whom reasonable assurance is attained or provided and the standard also does not provide an explanation of what the term reasonable assurance means.

The group considers that reasonable assurance is attained by the auditors rather than provided and should be characterised as follows:

> The auditors cannot attain absolute confidence because of numerous factors arising, amongst other things, from the limitations of audit evidence, the impracticality of examining all evidence and uncertainties as to the future.

> Reasonable assurance is the level of confidence that the auditors, by exercising professional skill and care, are expected to attain from the audit, that the financial statements are not materially misstated.

> The confidence that the auditors attain is subjective and is the basis for issuing an audit opinion. Auditors do not specifically express or provide reasonable assurance in their opinion but users nevertheless derive assurance/value from the auditors’ opinion. In practice users of financial statements may derive their confidence in the audited financial statements from many sources, including a knowledge that the auditors work to professional standards within a framework of regulation and that the auditors have felt sufficiently confident that the financial statements are not materially misstated to issue an unqualified opinion.

> As a consequence of their confidence that financial statements are not materially misstated, users of financial statements may also gain confidence that the management of the entity are conducting its affairs in the knowledge that the financial consequences of their actions will be reflected in the financial statements.
Other concerns

Some critics have asserted that the use of the term reasonable assurance in auditing standards suggests that it merely represents the completion of a series of procedures or processes designed to ensure that the audit has been conducted in accordance with a series of auditing rules, which are aimed at ensuring that the accounts as a whole are not materially misstated, without regard to the wider true and fair objective. On this basis, it has been suggested that there is too much focus on the process and that, as a result, the audit becomes input driven rather than opinion/output driven.

The overarching legal responsibility of auditors in UK law is, however, to reach an opinion on truth and fairness of the financial statements. In many cases, there is a range of audit approaches that auditors can justifiably choose in order to provide themselves with reasonable assurance as a basis for their opinion. Auditing standards require auditors to obtain a proper understanding of the business and financial risks before giving an opinion and to consider whether, having regard to the inherent limitations of an audit, they have obtained sufficient relevant and reliable evidence on which to base their opinion. The concept of reasonable assurance in the UK would embody professional judgement, objectivity and integrity and so would extend beyond simply following procedures. The concept of professional scepticism is included in auditing standards and is also an integral requirement in being able to provide reasonable assurance.

It is also important to emphasise the key enablers of audit quality that underpin the ability of the audit to provide reasonable assurance, such as the recruitment of high-quality people, relevant training and experience, continuous professional development and effective quality control measures at firm and engagement level to achieve this. The group notes that audit quality is a topic that is currently being looked at further by both the APB on behalf of the Financial Reporting Council (FRC) and the ICAEW.

The group notes that there is debate about the future direction of international auditing standards (which will impact UK standards in due course) as regards the relationship between the objectives of standards and the detailed requirements in standards. It is currently expected that in future international standards will clarify that auditors should meet the objectives of standards as well as comply with the detailed requirements. The new objectives will impose on auditors a higher test than simply complying with the requirements, thus reinforcing the need for professional judgement that is inherent in UK auditing.

Conclusion:

The group concludes that reasonable assurance is the degree of confidence that auditors require in order to provide their opinion as to whether the financial statements provide a true and fair view. Auditors acquire confidence in the financial statements from their audit work and in turn the shareholders acquire confidence from the audit report and their knowledge of the regulatory background and professional process that has determined the design and execution of the audit.

The group has also flagged the importance of the concepts of objectivity and professional scepticism and the key enablers of audit quality which underpin the ability of auditors to acquire reasonable assurance.
Bibliography


Auditor liability – claims by third parties, London: Audit and Assurance Faculty, ICAEW in conjunction with Simmons and Simmons, 2005.


Fraud and ‘the expectation gap’, A survey of senior businessmen’s views, Coopers & Lybrand Deloitte, February 1990.


Appendix 1

Further background information

The following working papers were prepared for the Audit Purpose working group to aid discussion of some of the issues around the purpose of an audit and to help the group to develop the paper, Audit Purpose:

> Current legal framework for the statutory audit (December 2005)
> Expectation gaps (February 2006)
> Key issues paper (March 2006)
> What do auditors in the UK mean by ‘reasonable assurance’? (May 2006)

The working papers do not necessarily represent the views of the members of the Audit Purpose working group or of the Audit Quality Forum, individually or collectively.

No responsibility for any person acting or refraining to act as a result of any material in these papers can be accepted by the authors, the Audit Purpose working group, or the ICAEW’s Audit and Assurance Faculty.

These working papers are available for download from www.icaew.co.uk/auditquality.
Appendix 2

Working group membership

We are grateful to the following people for their input to this paper issued to the Audit Quality Forum. Their input does not necessarily reflect the views of the organisations they work for or are attached to.

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British American Tobacco plc

Richard H Reid
KPMG

David Somerlinck
The Local Authority Pension Fund Forum

Observers:

Julian Rose
Professional Oversight Board

Sumita Shah
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Emma Ward
Department of Trade & Industry
Agency theory and the role of audit

This paper focuses on the role and importance of the agency relationship in the development of audit historically and how the relationship may be useful in understanding the role of the statutory audit in the UK today. It also introduces other issues, interests and relationships, which impact on the application of this theory and point to potential alternative purposes of an audit.

Principles-based auditing standards

What are ‘principles-based’ or ‘objectives-oriented’ auditing standards? This paper explores the perceptions of the nature of such standards. How do they differ in practice from ‘rules-based’ standards? Implementation issues are also explored including the capacity of such standards to deliver real improvements in audit quality and the need to balance the promotion of professional judgement with the need for auditor accountability.

FORTHCOMING TITLE

Making global auditing standards local

In practice how can auditing standards have global reach yet deal with local challenges? The qualities of auditing standards necessary to facilitate high quality audits of large, medium-sized and small entities in the UK will be considered. The project will set out the challenges to implementing global auditing standards in the UK.

FORTHCOMING TITLE

Auditor reporting

Is current auditor reporting, in particular the audit report, helpful to shareholders? This paper will consider the information that auditors should communicate and how this reflects audit purpose, the expectations of shareholders and the need to further enhance confidence in the independent audit.

FORTHCOMING TITLE

Third parties

How does the extent of disclosure of third-party information and advice to the board impact on audit quality? Advice given to boards and information held by third-party advisers, trading partners and others is relevant to the content and reliability of financial statements. What are the implications for the work of auditors, audit quality and transparency?