Expectation gaps

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Contents

Introduction...........................................................................................................................................2
Fraud.....................................................................................................................................................3
   History, legal requirements and case law .....................................................................................3
   Standards...........................................................................................................................................3
   What auditors consider their responsibilities are in respect of fraud ........................................6
   Expectations.......................................................................................................................................6
   Sources.............................................................................................................................................10
Going concern....................................................................................................................................12
   History and current legal requirements.......................................................................................12
   What auditing standards/other standards say...............................................................................14
   What auditors believe their responsibilities to be ........................................................................17
   What are the expectations of users...............................................................................................17
   Issues that the working group may wish to consider.................................................................18
Internal Control..................................................................................................................................19
   History, legal requirements and case law ....................................................................................19
   Auditing Standards........................................................................................................................27
   Expectations......................................................................................................................................30
   US developments and comparison...............................................................................................30
   Other consultations of interest........................................................................................................31
Appendix 1 – provisions in the FRC Combined Code......................................................................32
Appendix 2 - Other general research ...............................................................................................34

The working paper was prepared for the Audit Purpose group to aid discussion of some of the issues around the purpose of an audit and to help the group to develop the paper, Audit Purpose. The working paper does not necessarily represent the views of the members of the Audit Purpose group or of the Audit Quality Forum, individually or collectively.

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

This paper has been prepared for consideration by the Audit Purpose Working Group. It looks at auditors’ responsibilities with regard to the audit in the following key areas:

- Fraud;
- Going concern; and
- Internal controls.

The paper seeks to identify the current legal requirements and responsibilities placed on auditors in these areas, the requirements included in auditing standards, perceptions of auditors as to their responsibilities and what level and type of assurance users of financial statements believe they are receiving from the audit in these areas. In so doing, the paper aims to identify potential expectation gaps that arise as a consequence of these different perceptions.

Generally expectation gaps may arise in the following key areas:

- Reporting
- Assurance being provided
- Regulation and liability
- Audit independence

The auditing expectation gap refers to the difference between what the public and other financial statement users perceive auditors’ responsibilities to be and what auditors believe their responsibilities entail. This paper focuses on expectation gaps regarding the assurance being provided.
Fraud

History, legal requirements and case law

According to Brenda Porter, the historical development of auditors’ duties to detect and report fraud may be split into four phases:

- **Pre 1920s.** The detection of fraud was recognised as a primary audit objective.
- **1920s – 1960s.** The importance of fraud detection declined until it became a ‘responsibility not assumed’. The increased scale of business transactions was such that the cost of searching out fraud and error by the external audit was acknowledged as having become uneconomic. Some critics argue, however, that the audit profession played a more active role here in bringing about the change.
- **1960s – 1980s.** Auditors’ duties to detect fraud were partially reinstated.
- **Post 1980s.** Auditors’ duties to detect and report fraud have become more firmly established. During this period there has been a high level of public concern about the extent of corporate fraud.

In the 1980s/1990s working parties were established by various professional bodies to look at the auditors’ role in respect of fraud, in particular, fraud reporting. The Profession gave some ground in relation to fraud reporting responsibilities but avoided any extension in detection responsibilities.

The Companies Act 1985 does not mention auditors having a duty to detect fraud. Therefore, any responsibility that the auditor may have for detecting corporate fraud relates to his/her duty to form an opinion on the truth and fairness of the financial statements and/or on the adequacy of the accounting records and information/explanations received.

This seems to define auditors’ fraud detection duties fairly narrowly and deviates significantly from the general duty to detect corporate fraud which surveys have shown is expected of auditors by society. It can be argued, however, that major fraud is likely to affect the truth and fairness of the financial statements and/or involve improperly kept accounting records.

The Courts have kept auditors’ duty to detect fraud within reasonable bounds.

Standards

The Explanatory Foreword to the Auditing Standards and Guidelines issued in 1980 says that the primary responsibility for the prevention and detection of irregularities and fraud rests with an enterprise’s management.

It goes on to say that the auditors’ principal responsibility is seen as reporting on the truth and fairness of the enterprise’s financial statements and any duty in respect of
fraud detection is restricted to planning the audit so as to have a reasonable expectation of detecting any resultant material misstatements in the financial statements. This suggests that auditors who have executed their audits in a reasonable manner would not be held responsible for any failure to detect material fraud.

**ISA (UK and Ireland) 240**

Auditors’ responsibility to consider law and regulations in an audit of financial statements is established in ISA (UK and Ireland) 250, *Consideration of Laws and Regulations*.

ISA (UK and Ireland) 240 distinguishes fraud from error and describes the two types of fraud that are relevant to the auditor, that is, misstatements resulting from misappropriation of assets and misstatements resulting from fraudulent financial reporting. It goes on to describe the inherent limitations of an audit in the context of fraud and sets out responsibilities of the auditor for detecting material misstatements due to fraud.

Specific paragraphs of the Standard that deal with the auditors’ responsibilities in respect of fraud are highlighted below.

*Paragraph 3*

In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.

*Paragraphs 13 and 14*

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. It is important that management place a strong emphasis on fraud prevention.

*Inherent limitations of an audit in the context of fraud, Paragraphs 17 – 20*

ISA (UK and Ireland) 200 says:

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs (UK and Ireland).

The risk of detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error. *(paragraph 18)*

The subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs (UK and Ireland)…whether the auditor has performed an audit in accordance with ISAs (UK and Ireland) is determined by the audit procedures performed in the
circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor’s report based on an evaluation

_Responsibilities of the auditor for detecting material misstatement due to fraud (paragraphs 21-22)_

An auditor conducting an audit in accordance with ISAs (UK and Ireland) obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgement.

_Professional skepticism (paragraph 24)_

The auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience with the entity about the honesty and integrity of management and those charged with governance.

**US comparison**

Tone of US standards indicates more exacting duties for auditors in the USA.

_History: SAS 53_ – this auditing standard required auditors to provide reasonable assurance of detecting errors and irregularities. The ASB then issued SAS No 82 a decade later in an attempt to clarify but not increase the auditor’s responsibility to detect fraud.

_SAS 54_ – requires the auditor to plan the audit to give reasonable assurance that illegal acts with direct and material effects on the financial statements will be detected. The auditor is not required to plan the audit to provide reasonable assurance that illegal acts with a material but indirect effect on the financial statements will be detected. It has language that limits the auditor’s responsibility e.g. ‘...an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed’.

_SAS 58_ – has explicit reference that communicates to readers that an audit provides reasonable assurance of financial statements’ material accuracy.

_SAS 99, Consideration of Fraud in a Financial Statement Audit, (interim auditing standard AU 316 of the PCAOB)_ – arguably focuses on highlighting a lack of responsibility to detect fraud rather than a clear statement of responsibility that acknowledges the auditor’s role of protecting public investors. ‘Although this section focuses on the auditor’s consideration of fraud in an audit of financial statements, it is management’s responsibility to design and implement programs and controls to prevent, deter, and detect fraud’. (paragraph 4). Also states, however that ‘Due professional care requires the auditor to exercise professional skepticism... Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud.'
Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest’. (paragraph 13)

**What auditors consider their responsibilities are in respect of fraud**

ICAEW publication – Fraud: Meeting the Challenge through External Audit, says:

Auditors are not responsible, and should not be held to be responsible, for finding all fraud but auditors should be looking for ways of improving the detection rate, to help build public trust in the UK audit profession after the US corporate reporting scandals that have hit the headlines.

More information on this is provided in the section of expectations that includes surveys of auditors as well as audited entities.

**Expectations**

**General comment**

Society, financial and business community expect auditors to detect all (or at least all material) corporate fraud as auditors alone have legal right of access to all company’s accounts, books and records and right to seek explanations and information from company’s officers/employees. (Humphrey)

There is, however, an inherent contradiction in that the audit is a check on untrustworthy directors and yet in many respects auditors have to ‘trust’ management assurances in the conduct of their work.

**Auditors’ and investors’ perceptions of the ‘Expectation Gap’,**

*John E McEnroe and Stanley C Martens, December 2001*

A survey was performed in the US comparing audit partner’ and investors’ perceptions of auditors’ responsibilities involving various dimensions of the attest function.

The study found that expectation gaps exist and investors have higher expectations for various facets and/pr assurances of the audit than do auditors. The investing public does not want auditors to issue an unqualified opinion unless:
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- Every item of importance to investors and creditors has been reported or disclosed
- Auditors have been ‘public watchdogs’
- The internal controls are effective*
- The financial statements are free of misstatements resulting from management fraud
- The financial statements are free of misstatements intended to hide employee fraud
- The firm has not engaged in illegal operations.

* relevant to expectation gaps in internal controls

US Supreme Court describes the independent audit as a public watchdog function (United States v Arthur Young & Co, 1984). The Advisory Panel to the POB said, however, that they did not believe that ‘public watchdog’ is an operational description of the auditor-client relationship. The Panel did not agree that the public is the auditor’s true client.

Investors’ views of audit assurance: recent evidence of the expectation gap, Marc J Epstein and Marshall A Geiger

In US expectation gap SASs issued in 1988 and slowly introduced concept of reasonable assurance.

National survey conducted of investors to gather information on their views of various aspects of financial reporting issues. Participants were investors with 100 or more shares in stock listed on the American or New York stock exchanges. 246 responses received. Asked what level of assurance they believed auditors should provide for detecting material misstatements as a result of error and as a result of fraud.

- 51% of investors believed they should received reasonable assurance for material misstatement due to errors. Approximately 47% wanted absolute assurance.
- Over 70% expected absolute assurance that material misstatement due to fraud would be detected.

Conclusions drawn

- Profession should devote resource to increasing public understanding of an audit’s nature and its inherent limitations. Educating the public on the auditor’s role in financial reporting
- Adherence to current auditing standards
- Auditors should also be more sensitive to the possible existence of fraud in every audit they conduct.
- Auditors need to expand services offered, including more work to detect frauds and more internal control audits and disclosures.

The Audit Society, Rituals of verification, Michael Power, 1997

The early forms of audit process involved looking at every transaction with the objective of proving primarily that assets had not been misappropriated (fraud). The
detection of fraud seems to have been a primary objective of auditing until well into the twentieth century (though there is some debate about early audit objectives).

Quote: Today it remains true that most people, when asked about auditing, will tend to associate it with the search for fraud. And when auditors fail to uncover fraud which subsequently comes to light, these same people will assume that the audit process has failed in some way.

The detection of management fraud is neither ruled out of the audit process, because this would lower expectations to the point where audit might lose its value, nor clearly ruled in, since this would unfairly burden the auditor and would make audits much more expensive.

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

A survey was conducted in 1989 to understand the procedures by which companies dealt with fraud and the perceptions of senior executives (Finance Directors or Senior Accounting Executives at 50 UK listed companies) as to the role of the auditor in relation to fraud.

**Main findings**

- Over a third of business executives surveyed stated that their board of directors had not evaluated their companies’ exposure to fraud and over half believed that there was room to improve their business’s controls against fraud risks.
- 20% of respondents believed that the auditor should share with management responsibility for preventing and detecting fraud (but descriptive comments received suggest that even those saying shared responsibility were saying principally management)
- 60% of respondents believed that auditors should contribute more to preventing fraud
- Over 90% of respondents would find it helpful if the audit were to provide an overall assessment of their company’s main defences against fraud.

**Audit expectation-performance gap in the United Kingdom in 1999 and comparison with the gap in New Zealand in 1989 and in 1999, Brenda Porter and Catherine Gowthorpe, The Institute of Chartered Accountants of Scotland, 2004**

Research involved a questionnaire survey of four broad interest groups: auditors, auditees and audit beneficiaries inside and outside the financial community. It builds on earlier work that Brenda Porter carried out in New Zealand in 1989.

The questionnaire contained a list of 51 suggested responsibilities of auditors and respondents were asked to indicate:

- Whether the responsibility was or was not an existing responsibility of auditors, or whether they were not sure
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- If the responsibility was an existing responsibility of auditors, how well it was performed
- Whether the responsibility should be a responsibility of auditors.

In defining the audit expectation gap, the researchers split it into two elements:

**Reasonableness gap** – what society expects of auditors and what can reasonably be expected of auditors to accomplish

**Performance gap** – What society can reasonably expect of auditors and what it perceives they actually deliver. The performance gap can be split down further:

- **Deficient standards gap** – the gap between the responsibilities that society reasonably expects auditors to perform and auditors’ actual responsibilities under statute
- **Deficient performance gap** – the difference between the expected standard of performance of auditors and the actual performance of responsibilities by auditors

**Results**

The extent of the expectation gap was similar in the UK and New Zealand but the split between the various components was different.

- Reasonableness gap was a significant component though higher for the UK than New Zealand (50% and 41% respectively). Society’s expectations of auditors particularly in the UK outstrip what is expected of them and there is evidence of a ‘knowledge’ gap.
- Deficient standards gap was important too but more so in New Zealand than the UK.
- Deficient performance gap was the smallest component.

Of particular interest, are the comments about the knowledge of the auditor group.

The auditor group failed to recognise seven of their existing duties, the majority of which related to detecting or reporting theft of auditee assets or other illegal acts. The group disagreed strongly that auditors’ existing responsibilities include;

In the absence of a regulated industry requirement to do so, to report privately to an appropriate authority (such as the Serious Fraud Office) if during the audit it is discovered that the auditee’s directors or senior management have embezzled auditee assets or committed other illegal acts.

According to the researchers, case law and/or professional promulgations have established that auditors should plan and conduct their audits so to have a reasonable expectation of finding any material theft of auditee assets. Where such theft has occurred, if auditors approach their audits with sufficient knowledge of their auditee’s industry, business and operations, and with an appropriately sceptical attitude (as required by auditing standards), in the absence of an ingenious cover up, they should encounter suspicious circumstances if not actually uncover the theft. Once their suspicions are aroused they are required to probe the matter to the bottom.
Conclusions

The researchers suggest five measures to deal with narrowing the audit expectation-performance gap:

- Continued and strengthened monitoring of auditors’ performance
- Improving the quality control in audit firms
- Enhancing the education of auditing practitioners – 18% of auditors surveyed in UK appear uncertain or in error about their existing responsibilities
- Introducing new auditing standards to narrow deficient standards gap
- Educating Society about the audit function and work of auditor to narrow the reasonableness gap

Audit Quality, Audit and Assurance Faculty, ICAEW

There can be a difference between what shareholders expect an audit to achieve and what it can realistically be designed to achieve. There can be a perception that the audit does indeed certify the financial statements or that an audit can uncover every fraud within a company, however small.

It needs to be stressed that the purpose of the audit is to express an opinion with reasonable assurance that the financial statements give a true and fair view; it is not to provide a certificate or a legal warranty that they are completely accurate and without error. Such certification is simply not possible without re-performing every single financial transaction made by the company…

A continuing challenge facing those with an interest in corporate governance and every auditor is communicating the purpose, ambit and limitations of the audit.

Sources


The Audit Society, Rituals of verification, Michael Power, 1997


Fraud: Meeting the challenge through external audit, Audit and Assurance Faculty, ICAEW

The Audit Society, Rituals of verification, Michael Power, 1997

Audit Quality, Audit and Assurance Faculty, ICAEW

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

History and current legal requirements

Going concern is one of the fundamental accounting principles. This was identified under the old SSAP 2 – issued in the 1970s.

Section 173 of the Companies Act 1985 (derived from the Companies Act 1981, s 55) Conditions for payment out of capital (see emphasis added)

(1) Subject to any order of the court under section 177, a payment out of capital by a private company for the redemption or purchase of its own shares is not lawful unless the requirements of this and the next two sections are satisfied.

(2) The payment out of capital must be approved by a special resolution of the company.

(3) The company's directors must make a statutory declaration specifying the amount of the permissible capital payment for the shares in question and stating that, having made full inquiry into the affairs and prospects of the company, they have formed the opinion—
(a) as regards its initial situation immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts, and
(b) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.

(4) In forming their opinion for purposes of subsection (3)(a), the directors shall take into account the same liabilities (including prospective and contingent liabilities) as would be relevant under [section 122 of the Insolvency Act] (winding up by the court) to the question whether a company is unable to pay its debts.

(5) The directors' statutory declaration must be in the prescribed form and contain such information with respect to the nature of the company's business as may be prescribed, and must in addition have annexed to it a report addressed to the directors by the company's auditors stating that—
(a) they have inquired into the company's state of affairs; and
(b) the amount specified in the declaration as the permissible capital payment for the shares in question is in their view properly determined in accordance with sections 171 and 172; and
they are not aware of anything to indicate that the opinion expressed by the
directors in the declaration as to any of the matters mentioned in subsection (3) is
unreasonable in all the circumstances.

A director who makes a declaration under this section without having
reasonable grounds for the opinion expressed in the declaration is liable to
imprisonment or a fine, or both.

Schedule 4 of the Companies Act 1985

Under Schedule 4 of the Companies Act 1985 companies are required to prepare their
annual accounts on the basis that ‘The company shall be presumed to be carrying on
business as a going concern.’ (Paragraph 10)

Insolvency Act 1986

Section 214 of the Insolvency Act 1986 sets out the concept of ‘wrongful trading’:

214 Wrongful trading
(1) Subject to subsection (3) below, if in the course of the winding up of a
company it appears that subsection (2) of this section applies in relation to a person
who is or has been a director of the company, the court, on the application of the
liquidator, may declare that that person is to be liable to make such contribution (if
any) to the company's assets as the court thinks proper.

(2) This subsection applies in relation to a person if—
(a) the company has gone into insolvent liquidation,
(b) at some time before the commencement of the winding up of the company,
that person knew or ought to have concluded that there was no reasonable prospect
that the company would avoid going into insolvent liquidation, and
(c) that person was a director of the company at that time;
but the court shall not make a declaration under this section in any case where the
time mentioned in paragraph (b) above was before 28th April 1986.

(3) The court shall not make a declaration under this section with respect to any
person if it is satisfied that after the condition specified in subsection (2)(b) was first
satisfied in relation to him that person took every step with a view to minimising the
potential loss to the company's creditors as (assuming him to have known that there
was no reasonable prospect that the company would avoid going into insolvent
liquidation) he ought to have taken.

(4) For the purposes of subsections (2) and (3), the facts which a director of a
company ought to know or ascertain, the conclusions which he ought to reach and the
steps which he ought to take are those which would be known or ascertained, or
reached or taken, by a reasonably diligent person having both—
(a) the general knowledge, skill and experience that may reasonably be expected
of a person carrying out the same functions as are carried out by that director in
relation to the company, and
(b) the general knowledge, skill and experience that that director has.

(5) The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(6) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

(7) In this section “director” includes a shadow director.

(8) This section is without prejudice to section 213.

The audit and the Companies Act 1985

The sections in the Companies Act which deal with auditors’ responsibilities regarding the statutory audit (Section 235-237) make no specific reference to going concern.

What auditing standards/other standards say

UK requirements, ISA (UK and Ireland) 570

Management’s responsibility

The going concern assumption is a fundamental principle in the preparation of financial statements. (paragraph 3)

Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern… For example, International Accounting Standard 1 (revised 2003), ‘Presentation of Financial Statements’, requires management to make an assessment of an enterprise’s ability to continue as a going concern. (paragraph 4)

Appendix 1 to ISA (UK and Ireland) 570 contains a note of the legal and professional requirements for the preparation of company accounts in relation to going concern. The appendix refers to Schedule 4 of the Companies Act (highlighted above) and to FRS 18, which requires that:

An entity should prepare its financial statements on a going concern basis, unless

(a) the entity is being liquidated or has ceased trading, or
(b) the directors have no realistic alternative but to liquidate the entity or to cease trading,

in which circumstances the entity, may, if appropriate prepare its financial statements on the basis other than that of going concern.
FRS 18 also requires that ‘when preparing financial statements, directors should assess whether there are significant doubts about an entity’s ability to continue as a going concern’ and in relation to the assessment:

- Any material uncertainties relating to events/conditions that may cast doubt over the entity’s ability to continue as a going concern;
- Where the foreseeable future has been limited to a period of less than one year from date of approval of the financial statements, that fact; and
- When the financial statements are not prepared on a going concern basis, that fact, reasons why and the basis for preparing the financial statements

need to be disclosed in the financial statements.

An important consequence of the legal and professional accounting requirements in the UK and Ireland is that, when preparing financial statements, those charged with governance should satisfy themselves as to whether the going concern basis is appropriate. (ISA (UK and Ireland) 570, paragraph 4-2).

Auditor’s Responsibility

The auditor’s responsibility is to consider the appropriateness of management’s use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity’s ability to continue as a going concern that need to be disclosed in the financial statements. The auditor considers the appropriateness of management’s use of the going concern assumption even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern. (paragraph 9)

The auditor also considers whether there are adequate disclosures regarding the going concern basis in the financial statements in order that they give a true and fair view. (Paragraph 9-1)

The auditor’s procedures necessarily involve a consideration of the entity’s ability to continue in operational existence for the foreseeable future. In turn, that necessitates consideration both of the current and the possible future circumstances of the business and the environment in which it operates. (Paragraph 9-2)

The auditor cannot predict future events or conditions that may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern uncertainty in an auditor’s report cannot be viewed as a guarantee as to the entity’s ability to continue as a going concern. (Paragraph 10)

US relevant standards and guidelines

AU section 341 - The Auditor's Consideration of an Entity's Ability to continue as a Going Concern
The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a reasonable period of time). The auditor's evaluation is based on his knowledge of relevant conditions and events that exist at or have occurred prior to the completion of fieldwork. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in section 326, Evidential Matter. (para 2)

**Comparison**

Other countries around the world have similar documents; but like the UK most countries now take account of International Standards on Auditing (ISAs) in drawing up their requirements.

The most significant difference between UK and other requirements is the period that the auditor (and the directors of the company) are required to pay particular attention to in assessing going concern when preparing and auditing accounts. Although couched in terms of the ‘foreseeable future’, in most jurisdictions the practice is to consider a year from the balance sheet date on which the auditor is reporting. However, in the UK the auditor is required to consider a period of at least a year from the date of approval of the financial statements’ (ISA (UK & Ireland) 570 31-4). This was introduced by the UK Auditing Practices Board in the 1990s in SAS 130 as a response to concerns about companies being given clean audit opinions, sometimes almost a year after the balance sheet date on which the auditor was reporting, and becoming insolvent shortly afterwards, particularly during an economic downturn. It was also the case that subsidiaries that by themselves were solvent were dragged down if the rest of the group experienced difficulties.

Hence the extension of the period to be considered to twelve months after the approval of the financial statements. This aimed to avoid the risk that, if there was doubt about the going concern, directors might leave approval of the accounts until so close to the next balance sheet date that there was no risk of the company ceasing to be a going concern in the remainder of the period.

The whole question of going concern thus became part of the general debate about the usefulness of accounts. In particular it was felt that accounts – and auditors – were backward looking, concerned with the traditional ‘stewardship’ role for accounts, showing how the company had used the resources entrusted to the directors and management by the shareholders, whereas what was required was accounts that looked forward. In particular analysts were interested in the next earnings figures, not how the company had performed in the past. Various academic studies over the years had showed that share prices moved in response to news about the future, especially unexpected news, rather than past performance.
What auditors believe their responsibilities to be

Auditors are responsible for reporting on the truth and fairness, or fair presentation, of the financial statements prepared by those charged with governance. The directors are responsible for the accounts not the auditors. Particularly if the company is facing problems, if the directors are able to hide these it is often difficult for the auditors to find out what is going on. (This links considerations of going concern and fraud, as directors may seek to make every effort to keep the company going.) This can be exacerbated if the problems are being considered at the group level and the subsidiaries are not aware of them.

The procedures outlined in ISA (UK and Ireland) 570 are quite extensive. If there is any doubt about the company being able to continue as a going concern these can be almost as extensive as for a report on a working capital forecast. Of course this makes demands on the company and the auditors and can substantially increase the costs of the audit at a time when the company’s financial resources are already stretched.

The need for practitioners for guidance on addressing these issues can be seen by the launch by the US website Accountingmalpractice.com of a ‘Going Concern Risk Report’ on quarterly subscription at http://accountingmalpractice.com/0005/articles/gc-10-12-01a.pdf. This claims ‘to advise about emerging risks and provide a vehicle for solving related problems’.

Academic studies show that requiring auditors to focus on going concern improves the predictive value of reports – although there are still companies that go bankrupt without previous warnings from the auditors. (See REPORTING ON GOING CONCERN BEFORE AND AFTER SAS NO. 59 By Marshall A. Geiger, K. Raghunandan, and D.V. Rama – CPA Journal (US) August 1995)

A recent study in the US showed that, after the Sarbanes Oxley Act, auditors were more conservative in their opinions - based on analyses of 226 financially stressed companies that entered bankruptcy in the US during the period from 2000 to 2003, the researchers found that auditors are more likely to issue going-concern modified audit opinions in the period after December 2001. (See Recent Changes in the Association Between Bankruptcies and Prior Audit Opinions, by Marshall A. Geiger*, K. Raghunandan and Dasaratha V. Rama – NB this article has an extensive bibliography but I am not able to access the material it mentions.) (It is not clear where or when this article was published, but it appears if you search on Google for going concern audit expect*.)

What are the expectations of users

As outlined above, there is a growing demand for forward looking information in accounts and for auditors to include that in their opinion. However, this needs to be balanced against the risks to those giving or reporting on such information – hence much of the concern when the ill-fated Operating and Financial Review was being considered and the requests for ‘safe harbour’ for directors and auditors for statements made about the future.
There is also concern that any mention of going concern problems may turn out to be a self-fulfilling prophecy because, to protect themselves businesses, employees, etc will not wish to continue trading on normal terms with or working for an enterprise if they fear it will not be able to meet its commitments when they fall due.

**Issues that the working group may wish to consider**

The principal concern is how accounts and audit report on them can provide useful information about the future without exposing directors and auditors to potentially ruinous claims if anything goes wrong or anyone purports to have suffered loss by having relied on those statements.

- Are there proxies for going concern problems that directors and auditors can report on – cash flow, retained losses, net liabilities or net current liabilities, etc – that will give some indication of future prospects but do not involve making predictions about the future?

- Are there non-financial indicators? Can these be divulged with releasing commercially sensitive information that would give unfair advantage to competitors?

- Should companies provide forward looking information, like cash flow forecasts?

- What form of protection can be given to companies and their auditors in return for providing and reporting on this information? It is likely that the more meaningful the information the greater the protection that directors and auditors will demand - little protection will lead to ‘boiler plate’ statements.

- Should brokers’ forecasts be included in companies’ accounts? Similar concerns would arise here in relation to ‘safe harbour’.

- Should any changes apply only – or only at first - to listed companies?
Internal Control

**History, legal requirements and case law**

Over the last decade, internal controls and their effectiveness have been considered by academics, investors, companies and auditors under the heading of corporate governance. This paper goes on to introduce the concept of corporate governance clarifying and exploring how corporate governance has evolved in the UK and the impact that the various groups and consultations have had on the present day requirements and responsibilities of both auditors and companies.

**CORPORATE GOVERNANCE**

*What is Corporate Governance?*

The Cadbury Committee described corporate governance as "*the system by which companies are directed and controlled*"

Most UK companies have a single ‘unitary’ board of directors. Corporate governance in the UK corporate sector is, therefore, primarily concerned with:

- The procedures adopted by the board and its committees to discharge its duties (for example, membership of the board; frequency of, and procedures at, board meetings; the role of non-executive directors; constitution and terms of reference of audit and remuneration committees; and the role of the company secretary).

- The board's accountability to shareholders and other stakeholders (for example, annual reporting; use of AGMs and shareholder voting rights).

- The manner in which the board controls the company or group (for example, management structures; group legal structure; and internal control philosophy and practice).

**History of Corporate Governance**

In the 1980's there were a number of scandals and failures where it became clear that companies were failing due to poor (and sometimes illegal) management. Examples of these were Maxwell, BCCI and the issue of directors’ pay in privatised industries. It was felt that there was a low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected.

Over time three Committees (each named after the leader of the committee) have been involved in corporate governance procedures up to the present date:

- Cadbury Committee on the Financial Aspects of Corporate Governance
Greenbury Committee on Directors’ Remuneration
The Committee on Corporate Governance (the ‘Hampel Committee’) – this included both financial and non-financial aspects

The Cadbury Committee

Sir Adrian Cadbury headed up this committee, which was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance. It reported in December 1992.

The recommendations were summarised in a Code of Best Practice for companies and there were separate recommendations to auditors. As a result of this major changes were made in the way in which governance was viewed by companies as well as in the disclosures that they give. Examples of these were disclosures on internal financial controls, non-audit fees paid to auditors and the inclusion of balance sheet information in Interim announcements. A further key recommendation was that directors’ service contracts should not exceed more than three years without shareholder approval.

The Greenbury Committee

Whilst board remuneration was one of a number of issues addressed by Cadbury, it was not the main focus. Nonetheless, the level of board remuneration continued to attract a high profile and in response to this a separate group was set up by the CBI headed by Sir Richard Greenbury, chairman of Marks and Spencer.

The Greenbury report was issued in July 1995 and discussed the need for a Remuneration Committee. One of the recommendations of this Report was that there should be substantially increased disclosure of directors’ remuneration.

The London Stock Exchange introduced new requirements for disclosure of directors’ emoluments by UK listed companies. Some of these disclosures include policy on directors’ remuneration, and details of individual directors’ whole package including share options and pension entitlement.

The Hampel Committee

One of Cadbury’s recommendations was that a successor body should be set up to review progress and it identified a number of issues which that body might consider. This would include looking at non-financial controls as well as financial.

The Hampel report, published in January 1998, included 56 conclusions and recommendations, but many of those involved supporting conclusions previously arrived at by Cadbury and Greenbury.

Following the completion of its report, the Hampel Committee co-operated with the London Stock Exchange in producing ‘The Combined Code - Principles of Good Corporate Governance and Code of Best Practice’ in June 1998. The 1998 Combined Code embraced the Cadbury and Greenbury Reports taking into account the Hampel
Committee's Report and changes made by the London Stock Exchange, with the Committee's agreement, following consultation.

**The 1998 Hampel Combined Code**

The Combined Code was appended to the FSA Listing Rules, but did not form part of the rules. However, there is a listing rule [now LR12.43a] that requires companies to include a two part disclosure statement in their annual report describing how they have applied the principles of the Combined Code and whether or not they have complied with its detailed provisions throughout the accounting period with details of any non-compliance.

This listing rule only addresses the principles and provisions in Section 1 of the Combined Code (those which relate to listed companies), however the Hampel Committee regarded Section 2 as an integral part of the recommendations and it encouraged institutions to make voluntary disclosure to their clients and the public based on these recommendations.

The 1998 Combined Code advocated flexibility when considering corporate governance standards and a proper regard for the individual circumstances of the companies concerned as in the past (with Cadbury and Greenbury) many companies had had a "box-ticking" approach to corporate governance, just stating whether they complied with the provisions or not, without explaining the circumstances surrounding them.

**Contents of the 1998 Hampel Combined Code**

The 1998 Combined Code contained both principles and detailed code provisions and was in two parts - Part 1, 'Principles of good governance' and Part 2, 'Code of best practice' (the detailed bit).

The 1998 Hampel Combined Code broadly covers the following areas:

**Section 1**
- The Board
- Directors Remuneration
- Relations with shareholders
- Accountability and audit

**Section 2**
- Institutional investors (voting, dialogue, evaluation of disclosures)

There are 14 main principles covering the areas above and 45 detailed provisions.

A major impact of the Hampel code was the obligation to **review the effectiveness of all controls**, not just financial ones. Note that the principle applied to safeguarding shareholders’ investment as well as the company assets. The board and audit committee were required to consider the company's approach to evaluating risk, because of the importance of a leadership tone from the board to an effective control
framework. The work required up to now focused mainly on **financial controls**. The Hampel Committee endorsed continuing self-regulation of corporate behaviour which required:

- shareholders to exercise their rights of ownership in evaluating corporate governance disclosures and, to encourage that,
- boards to be imaginative in their approach.

**1998 Hampel Combined Code Extract**

**D.2 Internal Control**

**Principle**

The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

**Code Provisions**

**D.2.1.** The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.

**D.2.2.** Companies which do not have an internal audit function should from time to time review the need for one.

**Auditors' Responsibilities for Listed Companies 1999**


APB Bulletin 1999/5 focussed on general procedures covering the auditors’ work in relation to the **seven provisions (including D.2.1)** that auditors consider in relation to the 1998 Combined Code. Other than provision D.2.1, as shown above, the remaining six provisions to be reviewed by the auditor do not contain any internal control requirements for the board or management of the company to consider.

The scope of the **auditors' review required by Listing Rule 12.43A**, in comparison to the totality of the Code, is very narrow. The auditors are not required to review the directors' narrative statement of how they have applied the Code principles and are required to review only seven of the forty five Code provisions applicable to companies.

Listing Rule 12.43A is silent as to whether the auditors should report on their review of the directors' compliance statement and whether any such report should be published or referred to in the annual report.

Because of the limited nature of the auditors' review and in order **to avoid the possibility of misunderstandings arising** the APB recommended that:
(a) the auditors’ engagement letter explain the scope of the auditors' review, and

(b) prior to the release of the annual report and accounts the auditors communicate, and discuss, with the directors the factual findings of their review.

**Internal Control Working Groups: 1994 Rutteman and 1999 Turnbull**

In response to the Cadbury Committee a working group was set up in 1994 to look at the Committee's proposals on **internal financial control**. They specifically looked at a set of criteria for assessing effectiveness of controls and guidance for companies on the form in which directors should report on their assessment of controls. The guidance that the group produced (the Rutteman guidance) was standard for accounting periods beginning on or after 1st January 1995.

However the Hampel Combined Code (which came along later) stated that the directors should review the effectiveness of the group's system of internal controls – including **non-financial (operational and compliance) controls and risk management**. This became a difficult area for both auditors and clients in determining what this actually covers in practice. It then became clear that the Rutteman guidance was no longer applicable.

In 1998 a working party was set up by the ICAEW to provide guidance to assist listed companies to implement the new requirements relating to internal control. This guidance, **Internal Control: Guidance for Directors on the Combined Code** was first issued in September 1999 and became known as the "Turnbull guidance" after the chairman Nigel Turnbull. Full compliance with the guidance was applicable for accounting periods ending on or after 23 December 2000.

The Turnbull guidance covers both financial and non-financial controls and defines **Internal Control** as: "**Internal Control facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists compliance with laws and regulations.**"

More importantly it clarified to directors what is expected of them in relation to the Internal Control part of the Combined Code. **This is that directors are only required to state that they have reviewed the effectiveness of controls, not that the controls are effective.**

The LSE stated that compliance with the Turnbull guidance will constitute compliance with the 1998 Combined Code provisions D.2.1 and D.2.2 and provide appropriate narrative disclosure of how Code principle D.2 has been applied. Non-compliance with Turnbull does not strictly speaking have to be disclosed - only non-compliances with Combined Code provisions have to be disclosed. However Turnbull contains recommended disclosures, and since the LSE has said compliance with it constitutes compliance with Code provision D.2.1, then this effectively means that those disclosures recommended by Turnbull are required. Turnbull also says that where certain of the disclosures cannot be given, then the fact of and reason for that need to be disclosed.
The 2003 FRC Combined Code

In July 2003, the UK Financial Reporting Council agreed the final test of a new Combined Code, based on recommendations made by Derek Higgs on the role and effectiveness of non-executive directors and incorporating the Smith recommendations on audit committees.

The Turnbull guidance remained unchanged and appended to the Code and Internal control covered as principle C.2 (replacing D.2 in the former Code), requiring all material controls to be reviewed. The other main changes relating to internal controls responsibilities are set out below:

- Whilst the whole board has responsibility under the Turnbull Report for the risk management and internal controls system of the company and reviewing the effectiveness of that system, it may delegate to the audit committee operational aspects of this responsibility, and in particular review of the internal financial controls system.
- Unless the board itself, or a separate board risk committee composed of independent directors, is doing so, the audit committee should review the company's internal control and risk management systems.
- The audit committee should ensure arrangements are in place to facilitate 'whistle blowing' and follow up investigations and actions where appropriate.
- The audit committee should monitor and review the effectiveness of the internal audit function and its activities. If there is none, the committee must consider the need for it annually, and the reason for the absence of the function should be disclosed in the annual report.

The 2003 FRC Combined Code (‘the Code’) applies to UK listed companies for periods beginning on or after 1 November 2003. Hence it applied for the first time to companies with December 2004 year ends.

As required previously under the 1998 Combined Code, companies are required to state how they have applied the principles of the Code and whether or not they have complied with its provisions throughout the year. Where they have failed to comply for any part of the year, they should provide full details of the period of non-compliance and the reasons for non-compliance. Companies should not simply state areas of non-compliance but should also fully justify any departure.

### 2003 FRC Combined Code

#### C.2 Internal Control

**Main Principle**

The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets.

**Code Provision C.2.1**

The board should, at least annually, conduct a review of the effectiveness of the group’s system of internal controls and should report to shareholders that they have
The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

Requirements of auditors under the listing rules of the Financial Services Authority Nov 2004


This Bulletin includes material relating to:

- Requirements of the Listing Rule 12.43A relating to the auditor’s review of companies’ reporting on corporate governance matters.
- Implications of the Code on existing reporting by companies’ regarding corporate governance matters.

What do listed companies need to disclose in their annual reports?

Listing Rule 12.43A requires UK listed companies to include in their annual report and accounts a two-part disclosure statement in relation to the Code. The first part is to explain how the company has applied the principles (main and supporting) of the. The second part of the disclosure is a statement as to whether or not the company has complied throughout the accounting period with the Code provisions set out in Section 1 of the Code. If there are instances of non-compliance the company must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons (comply or explain).

What do auditors need to do?

As from 1 November 2004 a listed company is required to have its external auditor review the corporate governance statement disclosures in relation to nine out of the forty-eight Code provisions. Refer to Appendix 1 for details. The new APB Bulletin gives guidance to auditors on how to carry out the review.

The previous guidance, Bulletin 1999/5, focussed on general procedures covering the auditors’ work in relation to the seven provisions that auditors considered in relation to the 1998 Combined Code. However, the new Bulletin, in addition to the general procedures, sets out specific procedures to be carried out in relation to each of the nine provisions that fall within auditors remit. It also reminds auditors of their responsibilities under auditing standards to read other information in documents containing audited financial statements. Provision C.2.1 (see above) is one of the nine provisions which auditors are required to review and the remaining eight provisions (refer to appendix 1) do not relate to internal controls.
What is the impact on the wording of the audit report and the engagement letter?

As a result of the new Code, the standard audit report has been amended with new wording where the client's compliance statement refers to the 2003 FRC Combined Code (that is, for accounting periods beginning on or after 1 November 2003). The engagement letter should also incorporate new wording to reflect the audit report wording tailored for either a listed company, or a company voluntarily complying with the 2003 FRC Combined Code.

The paragraph in the audit report was amended as follows:

"We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 FRC 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 [company's] [group’s] corporate governance procedures or its risk and control procedures."

The above wording was required to avoid any potential misunderstanding and to clearly state the auditor’s responsibilities as it was felt that users may have thought that the auditors were responsible for auditing all 48 provisions of the Code rather than conducting a review of nine specific provisions.

The auditor has no responsibility to review or otherwise assess and comment upon a company’s decision to depart from the provisions of the Code.

Review of the company’s statement by the auditor

On 20 October 2004 the FSA issued instrument 2004/83 amending Listing Rule 12.43A entitled "Listing Rules (Auditors’ Responsibilities in relation to the Combined Code) Instrument 2004", This instrument came into force on 1 November 2004. The amendment requires that "A company’s statement under 12.43A(b) must be reviewed by the auditors before publication insofar as it relates to Code provisions C1.1, C2.1, C3.1, C3.2, C3.3, C3.4, C3.5, C3.6 and C3.7 of the Combined Code." This requires the auditor to review nine of the ten objectively verifiable 2003 FRC Code provisions relating to accountability and audit.

Important change to the Turnbull Guidance – Updated October 2005

In 2004, the Turnbull Review Group was established by the FRC and subsequently published, “Internal Control: Revised Guidance for Directors on the combined Code (October 2005)” in 2005. This publication updates the 1999 Turnbull Guidance on internal controls and follows the recent consultation process. The Group was established to consider the impact of the guidance and the related disclosures and to determine whether the guidance needed to be updated.
The FRC had invited views on issues such as the overall quality and level of dialogue between boards and investors, whether ‘comply or explain’ is working successfully, and whether companies have experienced any practical difficulties in attempting to implement the new requirements in the Combined Code. Views were sought from listed companies, directors, investors and other interested parties.

One change relates to the guidance in relation to code provision C.2.1 where the board is now required to “confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified” from the annual review of effectiveness of controls that is performed by the board.

**Auditing Standards**

**History**

There are no company law requirements for auditors to consider internal controls or their effectiveness.

SAS 300: Accounting and Internal Control Systems and Audit Risk Assessments has been superseded by the Audit Risk ISAs (UK and Ireland) 315 and 330

SAS 610 has been replaced by ISA (UK and Ireland) 260 Communication of Audit Matters with those charged with Governance

SAS 610.2 required:

’When material weaknesses in the accounting and internal control systems are identified during the audit, auditors should report them in writing to the directors, the audit committee or an appropriate level of management on a timely basis’.

ISA (UK and Ireland) 260 requires:

‘Auditors to report, or arrange to report, all significant control weaknesses and all other significant findings from the audit and consider their impact on the audit opinion’

‘Auditors to communicate to those charged with governance material weaknesses in internal control identified during the audit’ (paragraphs 11-12)

For accounting periods commencing on or after 15 December 2004 the APB’s ISAs (UK and Ireland) apply:

- ISA (UK and Ireland) 315: Obtaining an Understanding of the Entity and its Environment and Assessing the Risks of Material Misstatement.

- ISA (UK and Ireland) 330: The Auditor’s Procedures in Response to Assessed Risks.

The primary objectives of the new “audit risk” ISAs (UK and Ireland) are for auditors “to identify and assess the risks of material misstatement” at the financial statement
level and at the assertion level. The auditor then determines the scope of audit procedures required to respond to those risks identified and reduce them to an acceptably low level.

**ISA (UK and Ireland) 315**

The audit risk model has been substantially revised under ISAs (UK and Ireland) and as a consequence, many of the bold text requirements set out in ISA (UK and Ireland) 315, together with those in ISA (UK and Ireland) 330 are “new” and significantly increased in number compared to those in SAS 300.

Compared to previous SAS requirements, the auditor is required to obtain and document a broader understanding of the entity and its environment, including its process for identifying business risks relevant to financial reporting objectives and its information systems and internal control.

The extent of understanding of internal control is also broader in ISA (UK and Ireland) 315 than SAS 300 that it replaces.

The standard requires that the following procedures should be undertaken in an audit of financial statements in relation to internal controls.

The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures. (paragraph 2).

Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. (paragraph 6).

Auditors are required to perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

(a) Inquiries of management and others within the entity;
(b) Analytical procedures; and
(c) Observation and inspection. (paragraph 7).

SAS 300 required an understanding of the control environment and accounting systems, and recognised that understanding the accounting system was likely to result in understanding specific control procedures. ISA (UK and Ireland) 315 requires the auditor to address the following components:

- Control environment (paragraph 67)
- Entity’s risk assessment process (paragraph 76)
- Information and communication (paragraphs 81, 89)
- Control activities (paragraph 90)
- Entity’s response to risks arising from IT (paragraph 93)
- Monitoring of controls (paragraph 96)
The standard uses different terminology to SAS 300 requiring the auditor to assess the risk of material misstatement whereas previously under SAS 300 auditors were required to assess inherent risk. Also, in relation to internal control, the understanding of internal control includes consideration of design of controls, irrespective of whether the auditor expects to rely on controls, and also requires the auditor to evaluate whether the controls have been implemented. Consequently there is a much greater depth of understanding of control required. ISA (UK and Ireland) 315.55 also states that inquiry alone is not sufficient to evaluate the design of a control relevant to the audit and to determine whether it has been implemented.

For significant risks, auditors are required to evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented. (paragraph 113).

As part of the risk assessment process, ISA (UK and Ireland) 315 requires the auditor specifically to identify:

- Significant risks that require special consideration on the audit (paragraph 108). And, to the extent the auditor has not already done so, the auditor should evaluate the design of related controls, and determine whether they have been implemented.
- Risks for which, in the auditor’s judgment, it is not possible or practicable to reduce the risks of material misstatement at an assertion level to an acceptably low level with audit evidence obtained only from substantive procedures (for example because of the extent of automation in the client’s systems) (paragraph 115). For these risks, the auditor should evaluate the design and implementation of the entity’s controls, including relevant control activities.

Auditors are required to make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditors attention. ISA (UK and Ireland) 315.120.

ISA (UK and Ireland) 315.122 incorporates explicit documentation requirements covering:

- Engagement team discussion
- Key elements of the understanding of the entity and its environment, including each of the internal control components, to assess risks of material misstatement, sources of information and the risk assessment procedures.
- Identified and assessed risks of material misstatement at the financial statement and assertion level
- Significant risks, and those where substantive procedures alone will be insufficient, and the related controls.

ISA (UK and Ireland) 330

ISA (UK and Ireland) 330 follows on from ISA (UK and Ireland) 315, and consequently also has many “new” bold text requirements compared to the comparable parts of SAS 300.

For each risk of material misstatement that is identified, a response is required at two levels:
The financial statement level
The assertion level

There should be a clear linkage between the assessed risks and the audit responses.

The general principles in SAS 300 and ISA (UK and Ireland) 315 are the same. Both require tests of operating effectiveness of controls where the auditor wishes to obtain comfort from controls (although ISA (UK and Ireland) 315 also has the specific requirement to test controls where substantive procedures alone do not provide sufficient evidence at the assertion level). Both also note that the auditor can obtain comfort from tests performed in prior audits, provided that evidence is obtained that the controls have not changed in the year by inquiry combined with observation or inspection. However, ISA (UK and Ireland) 315 has more explicit requirements for testing:

- Controls on which the auditor places reliance must be tested at least every third audit.
- At least some controls must be tested every audit
- Where they are being relied on, controls over significant risks must be tested every year

The requirement that substantive tests must be performed for each material class of transaction, balance or disclosure, irrespective of the assessed risk previously included in SAS 300 is retained in ISA (UK and Ireland) 330.

ISA (UK and Ireland) 330 has explicit documentation requirements, and the auditor should document:

- The overall responses to address the assessed risks of material misstatement at the financial statement level
- The nature, timing and extent of the further audit procedures
- The linkage of those procedures with the assessed risks at the assertion level
- The results of the audit procedures
- If the auditor plans to use audit evidence about operating effectiveness of controls obtained in prior audits, the conclusions reached with regard to relying on such controls that were tested in a prior audit

**Expectations**

Many of the references under the section on fraud are relevant here and suggest that there are expectation gaps in this area. No research was identified, however, that specifically looked at this area.

**US developments and comparison**

On 2 March 2005, the SEC announced that it has extended the Section 404 – Reporting on Internal Control over Financial Reporting – compliance dates for foreign private issuers by one year. Foreign private issuers filing annual reports on Form 20-F or 40-F must begin to comply with the internal control over financial
reporting requirements for fiscal years ending on or after 15 July 2006. This is a one year extension from the previously established 15 July 2005. This is an actual rule change – not a proposed rule change.

Currently in the UK, auditors are required to carry out procedures to confirm that the board has conducted a review of internal controls. The new US requirements extend this to require the auditors to make a formal assessment of the effectiveness of design and operation of the financial reporting controls. This goes much further than the existing UK requirements.

The SEC has identified the Turnbull guidance as an appropriate framework for evaluating the effectiveness of internal controls over financial reporting. This does not reduce the requirements on companies, but it provides a useful flexibility for UK and Irish companies that are listed or considering listing in the US. This guide summarises those requirements and explains how the Turnbull guidance can be used as a starting point to address them.'

**Other consultations of interest**

**FRC 2003 Combined Code Consultation Dec 2005**

The FRC made a preliminary announcement of the results of its review of the 2003 FRC Combined Code (‘the Code’) on 15 December 2005. A full report was published on 18 January 2006 and as a result the FRC is now consulting on a number of proposed changes to Code. The FRC is seeking comments on the proposed changes by 21 April 2006. Any changes to the Code will take effect for financial years beginning on or after 1 November 2006.
Appendix 1 – provisions in the FRC Combined Code

The nine provisions auditors are responsible to review under the 2003 FRC Combined Code.

C.1.1 The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.

C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group’s system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies\(^1\) eight members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company’s financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company’s internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company’s internal control and risk management systems;
- to monitor and review the effectiveness of the company’s internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm;
- and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.
C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee’s objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee’s recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.
Appendix 2 - Other general research

MORI study conducted for the Accountancy Foundation Review Board in July/August 2002

MORI asked 50 institutional investors whether they agree or disagree with: *The auditor's remit should be broader than it currently is - providing opinion on such issues as information for investment decisions, financial viability, management effectiveness and risk plans*.

Responses:
- Strongly agree - 14%
- Tend to agree - 28%
- Neither agree nor disagree - 2%
- Tend to disagree - 22%
- Strongly disagree - 32%
- No opinion - 2%

MORI asked a similar question to 230 audit clients of various sizes: *The auditor should provide a broader opinion on issues such as information for investment decisions, financial viability, management effectiveness and risk plans*.

Responses:
- Strongly agree - 8%
- Tend to agree - 28%
- Neither agree nor disagree - 4%
- Tend to disagree - 31%
- Strongly disagree - 28%
- No opinion - 2%

MORI asked the 230 audit clients: *The auditor's duty of care should be extended to other stakeholders, such as employees, creditors and suppliers*.

Responses:
- Strongly agree - 10%
- Tend to agree - 30%
- Neither agree nor disagree - 7%
- Tend to disagree - 31%
- Strongly disagree - 22%
- No opinion - 1%

MORI asked the 62 auditors same question: *The auditor's duty of care should be extended to other stakeholders, such as employees, creditors and suppliers*.

Responses:
- Strongly agree - 5%
- Tend to agree - 19%
- Neither agree nor disagree - 2%
Tend to disagree - 26%
Strongly disagree - 48%
No opinion - 0%