The quality of audit files - common problems and solutions

The words ‘audit quality’ are used a lot at the moment. But what do they mean? What is expected from auditors? For example, what do the Quality Assurance Directorate (QAD) expect to see when they visit? Are you confident that your firm has systems in place to ensure good audit quality?

Autumn Roadshow

The faculty is running roadshows this autumn to help firms ensure that these systems are in place. The roadshow is being organised with the QAD to help identify the common areas of weakness and more importantly how to address these weaknesses.

The roadshow will cover a range of current issues including solutions to common audit problems in the following areas:

- Whole firm procedures in the International Standard on Quality Control (UK & Ireland) 1 (ISQC 1) - awareness and documentation
- ISAs (UK and Ireland)
- APB Ethical Standards - including the PASE
- Companies Act compliance - including disclosure
- Other regulated areas such as FSA, Charities, etc
- Practice Assurance issues

The material covered in the roadshow will be based upon the experiences of QAD reviewers which means that the areas covered will be relevant to auditors in practice. Using case studies the roadshow will give practical and effective solutions to these common audit problems.

Feedback about QAD visits

This roadshow has come about through faculty members telling us about their issues and experiences of QAD visits. Some members have said that they felt well prepared for their QAD visit and they were surprised when the QAD identified a number of weaknesses. Members and QAD reviewers alike tell us that these weaknesses often include non-compliance with Ethical Standards and the ISAs (UK and Ireland) which cover understanding the entity and risk assessment.

In the UK it has been all change for auditors in the last few years with new APB Ethical Standards (ESs), International Standards on Auditing (UK and Ireland) and numerous changes to the companies legislation with the Companies Act 2006 currently being implemented. Is it any wonder that auditors are not always clear as to what is expected of them?

QAD reviewers tell us that they are continuing to spend a lot of time helping firms to understand the requirements and how to comply with them. However, three years on from the implementation of the new standards, there is an expectation that auditors will have a command of the Ethical Standards and ISAs (UK and Ireland).
The needs of audit-exempt companies: consultation closing in August 2008

The faculty has been consulting on the needs of audit-exempt companies since 31 August 2006 and the two year consultation period will soon be coming to a close.

During this period, the faculty has spoken to a number of practitioners and stakeholders including banks and credit referencing agencies. To seek further information, the faculty has also looked at existing research, statistical information, and arrangements that exist in other countries.

A final report will be issued which will consider the impact of the last audit exemption threshold rise, views of stakeholders and future actions that the faculty may take. The report is expected to be published in autumn 2008.

The findings are likely to be significant, as many faculty members provide services to companies that are under the audit exemption threshold.

The faculty will continue to provide valuable information and guidance in relation to the statutory audit, but it will also seek to address the needs of its members whose clients may be seeking different types of services. The faculty already has guidance in relation to accounts compilation services (AUDIT 02/04 Chartered Accountants’ Reports on the compilation of financial statements of incorporated entities and AUDIT 01/05 Chartered Accountants’ Reports on compilation of historical financial information of unincorporated entities) and non-audit assurance service (AAF 03/06 The ICAEW Assurance Service on unaudited financial statements).

Understanding member views is vitally important for the faculty so that it can continue to provide relevant services to its members.

The implications of the report may also be significant to standard setters, including the International Auditing and Assurance Standards Board (IAASB)’s Strategy for 2009-2011 as this mentions the potential need to consider an alternative assurance service for SMEs.

As part of this consultation exercise, the faculty launched the ICAEW Assurance Service together with a complementary practical guide which helps members communicate the services they can offer to their clients. The final report will consider the practical benefits of the Assurance Service, based on the views received from members.

Jo Iwasaki | Manager, Audit and Assurance Faculty

Has the audit exemption threshold rise affected the services you offer to your clients? Do you have any comments from using the ICAEW Assurance Service? Do you wish to be involved in helping the faculty to form its view? Get in touch at tdaf@icaew.com.

The quality of audit files - common problems and solutions cont’d from page 1

Why attend the Roadshow?
John Selwood will again be presenting the roadshows for the faculty and he will be working closely with the QAD reviewers to identify real life examples of how things can go wrong and how to get it right.

John says that ‘If you attend the roadshow you will learn through the experiences of other audit firms, the QAD reviewers and the faculty how to consistently ensure audit quality.’

The following are the areas that will be covered on the roadshow:

- Procedures for gathering and documentating audit evidence - sampling and analytical review
- Documenting the auditors’ understanding of the entity and risk assessment
- Assessment of the design and implementation of internal controls
- Consideration of the fraud risk
- Use of proprietary audit systems
- Communications with the audit client - unadjusted errors
- Law and regulations
- CPD requirements
- Engagement letters
- Financial Statements disclosure
- Review procedures
- Practice Assurance issues

The roadshow will run from September to December 2008 and we would advise you to book early to avoid disappointment. We hope to cover 18 venues. Sessions will run for half a day. The enclosed flyer provides further details.
Integrity in organisations - next steps

In May 2007, we wrote an article on some of the ideas and suggestions for promoting integrity, that were included in the ICAEW’s publication Reporting with Integrity. This publication aimed to advance the debate on integrity in reporting by exploring what integrity means and how it is promoted by individuals and organisations, including professional bodies.

We proposed a framework for integrity based on three building blocks: definition, behavioural characteristics associated with integrity and organisational drivers.

![Framework for integrity]

Since its publication, the Institute has organised or participated in a number of events to advance the debate on the topic of integrity. Readers of the report were also invited to respond to the issues raised in the report.

The publication has attracted considerable feedback from academics, standard setters, and professional accountants in business and in practice. In general, respondents were of the opinion that the publication is a welcome addition to the debate on integrity. It was thought to be well structured, thought-provoking and unique in its approach to exploring what integrity means in the accountancy profession by looking at different disciplines such as philosophy and psychology. Whilst respondents were broadly supportive of the behavioural characteristics associated with integrity and the key organisational drivers for promoting integrity, there was a mixed response about the notion that integrity has five key aspects. The feedback received from events, meetings and respondents to the consultation is summarised at www.icaew.com/ethics.

Where do we go from here?

The Institute will be taking forward existing work on integrity generally as part of the Market Foundations thought leadership initiative. Possible routes include:

- Exploring further decision-making, judgement and ethical behaviour across different cultures
- Roundtable discussions and events such as the Professional Associations Research Network (PARN) conference
- Further research including:
  - What techniques are effective in promoting organisational integrity in businesses generally?
  - What mechanisms are effective for promoting integrity in the accountancy profession?
  - The impact of reporting quality of different institutional arrangements covering companies, audit firms and professional bodies.

We would like to take this opportunity to thank those who responded to the consultation. Any further feedback on the above issues would be welcome. Please send comments to anne.davis@icaew.com.

Anne Davis | Ethics Manager, ICAEW

EC simplification - developments

In the September 2007 issue of Audit & Beyond we reported on a consultation paper from the Commission of the European Communities. This consultation paper included a series of proposals designed to simplify the business environment for EU companies in the areas of company law, accounting and auditing. We then reported the ICAEW response to this consultation in the December 2007/January 2008 issue. This article summarises further progress.

The Commission has now released its proposals for simplification fast track options for 2008. These fast track options are intended to be small and uncontroversial proposals that can be adopted within a short timeframe. There are three accounting related proposals:

- The removal of disclosure requirements for formation expenses - the EC is proposing to extend the scope of the exemption for small companies to include medium-sized companies too
- Removal of the disclosure requirements for breakdown of turnover into activity and geographical markets for SMEs
- Amendment to clarify the relationship between the 7th Company Law Directive and the IAS regulation in the case of parent companies that have no material subsidiaries. The EC is seeking to clarify that these companies are not required to prepare IFRS financial statements

It is unlikely that there will be major objections from the European Parliament or Council to these proposals. Further information is available at [Report link].

In terms of the other (longer term) proposals, the Commission is still considering whether there is enough political support for them.

We will keep you updated on any further progress in respect of these simplification proposals, particularly in the area of auditing.

Louise Sharp | Manager, Audit Practice Issues, Audit and Assurance Faculty
The majority of the auditing requirements of the Companies Act 2006 (the Act) came into force for periods commencing on or after 6 April 2008. A challenge for auditors over the next year will be to understand the implications for their work of the requirements of the Act. To help auditors meet this challenge the Auditing Practices Board (APB) has issued four Bulletins:

- **2008/3** The auditor’s statement on the summary financial statement in the United Kingdom (Applicable Regulations in SI 2008 No. 374)
- **2008/4** The special auditor’s report on abbreviated accounts in the United Kingdom (Applicable Regulations for small companies in SI 2008 No. 409 and for medium-sized companies in SI 2008 No. 410)
- **2008/5** Auditor’s reports on revised accounts and reports in the United Kingdom (Applicable Regulations in SI 2008 No. 373)
- **2008/6** The Senior Statutory Auditor under the United Kingdom Companies Act 2006

The focus of the first three of these Bulletins is to illustrate example auditor’s reports that meet the requirements of the Act and the Regulations that underpin them. These Bulletins describe procedures that auditors would undertake when reporting in respect of each engagement and provide some commentary on the requirements of the Act and applicable Regulations. However, the Bulletins are not a substitute for reading the requirements of the Act and, in particular, the Regulations. In common with all APB publications the Bulletins may be downloaded free of charge from the APB website.

The summary financial statement (2008/3)
Since the APB’s previous guidance was issued the law has been amended to:

- Extend to all companies the ability to send out summary financial statements
- Specify the content of the summary financial statement of companies that prepare accounts in accordance with IFRS
- Remove the requirement for the summary financial statement to include a summary of the directors’ report. (However, companies may include a summary directors’ report if they wish)

Four illustrations of auditors’ statements are illustrated in Bulletin 2008/3 to reflect the fact that both quoted and unquoted companies are now able to provide summary financial statements and that unquoted companies may decide not to include any ‘surround information’ with the summary financial statement.

The small companies regime (2008/4)
A small company (that is not exempt from audit or has not taken advantage of an exemption) may deliver to the Registrar a copy of the full auditor’s report prepared in accordance with section 495 of the Act. In the case of (c) the company is required to deliver the ‘special auditor’s report’ prepared in accordance with section 449(2) of the Act.

Bulletin 2008/4 provides an illustrative example of a special report on the abbreviated accounts of a small company. (It also provides an illustrative report on the abbreviated accounts of a medium-sized company).

In respect of (a) and (b) above the company is required to deliver a copy of the full auditor’s report notwithstanding that the auditor’s opinion is expressed on the full accounts and report, rather than being restricted to reporting on the primary statements that have been filed. Although the auditor is not permitted to amend its report it is not precluded from adding a preface to the copy report explaining that certain primary financial statements and the directors’ report originally reported on are not included within the filing. The Bulletin provides illustrative wording for such a preface.
Audit Quality Forum - update on Evolution work programme

The new Evolution work programme was launched in 2007 and covers the following topics:

- The impact of audit committees on auditing
- The statutory audit: reconciling stakeholder expectations
- Changes in what is audited: how changes in financial reporting affect audit practice.

As highlighted in the November 2007 issue of Audit & Beyond (see Bulletin Board), the forum held a successful debate in September 2007 on the impact of audit committees on auditing. This was attended by investors, audit committee members, the business community, practitioners and regulators. A summary of the debate is available on the website.

The forum recently met to discuss the progress on some of these projects. Robert Hodgkinson, Executive Director, Technical Strategy at ICAEW, presented a paper on the impact of audit committees on auditing for discussion which considered public policy options, such as:

- All entities subject to audit should have audit committees
- Auditors’ interaction with audit committees should be an integral part of the audit process set out in auditing standards
- Auditors should evaluate whether audit committees are effective in supporting the quality of audited financial statements.

The paper will shortly be available on the website.

Stella Fearmley, an academic from Bournemouth University, gave a presentation on financial reporting and audit quality under current UK regulation. This Institute-funded research follows the publication of Behind Closed Doors some seven years ago. It compares what the different stakeholders think audit is adding to the financial reporting process. The research is based on a survey of finance directors, audit committee chairs and audit partners.

Questions were asked about the composition of audit committees, what they discussed with their auditors, what had changed as a result, and what effect recent and forthcoming changes would have on audit quality and financial reporting. The findings are available on the website.

Finally, Louise Sharp updated the forum on progress on the reconciling stakeholders’ expectations of audit paper and the third project in the Evolution work programme, Changes in what is audited: how changes in financial reporting affect audit practice.

Louise Sharp | Manager, Audit practice issues, Audit and Assurance Faculty

Auditor’s reports on revised accounts and reports (2008/5)

Regulations to the Act continue to permit annual accounts (including abbreviated accounts), directors’ reports, directors’ remuneration reports and summary financial statements to be revised either by replacement or by supplementary note. With respect to revised accounts the auditor is required to state whether a true and fair view ‘seen as at the date the original defective annual accounts were approved’ is given by the revised accounts.

In addition to the requirements of the law ISA (UK and Ireland) 560 Subsequent Events requires that ‘the new auditor’s report should include an emphasis of matter paragraph...’. ISA 560 permits the auditor to restrict the audit procedures regarding the revised financial statements to the effect of the event that necessitated the revision. In such cases the emphasis of matter in the auditor’s report on the revised accounts is required to contain a statement to that effect. The interaction of the requirements of the Act and ISA 560 is illustrated in Appendices 2 and 3 of Bulletin 2008/5.

Senior Statutory Auditor (2008/6)

The Act requires, where the auditor is a firm, that the auditor’s report must be signed by the ‘senior statutory auditor in his own name for and on behalf of the auditor’. Bulletin 2008/6 provides guidance with respect to the meaning of the term ‘senior statutory auditor’ and indicates that the term has the same meaning as the term ‘engagement partner’ as used in ISA (UK and Ireland) 220 Quality control for audits of historical financial information.

The senior statutory auditor is required to sign the auditor’s report provided to the company by the auditor upon completion of the audit. Appendix 2 of Bulletin 2008/6 illustrates how the signature of the senior statutory auditor is presented in the auditor’s report.

The requirement for the senior statutory auditor to personally sign the auditor’s report may give rise to logistical difficulties as another partner, or responsible individual, is not able to sign for and on behalf of the senior statutory auditor. Therefore, with respect to listed and other public interest entities, where adherence to an established timetable is important, the Bulletin recommends that firms have a contingency plan as to who would succeed as senior statutory auditor in the event that the senior statutory auditor is unable to sign the auditor’s report.

The requirement for the senior statutory auditor to sign the auditor’s report does not apply to copies of auditor’s reports required to be delivered to the Registrar of Companies. These are required to state who signed the report as senior statutory auditor, but they may be signed by any person authorised to sign on the audit firm’s behalf.

Steven Leonard is a Project Director at the Auditing Practices Board. Any views expressed in the article are those of the author and should not be attributed to either the Auditing Practices Board or the Financial Reporting Council.
The Auditing Practices Board (APB) has issued revised Ethical Standards on auditor independence on 4 April 2008, which apply to audits of periods which commence on or after 6 April 2008. This clearly does not allow much time for implementation but there are some limited transitional arrangements. The basic structure of the Ethical Standards is not changed.

Changes
There are some changes however, stemming from the revised EU Statutory Audit Directive (implemented in the UK via the Companies Act 2006), prospective revisions to the International Federation of Accountants (IFAC)’ Code of Ethics and clarification of wording in the existing standards to assist in their implementation.

The overall structure of the main Ethical Standards (ES1-ESS) remains the same and the Provisions Available for Small Entities (ES-PASE) has been retained. Some of the key changes resulting from the revisions are listed below:

- **Networks:** the definition and requirements for network firms have been aligned with the definition included in the current IFAC Code of Ethics. This requires network firms to be independent of each other’s clients. Networks have to have global policies and procedures designed to comply with these requirements. Audit firms are required to implement revisions to their policies and procedures by 30th September 2008
- **Relationships:** easing of requirements relating to inconsequential business relationships and financial interests for partners not involved in the audit
- **Cooling off periods:** additional requirements regarding ‘cooling off’ periods when partners join their audit clients
- **Staff loan assignments:** additional requirements that staff loan assignments should be short and not used to do anything ES 5 (Non-audit services provided to audited entities) would prohibit

- **Key audit partner:** widening the scope of key audit partner (now called key partner involved in the audit) to include those primarily responsible for the audit of significant affiliates, even if not operating at group level
- **Audit fees:** inclusion of a new requirement that audit fees should not be influenced by the provision of non-audit services to the audit client
- **Informed management:** extended discussion of management decisions and clarification about what ‘informed management’ means
- **Valuations:** extended discussions on what valuations are and a prohibition on auditors providing valuation services to listed clients where the valuation is material and impacts on the accounts
- **Tax accounting:** prohibition of tax accounting entries to listed entity audit clients
- **Contingent fees:** changes in corporate finance contingent fee wording
- **Exemption limits in ES-PASE:**
  - Alignment of small company exemption limit with that in the Companies Act
  - A reduction in the exemption for pension fund audits entitled to apply the ES-PASE, from those with less than 1000 members to those with less than 100 members. This was not included in the original consultation but was apparently requested by the Pensions Regulator

Further work
In the APB’s feedback paper which summarises the responses received to the consultation on their Ethical Standards, the APB noted that it intends to undertake further work in the following areas:

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

Regarding the above, the Institute will continue to support:

- A principles-based approach to standards
- Convergence of international and national ethical standards
- A move to 7 year rotation for the audit engagement partner and the engagement quality control reviewer

More detailed information on changes to the APB Ethical Standards and other ethics-related matters can be found at www.icaew.com/ethics. If you have any views on the issues raised above or would like to participate in future consultations on proposed revisions to the APB Ethical Standards, please e-mail us at ethicspolicy@icaew.com.

Anne Davis | Ethics Manager, ICAEW
Risk maturity - auditing risk management

Over the last few years the need to manage risks has been recognised as an essential part of corporate governance. Organisations are under increasing pressure to identify all the business risks they face, and to explain how they will manage them to an acceptable level, so it’s not surprising that auditing risk management is now on the boardroom agenda.

At the April Internal Audit Lecture attended by delegates from the private and public sector, Dr Sarah Blackburn, Managing Director of Wayside Network Ltd and Chairman of the Institute of Internal Auditors (IIA) UK and Ireland Professional Development Committee, explained that the responsibility for managing risks has been clearly assigned to the senior management team of the organisation.

The processes involved in managing risks have been recognised as playing a central and essential role in a sound system of internal control. With the current economic climate, Boards and their Audit Committees want assurance that organisations are managing risks effectively.

Delegates were presented with the IIA UK and Ireland definition of Risk Based Internal Auditing (RBIA): ‘A methodology that links internal auditing to the organisation’s overall risk management framework.’ The IIA UK and Ireland believes that professional internal audit activity can best achieve its mission as a cornerstone of corporate governance by positioning its work in the context of the risk management and assurance framework. Its guidance on RBIA, published in 2005, recommends that internal auditors assess the risk maturity of their organisations as a pre-requisite for RBIA planning.

Identifying risks
Every organisation is different, and has a different attitude to risk, different structures and different processes to tackle issues that might affect the success of the organisation. However, an organisation’s risk management framework should include all types of risks that might affect its objectives. One benefit of RBIA is that not only should it highlight risks which are not properly controlled, it should highlight risks which are over-controlled and therefore consuming unnecessary resources.

Dr Blackburn, who has carried out reviews on risk management maturity in several companies and public sector bodies, went on to discuss models of good practice in risk management and explained how delegates can provide assurance on the maturity of risk management in their organisations.

Internal audit will help to provide assurances on three areas: risk management processes, both their design and their effectiveness; management of those risks classified as ‘key’ including the effectiveness of the controls and other responses to them, and the complete, accurate and appropriate reporting and classification of risks. In order to support these assurances, internal auditors are required to provide evidence against criteria. The results of each internal audit assignment may require management to revise or amend the risk register or the internal audit activity to revise its assessment of the overall risk maturity.

Managing risk
Dr Blackburn elaborated on two risk management models, which provide criteria that can help determine the organisation’s risk maturity. The IIA has developed the Risk Management Maturity Model, which aims to provide criteria against which to evaluate risk management process. It has five levels of competencies: risk naïve, risk aware, risk defined, risk managed and risk enabled. It is based on expert practitioner consensus and the IIA would support further research showing the link between risk management processes and effectiveness.

In addition, Dr Blackburn highlighted a model used by HM Treasury based on the European Foundation for Quality Management (EFQM) Business Excellence Model. This provides a framework, which can be used to assess an organisation’s progress towards achieving excellence and allows organisations to identify its strengths and potential areas for improvement. Using this model, organisations can develop benchmarking internally, and against other organisations.

Dr Blackburn warned against adopting a tick-box approach to the criteria and advocated understanding the culture of the organisation.

To conclude, Dr Blackburn emphasised it is the responsibility of management for ensuring that all risks are identified properly and that responses to risks are working effectively. And it’s the internal auditors’ role to provide objective assurance and to facilitate management’s efforts to implement responses to risk. Ultimately, risk based internal auditing should not be a standalone action but embedded within the overall company risk management strategy.

Lorna Webley  |  Independent Consultant
ICA EW Business Information Centre

The Institute is creating a new Business Information Centre for members, which will include a more modern library and full business facilities. In preparation for this, the Library will move into temporary accommodation in the Members’ Room in Chartered Accountants’ Hall.

Please note that the dates below are provisional - please check www.icaew.com/library for future updates and further information.

Monday 9 to Thursday 12 June inclusive
The Library Enquiry Service will operate a restricted service. You can still contact the Enquiry Service by email library@icaew.com or by leaving a voicemail on 020 7920 8620. We will try to deal with as many enquiries as possible. Access to the physical library will not be possible.

Friday 13 June to Friday 20 June inclusive
We will unfortunately not be able to deal with any enquiries during this period. If you have a non-urgent enquiry, please email it to library@icaew.com and we will deal with it after we re-open on Monday 23 June. Access to the physical library will not be possible.

Monday 23 June onwards
The Library will re-open in the Members’ Room in Chartered Accountants’ Hall. All services will be available as normal.

Solicitors Accounts Rules

Following the consultation on residual client account balances last year, the Council of the Law Society has now made a number of amendments to the accounts rules with the concurrence of the Master of the Rolls. The changes will take effect from 14 July 2008. A notice, together with a copy of the amendment rules, are available at www.sra.org.uk/accounts-rules.

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Audit & Beyond editorial information

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