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Fundamentals – 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?

The *Audit Quality Forum* brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of government and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

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

This paper is published so that the appropriate government and regulatory bodies can consider the conclusions and recommendations and take such actions as they consider necessary and appropriate in accordance with their own due process.

Anyone interested in providing feedback on this paper should send their comments to **felicity.banks@icaew.com**

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

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ISBN-13: 978-1-84152-469-6

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Executive summary

Companies interact with a large number of third-party organisations, such as customers, suppliers and professional advisers whose influence on financial statements is significant and who can hold information that is material to financial statements. This paper prompts questions about whether enough is being done locally and internationally to ensure that the availability of third-party information supports audit quality. Whilst the paper explores the issues based on the situation in the UK, they should be relevant in other jurisdictions and therefore the *Audit Quality Forum* hopes that an international audience will find the paper useful.

Third parties may hold information which is material to the truth and fairness of financial statements, but which does not reach the board, let alone the auditors. Unless there are appropriate legal, contractual or regulatory conditions, auditors may be unable to access sufficient audit evidence to form an independent opinion on the truth and fairness of financial statements. Can or should more be done by way of requirements on preparers, auditors or third parties, in a local or international context, to improve the impact of third-party information and advice on audit quality?

This paper considers the implications of the extent of disclosure of third-party information and advice on the work of auditors, audit quality and transparency. It explores issues arising where advice is given to boards or management by third-party experts as well as information held by third-party advisers, trading partners or others, which although relevant to the content or reliability of financial statements, may not be made available to auditors. The paper also considers the complex issue of legal professional privilege claimed over advice or information which is material to the truth and fairness of financial statements.

Rights and duties of those with a role in financial reporting

Companies and their subsidiaries may operate in many jurisdictions, with diverse legal and regulatory backgrounds. Financial reporting requirements, professional ethical requirements and legal systems (including the principles of legal professional privilege) may differ across jurisdictions. When holding companies are incorporated in the UK, their responsibilities and those of their directors and auditors are bound by UK law and regulation as outlined in this paper. Foreign legal and regulatory requirements may make the job of directors and auditors more complex, but will not change its fundamental nature.

Directors have a general responsibility for the whole of the business of companies, including ensuring that all transactions are recorded appropriately, and the preparation of financial statements that are true and fair. Where directors do not carry out their functions directly, this is carried out by direction of the managers and employees of the company.

Auditors are contracted by companies and their shareholders to obtain reasonable assurance that the financial statements give a true and fair view. They carry out their duties in accordance with the auditing, ethical and quality control standards which govern the collection of audit evidence and other matters. Audit evidence can often be more reliable when it is obtained from independent sources outside the company, though third-party information will not always be required to support an audit opinion.

Third parties have no direct obligations for the preparation of financial statements or for the provision of relevant information to the auditor although they may be required to do so by contract. They may also be bound by personal, legal, regulatory or professional requirements for integrity, to report crime or misconduct or to serve the public interest or the best interests of their clients. These requirements may or may not be sufficient to provide an indirect obligation in relation to the provision of reliable information to auditors.

Lawyers can be distinguished from other professional advisers not only by their specialist knowledge of the law, but also by their distinct position in the criminal and civil justice systems. The clients of lawyers are entitled to legal professional privilege – the fundamental right to consult a legal adviser in confidence. Lawyers in the UK are required to act in the best interests of their clients, which would normally preclude the giving of advice to companies which is inconsistent with their clients' legal obligations.

Impact of third-party involvement on audit quality

Unless appropriate legal, regulatory or ethical incentives are present, there may be little reason for any third parties to cooperate in the audit process or to recognise their part in supporting the truth and fairness of financial statements. There is a danger that information which is of importance in assessing the truth and fairness of financial statements may not be available to either the board or the auditors.

The work of third-party advisers can have a major influence on financial statements. But like other third parties, advisers have no automatically imposed contractual or statutory obligations to auditors and there are consequent dangers that the effects of their work are not transparent or may not be fully taken into account in the audit process. Third parties could also be engaged to advise companies on how their transactions or financial statements might be structured to give a more favourable (and potentially misleading) impression or might be given instructions to withhold information from auditors.

Information obtained direct from third parties can be particularly valuable to auditors in providing independent corroboration of a company's own records, but the lack of statutory duties may result in a lack of incentive to provide reliable information. Third-party information which is misleading can be particularly damaging to audit quality.

A particular tension arises in the case of legal professional privilege. Privileged information may be material to the truth and fairness of financial statements but may quite legitimately be withheld from auditors. Equivalent reliable audit evidence will not always be available.

Improving the impact of third-party involvement

In recent years, the duties of directors and employees in relation to the provision of audit information in the UK have been increased, and the rights of auditors strengthened, as a result of legislative reforms. The working group reached a clear consensus that the board, and the directors who sit on it, should continue to have the statutory responsibility for the preparation of true and fair financial statements, and for ensuring that auditors are given access to relevant audit information. Recent legislative changes in the UK do not significantly change this key obligation of the board, but they do increase and clarify the responsibilities of individual directors.

Further legislative changes on third-party information may not be necessary if existing requirements including the changes regarding internally available information are

sufficiently robust and are recognised by all parties. In addition, to introduce additional legislative changes on third parties could increase costs disproportionately or have unintended consequences for information flow. However, the working group does consider that a public policy debate should be promoted to ensure that decisions on future legislative changes are made in the full recognition of the implications for true and fair financial statements and audit quality. Much could also be done through the provision of clearer and more authoritative guidance, for both directors and third parties, and greater awareness of the implications of the universal need for integrity.

Key recommendations of the group

This paper sets out recommendations for action that could be taken in the UK to reduce the possible adverse impact on financial statements that can arise, due to the action or inaction of third parties, and ways in which these may be compensated for, in particular by those with a direct responsibility for the preparation and audit of financial statements. Although the working group considered these issues from the perspective of the UK, the conclusions flow through to the international context. Similar issues arise in many jurisdictions while, increasingly, auditing, accounting and legislative requirements are set, or coordinated, on an international basis.

> Steps should be taken to develop guidance for directors to assist them in meeting their statutory obligations in relation to the preparation of true and fair financial statements and the provision of all relevant audit information to auditors. Guidance should be given, at least, on:

- The requirement for each director to make sufficient enquiries to be able to confirm that the auditors have been provided with the information they need in order to carry out their audit. Such necessary audit information will frequently include third-party information and the terms of contracts with third parties, including any informal agreements.
- The drafting of instructions to third-party advisers, such as valuers and lawyers, which covers the need for their advice to support the promotion of the true and fair view, and which supports the provision of all relevant audit information.
- Company policy requirements and ethical norms governing the conduct of company employees and managers in relation to the preparation of financial information and their relationships with third parties.

> Professional bodies and regulators should be alert to the possibility that persons subject to their oversight may fail in their duties if they pay insufficient regard to the legal obligations of their clients. These include the requirements for the preparation of true and fair financial statements, and the need for the provision of relevant audit information to auditors. These issues should be covered in guidance or standards on the provision of valuations, advice or other services, whether to boards or employees.

> Public debate should be promoted on the desirability of introducing a criminal offence which could be committed by third parties who knowingly provide false, misleading or deceptive information to auditors. Such debate should encompass the issue of deception by the omission of information, such as key contract terms, and how and whether such an offence could be formulated in a way which did not impose inappropriate compliance burdens. Public debate should also be promoted on the possibility of introducing direct

duties on third parties such as a duty to respond to queries from auditors perhaps backed with an enforcement regime, similar to the arrangements for insolvency office holders set out in sections 236 to 237 of the Insolvency Act 1986.

> Existing guidance for auditors on the structure and format for making requests to lawyers for information relevant to the audit should be revised and extended, taking into account the need to respect the client's privilege as well as the needs of auditors to work in the public interest. The revised guidance should be developed in consultation with the professional bodies for lawyers, to facilitate reconciliation of the existing tension between two public interest obligations without undermining either of them. It should also address issues of advice given by lawyers outside the UK, and the possibility of a scope limitation where inadequate audit information is available.

> Guidance for lawyers on the provision of information relevant to the audit should be provided, which is consistent with the need to balance the public interest imperatives of the right to legal professional privilege and the need to respect the duties of their clients in relation to true and fair financial statements and their audit.

> Public debate on the balancing of the right to legal professional privilege with the benefits of true and fair financial reporting should be encouraged to ensure that future public policy decisions are made on a fully informed basis. Such debate should encompass the possibility of the extension of the scope of privilege to include company auditors and their regulators, where third-party advice impacts on financial statements.

Introduction

Background

In May 2005, the *Audit Quality Forum* agreed to explore a broad agenda, which would examine the relationships between shareholders, boards, auditors, regulators and other stakeholders in the audit. All of these stakeholders have an interest in 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. A further area identified as a priority was the extent of disclosure to auditors of third-party information and advice provided to the board.

In the light of these concerns, working groups were established to take forward a project to understand and articulate the purpose of an audit and other closely-related projects on auditing standards and reporting. This paper considers the transparency of third-party information to auditors.

Companies interact with a large number of outside organisations, such as customers, suppliers and professional advisers. Transactions with these third parties form the basis of the information from which financial statements are prepared. In recent years, companies have increasingly contracted with third-party advisers as well as trading partners. Information from these advisers may be a key factor in the preparation and audit of the financial statements. They may be directly involved, for example where contracted to value assets or liabilities, or indirectly involved, where advising on significant transactions or otherwise providing expert input. In terms of the statutory audit, third-party information can be a valuable element of audit evidence which may be difficult to acquire reliably from other sources.

This paper prompts questions about whether enough is being done locally and internationally, to ensure that the availability of third-party information supports audit quality. The paper is written from a UK perspective, but much of it is relevant in other jurisdictions and therefore the *Forum* hopes that an international audience will find the paper useful.

Key objective of the group

The key objective of the group was to consider the potential risks to audit quality that could arise where information held by third parties is significant to financial statements. Three such areas of risk were identified in the initial planning of this project:

- Advice given to the boards of directors or management of companies by third-party experts which could materially influence the preparation of financial statements.
- Information held by third-party advisers, trading partners or others which is relevant to the content or reliability of financial statements, but is not made available to auditors.
- Legal professional privilege claimed over advice or information which is material to the truth and fairness of financial statements.

The group considered and discussed a number of key issues including:

- The requirements upon directors in preparing true and fair financial statements, including recently strengthened legislative requirements on individual directors.
- The requirements on auditors, including the requirements on them to obtain and record sufficient audit evidence on which to base an audit opinion.
- The key audit issues arising where information which is subject to legal professional privilege could be material to the financial statements.
- The possibility of recommending that a potentially large and diverse category of professional advisers and other third parties should have obligations imposed on them in relation to the effect their input might have on the content and reliability of financial statements.

This paper sets out recommendations for action that could be taken in the UK to reduce the possible adverse impact on financial statements that can arise from the action or inaction of third parties, and ways in which these may be compensated for, in particular by those with a direct responsibility for the preparation and audit of financial statements presenting a true and fair view.

Current rights and duties of those with a role in financial reporting

Statutory provisions regarding the preparation and audit of financial statements in the UK are contained in the Companies Act 1985 and in the Companies (Audit, Investigations and Community Enterprise) Act 2004 (the 2004 Act)[1].

Numerous parties are involved in preparing and reporting on financial statements: boards; individual directors; employees; auditors; regulators; third parties such as customers and suppliers; and third-party advisers such as lawyers, bankers and valuers.

Companies and their subsidiaries may operate in many jurisdictions, with diverse legal and regulatory backgrounds. Financial reporting requirements, professional ethical requirements and legal systems (including the principles of legal professional privilege) may all differ across jurisdictions.

When holding companies are incorporated in the UK, their responsibilities and those of their directors and auditors are bound by UK law and regulation. Foreign legal and regulatory requirements may make the responsibilities of directors and auditors more complex, but will not change their fundamental nature, or the ways in which problems are resolved. Issues of third-party information and advice arising for the directors and auditors of companies with material foreign involvement would be worthy of further study, but do not undermine the key recommendations of this paper.

Recent developments in financial reporting include a greater use of current values, in particular fair values, in the measurement of the assets and liabilities of companies, which will increase the extent to which directors and auditors need to rely on valuations by specialist experts. This makes the task of directors and auditors more complex but again does not change the conclusions of this paper.

Boards, individual directors and employees

Boards of directors have a general responsibility for the undertakings of a company and the way in which they are conducted. They also have a specific duty to ensure that financial statements[2] are prepared which show a true and fair view. Audited financial statements matter not only to the shareholders for whom they are prepared, but also to potential investors, creditors, employees and other sectors of the business community, as well as government and the public at large. They conduct their affairs on the basis of the soundness of financial reporting which therefore has an impact on the economic wellbeing of the community[3].

Under provisions introduced in the 2004 Act, each director is required to take steps to ensure that the auditor has been provided with all relevant audit information, which is defined as 'information needed by the company's auditors in preparing their report'. A statement must be included in the directors' report confirming that each director has

[1] The 2004 Act reformed the responsibilities of directors and employees of companies in respect of the provision of audit evidence in certain key respects, outlined below. An extract of these key provisions has been included in Appendix 1 to this paper. These provisions have been repeated in the Companies Act 2006.

[2] Statutory requirements for the preparation of periodic financial information refer to 'accounts', while generally recognised standards for their preparation use the term 'financial statements' for the same documents. We have used the term 'financial statements' in this paper.

[3] The public interest function of financial statements and their audit is articulated in the paper titled *Audit Purpose* which forms part of the *Fundamentals* series issued by the *Audit Quality Forum*.

taken appropriate steps to ensure that the company's auditors are aware of any relevant audit information.

Officers and employees of a company (and a limited category of other relevant people) are required to respond without delay to requests for information or explanations that auditors think necessary for the performance of their duties as auditors. It is a criminal offence to provide misleading or false information to an auditor, or to fail to provide information which has been required, in those circumstances. These duties are subject to an exception for information covered by a right to legal professional privilege.

From time to time, directors are likely to require advice from third parties in fulfilment of their duties. As regulatory and legal requirements and contractual relationships become increasingly more complex, directors need to call on advisers with specialist knowledge to assist them in ensuring that they maximise business opportunities, as well as complying with their legal and regulatory obligations. In addition, outside advice from non-accountant professionals is increasingly needed in the process of the preparation of financial statements. For example, some assets and liabilities are required to be assigned a value, which can often only be properly evaluated by a specialist. Experts may be engaged to provide advice on the valuation of items included in the financial statements including the fair value of land and buildings, actuarial assessments of pension obligations or other obligations such as environmental liabilities.

Advice on other issues affecting the business may cover the setting-up of special purpose vehicles for mortgage securitisation, litigation matters, restructuring or potential acquisitions. The specialist knowledge of experts will be relevant in assessments made by the directors of the appropriate treatment of these items in the financial statements. Such advice, and the contractual terms under which it is supplied, may also represent relevant audit evidence, and so be included within the scope of the directors' duty to ensure that all such information is made available to the auditors.

Directors do not normally prepare financial statements themselves, nor carry on the detail of commercial relationships with third parties. Their control over both transactions and the recording of them therefore depends on their direction of managers and employees of the company. Directors will not necessarily have any direct personal contact with third parties whose transactions with the company or whose advice to the company may have a material effect on the financial statements. Nevertheless, directors are responsible through their governance of the company to ensure that such transactions are carried out and recorded appropriately, to permit the preparation of financial statements that give a true and fair view.

Auditors and their rights of access to information

Auditors are contracted by companies and their shareholders to obtain reasonable assurance that the financial statements give a true and fair view of the state of the company's affairs at the balance sheet date, and of the profit or loss for the year, and that they are free from material misstatements. They are required by professional and regulatory requirements to carry out their duties in accordance with the auditing, ethical and quality control standards issued by the Auditing Practices Board[4] (APB) and in doing so are subject

[4] Auditing standards referred to in this paper are the International Standards on Auditing (UK and Ireland) – ISAs (UK and Ireland) – issued by the Auditing Practices Board, an operating body of the Financial Reporting Council. ISAs (UK and Ireland) are the ISAs issued by the International Auditing and Assurance Standards Board augmented where necessary by UK specific requirements and guidance. Copies of ISAs (UK and Ireland) are available from the APB website. The challenges of implementing global auditing standards in a national environment are explored in the paper titled *Making global auditing standards local* which forms part of the *Fundamentals* series issued by the *Audit Quality Forum*.

to independent oversight by the relevant regulatory body. Individual auditors are also required by their professional body to comply with rigorous personal professional requirements for ethical behaviour.

Auditors have a statutory right of access at all times to a company's books, accounts and vouchers, in whatever form they are held. They also have the right to require such information or explanations as they think necessary for the performance of their duties from directors and employees and a limited category of other relevant people. It is a criminal offence for those persons to provide misleading or false information to the auditor, or to fail to provide information which has been required of them by the auditor. Information which is legally privileged (see *legal professional privilege* below) is exempted from these disclosure requirements. Apart from this exception, the legislation is unambiguous in its requirements for the provision to the auditors of all the information that they require to perform their audit.

During the course of the audit, auditors obtain and evaluate audit evidence, using their professional judgement and in compliance with ISA (UK and Ireland) 500 *Audit Evidence*. ISA (UK and Ireland) 500 defines audit evidence as all the information used by auditors in arriving at the conclusions on which the audit opinion is based. This includes the information contained in the accounting records underlying the financial statements as well as information obtained from a number of other sources.

Other sources of audit evidence include internal records, such as minutes of meetings, and external sources, such as confirmations from third parties, analysts' reports or professional valuations. Further evidence comes from auditors' own procedures, such as inquiry, observation and inspection. ISA (UK and Ireland) 500 makes the generalisation that audit evidence is more reliable when it is obtained from independent sources outside the company. However, audit evidence is accumulative and third-party information will not always or necessarily be required to obtain sufficient audit evidence to support an audit opinion.

ISA (UK and Ireland) 505 *External Confirmations* requires auditors to determine whether the use of external confirmations is necessary in obtaining audit evidence. One example of a situation where external confirmations may be used is to provide evidence in relation to bank balances and other information from bankers. The APB has issued guidance to auditors, revised in October 2006, in Practice Note 16 *Bank Reports for Audit Purposes (Revised) Interim Guidance*.

Standards for auditors with regard to evaluating the work of a third-party expert are set out in ISA (UK and Ireland) 620 *Using the Work of an Expert*. This includes provisions on the review of the contractual terms of engagement between the company and the expert.

Standards and guidance for auditors, with regard to audit procedures for litigation and claims provisions and disclosures are set out in ISA (UK and Ireland) 501 *Audit Evidence – Additional Considerations for Specific Items (Part B)*. This requires auditors to carry out procedures to become aware of any litigation and claims involving the entity which may result in a material misstatement in the financial statements. These may involve direct communication with the entity's legal counsel, initially in the form of a letter addressed to counsel by the board. Further guidance is available to auditors in Statement 903 *The ascertainment and confirmation of contingent liabilities arising from pending legal matters* issued by the Institute of Chartered Accountants in England and Wales (ICAEW) in 1970[5], prepared after discussions with the Council of the Law Society, and supplemented by the

[5] For information on the availability of this statement, reference may be made to the Library and Information Service of the ICAEW on +44 (0)20 7920 8620.

guidance contained in the Technical Release AUDIT 2/95. The ICAEW guidance has not yet been updated to reflect recent changes in the legal environment.

By its nature, information concerning frauds or other misconduct is unlikely to be revealed to the auditors by the perpetrators and may be carefully concealed. The requirements on auditors to consider the possibility of fraud and error in the preparation of financial statements have recently been strengthened in ISA (UK and Ireland) 240 *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*. These provisions serve as a reminder to auditors of the need to be constantly alert to the dangers of complacency and the procedures to take in relation to the possibility of the presence of fraud with a material effect on the financial statements, including fraud involving collusion with third parties.

Further considerations arise for auditors from requirements for them to document their conclusions and the evidence on which those conclusions are based, as set out in ISA (UK and Ireland) 230 *Documentation*. The Companies Act 2006 includes a clause, which has not been brought into force at the time of publication of this paper, introducing a criminal offence if an auditor knowingly or recklessly includes in the audit report any matter that is misleading, false or deceptive in a material particular. This may result in further pressure on auditors to record comprehensively the basis of their audit opinion, including the basis of their opinion on matters which have been the subject of legal advice, or which involve litigation.

Audit files are subject to review by audit regulators including the Audit Inspection Unit (AIU) of the Professional Oversight Board, an operating body of the Financial Reporting Council. The Professional Oversight Board has been made a 'designated body' under the Freedom of Information Act, in the Companies Act 2006, which will limit its ability to maintain confidentiality of information that has been recorded in the course of its functions as a public body. Audit files are also not covered by legal professional privilege.

Third parties

Third parties have no direct obligations for the preparation of financial statements. Nor do they have a direct statutory obligation to provide relevant information to the auditor, though they may be required to do so under the contractual terms of their relationship with the company, its directors or managers.

In many cases, personal, regulatory or professional ethical requirements for integrity, and to serve the public interest or the best interests of their clients, also provide an indirect obligation in relation to the integrity of third parties' contribution to financial records and hence to the financial statements which are based on them. It is fundamental to the integrity of advice that it should not be prepared so as to promote a failure to comply with a statutory or other legal responsibility. For example, if an adviser were asked to advise a company's directors on matters relevant to the presentation of the company's financial statements, and the advice given promoted the suppression or manipulation of audit evidence, or promoted a failure to produce financial statements showing a true and fair view, this would effectively amount to advising the directors to engage in illegal or unethical behaviour.

Third-party advisers who are members of a professional body, or are subject to statutory regulation, are likely to be subject to rules or other obligations backing up underlying requirements to comply with ethical principles. These may directly or indirectly require them to take into account the legal obligations of their clients including the requirements for the preparation of financial statements and the provision of information to auditors,

as a matter of integrity. In addition, the courts may assume an implied term of the contract between any professional adviser and a client, that clients will not be advised to engage in illegal behaviour.

Banks and other financial service organisations, lawyers and accountants in the UK are within the scope of the anti-money laundering legislation, which requires them to report to the law enforcement authorities if they know or suspect that their clients or any third party has profited from illegal activities. This represents a further disincentive to turning a blind eye to financial malpractice.

The Financial Services Authority (FSA) is the regulator of all financial services organisations in the UK (including investment banks) and has strong regulatory requirements for fitness and propriety, and for management controls and supervision. These are backed by the inclusion in its statutory constitution of a regulatory objective for the reduction of financial crime. This includes the knowing production of misleading financial statements. Advisers who are regulated by the FSA therefore have an additional imperative not to advise clients in ways that could lead to the preparation of misleading financial statements.

Lawyers and legal professional privilege

Lawyers can become involved in the financial reporting process through their work on specific transactions, or as general advisers to boards, individual directors or managers. They can be distinguished from other professional advisers not only by their specialist knowledge of the law, but also by their distinct position in the criminal and civil justice systems. The clients of lawyers are entitled to legal professional privilege, which gives effect to the fundamental human right, recognised for centuries in English law and many other jurisdictions, to consult a legal adviser in confidence. As such, it has been given very strong support in the legislative framework of the UK, and generally takes priority over any other right of access to information (including that granted to auditors in the Companies Act).

All lawyers, including solicitors, barristers and foreign lawyers licensed to practice in the UK, are bound by strong ethical requirements, which include the general principles of integrity and a requirement to act in the best interest of their client. This contrasts with ethical requirements on auditors and accountants, whose responsibilities are not exclusive to the client, but which also require them to act in the public interest.

Under the Law Society's Practice Rules, solicitors must not do anything which compromises their duty to act in the best interests of the client (Law Society Practice Rule 1.01). Giving clients advice which may lead them to commit a breach of the law will not be in their best interests, so lawyers acting in accordance with these Practice Rules should not recommend boards or individual directors to take any course of action likely to lead to a breach of the duties to prepare true and fair financial statements, or to a failure to ensure the provision of relevant information to the auditors.

However, a key consideration for lawyers will always be the requirement to respect their clients' right to privilege, and not to allow their clients' interests to be undermined by the inappropriate disclosure, in any circumstances, of privileged information.

The impact of third-party involvement on audit quality

Third parties have no direct responsibility for the truth and fairness of financial statements. Nor do they have a direct contractual relationship with auditors. Their relationship normally lies with company management or other officials, not with its board or shareholders, still less with its auditors. In some circumstances, legal or business reasons may cause third parties to actively withhold cooperation from the auditors. But information they hold can materially affect the preparation and audit of those statements. Unless the legal, ethical or contractual conditions are such that appropriate incentives are present, there may be little reason for third parties to cooperate in the audit process or to recognise their part in supporting the truth and fairness of financial statements. There is a danger that information which could be of importance in assessing the truth and fairness of financial statements may not reach the board, let alone the auditors.

Auditors have no statutory right of access to information held by persons other than the company or its officers or employees. Where information is held by trading partners, service providers, third-party advisers or others, it may be outside the control of directors or employees. Directors may request the disclosure of information from third parties to the auditors, in fulfilment of their obligations in respect of the provision of relevant audit information, or may require the terms of contracts between the company and third parties to include provision of such information. However, in some circumstances, relevant audit information may not be made available to the auditor, either because the auditor does not have access to or knowledge of the existence of those third parties or because those parties do not provide the auditor with the appropriate information.

Relevant information held by third parties will usually be mirrored by information held by the directors or employees of the company, which should be available to auditors (though exceptions may exist in cases of legal advice or other matters attracting legal professional privilege). The audit problems caused through lack of access to third-party information may therefore be at least partially ameliorated by the recent strengthening of the rights of auditors in relation to the obtaining of audit information from directors, officers and employees.

Audit evidence from sources external to the company is identified by ISA (UK and Ireland) 500 as generally more reliable than evidence from sources within the company. It is true that third-party evidence generally has the benefit of independence from the company being audited but in the UK external sources are not bound by statutory duties equivalent to those enforceable on internal sources like directors and employees. The lack of statutory duties may result in less incentive to provide reliable information.

Information obtained direct from third parties can be particularly valuable to auditors in providing independent corroboration of the company's own records. It therefore follows that third-party information which is misleading can be very damaging to audit quality.

In the case of multinational companies or companies with any significant overseas activities there may be cultural, legislative and regulatory differences that affect the impact of third parties on group accounts and the audit of subsidiaries or operations overseas. The possibility of 'forum shopping' where entities or individuals seek to obtain services in jurisdictions with more restrictive confidentiality requirements, leading to less available accounting and audit information, may also arise.

Audit quality may be impaired if auditors obtain insufficient or misleading evidence concerning the company's transactions with third parties, and its relationships with, and feedback from, third parties. This may arise where auditors are unaware of the existence of third parties, or of some aspects of the company's relationship with them, or where there is insufficient evidence to support the company's record of matters influenced by third-party relationships.

Trading partners and service providers

Third parties, such as trading partners or customers with whom there are side-agreements, may hold information which is material to the preparation or audit of financial statements. Their relationships are more likely to be held with employees rather than the directors and could give rise to problems of information flow to the board or the auditors.

Banking relationships are a key element of business relationships and a significant source of a company's transactions and records. Bank confirmations are an important source of audit evidence but the completion of such confirmation reports has become increasingly complex for a number of reasons. These include the fact that companies increasingly operate through complex group structures, have accelerated reporting timetables and require a wider range of financial services with disclosure implications. Also banking services may be provided through a number of specialist divisions within a bank, making the completion of confirmations a more challenging task for the banks themselves.

Third-party advisers

Third-party advisers can form a key part of the 'information supply chain'[6] that contributes to the preparation of financial statements. Third-party advisers may, in effect, be appointed to support directors' and employees' statutory duties in relation to the preparation and audit of financial statements but may not be aware of the full implications of the responsibilities of their clients. In addition, advisers may not have regard to directors' responsibilities to prepare true and fair financial statements when advising on matters not directly related to those financial statements. The work of third-party advisers can have a major influence on financial statements. But like other third parties, they have no automatically imposed contractual or statutory obligations to auditors, and there are consequent dangers that the effects of their work are not transparent and may not be fully taken into account in the audit process.

Advisers could be specifically engaged to advise companies on ways in which their financial statements might be structured to show a more favourable (and potentially misleading) financial position while still remaining in technical compliance with the relevant accounting standards. Less directly, advisers could be instructed to advise on contracts or transactions, and their terms of engagement might include either instructions for those contracts or transactions to be structured to give a more favourable (and potentially misleading) impression or instructions to withhold information from the auditors. Where such instructions are given by companies in the UK and result in the preparation of financial statements which fail to show a true and fair view, this would result in a failure of the directors to fulfil their statutory responsibilities. It would also be unlikely to be consistent with acceptable standards of behaviour on the part of third parties.

Advisers who are not members of professional bodies, nor subject to appropriate external regulation, may not be subject to enforced professional standards of integrity, public

[6] See the IFAC Task Force *Rebuilding Public Confidence in Financial Reporting – An International Perspective.*

interest or client service. In such cases, the company's terms of engagement with such advisers may be used to promote public interest requirements by contractually binding third parties to give due consideration to these matters. Additional assurance may be obtained where advisers are chosen on the basis that they are reputable organisations, and their advice is reviewed for propriety.

Auditors may not always be given access to information which supports the conclusions reached by third-party advisers, as well as the conclusions themselves, in the form of valuations reached or accounting treatment used. For example, boards sometimes take advice from experts who provide ranges of possible outcomes depending on the assumptions used. The truth and fairness of the resulting financial statements will frequently depend on the appropriateness of the assumptions, and disclosure of sufficient supporting information to enable valid conclusions to be reached by the users of financial statements.

Situations may also arise where employees have engaged a third-party adviser and obtained advice that should be made available to the auditors, but this advice does not find its way either to the board or to the auditors. Lack of awareness by the board of their responsibilities to be proactive in seeking relevant information, or weaknesses in the employment policies or ethical norms within a company, may reduce the effectiveness of the statutory requirements.

Legal professional privilege

Advice or information which is material to financial statements could be withheld from the auditors on the basis of legal professional privilege, whether in the hands of the lawyer generating such information or in the hands of the client. Revealing privileged information to any third party (including the auditor) could risk jeopardising the privileged nature of that advice or documentation, which could in turn have adverse legal consequences for the client. Legal advisers may be reluctant to be open, or for their clients to permit them to be open, in discussing legal issues with auditors, in the light of their duties in relation to legal professional privilege and more general principles of client confidentiality. This causes a tension in view of the public interest functions of financial reporting and the complex nature of the duties of companies, their boards and employees.

The existence of privilege does not relieve directors of their responsibilities to prepare financial statements showing a true and fair view, nor of ensuring that the auditor has access to relevant audit evidence. Neither does it relieve auditors of their responsibilities in relation to making a judgement on the truth and fairness of financial statements.

It is the opinion of the working group that in a substantial majority of cases sufficient audit information can be provided to auditors without undermining legal professional privilege. Where directors have taken seriously their responsibility to account appropriately for the financial effects of litigation and where they have not been naive, over-optimistic or dishonest, then it is difficult to conceive that confirmation from lawyers to the auditors that this is the case would undermine privilege. In addition, access should not be denied in relation to information which is not privileged, for example because it pre-dated the contractual relationship between the client and lawyer.

There remain some intractable problems, and there may remain circumstances where lawyers are genuinely in a position where they are unable either to confirm to auditors that the advice they have given relates to matters which are immaterial in the context of the financial statements or to give their professional view on the appropriateness of the proposed disclosure.

Lawyers may also be reluctant to confirm or comment on the treatment in the financial statements of matters on which they have advised, on the basis that they are not qualified or required to opine on matters of accounting or auditing. In these circumstances, where the issues concerned are material to the financial statements, the auditors may be in a position where they are unable to form an unqualified opinion on the truth and fairness of the financial statements. In such exceptional cases, auditors may have to draw up their audit report on the basis of a scope limitation which will normally lead to a qualified opinion or a disclaimer of opinion. This is likely to be taken by the financial markets as an indicator of severe doubt over the truth and fairness of the financial statements and is unlikely to be in the interests of the company, its directors or employees whose reputation may be affected.

Other legal bars on the disclosure of information

In some circumstances, there are bars on the disclosure of information, which have been imposed for reasons other than legal professional privilege, such as for the purposes of crime prevention and law enforcement. The most obvious of these is the bar on 'tipping off' under anti-money laundering legislation.

Under section 333 of the Proceeds of Crime Act 2002, a person commits an offence if they know or suspect that a money laundering suspicion report has been made to a law enforcement agency and a resulting investigation might be prejudiced by any disclosure made by them. It is possible that in some cases disclosure of information to the auditors, or in the financial statements, could alert an offender to the fact that their wrongdoing had been recognised, enabling evasive action to be taken and thus prejudicing an investigation. If such circumstances arise, they will generally be capable of resolution by means of discussion between the main parties with an interest in either the disclosure or non-disclosure of the information. Guidance on the interaction of different reporting duties is available from Technical Release 12/04 *Anti-money laundering (Proceeds of Crime and Terrorism) – Second Interim Guidance for Accountants*[7].

[7] Copies of this Guidance, which has been issued by the Consultative Committee of Accountancy Bodies, is available from http://www.ccab.org.uk

Improving the impact of third-party involvement on audit quality

The conditions under which third-party information and advice is made available to auditors could be strengthened by a number of means, including:

> Changes to the statutory and other legislative background.

> Changes to professional or regulatory requirements for auditors and for those third parties which are governed by similar requirements.

> The raising of the awareness of third parties of the impact that their involvement can have on financial statements and the legal, ethical and regulatory implications.

> Improvements to the drafting of contracts between companies and third parties.

> Improvements to the control environment within companies, which governs the relationship between company officials and third parties, and the ability of directors to be able to confirm that all potentially relevant evidence has been supplied to the auditors.

In recent years, the statutory duties of directors and employees in relation to the provision of audit information have been increased, and the rights of auditors strengthened, by the provisions of the 2004 Act. These reforms were introduced to improve the reliability of audit evidence available to auditors. Against this background, the majority of the working group did not consider it appropriate to make firm recommendations as to further legislative changes, while the full effect of the reforms has yet to be evaluated. However, the working group does think that a public policy debate should be promoted to ensure that decisions on future legislative changes are made in the full recognition of the implications for true and fair financial statements and audit quality. Any proposals for future legislative or regulatory changes should be supported by an appropriate regulatory impact assessment.

The working group also considers that recommendations are appropriate in the areas of: guidance for directors; action by professional bodies and regulators of third parties; and guidance for auditors and lawyers on making requests for audit information and responding to such requests. These are considered below.

Guidance for directors

The strengthening contained in the 2004 Act of the powers of auditors to obtain information improves their position, in relation to third-party information and advice, as for all other audit information. The working group reached a clear consensus that the board, and the directors who sit on it, should continue to have the statutory responsibility for the preparation of true and fair financial statements, and for ensuring that auditors are given access to relevant audit information. Management and other directly involved individuals and employees should continue to have a statutory duty to respond to the enquiries of auditors honestly and openly.

The responsibility for the management of companies, and the truth and fairness of the financial statements, should remain with the board of directors. It is also their responsibility to ensure that this task is made manageable by the engagement and instruction of advisers sufficient to the task. Where directors delegate the task of

instructing third-party advisers to executives, managers or other employees, they will need to do this in a way that ensures that the board and its individual directors can continue to comply with their obligations. Relevant audit evidence could include the contract terms under which advisers have been appointed, including those which have not been included in formal contract documents, but are agreed informally, such as in 'side letters'.

Recent legislative changes do not significantly change this key obligation of the board, but they do increase and clarify the responsibilities of individual directors, and could provide a further disincentive to appropriate people, particularly those from backgrounds unrelated to financial reporting or internal control, from taking on board responsibilities, including as non-executive directors. This disincentive could be mitigated by the provision of additional guidance to boards and directors on the management of these responsibilities. Authoritative guidance would also help ensure that the scope of directors' responsibilities and effective methods of compliance are widely recognised.

Guidance to directors should include coverage of the statutory exemption from providing information to auditors which is legally privileged. This could cause particular problems where directors are in possession of adverse legal advice or advice on other very sensitive matters. The possession of such advice will not absolve the directors from accounting for the matters which are the subject of the advice in a way that provides a true and fair view, nor from providing adequate alternative evidence to the auditors.

Steps should be taken to develop guidance for directors to assist them in meeting their statutory obligations in relation to the preparation of true and fair financial statements and the provision of all relevant audit information to auditors. Guidance should be given, at least, on:

> The requirement for each director to make sufficient enquiries to be able to confirm that the auditors have been provided with the information they need in order to carry out their audit. Such necessary audit information will frequently include third-party information and the terms of contracts with third parties, including any informal agreements.

> The drafting of instructions to third-party advisers, such as valuers and lawyers, which covers the need for their advice to support the promotion of the true and fair view, and which supports the provision of all relevant audit information.

> Company policy requirements and ethical norms governing the conduct of company employees and mangers in relation to the preparation of financial information and their relationships with third parties.

Regulatory and professional requirements on third parties

In 2003, a report *Rebuilding Public Confidence in Financial Reporting – An International Perspective*[8] was published by the International Federation of Accountants Task Force on rebuilding public confidence in financial reporting (the Credibility Task Force) following audit failures in the US and internationally. In the summary of conclusions it was stated that:

'We conclude that these duties [in relation to financial statements that are a fair presentation] should be extended to cover all those who are involved in the process of public reporting, including advisors such as lawyers, bankers, brokers, analysts and public relations advisers,

[8] Copy available from http://www.ifac.org/credibility/

so that they as well as the management, the board of directors and the independent auditors have a duty to ensure that public reporting presents the information fairly. In respect of public reporting, this duty should override all other duties of the individuals and firms concerned.'

And it was recommended that:

'Codes of conduct need to be put in place and their compliance monitored for other participants in the financial reporting process, such as financial analysts, credit rating agencies, legal advisers, and investment banks.'

The working group agrees that appropriately enforced standards and guidance for regulated and professional advisers (including investment banks) need to be in place in relation to their role in the financial reporting process. The role of financial analysts and credit rating agencies does not directly relate to the preparation or audit of financial statements, and is outside the scope of this paper. The nature and extent of such standards and guidance should be considered with care. Core professional and regulatory requirements for integrity will assist in ensuring appropriate conduct on the part of those subject to them, but will not always be sufficient.

Professional bodies and regulators should be alert to the possibility that persons subject to their oversight may fail in their duties if they pay insufficient regard to the legal obligations of their clients. These include the requirements for the preparation of true and fair financial statements, and the need for the provision of relevant audit information to auditors. These issues should be covered in guidance or standards on the provision of valuations, advice or other services whether to boards or employees.

Direct statutory requirements for third parties?

Certain categories of advisers and other third parties who are not members of professional bodies or the subject of regulatory requirements, provide advice and other input that is relevant to financial reporting and that needs to be evaluated by both directors and auditors. It is unrealistic to expect specifically tailored guidance or standards to be available to, and used by, every category of adviser or other third party whose work may influence the financial reporting process. In addition, circumstances may arise where professional or regulatory standards for third parties are in place, but are insufficiently robust to ensure compliance.

Third parties may well have a moral, ethical or contractual obligation to respond to enquiries from auditors, and their responsibilities in these areas should be clear and enforceable by regulators and professional bodies, where appropriate. Should they be given a statutory duty to do so?

It is the responsibility of boards to manage and control companies. This responsibility is delegated to them by shareholders and includes the preparation of financial statements. Markets, company regulators and society look to directors to ensure the companies operations are conducted appropriately. Third parties have no direct legal or practical responsibility for the running of a company or the preparation of its financial statements. It was the view of many of the participants on the working group that an additional statutory obligation on third parties in relation to the financial statements of a company and the audit thereof could impose potentially significant burdens on a wide class of person, which would not be warranted in the circumstances.

Against this should be set the fact that it is wrong to knowingly mislead, deceive or provide false information to auditors – that is to lie to them. In addition, auditors do not

have the right to procure the provision of information relevant to their audit direct from third parties. There is a very wide public interest in the preparation of true and fair financial statements, to a very wide class of users and to the economy and well being of all within it. This is consistent with a similarly wide public interest in ensuring that auditors obtain relevant audit information.

The working group discussed the possibility of recommending the introduction of statutory provisions which would give third parties duties in relation to the audit of financial statements. This could be formulated, for example, as the introduction of an additional offence which could be committed by any person who knowingly or recklessly deceived a company auditor. This would not go beyond normal expectations of ethical behaviour, though any statutory responsibility has a tendency to introduce additional compliance burdens. However, such a change could have the serious unintended consequence that rational third parties could become more reluctant to provide information to auditors, for fear that, were strict controls not maintained over its production, it could inadvertently include misleading material.

An alternative possibility would be to introduce a 'duty to co-operate with the auditor' regime, with an enforcement regime similar to the arrangements for insolvency office holders set out in sections 236 to 237 of the Insolvency Act 1986. However, the introduction of such a requirement in relation to the audit of financial statements could add significantly to third-party costs. It would not be appropriate to introduce additional burdens unless these were, on balance, in the public interest. The increased responsibilities of directors and employees, in respect of the provision of information and explanations to auditors, may be sufficient to compensate for the lack of direct responsibilities of the majority of third parties. This should be fully evaluated before additional legislative provisions are introduced.

The working group was very conscious of the involvement of third parties, as advisers or trading partners, in some instances of inappropriate or misleading financial statements. These might have been avoided had more or better third-party information been made available to the auditors. Though the working group was unable to give a clear recommendation at this time for a change to the legislation to introduce direct responsibilities on third parties, they were unanimous in their view that third parties should be held accountable for any misconduct for which they are responsible and which leads to misleading financial statements or audit failure. If the existing provisions, or the other proposals outlined in this paper, prove insufficient to ensure that third parties promote rather than hinder the production and audit of true and fair financial statements, then additional legislative provisions should not be ruled out. Continuing debate should be promoted to this end.

Public debate should be promoted on the desirability of introducing a criminal offence which could be committed by third parties who knowingly provide false, misleading or deceptive information to auditors. Such debate should encompass the issue of deception by the omission of information, such as key contract terms, and how and whether such an offence could be formulated in a way which did not impose inappropriate compliance burdens. Public debate should also be promoted on the possibility of introducing direct duties on third parties such as a duty to respond to queries from auditors perhaps backed with an enforcement regime, similar to the arrangements for insolvency office holders set out in sections 236 to 237 of the Insolvency Act 1986.

Guidance for auditors and lawyers on the communication of audit information

Requirements on auditors in areas affected by third-party information and advice are detailed in auditing standards, ISAs (UK and Ireland). Though audit performance in areas which may be affected by third-party information and advice is kept under review, there is no reason to doubt the effectiveness of these standards and the working group has no recommendations to make on the generality of the requirements on auditors or guidance for them.

An exception lies in the guidance available for auditors in respect to the structure and format for making requests to lawyers for audit information. Legal professional privilege can have an impact on audit quality. The working group concluded that the situation could be improved by better appreciation by both the legal and auditing professions of the needs of each other and by a willingness of both to understand and try to ameliorate problems inherent in the differences. Much could be done by clear communication between the two professions, both at the level of professional bodies and regulators in drawing up appropriate guidance and at the level of communication between those acting for mutual clients. Existing guidance should be revised and extended, taking into account the ethical and professional requirements of both professions.

In acting in the best interests of their clients, lawyers also need to be alert to the dangers of loss of privilege, by inappropriate disclosure of privileged information. The tension between the caution natural to lawyers in relation to privileged information and the need to assist companies and directors (or the employees to whom such functions are delegated) in the provision of relevant audit information to the auditors is one which may require careful thought and discussion with auditors and the client as to what information may be disclosed without impairing the interests of the client. Up-to-date guidance to lawyers from the Law Society is highly desirable in promoting understanding and compliance with these complex duties.

In relation to legal advice, the issue of different considerations arising in jurisdictions outside the UK may lead to particular difficulties, due to variations in the nature of legal professional privilege. This, together with the other complexities arising in this area, should be addressed in the guidance to auditors. Ultimately, where adequate audit evidence is not available to auditors, then this may result in a scope limitation on their audit.

Existing guidance for auditors on the structure and format for making requests to lawyers for information relevant to the audit should be revised and extended, taking into account the need to respect the client's privilege as well as the needs of auditors to work in the public interest. The revised guidance should be developed in consultation with the professional bodies for lawyers, to facilitate reconciliation of the existing tension between two public interest obligations without undermining either of them. It should also address issues of advice given by lawyers outside the UK and the possibility of a scope limitation where inadequate audit information is available.

Guidance for lawyers on the provision of information relevant to the audit should be provided, which is consistent with the need to balance the public interest imperatives of the right to legal professional privilege and the need to respect the duties of their clients in relation to true and fair financial statements and their audit.

Legislative changes to legal professional privilege?

Currently, the right of persons or organisations to consult a lawyer in confidence is held to represent a higher public interest need than the right of shareholders, markets and society as a whole to benefit from true and fair financial statements. Such a fundamental human right is a cornerstone of individual freedom, but its importance should not cloud the rights of shareholders and other users of financial statements. Both these need to be taken into account by those responsible for public policy and the legislative environment.

A change to the legislation surrounding legal professional privilege in the context of advice to companies and their boards of directors could resolve many of the issues which were the subject of discussion by the working group. Auditors' working papers are private and confidential and are drawn up only for the purposes of reaching their conclusions on the truth and fairness of financial statements and providing evidence that the conclusions have been drawn on an appropriate basis. It is possible that a case could be made for reform of the law so that, rather than the access of auditors to privileged information being restricted, auditors should be included within the scope of privilege, so that their access (and that of the AIU) is unrestricted, but the resulting audit working papers are also privileged, and auditors (and the AIU) are subject to the equivalent bars on the disclosure of such information as would apply to lawyers.

Legal professional privilege periodically comes under scrutiny by government and legislators. Some members of the working group are of the view that this area of tension, and potential conflict, between differing aspects of the public interest, should be drawn to the attention of legislators, and others responsible for the development of this area of the law, with a view to legislative change. Other members of the working group consider that such law reform is unlikely and that the tension can be resolved by the development of existing professional guidance to lawyers and auditors. However, clear understanding of the nature of the tension and of the possible consequences for various public policy objectives should be understood by those responsible for the setting and implementation of that public policy, as well as by the professional bodies for lawyers and chartered accountants.

It should be absolutely clear that auditors cannot be held responsible for any instance of audit failure which has resulted directly from the impact of legal professional privilege on the availability of audit information.

Public debate on the balancing of the right to legal professional privilege with the benefits of true and fair financial reporting should be encouraged to ensure that future public policy decisions are made on a fully informed basis. Such debate should encompass the possibility of the extension of the scope of privilege to include company auditors and their regulators, where third-party advice impacts on financial statements.

Appendix 1: Extract of Companies (Audit, Investigations and Community Enterprise) Act 2004

The Companies (Audit, Investigations and Community Enterprise) Act 2004 included a number of provisions which strengthen the rights of auditors and the duties of directors and employees of companies, in relation to audit information. In this Appendix are duplicated extracts of the 2004 Act dealing with the following matters:

> Auditors' rights to information, including the right to make enquiries of all employees and categories of other person.

> The criminal offence committed by such persons providing information which is misleading, false or deceptive in any material particular.

> The requirement for each director to satisfy themselves that the auditors have been made aware of all the relevant audit evidence they require to form their opinion.

These provisions have been repeated in the Companies Act 2006 with some rewording for clarification but without substantive change. The Companies Act 2006 has yet to be brought into force at the time of the finalisation of this paper.

Auditing of accounts

8 Auditors' rights to information

For section 389A of the Companies Act 1985 (c. 6) substitute-

"389A Rights to information

(1) An auditor of a company-

(a) has a right of access at all times to the company's books, accounts and vouchers (in whatever form they are held), and

(b) may require any of the persons mentioned in subsection (2) to provide him with such information or explanations as he thinks necessary for the performance of his duties as auditor.

(2) Those persons are-

(a) any officer or employee of the company;

(b) any person holding or accountable for any of the company's books, accounts or vouchers;

(c) any subsidiary undertaking of the company which is a body corporate incorporated in Great Britain;

(d) any officer, employee or auditor of any such subsidiary undertaking or any person holding or accountable for any books, accounts or vouchers of any such subsidiary undertaking;

(e) any person who fell within any of paragraphs (a) to (d) at a time to which the information or explanations required by the auditor relates or relate.

(3) Where a parent company has a subsidiary undertaking which is not a body corporate incorporated in Great Britain, the auditor of the parent company may require it to obtain from any of the persons mentioned in subsection (4) such information or explanations as he may reasonably require for the purposes of his duties as auditor.

(4) Those persons are-

(a) the undertaking;

(b) any officer, employee or auditor of the undertaking;

(c) any person holding or accountable for any of the undertaking's books, accounts or vouchers;

(d) any person who fell within paragraph (b) or (c) at a time to which the information or explanations relates or relate.

(5) If so required, the parent company must take all such steps as are reasonably open to it to obtain the information or explanations from the person within subsection (4) from whom the auditor has required the company to obtain the information or explanations.

(6) A statement made by a person in response to a requirement under subsection (1)(b) or (3) may not be used in evidence against him in any criminal proceedings except proceedings for an offence under section 389B.

(7) Nothing in this section or section 389B compels any person to disclose information in respect of which in an action in the High Court a claim to legal professional privilege, or in an action in the Court of Session a claim to confidentiality of communications, could be maintained.

389B Offences relating to the provision of information to auditors

(1) If a person knowingly or recklessly makes to an auditor of a company a statement (oral or written) that-

(a) conveys or purports to convey any information or explanations which the auditor requires, or is entitled to require, under section 389A(1)(b), and

(b) is misleading, false or deceptive in a material particular, the person is guilty of an offence and liable to imprisonment or a fine, or both.

(2) A person who fails to comply with a requirement under section 389A(1)(b) without delay is guilty of an offence and is liable to a fine.

(3) However, it is a defence for a person charged with an offence under subsection (2) to prove that it was not reasonably practicable for him to provide the required information or explanations.

(4) If a company fails to comply with section 389A(5), the company and every officer of it who is in default is guilty of an offence and liable to a fine.

(5) Nothing in this section affects any right of an auditor to apply for an injunction to enforce any of his rights under section 389A.”

9 Statement in directors' report as to disclosure of information to auditors

(1) Part 7 of the Companies Act 1985 (c. 6) (accounts and audit) is amended as follows.

(2) In section 234 (duty to prepare directors' report), after subsection (2) insert-

"(2A) If section 234ZA applies to the report, it shall contain the statement required by subsection (2) of that section."

(3) After section 234 insert-

"234ZA Statement as to disclosure of information to auditors

(1) This section applies to a directors' report unless the directors have taken advantage of the exemption conferred by section 249A(1) or 249AA(1).

(2) The report must contain a statement to the effect that, in the case of each of the persons who are directors at the time when the report is approved under section 234A, the following applies-

(a) so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware, and

(b) he has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

(3) In subsection (2) 'relevant audit information' means information needed by the company's auditors in connection with preparing their report.

(4) For the purposes of subsection (2) a director has taken all the steps that he ought to have taken as a director in order to do the things mentioned in paragraph (b) of that subsection if he has-

(a) made such enquiries of his fellow directors and of the company's auditors for that purpose, and

(b) taken such other steps (if any) for that purpose, as were required by his duty as a director of the company to exercise due care, skill and diligence.

(5) In determining for the purposes of subsection (2) the extent of that duty in the case of a particular director, the following considerations (in particular) are relevant-

(a) the knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by the director in relation to the company, and

(b) (so far as they exceed what may reasonably be so expected) the knowledge, skill and experience that the director in fact has.

(6) Where a directors' report containing the statement required by subsection (2) is approved under section 234A but the statement is false, every director of the company who–

(a) knew that the statement was false, or was reckless as to whether it was false, and

(b) failed to take reasonable steps to prevent the report from being approved, is guilty of an offence and liable to imprisonment or a fine, or both."

Appendix 2: Working group membership

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

Stephen J. Lewis – Chair
Clifford Chance

Felicity Banks
ICAEW

Chris Arnull
KPMG

Clive Edrupt
CBI

Joyce Grant
RSM Robson Rhodes

Andy Harris
Deloitte

Ian Harrison
LIBA

Richard Mallett
CIMA

David Miller
Grant Thornton

Colin Passmore
Simmons & Simmons

Derek Scott
NAPF Investment Council

Richard Spofforth
Spofforths

Myles Thompson
KPMG

Graham Ward CBE
IFAC

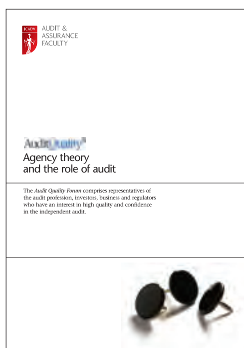
Derek Wright
Institute & Faculty of Actuaries

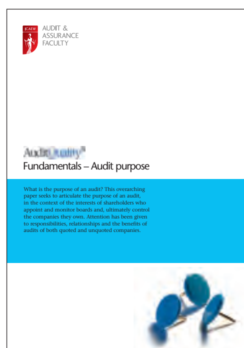
Observers

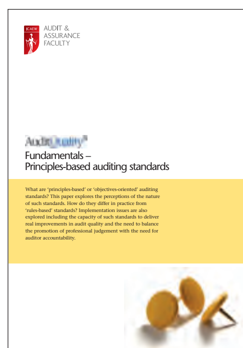
Tom Barrett
Financial Reporting Council

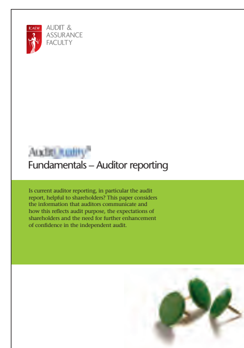
Jim Bellingham
Department of Trade and Industry

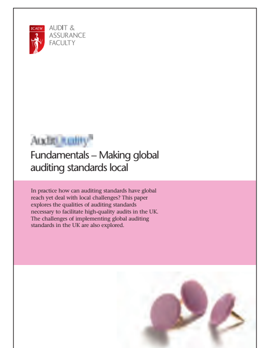
AuditQuality@
Fundamentals











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.*

Auditor reporting

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

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 explored.*

ICAEW Audit and Assurance Faculty
Chartered Accountants' Hall
PO Box 433 Moorgate Place
London EC2P 2BJ
T +44 (0)20 7920 8493
F +44 (0)20 7920 8754
E auditquality@icaew.com
www.auditqualityforum.com

TECPLM6395 07/07