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Fundamentals – Auditor reporting

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



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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. This paper is being published so that the appropriate government and regulatory bodies identified within can consider the conclusions and recommendations of the working group and take such actions as they consider necessary and appropriate in accordance with their own due processes.

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, management, auditors, regulators and other stakeholders in the audit.

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Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at www.auditqualityforum.com or contact +44 (0)20 7920 8493.

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There are references to the provisions in the Companies Act 2006. Although this Act has been enacted, it has yet to be brought into force at the time that this paper is published. Other law and regulations referred to in this paper are stated as of 31 January 2007.

No responsibility for any persons acting or refraining to act as a result of any material in this paper can be accepted by the authors, the Auditor Reporting working group, or the ICAEW's Audit and Assurance Faculty.

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Contents

	Page
Executive summary	4
Introduction	7
Background	7
Key objectives of the group	7
Purpose of the audit and audit report	8
What is the purpose of the statutory audit?	8
Who are the stakeholders?	8
The purpose of the audit report	8
Information flows	9
Communication between the auditor and the company, via the audit committee or those charged with governance	9
Communication between the auditor and the shareholders	9
Communication between the company and the shareholders	10
Shareholder expectations	11
Information currently contained within an audit report	11
Information that shareholders would like to see in the audit report	12
Considerations prior to making change	12
Confidentiality	12
Information available through other means	12
Changes already or soon to be addressed through new legislation and standards	13
Reasons why change to the current regime may be appropriate	15
Conclusions and recommendations	16
Proposed changes to the format of current audit report	16
The opinion paragraphs	16
Improving readability	19
Company specific information	19
Disclosures contained within the annual accounts	19
Review of the Combined Code	20
Company specific information within audit report	20
International and European considerations	21
Appendix A: Current UK reporting framework	22
Legal framework	22
Companies Act 1985	22
Identification of financial reporting framework	24
Companies Act 2006	25
International and European considerations	25
International Standards	25
EC 8th Directive on the Statutory Audit	26
APB guidance	27
Standards and guidance	27
Appendix B: Example of a current audit report for a UK listed company	29
Appendix C: Legal considerations	31
Appendix D: Example of a French audit report	32
Appendix E: Example of a possible new format for the UK audit report	34
Appendix F: Working group membership	37

Executive summary

This paper is written for the UK, drawing on the views of investors, business, representatives trade bodies, practitioners and academia. However, much of it is relevant in an International and European context and therefore the Auditor Reporting working group hopes that the IAASB and key European bodies will also find the paper useful.

Key recommendations of the working group

The working group considers that the audit report should, within a clearly defined framework (which would need to be considered and developed), and in line with applicable European Commission (EC) requirements, include the following:

- > an opinion paragraph adopting as soon as practicable the wording and structure of Section 495(3) of the Companies Act 2006 in its three distinct parts (see paragraph 49(a) below). Clearly, the wording of audit reports will have to comply with the law from the effective date of the Companies Act 2006 regardless of whether there is early adoption;
- > a positive statement that adequate accounting records have been kept (see paragraph 49(b) below); and
- > a positive statement that there are no matters that auditors wish to draw attention to by way of emphasis under Section 235(2A)(b) of the Companies Act 1985 or Section 495(4)(b) of the Companies Act 2006 (see paragraph 49 (c) below).

The working group agreed that the readability of audit reports would be improved by moving the opinion to the front and much of the standardised boilerplate text to the back or into an appendix (see paragraph 53 below).

To meet the investors requirements for more company-specific information (of key subjective areas (paragraph 26)), the working group considers that a review needs to be carried out of the current disclosures within the annual accounts, and information to be provided under future new requirements to assess the extent to which disclosures being made in practice, go all or part of the way to meeting the wishes of investors for further information (see paragraph 57 below).

In addition, the Combined Code recommendations for audit committee disclosures could be reviewed and amended such that audit committees would be expected to include more specific information through their report to shareholders, including identifying key issues and significant accounting and reporting matters discussed with auditors as a result of the audit. This review would also need to consider the auditors' reporting role in relation to these disclosures. In the meantime, the working group encourages audit committees to do this as a matter of course and would like to see this evolving as best practice (see paragraphs 58 and 59 below).

A further recommendation made by the working group which will require further debate with key stakeholders, is for auditors to consider providing company-specific information (where it is not already available), within the audit report, identifying significant and particularly subjective issues in relation to the audit (see paragraphs 60–62 below).

All the recommendations will need to be considered in the context of the EC's appetite for a single common audit report in Europe. The working group recommends that the Department of Trade and Industry (DTI), the Financial Reporting Council (FRC) and other UK stakeholders encourage the International Auditing and Assurance Standards Board (IAASB), the EC and other bodies that operate at European level to consider the recommendations above, especially in discussions around the development of ISA 700 and the common audit report (see paragraph 63 below).

The *Audit Quality Forum's* working group on auditor reporting was tasked with considering whether the wording of the audit report satisfies shareholders' expectations. To achieve this, the working group considered the information that shareholders wished to see within the audit report, why they require this information and whether the current audit report meets their needs. In its deliberations, it has considered the current barriers to change and has sought to identify ways to overcome them. The working group's key recommendations are shown opposite.

The Companies Act 1985 requires that a company's annual accounts are laid before the company (which for these purposes means the body of shareholders) in general meeting. The annual general meeting provides the shareholders with an opportunity to review the stewardship of the company during the preceding year, to vote for or against the election (or re-election) of directors, to approve or disapprove the appointment or reappointment of auditors, and to take other decisions affecting the company as a whole or themselves as members of a particular class of shareholders. The annual accounts are prepared by the directors and sent to the shareholders to enable them to exercise their rights in general meeting.

Auditors are appointed, amongst other things, to provide an independent opinion to shareholders on the truth and fairness of the company's annual accounts and an opinion as to whether they have been properly prepared by the directors in accordance with the Companies Act 1985. The auditor's opinion to the shareholders, as a body, is expressed in the audit report which is published with the annual accounts. The form of the audit report has developed significantly over the years, but is governed largely by legislative requirements and auditing standards.

Auditing standards require auditors to communicate audit matters of governance interest arising from the audit of the annual accounts with those charged with governance of an entity. Such matters are those that arise from the audit of the annual accounts (e.g. on various matters relating to the company itself, the business of the company and its assets) and, which in the opinion of the auditor, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process.

In the UK, audit reports are governed by legislation and ISA 700 (UK and Ireland), *The auditor's report on financial statements*. A revised version of ISA 700, *The independent auditor's report on a complete set of general purpose annual accounts* was issued in 2003 and is effective for auditor's reports dated on or after 31 December 2006, but has not yet been adopted by the Auditing Practices Board (APB) for use in the UK and Ireland. The IAASB, in its deliberations, was concerned with the need to provide consistency in audit reports but without introducing rigidity that might affect the ability of individual jurisdictions to adopt the revised ISA and hence the auditor's ability to comply with ISAs. The revised ISA allows for a two-part report. The first part of the report deals with an opinion as to whether the accounts give a true and fair view. The second part includes local legal or regulatory requirements to be included within the audit report. The conclusions and recommendations in this paper therefore need to be considered in the context of these wider considerations.

Some shareholders have expressed a wish for more discursive information within the audit report, which would include matters that auditors have discussed with the audit committee. In particular, they would like to see information on matters of emphasis; reference to uncertainties and future risks; details of difficult, sensitive and contentious issues; a discussion of the accounting treatments considered and those eventually adopted; and other material issues encountered during the course of the audit. With the exception of matters of emphasis relating to significant uncertainties and going concern problems, auditing standards concentrate on auditors communicating audit matters with those

charged with governance and neither they, nor company law, require auditors to report to shareholders matters that they report to the directors.

Some of what auditors discuss with audit committees is confidential. Inappropriate disclosure of confidential and commercially sensitive information may not necessarily benefit the shareholders. There is a risk of misunderstandings arising as a result of lack of context since shareholders will not be in possession of the same up-to-date knowledge about the company that the directors have through their day-to-day activities.

The working group perceives that the corporate governance framework that has been developed over the last decade and the increased clarity around the role of the non-executive directors, especially those on audit committees, has improved transparency and increased the level of dialogue between companies and shareholders.

There was, however, a consensus within the working group that audit reports as the main channel of communication between auditors and shareholders, are too boilerplate and standardised. It was recognised that some of the standardised wording is necessary in order to provide clarification as to what auditors' responsibilities are and, perhaps more importantly, to clarify what they both can and cannot do; but it was also agreed that the current format is too long, with much of the information being too generic. It was also acknowledged that the responsibilities section of the audit report has become more complex because, in recent years, the Listing Rules and auditing standards have extended the auditors' responsibilities beyond those in the Companies Act 1985.

In trying to provide a balance between what investors would like to see and what information auditors may be able to provide, given the constraints within which auditors work, the working group makes the recommendations set out at the start of this executive summary. It should be noted that these are simply proposals by the *Audit Quality Forum* working group and they will need to be considered further by the bodies identified within the paper and, at the discretion of these bodies, will be the subject of further wider consultation and debate.

In the short term, it is recommended that the APB considers whether it is feasible to adopt the changes to the opinion wording, identified in the three bullets above, early i.e. in advance of the Companies Act 2006 coming into force, taking account of the potential legislative implications. In the longer term, these recommendations would need to be considered in the context of the requirements of the 8th Directive.

Any changes that are made to the audit report would need to be considered and developed through a framework that identifies all the legal, regulatory and practical issues that would result from these changes. It will be important to carry out a regulatory impact assessment to consider the impact of reporting in this way and to assess whether these recommendations should apply to all public interest companies or only to companies admitted to trading on a regulated market.

The recent introduction of International Financial Reporting Standards (IFRS), ISAs (UK and Ireland), changes to Turnbull and the legal requirements for narrative reporting and new Combined Code recommendations have meant that the form and content of annual reports and audit reports has changed markedly in the last year. In the short term, these changes need to be given time to be implemented and settle down.

Introduction

Background

1. 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 a 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 amongst 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.
2. 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.
3. This paper has been prepared by a working group drawn from investors, business, representative trade bodies, the audit profession and academia. It considers the information that auditors communicate and whether the wording of the audit report satisfies the expectations of shareholders, taking into consideration any perceived need for enhancing confidence in the independent audit and whether it clearly reflects auditors' responsibilities under the legal requirements as they currently stand.

Key objectives of the group

4. The objectives of the group were:
 - > to identify what information shareholders might find useful from audit reports, why they need this information and whether these needs are currently met; and
 - > to identify barriers to change and ways to overcome them.
5. Against the conclusions of the *Forum's* paper entitled *Audit Purpose*, the project has considered and discussed a number of key issues including:
 - > the current UK legal and other requirements governing responsibilities of auditors and the form and content of the audit report in relation to reporting to shareholders;
 - > the key stakeholders with an interest in the audit report and their expectations;
 - > whether such expectations can be met via the current audit report, or whether they might more appropriately be met through dialogue with the company, and indeed to what extent such expectations are already being met through reporting by companies following the introduction of International Financial Reporting Standards (IFRS); and
 - > how recent and prospective developments in financial reporting, auditing standards and legislation will impact on the audit report and whether these will assist shareholders in obtaining the information that they are seeking.
6. The focus of this project is the provision of information in the statutory audit report under UK legislation. The paper does not consider information contained in other reports that auditors might provide, under separate engagements outside of the statutory audit. In considering the information contained within the audit report, the group also considered the form of audit reports in certain other jurisdictions.

Purpose of the audit and audit report

7. In considering the information provided in the audit report, it is first necessary to re-iterate the purpose of the audit and to consider who the stakeholders are that may seek to rely on the report.¹

What is the purpose of the statutory audit?

8. Auditors are appointed, amongst other things, to provide an independent opinion to shareholders on the truth and fairness of the annual accounts and on whether the annual accounts have been properly prepared in accordance with the Companies Act 1985 and where appropriate, Article 4 of the IAS Regulation.² In line with the requirements of company law, the auditor also reports by exception to the shareholders on certain other areas, such as whether, in the auditor's opinion, proper³ accounting records have been kept.

Who are the stakeholders?

9. The addressee of the audit report as defined in law is clear: it is the shareholders as a body. Potential investors, creditors, employees and other sectors of the business community, as well as government and the public at large, may wish to be confident about the soundness of a company's reporting and its impact on the economic well-being of the wider community and, to that end, may seek to place reliance on the audit report. The interests of other stakeholders and any value that they believe they gain from the audit report are incidental since the report arises as a consequence of the performance of the statutory audit, and the audit is not designed to address such interests.

The purpose of the audit report

10. The auditor's reporting environment has always been governed largely by legislative requirements and auditing and ethical standards developed by, amongst others, the APB. However, these have changed significantly over recent years. They are detailed in Appendix A. The purpose of the audit report is to provide an opinion as to whether or not the annual accounts give a true and fair view.

¹ The purpose of the audit and who the stakeholders are has been considered and defined by a separate *Audit Quality Forum* working group on audit purpose. This paper is therefore prepared in line with these definitions.

² The IAS regulation is European Commission Regulation No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of International Accounting Standards (which are now referred to as International Financial Reporting Standards (IFRSs)).

³ Under the Companies Act 2006, auditors will be required to give an opinion on whether 'adequate accounting records have been kept'.

Information flows

11. Before considering the information expectations of shareholders, it is useful to consider and understand the reporting requirements and flows of information that currently exist between the auditor and the company, the auditor and the shareholders, and the company and the shareholders.

Communication between the auditor and the company, via the audit committee or those charged with governance

12. Under the Companies Act, boards appoint directors who are subject to election by shareholders at the first annual general meeting (AGM) after their appointment. The Combined Code also recommends that the board establishes an audit committee. The audit committee's role together with that of other non-executive directors (NEDs) has a number of dimensions, with one of these being to provide independent scrutiny, seeking to represent shareholders' interests in all aspects of the company's business and to act on their behalf to a degree. An element of the role of the NED is to understand the views of major investors, both directly and through the chairman and the senior independent director.
13. Auditors are required by auditing standards to report to the board or the audit committee (where one exists) on issues in relation to corporate governance and other key matters arising from their audit. Where there is an audit committee, the board usually delegates to it oversight of certain areas including financial reporting, risk management and internal control, and external auditors' findings and conclusions and the audit committee reports back its own conclusions and recommendations for a decision by the board.

Communication between the auditor and the shareholders

14. In line with the Companies Act 1985, the audit report is addressed to and provides an opinion to the company's shareholders, as a body. The wording of the opinion is governed by the Companies Act with the form and most of the content of the audit report being derived from standards and guidance provided by the APB, with the auditors' professional bodies providing additional guidance to their members on risk and liability considerations.
15. Both the 1985 and the 2006 Acts and auditing standards prescribe the minimum rather than the maximum contents of the audit report. The Companies Act 1985 and other requirements therefore do not currently preclude auditors from making additional remarks or providing opinions on other matters, in the audit report or elsewhere, although forthcoming EC developments may restrict the provision of additional information unless it forms part of legislative requirements. However, currently there is no obligation on auditors to report more than is required by statute and auditing standards and historically auditors have usually not gone beyond such requirements.
16. Section 390 of the Companies Act 1985 gives the auditors the right (but does not impose a duty) to attend meetings and to be heard on matters that concern them as auditors. Many auditors of public interest entities attend the AGM as a matter of course. Some auditors also voluntarily answer questions at AGMs even though, again, there is no obligation to do so and any answers given are provided in the absence of a clear legal framework. Auditors may also read the full audit report or a summary of the key contents at the AGM.

Communication between the company and the shareholders

17. As well as the annual report and other company announcements, the main vehicle for the company to communicate with the shareholders as a body is the AGM. The main purpose of the AGM is to provide shareholders with the opportunity to exercise their rights including the ability to vote on the annual accounts, the remuneration report and the appointment or re-appointment of directors and auditors. Directors can, and often do, meet separately with institutional shareholders to discuss matters in relation to the company. All shareholders have the right to ask questions at the AGM and can ask questions of the auditor, via the Chair, on matters related to the audit of the annual accounts.⁴
18. As shareholders are not a homogeneous group, the concerns of private shareholders might not be the same as those of institutional shareholders, and indeed there can be diversity within these two groups. Institutional shareholders often have the ability to meet with the Audit Committee Chair to discuss matters of concern in relation to the audit.
19. It is important to note that if the directors are unwilling or unable to answer questions put to them by shareholders, then currently, it is unlikely that shareholders would be able to obtain the same information from their auditors, who have no obligation to communicate directly with shareholders outside of the confines of the audit report and who are bound by a duty of confidentiality. It would be difficult for auditors to invite the directors to waive their duty of confidentiality in this context as it could fundamentally alter the relationship of trust that is necessary for an effective audit to take place.

⁴ The issue of shareholders questioning auditors at AGMs was the subject of discussion in the *Audit Quality Forum* publication *Questions to the auditor* published in March 2006. Section 527 of the Companies Act 2006 deals with some of the issues raised in this publication.

Shareholder expectations

20. The previous sections have highlighted the statutory purpose of the audit and therefore the purpose of the audit report, and the information provided to shareholders as a result of statutory requirements. They have also highlighted the communication flows that exist between auditors and the company, via those charged with governance, the company and shareholders and between auditors and shareholders, both through the audit report and through other means.
21. This section focuses on the content of the audit report and the potential closing of the gap between what shareholders would like to see and what is currently included within an audit report. The reasons both for and against changes to the current regime are explained.
22. Some shareholders would like to see more information within the audit report but auditors are restricted by confidentiality considerations and are also constrained by the threat of litigation, which results in a tendency to be more circumspect in what they say and how they say it. In considering shareholders' expectations, the group considered the current form and content of the audit report, its usefulness and whether it could be better formatted and worded for ease of use and readability.
23. There is a widely held belief that audit reports are too boilerplate and overly standardised. Some members of the working group have expressed a wish for disclosure of more comprehensive information by auditors, in the audit report or by other means, on material areas of judgement, difficult, sensitive or contentious matters and the outcome of discussions that auditors may have had with those charged with governance.
24. A survey was conducted amongst the investors on the working group to enable the group as a whole to understand better the type of reporting that shareholders ideally would like to see. The results of the survey indicated that there was a range of differing expectations.

Information currently contained within an audit report

25. An example of an audit report is included at Appendix B. As prescribed in law and auditing standards, the nature of the work that auditors do and the inherent limitations of an audit feature prominently. Much of this wording is necessary in order to provide clarification as to what auditors' responsibilities are and perhaps more importantly, in order to clarify what auditors both can and cannot do. There was consensus within the working group that the current format of the audit report is too long and standardised, with reports being virtually identical from one company to another and, consequently, most of the information being too generic to be of real use. Some members of the working group felt that despite the existence of wording within the audit report that provides the assurance that the annual accounts have been prepared in accordance with the relevant standards and show a true and fair view, the report does not clearly identify the key areas of audit focus that were addressed to arrive at these conclusions.

Information that shareholders would like to see in the audit report

26. Through the survey, it was established that the following would be helpful to some shareholders:
- > more information about emphases of matter and references to uncertainty and future risk;
 - > discussion of material issues encountered during the audit and their resolution;
 - > tailored company reports rather than a standardised report;
 - > alternative accounting treatments considered and the reasons for adopting the treatment chosen, where material; and
 - > more information on material areas of judgement, and difficult or sensitive issues.

Considerations prior to making change

27. There are a number of issues that need to be considered prior to making changes to the existing form and content of the audit report.

Confidentiality

28. A reluctance to share information widely is not a matter of auditors trying to keep matters hidden from shareholders. Rather it arises because there are restrictions placed on auditors through legislation, case law and auditing standards which prevent them from sharing information. More detail about the restrictions is given in Appendix C but briefly these are as follows:
- > case law⁵ has established that under the Companies Act, the purpose of the audit report is to enable shareholders to exercise their rights at annual general meetings. Provision of additional information within the audit report, beyond that which auditors are statutorily required to provide, could extend their duty of care and make them open to future liability claims; and
 - > auditors are also bound by duties of confidentiality which prevent them from disclosing their discussions regarding company matters with anyone other than the directors. In addition to being confidential, much of the information obtained by auditors may be commercially sensitive ‘insider information’ such that there is a risk of influencing the market value of the company by inappropriately making sensitive information more widely available.
29. Wider sharing of information currently provided by auditors to directors regarding the company may require the directors’ approval (in order that the duty of confidentiality can be relaxed) and the consent of the auditors (so that any disclosure restrictions governing the relevant communication may be relaxed), both parties being likely to seek legal advice before giving such consent. In addition, the wider sharing or distribution of matters intended for a limited and well informed audience may not assist shareholders in gaining a full understanding without additional explanations and clarifications.

Information available through other means

30. The additional information sought by investors as identified in paragraph 26 is not normally available through the audit report. However, some of it is reported by auditors to the audit committee (or to the full board where there is no audit

⁵ *Caparo v Dickman* (1990).

committee) through reporting requirements set out in auditing standards e.g. under ISA (UK and Ireland) 260 *Communication of audit matters with those charged with governance* and other ISAs. Indeed ISA (UK and Ireland) 260 was developed based on the premise that the entity should have in place a governance structure which enables the board as a whole to exercise objective judgment on the company's financial reporting,⁶ including an element of suitable challenge from a viewpoint independent from that of management. Auditors may discuss difficult, sensitive or contentious matters with the board or the audit committee (where one exists), but due to confidentiality are not at liberty to discuss these issues with others.

31. There was a consensus within the working group that some of the information identified in paragraph 26 should be communicated to shareholders. Some members of the working group were of the view that some, but not necessarily all, of this information might feasibly be obtained by shareholders from those charged with governance. Institutional shareholders have the facility to meet with the NEDs, especially the senior independent director to discuss issues and obtain information through direct dialogue with the company, since as owners they have appointed the directors as their agents to run the company for them. If, following such dialogue, they remain dissatisfied, there is a further opportunity for them to question the audit committee chair, the company chair and other directors at the AGM as well as auditors who may also be present. Another method for information to be shared directly between the audit committee and the shareholders might be via the report made by the audit committee to shareholders annually on the ways in which they have discharged their duties.

Changes already or soon to be addressed through new legislation and standards

32. Over the last few years, there has been an appetite in Europe to have a degree of comparability and commonality in the way in which audit reports are presented. The IAASB considered this in its revision of ISA 700 *The independent auditor's report on a complete set of general purpose annual accounts*. A revised version of ISA 700, is effective for auditor's reports dated on or after 31 December 2006, but has yet to be adopted by the APB for use in the UK. The IAASB, in its deliberations, was concerned with the need to provide this consistency that the EC was looking for in audit reports but without introducing such rigidity that might affect the ability of individual jurisdictions to adopt the revised ISA and hence the auditor's ability to comply with ISAs. The revised ISA allows for a two-part report. The first part of the report deals with an opinion as to whether the accounts give a true and fair view. The second part includes local legal or regulatory requirements to be included within the audit report.
33. Article 26 of the 8th Directive allows the EC to require Member States to apply International Standards on Auditing (ISAs). However, Article 28 gives the EC the option to require Member States to adopt a common standard audit report instead of adopting the ISAs. Consequently, any proposals to make changes to the UK audit report will need to be considered in the light of the EC's decision on the form the audit report should take.
34. Changes in law, accounting and auditing standards in the past 18 months have impacted on what should be included within the annual accounts and the audit report. Therefore some of the issues in relation to information that shareholders have expressed an interest in seeing will already be covered through new reporting requirements. Under the new IFRS that apply for the first time for the period ending in 2006, there are now clearer disclosure requirements for companies (e.g. there is now

⁶ The 8th Directive on Statutory Audit requires member states to put in adequate rules about confidentiality.

a requirement for companies to provide information about assumptions and estimates in the annual accounts). Auditors will have a duty to consider the extent to which companies have fulfilled the new reporting requirements, following a full year of reporting in this way and where appropriate disclosures have not been made auditors will discuss with directors, and may ultimately seek to highlight any material deficiencies in their audit report.

35. The FRC consulted on the Combined Code in 2005, which led to the revised Code effective for periods commencing on or after 1 November 2006. In conjunction with the new Code, revised Turnbull guidance on internal control has been issued which recommends additional disclosure by directors on internal control. The Companies Act has also been amended for periods commencing on or after 1 March 2005, which mandates increased disclosure about risks and uncertainties. With the introduction of these changes and the switch to IFRS, which also requires additional information on the effect of estimates and significant judgements, companies are under significant pressure to review their existing practices and implement the changes required. These changes may need to be given time to settle down and investors need to consider the content of audit reports on the annual accounts and annual reports prepared under the new regime before further changes are made to either companies' or auditors' reporting requirements.
36. Section 235 (2A)(b) of the Companies Act states that the auditor's report must include a reference to *any* matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report. This is known as an emphasis of matter paragraph. ISAs (UK and Ireland)⁷ envisage that auditors report emphasis of matter paragraphs in instances where significant uncertainties or going concern problems are already adequately disclosed in the annual accounts, but the auditor considers it to be of such importance to users' understanding of the annual accounts as a whole that it would be appropriate to draw attention to them. An emphasis of matter paragraph in the audit report provides the means for auditors to do so. The ISA (UK and Ireland) appears to be more restrictive than the legislation in this respect. However, in drafting ISA 700 (UK and Ireland), the APB presumably considered that the routine use of emphasis of matter paragraphs might diminish the effectiveness of the auditors' communication of such matters by downplaying the significance of seeing an emphasis of matter. Where auditors consider attention should be drawn to a matter but the company has not disclosed the matter in the annual accounts, auditors qualify their report on the grounds of inadequate disclosure rather than by issuing an unqualified report with an emphasis of matter.
37. A recent international exposure draft ISA 706, *Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report* facilitates more expansive reporting by auditors and therefore may result in more information being contained in audit reports in the future. The purpose of this draft ISA was to establish standards and provide guidance on circumstances when auditors include an emphasis of matter paragraph in their report on the annual accounts, to draw attention to the disclosure in the annual accounts that discusses the matter, and on the form and placement of such paragraphs. The reference to 'other matters' in the title of the draft ISA refers to matters other than those that are presented and disclosed in the annual accounts. When ISA 706 is adopted in the UK and Ireland, auditing standards and company law will be aligned. However, under neither the Companies Act nor the proposed ISA 706, do auditors have to confirm that there are no such 'other matters' to be emphasised.⁸

⁷ ISA 700 (UK and Ireland), *Audit Reports* (paragraphs 30 to 35) refers to emphases of matter.

⁸ ISA 706 was approved by the IAASB in July 2006 and will now be redrafted under the clarity conventions before it is issued (possibly in 2008).

38. If matters of substance are dealt with within the audit report, these should not be interpreted as a modification of the audit opinion, but they could be seen by existing and potential investors as a form of qualification and could thus result in a negative effect on the market's perception of the company.
39. Currently auditors include in their audit report paragraphs in relation to directors' responsibilities, where management has not made a statement that can be cross-referred to. Changes in company law requiring directors' responsibility statements to be included in annual reports will mean that it will be unnecessary for auditors to explain directors' responsibilities. This change will enable audit reports to become less complex and lengthy.

Reasons why change to the current regime may be appropriate

40. There are a number of reasons why change is sought and why change would be welcomed, in particular, by shareholders. The working group identified the following reasons why change to the current regime may be appropriate:
 - > need for less standardisation and more distinction between companies in auditor reporting;
 - > desire for audit reports to become more shareholder friendly and readable; and
 - > some shareholders wish to understand more about the matters the auditor has discussed with the company.
41. The first two bullets are dealt with in more detail in the conclusions and recommendations section of this paper (see paragraphs 49 to 53 below). In relation to the last bullet, although NEDs represent shareholders' interests and receive information from auditors in that capacity, it was acknowledged by the working group that some shareholders would prefer a higher level of independent confirmation of issues that arose during the course of the year. External auditors were identified by the working group as representing the level of independence that shareholders were seeking and therefore they would like direct communication with them via the audit report, where possible, on matters that the external auditors currently communicate to audit committees (including some of the items listed in paragraph 26 above).
42. In considering expanded audit reports, the working group reviewed French audit reports. An example of a French audit report is included at Appendix D. In considering these reports, the working group did not review the liability or reporting framework that applies in France.
43. In France, audit reports (of listed companies) are required to provide information concerning items that are the subject of significant accounting judgements or estimates. This requirement is the result of separate legislation. However, auditors do not provide separate conclusions on these areas. Although across industry sectors there is a degree of standardisation around the structure and wording of the discussions, it is done this way in order to make it as relevant as possible and to provide more information to shareholders in a consistent manner across all companies. An objective of the French audit report is to clarify the key judgements and assessments which have been made by the directors and considered by the auditors during their audit. The conclusion on the audit is in the audit opinion, and no separate opinion is expressed specifically on any of the 'focus' areas. One of the aims of the French model in including this section in the audit report was to reduce the expectations gap between what audit work was being undertaken and what was expected, by setting out more clearly which areas the auditors focussed on.

Conclusions and recommendations

44. There was agreement within the working group that there needed to be some change to the format of the audit report. There was also agreement that some of the information identified in paragraph 26 should be communicated to shareholders but whether this was done through the audit report or through other means, including additional disclosure in the annual accounts and accompanying narrative reporting, was the subject of much debate.
45. The working group agreed that the corporate governance framework that has been developed over the last decade has been helpful and the increased clarity around the role of the NEDs especially those on audit committees who, at least in part, act on behalf of shareholders, has resulted in significant improvements in dialogue between companies and shareholders including the sharing of some relevant information.
46. It was also agreed that the developments in the corporate governance framework were not a substitute for recommending improvements in the audit report to shareholders. The working group considered that current audit reports, being the main channel of communication between external auditors and shareholders, are too boilerplate and overly standardised and that shareholders can feel excluded from what they perceive to be the “real” findings of the audit. For this reason, the working group agreed that changes to facilitate a more open and preferably more discursive line of communication between auditors and shareholders should be recommended.
47. As already alluded to, because of legal and regulatory requirements and restrictions around confidentiality and duty of care (Appendix C), it may not be possible for auditors to report some issues in the way that some shareholders would prefer. If auditors had to include everything that they communicated to the directors in the audit report to shareholders there would inevitably be a risk of this confidentiality becoming reduced or lost. There could also be practical difficulties in communicating information so widely on a timely basis and auditors may become circumspect in respect of commercially sensitive issues. Wider communication could also give rise to misunderstandings, unrealistic expectations, misplaced concerns and other problems derived from a lack of knowledge on the part of shareholders as compared to directors who have in depth knowledge as a result of running the business.
48. In trying to provide a balance between what investors would like to see and what information auditors may be able to provide, given the constraints within which auditors work, the working group has identified a number of recommendations.

Proposed changes to the format of current audit report

The opinion paragraphs

49. The working group has identified three areas, where in its view, there could be more clarity in the audit report:
 - a. Section 495 (3) of the Companies’ Act 2006 provides the statutory requirements for the audit opinion and is laid out in three distinct parts (see paragraph 6, Appendix A). The audit opinion wording should therefore follow this wording and give an opinion on whether the accounts:
 - i. give a true and fair view;
 - ii. have been properly prepared in accordance with the relevant financial reporting framework; and

- iii. have been prepared in accordance with the requirements of the Companies Act and, where appropriate, Article 4 of the IAS regulation.

It is recommended that this wording is adopted as soon as possible rather than wait for the Companies Act 2006 to come into force.

- b. The audit opinion should further include a positive statement that *“adequate accounting records have been kept by the company”*. Shareholders would take from this that the records underlying the annual accounts were adequate. Currently, auditors are only required to *“carry out such investigations as will enable them to form an opinion as to whether proper accounting records have been kept by the company”*... and *“if auditors are of the opinion that proper accounting records have not been kept”*... they *“shall state that fact in their report...”*. For auditors to make a positive statement (in the way suggested) may require a change to company law, specifically a change to Companies Act 1985 section 237 (2) along the lines of:
 - i. *“auditors must also include a reference in their audit report as to whether in their opinion adequate accounting records have been kept by the company”*;
 - c. The audit opinion should further include a positive statement that *“there are no matters within the annual accounts to which the auditors wish to draw attention by way of emphasis”*. Shareholders would take from this that the absence of any emphasis reference was the result of a positive consideration by the auditors. To make this a requirement upon auditors would require a change in company law, specifically a change to Companies Act 1985 section 235 (2A)(b) which could read as follows:
 - i. *“must include a reference to any matters within the annual accounts to which the auditors wish to draw attention by way of emphasis without qualifying the audit report or a statement that there are no such matters”*.⁹
50. The above proposals have the advantage that readers of the audit report would not be in any doubt about these areas hence providing shareholders with more of the transparency that they would like to see within the audit report. To include the above suggestions within the audit opinion paragraph in the audit report, prior to changes to the requirements of the Companies Act 2006 coming into force, changes would need to be made to the relevant auditing standards. Before this is done, legal advice would be needed to assess the impact of making such statements without their being enshrined in legislation.
51. As previously mentioned in paragraph 37 above, the recent international exposure draft ISA 706 *Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report*, when it is exposed in the UK, may also help to provide the sort of information that shareholders are looking for. Therefore shareholders may wish to consider the extent to which their expectations will be fulfilled following a full year of auditors reporting under any resulting new requirements. Investors should take advantage of the opportunity to respond to the APB when the ISA is exposed in the UK.
52. In implementing the suggested proposals in paragraph 49 there are a number of factors to be considered:
- i) The changes outlined in paragraph 49(a) and included in section 495 (3) of the Companies Act 2006 are intended to enhance confidence in independent audit and the credibility of the annual accounts as they reinforce the primacy of the true

⁹ Section 495 (4) of the Companies Act 2006 states ‘The auditors’ report –

(a) must be either unqualified or qualified; and

(b) must include reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.’

and fair view. As outlined in paragraph 33, the EC will be considering the wording of the audit report in its deliberations as to whether to adopt a single European report. The changes described in paragraph 49 (a) could be incorporated as part of this process. The DTI and APB might therefore wish to make representations to the IAASB and the EC to adopt these recommendations.

- ii) In the discussions around the development of a single European report the DTI and APB could further encourage the IAASB and the EC to include the positive statements outlined in paragraphs 49(b) and (c) as part of the ISA and the single common standard audit report.
- iii) To make the change in paragraph 49(b) within the UK would be a relatively straightforward change in either legislation or auditing standards, and would not of itself incur additional costs as it does not change the directors' duties in respect of accounting records, nor the extent of the auditor's work; indeed, auditors in the Republic of Ireland already give such a positive statement on accounting records using the same auditing standards as the UK.
- iv) However, irrespective of whether a positive or a negative statement is given, the term 'adequate' in the context of 'adequate accounting records' needs to be defined clearly. Discussions at the working group and within the *Forum* have shown that there is an expectations gap over what constitute adequate accounting records and directors' duties to maintain these. This may lead to an expectation gap about the nature of the auditor's statement and what is meant when a positive or negative statement is given. Updating the guidance on accounting records issued by the ICAEW in 1992¹⁰ (after discussion and debate with investors and business) would help to resolve this gap and therefore improve the usefulness of the auditor's statement on accounting records. The FRC should be asked to issue such revised guidance in time for the coming into force of the Companies Act 2006. Guidance from the APB as to the extent of investigations to be carried out by auditors will also be needed to mirror the updated guidance for directors.¹¹
- v) Paragraph 49(c) proposes extending the auditor's duty to report "matters of emphasis" to require reporting where there are none. At present auditors interpret this phrase in the Act to mean the same as 'emphasis of matter' in auditing standards. Discussions in the working group showed that there was a lack of awareness of what the definition in the forthcoming ISA 706 *Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditors' Report* (see paragraph 37) includes and, more importantly, what it excludes. Work is needed to improve awareness of what these definitions are and potentially whether the list should be extended. The APB should consider consulting on this point when introducing ISA 706 in the UK.
- vi) The legal implications of amending the wording of the audit report in line with the proposals above would need to be considered, in particular in the context of auditors' and directors' respective statutory and regulatory responsibilities around the audit itself.
- vii) There may be implications for chapter 9 of Listing Rules, as some listing rules may need to change to accommodate what is being proposed.

¹⁰ FRAG 5/92 *Accounting Records*, published by the Institute of Chartered Accountants in England and Wales.

¹¹ The APB has made a commitment; in its recent document *Promoting Audit Quality*, to produce guidance for auditors.

Improving readability

53. The working group believes that the format of the current audit report could be re-arranged so that the most relevant information, i.e. the opinion, is shown first. It was suggested that the standardised, generic information (e.g. the inherent limitations and the scope of audit) could be shown elsewhere within the audit report or easily distinguished, for example by use of a different font or by placing the information in an appendix to the main report. Alternatively this information could be placed on a website or in a place that is publicly accessible, and cross-referenced from the audit report to its location and availability. In particular, the recommendations of the *Audit Quality Forum* through its report *Auditor engagement: disclosure of contractual terms*¹² in relation to the publication of the engagement letter need to be considered when regulations are provided under Section 493 of the Companies Act 2006. If the engagement letter is published on a company's website, then the paragraphs in relation to the scope of audit and inherent limitations could be included within the published engagement letter.

Company specific information

54. To meet investors requirements as outlined in paragraph 26, the working group was of the view that there needs to be a review of what is currently available under new reporting requirements, whether some of this information can be provided through the audit committee report and finally whether some of the information could be provided through the audit report if it is not available through other means.

Disclosures contained within the annual accounts

55. As the annual accounts are the responsibility of the directors and the auditor's role is to form an independent opinion on the annual accounts, one way to meet investors' expectations would be for the directors to include the information shareholders would like to see in the annual report (either within the annual accounts or elsewhere). Auditors already have to read all information published with the annual accounts and consider, in the light of the knowledge acquired during the audit, whether that information has been presented in a manner which is inaccurate or inconsistent or if there are significant omissions. If any of this proves to be the case, auditors have to take action, in accordance with auditing standards. This includes asking those charged with governance to include missing information and/or correct misleading or inaccurate information, and ultimately modifying the audit opinion if they do not do so. Such modifications may include the omitted or corrected information within the audit report.

56. In addition, some of the information that investors identified that they would like to see under paragraph 26 will be available through the new reporting requirements under IFRS, the new Companies Act requirements for enhanced business reviews and the revised Turnbull guidance, in particular:

- > accounting treatments considered and the reasons for adopting the treatment chosen, where the item subject to the treatment is material; and
- > more information on material areas of judgement, and difficult or sensitive issues.

¹² Published in March 2006.

57. A programme of review of listed companies' annual accounts should therefore be initiated to assess the extent to which the disclosures being made in practice, as required by IFRS, the Companies Act 1985 (e.g. Business Review) and the revised Turnbull guidance currently and those shortly to be introduced changes through the Companies Act 2006, go all or part of the way to meeting the wishes of shareholders for further information. The review could also consider whether, in instances where the appropriate disclosures are not being made, auditors are reporting on them, and whether there is a need for further assurance on some of the additional disclosures outside the annual accounts. This review should be carried out in mid-2008 (at the end of the 2007 reporting season), using December 2007 reports.

Review of the Combined Code

58. Currently audit committees are recommended by the Smith Guidance to report annually to shareholders on activities undertaken during the year to discharge their responsibilities. There is no requirement for them to communicate to shareholders issues that are raised by auditors as a result of the audit. The Combined Code will be reviewed in the spring of 2007 and the FRC may be able to consider some of these issues as part of this review.
59. In particular the FRC may wish to consider whether there would be a benefit in putting into place more explicit recommendations for audit committees to communicate more specific information through their report to shareholders, including identifying key issues and significant accounting and reporting matters discussed with auditors as a result of the audit. This review would also need to consider the auditors' reporting role in relation to these disclosures. In the meantime, the working group encourages audit committees to provide this information as a matter of course and would encourage this evolving as best practice.

Company specific information within audit report

60. In considering the contents of the current audit report and some shareholders desire for more company specific reporting (as stated in paragraph 26), the working group considered an example of a report that provided more expansive reporting. The format of the French audit report set out in Appendix E provides a form of expanded reporting, though it was accepted that the legislative and reporting frameworks in France and the UK are different. However, the working group agreed that there is merit in considering whether the sort of expansive reporting illustrated in this model could be made applicable in a UK context to provide more company-specific audit reports.
61. In considering whether to make audit reports more company specific, the APB would need to consider:
- > the outcome of the review of the changes to the annual accounts and the auditors' report as outlined in paragraph 57 above and based on the new reporting requirements and whether these changes provide the sort of information that investors would like to see;
 - > whether duties around confidentiality will be compromised and whether it is necessary to seek or obtain permission from the directors of the company before reporting any issues that might undermine the relationship of trust that is necessary for an effective audit to take place; and
 - > the liability regime that exists in the UK and whether it would facilitate reporting in this way.

62. If it is considered that there is merit in adapting the UK audit report in this way, then some of the considerations outlined in paragraph 52 may also need to be considered here. This may require a legislative requirement to be put into place to include such wording within the audit report. An auditing standard or alternative audit guidance might need to be developed providing auditors with a framework within which to report key issues in this way, with consideration given as to whether there are any industry specific issues.

International and European considerations

63. As outlined in paragraphs 32 and 33 and 52(i) and (ii), the way in which the UK takes forward some of these recommendations will be partly dependant on the direction provided by the EC and the IAASB. This paper recommends some key and fundamental changes to the audit report which should not be lost in the continuing discussions at both international and European level. The working group therefore recommends that the DTI, the APB and other UK stakeholders that have influence at both levels, encourage the EC, the IAASB and other bodies to consider this paper. We hope that this paper will be helpful to the bodies that take forward the development of the requirements of the 8th Directive.

64. Appendix F illustrates what the UK audit report could look like if the proposals set out in paragraphs 49 to 62 were taken forward.

Appendix A:

Current UK reporting framework

Legal framework

Companies Act 1985

1. The Companies Act 1985 (as subsequently amended by the Companies Act 1989) clarifies what a statutory audit is and who it is for, and requires auditors to carry out such investigations as will enable them to form an opinion. In law, the auditors are appointed by the shareholders of the company to provide them with an independent report.
2. Section 235 of the Companies Act 1985 ('Companies Act') sets out the law in relation to audit reports. It deals with the auditor's responsibilities to form an opinion on whether the annual accounts have been properly prepared in accordance with the Act, and on whether those accounts show a true and fair view. It also requires the report to include reference to any matters included in the annual accounts that the auditors wish to draw attention to, by way of emphasis, for the benefit of readers. Section 237 of the Companies Act requires the auditor to form an opinion as to whether proper books and records have been kept by the company, and to report to shareholders if such books and records have not been kept. Also under this section, auditors are required to state in their report, if they fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purpose of the audit.
3. The framework set out in legislation reflects the stewardship role that directors undertake. Bearing in mind the purpose of the statutory audit, the purpose of the audit report is therefore to *'provide an independent opinion to the shareholders of the company as to whether, in their opinion, the annual accounts have been properly prepared in accordance with the requirements of this Act and whether they give a true and fair view, in accordance with the relevant financial reporting framework.'*
4. Auditors have further responsibilities set out in statute. They are required to report their opinion on whether the information given in the directors' report (including the enhanced business review which details the principal risks and uncertainties facing the company) is consistent with the accounts. They are also required to consider whether the company has kept proper books and records; whether the accounts agree to the underlying financial records and whether they have received all the information and explanations they require. Where, in the auditors' opinion these requirements have not been met, auditors must state this fact in the audit report. In the case of omitted disclosures relating to directors' remuneration, auditors need to give the particulars of such remuneration.

Extract from Companies Act 1985 (as amended by SI 2004/2947)

Section 235 states:

- (1) A company's auditors shall make a report to the company's members on all annual accounts of the company of which copies are to be laid before the company in general meeting during their tenure of office.

- (1A) The auditors' report must include:
- (a) an introduction identifying the annual accounts that are the subject of the audit and the financial reporting framework that has been applied in their preparation;
 - (b) a description of the scope of the audit identifying the auditing standards in accordance with which the audit was conducted.
- (1B) the report must state clearly whether in the auditor's opinion the annual accounts have been properly prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).
- (2) The report must state in particular whether the annual accounts give a true and fair view, in accordance with the relevant financial reporting framework –
- (a) in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year,
 - (b) in the case of an individual profit and loss account, of the profit or loss of the company for the financial year,
 - (c) in the case of group accounts, of the state of affairs as at the end of the financial year and of the profit or loss for the financial year, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.
- (2A) The auditors' report –
- (a) must be either unqualified or qualified, and
 - (b) must include a reference to any matters to which the auditors wish to draw attention by way of emphasis without qualifying the report.
- (3) The auditors must state in their report whether in their opinion the information given in the directors' report for the financial year for which the annual accounts are prepared is consistent with those accounts.
- (3A).....
- (4) If a directors' remuneration report is prepared for the financial year for which the annual accounts are prepared, the auditors shall in their report
- (a) report to the company's members on the auditable part of the directors' remuneration report, and
 - (b) state whether in their opinion that part of the directors' remuneration report has been properly prepared in accordance with this Act.
- (5) For the purposes of this part, "the auditable part" of the directors' remuneration report is the part containing the information required by Part 3 of Schedule 7A.

Section 237 lays out the duties of auditors in preparing their report:

- (1) A company's auditors shall, in preparing their report, carry out such investigations as will enable them to form an opinion as to –
- (a) whether proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them, and
 - (b) whether the company's individual accounts are in agreement with the accounting records and returns, [and

(c) (in the case of a quoted company)¹³ whether the auditable part of the company's directors' remuneration report is in agreement with the accounting records and returns.]

(2) If the auditors are of opinion that proper accounting records have not been kept, or that proper returns adequate for their audit have not been received from branches not visited by them, or if the company's individual accounts are not in agreement with the accounting records and returns, [or if in the case of a quoted company the auditable part of its directors' remuneration report is not in agreement with the accounting records and returns,] the auditors shall state that fact in their report

(3) If the auditors fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit, they shall state that fact in their report.

[(4) If –

(a) the requirements of Schedule 6 (disclosure of information: emoluments and other benefits of directors and others) are not complied with in the annual accounts, or

(b) where a directors' remuneration report is required to be prepared, the requirements of Part 3 of Schedule 7A (directors' remuneration report) are not complied with in that report,

the auditors shall include in their report, so far as they are reasonably able to do so, a statement giving the required particulars.]

[(4A) If the directors of the company have taken advantage of the exemption conferred by section 248 (exemption for small and medium-sized groups from the need to prepare group accounts) and in the auditors' opinion they were not entitled so to do, the auditors shall state that fact in their report.]]

Identification of financial reporting framework

5. Following the adoption of IFRS by the European Union (through the IAS Regulation) for consolidated accounts of companies admitted to trading on a regulated market,¹⁴ and the retention of the possibility for other companies of using either adopted IFRS or UK GAAP, Section 235 of Companies Act 1985 includes a new requirement for the auditors' report to identify the financial reporting framework applied in the preparation of the annual accounts. As explained in guidance issued by the DTI '*the requirement that an audit opinion states whether the annual or consolidated accounts give a true and fair view in accordance with the relevant financial reporting framework clarifies the context in which the audit opinion was given, it does not represent a restriction of the scope of that opinion.*'

¹³ For the purposes of this section, a quoted company is one with equities admitted to trading on a regulated European market, the New York Stock Exchange or NASDAQ. This includes the main market of the London Stock Exchange but excludes AIM.

¹⁴ This includes the main market of the London Stock Exchange but excludes AIM. The London Stock Exchange has made a separate change to the AIM rules imposing a similar requirement for periods commencing on or after 1 January 2007.

Companies Act 2006

6. The legal framework for the audit report is also addressed in the Companies Act 2006 Section 495 (3) of the Companies Act 2006 states that:

The report must state clearly whether, in the auditor's opinion, the annual accounts—

- (a) *give a true and fair view-*
 - (i) *in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year,*
 - (ii) *in the case of an individual profit and loss account, of the profit or loss of the company for the financial year,*
 - (iii) *in the case of group accounts, of the state of affairs as at the end of the financial year and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company;*
- (b) *have been properly prepared in accordance with the relevant financial reporting framework; and*
- (c) *have been prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).*

The provisions in the Companies Act 2006, which has yet to be brought into force at the time that this paper is published.

International and European considerations

7. Over the last few years, there has been an appetite in Europe to have a degree of comparability and commonality in the way in which audit reports are presented. The International Auditing and Assurance Standards Board (IAASB) considered this in its revision of ISA 700 *The independent auditor's report on a complete set of general purpose annual accounts*.

International Standards

8. The international version of ISA 700 was revised in 2003 and is effective for auditor's reports dated on or after 31 December 2006. The IAASB's primary concern in redrafting ISA 700 was the need to provide consistency in audit reports but without introducing such rigidity that might affect a jurisdiction's ability to adopt the ISA and the auditors' ability to comply with it.
9. The IAASB recognised that the current ISA700 may not meet the needs of certain jurisdictions and concluded that national legal or regulatory circumstances should not drive ISA development. However, failing to allow for such circumstances in ISAs might ultimately affect a jurisdiction's ability to adopt ISAs and the auditors' ability to comply with them.
10. The IAASB, therefore, went on to say that it acknowledged that in certain jurisdictions it may be appropriate – and indeed in the public interest – to expand the standard ISA audit report wording to accommodate national provisions, the question being how best to accommodate flexibility while continuing to promote consistency in an ISA audit report. The revised international ISA 700 allows for a two part report and permits, in the second part, national or regulatory requirements (that exist in different jurisdictions) to be included within the report.

EC 8th Directive on the Statutory Audit

11. Appendix B includes the relevant clauses from the 8th Directive. Article 26 generally provides an endorsement mechanism for auditing standards for use in the EU but states that if Member States want to go beyond what is recommended by international auditing standards, the additional requirements need to stem from specific national legal requirements. Article 28 allows the EC to introduce a common standard audit report if it chooses not to recommend the adoption of the ISAs. Since the revision of ISA 700, with its two-part report, the EC has yet to decide whether or not to exercise its option to adopt a common standard for audit reports. It has not yet indicated what form the report might take but the current direction appears to be that for additional wording to be included within the audit report there will need to be a national requirement with specific legislation in place.

Extract from EC 8th Directive on statutory audit of annual accounts and group accounts - clauses relevant to audit reports**Article 26**

1. Member States shall require statutory auditors and audit firms to carry out statutory audits in compliance with international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 48(2). Member States may apply a national auditing standard as long as the Commission has not adopted an international auditing standard covering the same subject-matter. Adopted international auditing standards shall be published in full in each of the official languages of the Community in the Official Journal of the European Union.
2. The Commission may decide, in accordance with the procedure referred to in Article 48(2), on the applicability of international auditing standards within the Community. The Commission shall adopt international auditing standards for application in the Community only if they:
 - a. have been developed with proper due process, public oversight and transparency, and are generally accepted internationally;
 - b. contribute a high level of credibility and quality to the annual or consolidated accounts in conformity with the principles set out in Article 2(3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC; and
 - c. are conducive to the European public good.
3. Member States may impose audit procedures or requirements in addition to – or, in exceptional cases, by carving out parts of – the international auditing standards only if these stem from specific national legal requirements relating to the scope of statutory audits. Member States shall ensure that these audit procedures or requirements comply with the provisions laid down in points (b) and (c) of paragraph 2 and shall communicate them to the Commission and Member States before their adoption. In the exceptional case of the carving out of parts of an international auditing standard, Member States shall communicate their specific national legal requirements, as well as the grounds for maintaining them, to the Commission and the other Member States at least six months before their national adoption or, in the case of requirements already existing at the time of adoption of an international auditing standard, at the latest within three months of the adoption of the relevant international auditing standard.

4. Member States may impose additional requirements relating to the statutory audits of annual and consolidated accounts for a period expiring on four years after the date of entry into force of this Directive.

Article 28

1. Where an audit firm carries out the statutory audit, the audit report shall be signed by at least the statutory auditor(s) carrying out the statutory audit on behalf of the audit firm. In exceptional circumstances Member States may provide that this signature need not be disclosed to the public if such disclosure could lead to an imminent and significant threat to the personal security of any person. In any case the name(s) of the person(s) involved shall be known to the relevant competent authorities.
2. Notwithstanding Article 51a(1) of Directive 78/660/EEC, if the Commission has not adopted a common standard for audit reports in accordance with Article 26(1) of this Directive, it may, in accordance with the procedure referred to in Article 48(2) of this Directive, adopt a common standard for audit reports for annual or consolidated accounts which have been prepared in accordance with approved international accounting standards, in order to enhance public confidence in the audit function.

APB guidance

12. In the UK, audit reports are governed not just by companies legislation but also by ISA 700 (UK and Ireland), *The Auditor's Report on the Financial Statements*. The revised ISA 700 has yet to be adopted by the Auditing Practices Board. The APB has not adopted the revised ISA 700 pending finalisation of the Companies Act 2006 and because it is not known whether the form and wording of the auditor's report required by the revised ISA 700 will be approved for adoption in the EU. The APB believes that it is sensible to defer adoption of the revised ISA 700 until the position in Europe is clearer.

Standards and guidance

13. The APB establishes standards and provides guidance on the objective and general principles governing an audit of annual accounts. ISA (UK and Ireland) 700, *The Auditor's Report on the Financial Statements* provides standards and guidance on the form and content of the audit report issued as a result of an audit performed by an independent auditor of the annual accounts of an entity. There are also further illustrative examples of audit reports laid out in APB Bulletin 2006/6 *Auditor's Reports on Financial Statements* in the United Kingdom which take account of changes to reporting and accounting provisions and some corporate governance requirements. In addition, there are a number of other ISAs (UK and Ireland) which require auditors to communicate matters with management and those charged with governance.
14. The APB has also issued Ethical Standards. Paragraph 1 of ES 1 on *Integrity, Objectivity and Independence*, provides an explanation for the primary purpose of the annual accounts and the primary objective of the audit.

The primary purpose of the annual accounts of an entity is to provide its owners – the shareholders (or those in an equivalent position) – 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 (or those in an equivalent position) over the business that has been entrusted to them.

15. The purpose of the audit report is then laid out in Paragraph 3 of ES 1:

The primary objective of an audit of the annual accounts is for the auditors to provide independent assurance to the shareholders that the directors have prepared the annual accounts properly. The auditors issue a report that includes their opinion as to whether or not the annual accounts give a true and fair view in accordance with the relevant financial reporting framework. Thus the auditors assist the shareholders to exercise their proprietary powers as shareholders in the Annual General Meeting.

Appendix B: Example of a current audit report for a UK listed company

Independent auditor's report to the members of XYZ Plc¹⁵

We have audited the group and parent company financial statements (the 'financial statements') of XYZ Plc for the year ended which comprise [state the primary financial statements such as the Group and Parent Company Income Statement, the Group and Parent Company Balance Sheets, the Group and Parent Company Cash Flow Statements, the Group and Parent Company Statement of Change in Equity/Statement of Recognised Income and Expense] and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

[This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.]¹⁶

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and as regards the group financial statements, Article 4 of the IAS Regulation. We also report to you, whether in our opinion, the information given in the directors' report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Operating and Financial Review that is cross referred from the Business Review section of the Directors' Report.

In addition, we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

¹⁵ This example is based on Example 13 in Appendix 1 of APB Bulletin 2006/6, *Auditors' reports on financial statements in the United Kingdom*.

¹⁶ This paragraph is recommended by the ICAEW in its technical release Audit 01/03, *The audit report and the auditor's duty of care to third parties*. It is not part of the APB's examples and hence, it is shown in square brackets. Its insertion in the audit report has come after obtaining legal advice and therefore repositioning it elsewhere in the audit report would also require legal advice.

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' Report, the unaudited part of the Directors' Remuneration Report, the Chairman's Statement, the Operating and Financial Review and the Corporate Governance Statement. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

- > the financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the group's and the parent company's affairs as at [period ended] and of the group's and the parent company's profit for the year then ended;
- > the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and as regards the group financial statements, Article 4 of the IAS Regulation; and
- > the information given in the directors' report is consistent with the financial statements.

[Name of Auditor]

Registered auditor

Address

Date

Appendix C: Legal considerations

Auditors are required to report to the company's shareholders as a body on the truth and fairness of the annual accounts and on whether they have been prepared by the directors in accordance with the relevant accounting framework. Auditors are also required to communicate audit matters of governance interest (in the sense of having a dialogue) with those charged with governance. There is no requirement to have any such communication with shareholders (but a dialogue with particular shareholders is a possibility).

Auditors may also provide other information to the directors regarding the company. Audit matters and information communicated or provided in this way are inherently confidential. In respect of their audit work auditors owe a duty of care to shareholders as a group and the audit report is addressed to shareholders as a group. Auditors do not owe a duty of care to individual shareholders. This is established through the Companies Act and case law. These factors result in the following consequences:

- > Case law¹⁷ dating back to 1990 has established that the purpose of the statutory requirement for an audit of companies under the Companies Act was the making of a report to enable shareholders to exercise their rights at annual general meetings and the auditor's duty therefore did not extend to the provision of information to assist shareholders in the making of decisions as to future investment in the company. Provision of information within the audit report, beyond that which auditors are statutorily required to provide, could extend that duty of care and make them open to future liability claims against them.
- > Auditors owe those charged with governance a duty of care in respect of audit matters of governance interest communicated to them but there is no requirement to communicate such matters more widely and auditors do not normally do so. The communication of such matters beyond those charged with governance could extend that duty of care.
- > Auditing standards envisage that audit matters communicated to those charged with governance will be confidential to them. Other information provided by the auditors to the directors regarding the company would also be confidential. There is no requirement on auditors to report to shareholders everything that is communicated or provided to the directors. In addition to being confidential, much of the information obtained by auditors may be commercially sensitive 'insider information' such that there is a risk of influencing the market value of the company by inappropriately making sensitive information more widely available. The directors are responsible for running the company and the shareholders can question them on this or any aspects of the business. The shareholders retain the ultimate sanction of removal from office if they are not satisfied with the directors' performance. If a matter has been communicated privately by the auditors to the directors, it may be confidential to the directors and wider sharing may therefore require the directors' approval (so that confidentiality is relaxed) and the consent of the auditors (so that any disclosure restrictions governing the relevant communication are also relaxed). The wider distribution of matters intended for a limited audience may not assist shareholders in gaining a full understanding without additional explanations and clarifications. Relaxing confidentiality can also lead to confidentiality being reduced or lost, which can be detrimental to the business and therefore to the interests of the directors and shareholders.

¹⁷ *Caparo v Dickman* (1990).

Appendix D: Example of a French audit report

Following our appointment as Statutory Auditors by your Annual General Meeting, we have audited the accompanying consolidated financial statements of XYZ company for the year ended 31 December 2005.

The consolidated financial statements have been approved by the Managing Board. Our role is to express an opinion on these financial statements based on our audit. These financial statements have been prepared in accordance with IFRSs as adopted for use in the European Union. They include comparative information restated in accordance with the same standards in respect of the financial year 2004.

Opinion on the consolidated financial statements

We conducted our audit in accordance with professional standards applicable in France. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the assets and liabilities and of the financial position of the [Group] as at 31 December 2005 and of the results of its operations for the year then ended in accordance with IFRSs as adopted for use in the European Union.

Justification of our assessments

In accordance with the requirements of article L. 823-9 of the French Commercial Law relating to the justification of our assessments, we bring to your attention the following matters:

- > Regarding the first time adoption of IFRS to prepare the 2005 consolidated financial statements, note 44 sets out all the disclosures required concerning the change in accounting standards at 1 January 2004 and describes the steps taken to ensure that the financial statements presented for 2005 and 2004 in accordance with IFRS are comparable. As part of our assessment of the accounting principles and methods applied, we verified, in particular, the correct application of the method used to record development expenditure within assets (note 1.11A), as well as the amortization method applied in view of the revised useful life of vehicle projects, which is now capped at seven years (Note 44.1A), and the method of testing the recoverable amount of these assets (note 1.13). We also verified the correct calculation of the adjustments in respect of sales subject to a buyback commitment (note 1.5.Aa) in view of the increased accuracy resulting from the new IT programs developed for this purpose (note 44.1.A), and that any other changes described in this note were appropriate.
- > As indicated in note 1.10, goodwill is no longer amortized but is tested for impairment at least annually according to the method set out in note 1.13. In 2005, impairment tests conducted by the Automotive Equipment Division, as described in note 8.1, led to a write-down of 180 million euros on assets assigned to the vehicle interior systems

and modules segment. As part of our assessment of the significant estimates made by management, we verified that this approach complied with IFRS and that the impairment tests described in the notes to the consolidated financial statements were carried out correctly. We also assessed whether the cash flow projections applied and other assumptions used were reasonable.

These assessments were made in the context of our audit of the consolidated financial statements taken as a whole, and therefore contributed to the opinion we formed which is expressed in the first part of this report.

Specific verification

In accordance with professional standards applicable in France, we have also verified the information given in the Group's management report. We have no matters to report as to its fair presentation and its consistency with the consolidated financial statements.

Appendix E: Example of a possible new format for the UK audit report

Independent auditors' report to the members of XYZ Plc

We have audited the group and parent company financial statements (the 'financial statements') of XYZ Plc for the year ended which comprise [state the primary financial statements such as the Group and Parent Company Income Statement, the Group and Parent Company Balance Sheets, the Group and Parent Company Cash Flow Statements, the Group and Parent Company Statement of Change in Shareholders' Equity] and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

Opinion

In our opinion:

- > the financial statements
 - give a true and fair view of the state of the group's and parent company's affairs as at 31 March 20XX and of its profit for the year then ended;
 - have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union; and
 - have been prepared in accordance with the requirement of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation;
- > the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the requirements of the Companies Act 2006;
- > the information given in the directors' report and business review is consistent with the financial statements;
- > the company has kept adequate accounting records; and
- > there are no matters arising within the financial statements to which we wish to draw attention by way of emphasis.

[This report is made solely to the company's members, as a body, in accordance with Section 495 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.]¹⁸

¹⁸ As indicated in note 8 the inclusion of this paragraph is recommended by the ICAEW and is not part of the APB's examples, hence it is shown in brackets. Its insertion in the audit report has come after obtaining legal advice.

Key issues

In accordance with requirements of section XX of the Companies Act 200X, we bring to your attention the following matters:

- > **Accounting principles and policies:** Note 1 to the financial statements sets out the accounting principles and policies in relation to the preparation of the company's financial statements. Within the scope of our audit work in relation to the accounting principles and policies used by the company, we verified the appropriate nature of the accounting methods and the information provided in the notes to the financial statements and we ensured that these principles and policies were correctly applied.
- > **Accounting estimates:** The Company's directors are required to make estimates and assumptions that affect certain amounts included in the financial statements of the group and the accompanying notes to the financial statements. We consider that the items which have been subject to the significant accounting estimates, and which are likely to require justification, include long term contracts, acquisition goodwill, and deferred tax assets.
 - **Long-term contracts:** the company recognises income on long-term contracts in accordance with the methods set out in note 1.j to the financial statements. Such income is based on estimates of income on completion made by the project managers under the responsibility of management. Based on the information available at the time of our audit, our work consisted of assessing the data and assumptions used to estimate the income on completion for these contracts, reviewing the calculations made by the company, comparing the amounts of income on completion from previous financial periods with the actual figures for the financial period and examining the procedures used by management to approve such estimates.
 - **Acquisition goodwill:** acquisition goodwill, which appears in the balance sheet as of 31 December 200X for a net amount of £1,990 million, was subject to impairment tests in accordance with the methods set out in note 1.a to the financial statements. We reviewed the methods for carrying out these tests, based on the current market prospects of the business activities and divisions concerned, and checked the consistency of the assumptions used with the forecast data taken from the strategic plans drawn up for each of these business activities and divisions under the Group's control.
 - **Deferred tax assets:** As of 31 December 200X, net deferred tax assets recorded amounted to £220 million as stated in note 7.c to the financial statements. The recoverability of these amounts was assessed by the company on the basis of forecast data taken from the strategic plans drawn up for each of the consolidated tax groups concerned, under the group's control. As in the case of acquisition goodwill, we reviewed the recoverability tests performed on these deferred tax assets by the Company.

Basis of audit opinion

Our responsibilities as auditors are laid out in Appendix 1.

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

In addition to the matters upon which we have reported, we also have a duty under the Companies Act to report to you whether, in our opinion, the company has kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' benefits and remuneration is not disclosed. There are no such matters that we wish to report.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

[Name of Auditor]

Registered auditors

Location

Date

Appendix 1

Responsibilities of auditors

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only [the Directors' Report, the unaudited part of the Directors' Remuneration Report, the Chairman's Statement, the Operating and Financial Review and the Corporate Governance Statement]. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Appendix F: 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.

Richard H Reid – Chair
KPMG LLP

Sumita Shah
Audit & Assurance Faculty, ICAEW

Christopher Arnall
KPMG LLP

Jac Berry
Mazars

Anthony Carey
Mazars

Margaret Cassidy
PricewaterhouseCoopers LLP

John Curran
UK Shareholders Association

Stella Fearnley
Portsmouth University

Richard Gillin
Deloitte & Touche LLP

Kari Hale
Financial Services Authority

Liz Lewzey
Tomkins plc

Mike McKersie
Association of British Insurers

Elizabeth Murrall
Investment Managers Association

Giles Peel
Institute of Chartered Secretaries and Administrators

Geoff Swales
PricewaterhouseCoopers LLP

Jennifer Walmsley
Hermes

Beverly Wilkinson
Coal Pension Trustees Services Ltd

Observers:

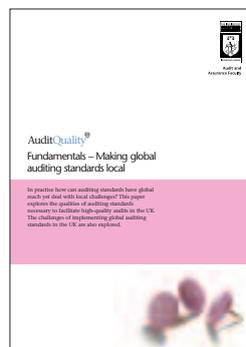
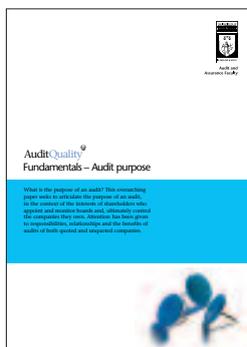
Jim Bellingham
Department of Trade and Industry

Clive Edrupt
Confederation of British Industry

Steven Leonard
Financial Reporting Council

AuditQuality[®]

Fundamentals



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.

Audit purpose

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.

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.

Making global auditing standards local

In practice how can auditing standards have global reach yet deal with local challenges? This paper explores the qualities of auditing standards necessary to facilitate high-quality audits in the UK. The challenges of implementing global auditing standards in the UK are also explored.

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?



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