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THE AUDITING PRACTICES BOARD

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Our Ref: RC/CC

2nd July 1993

Sir Adrian Cadbury
The Committee on the Financial Aspects of Corporate Governance
The London Stock Exchange
London EC2N 1HP

Dear Sir Adrian

Your Committee's Report included a number of recommendations concerning the responsibilities of auditors of listed companies. These included that the auditors of a listed company should:

- review the company's statement of compliance with the Code of Best Practice, and
- review the company's interim report, and discuss their findings with the audit committee.

On both of these subjects the Report specifically recommended that the Auditing Practices Board should develop the appropriate guidance for auditors.

The Board's work on both subjects is now well-advanced and it is hoped that guidance in the form of Bulletins can be published in the near future. However, the Board has decided that it would be helpful at this stage to conduct a short consultation exercise on the proposed guidance. Copies of the drafts are therefore being circulated for comment to a number of individuals and organisations with an interest in this area.

I therefore enclose for your consideration copies of the two draft Bulletins on:

- 'Disclosures relating to corporate governance' and,

- 'Review of interim financial information',

and I would invite you (or your colleagues, as appropriate) to send me your written comments on this proposed guidance.

In view of the pressing need for the guidance to be finalised and made generally available with minimum delay, please may I receive your letter of comment by no later than 30 July 1993?

Yours sincerely

Robert Charlesworth

Robert Charlesworth
Secretary

THE AUDITING PRACTICES BOARD

BULLETIN

DISCLOSURES RELATING TO CORPORATE GOVERNANCE

PRELIMINARY GUIDANCE FOR AUDITORS

The purpose of Bulletins issued by the Auditing Practices Board is to provide auditors with timely guidance on new or emerging issues. They are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for Statements of Auditing Standards.

Draft 1 July 1993

THE AUDITING PRACTICES BOARD

DISCLOSURES RELATING TO CORPORATE GOVERNANCE

PRELIMINARY GUIDANCE FOR AUDITORS

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Draft 1 July 1993

DISCLOSURES RELATING TO CORPORATE GOVERNANCE PRELIMINARY GUIDANCE FOR AUDITORS

INTRODUCTION

1 On 1 December 1992 the Committee on The Financial Aspects of Corporate Governance (the Cadbury Committee) published its report (the Cadbury Report). The recommendations contained in the Cadbury Report included several having a direct impact on the responsibilities of auditors of listed companies, some of which have subsequently been incorporated into the Continuing Obligations for companies listed on the London Stock Exchange. This Bulletin provides preliminary guidance for auditors on these new responsibilities; it also indicates areas where further guidance will require development.

2 The Auditing Practices Board recognises that this is a new and evolving area, and that auditing practices will need to respond appropriately to developments in the way in which companies report publicly on corporate governance issues. The Bulletin reflects the initial views of the Auditing Practices Board: the Board intends to re-visit the topic at a future date and to reconsider the guidance in the light of experience and any comments received. Comments on the Bulletin should be addressed to:

The Secretary
The Auditing Practices Board
P O Box 433
Moorgate Place
London EC2P 2BJ

As indicated at paragraph 11 below, further Bulletins will be issued by the Board, giving guidance on auditors' responsibilities arising from other recommendations contained in the Cadbury Report.

THE RESPONSIBILITIES OF AUDITORS

THE CODE OF BEST PRACTICE

3 The Cadbury Report includes a recommended Code of Best Practice (the Code), which is directed to the boards of directors of all listed companies and which is:

> '... designed to achieve the necessary high standards of corporate behaviour.' (Report 1.3).

4 The Cadbury Report recommends that:

'... listed companies reporting in respect of years ending after 30 June 1993 should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance.' (Report 3.7).

This acknowledges that a listed company may not be able to comply initially with every provision of the Code, but any area of non-compliance should be identified and the reasons given by the company in the statement of compliance.

5 With regard to the company's statement of compliance, the Cadbury Report states that:

'The continuing obligations laid down by the London Stock Exchange should require companies' statements of compliance to have been the subject of review by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified.... ' (Report 3.9).

6 The provisions of the Code where compliance can be objectively verified, and which therefore are within the scope of the auditors' review, are specified as the following:

'1.4 The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.'

'1.5 There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.'

'2.3 Non-executive directors should be appointed for specified terms and reappointment should not be automatic.'

'2.4 Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.'

'3.1 Directors' service contracts should not exceed three years without shareholders' approval.'

'3.2 There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.'

'3.3 Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.'

'4.3 The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.'

'4.4 The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.'

'4.5 The directors should report on the effectiveness of the company's system of internal control.'

'4.6 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.'

7 On 23 April 1993, the London Stock Exchange adopted the following listing rule as an addition to the continuing obligations for listed companies:

> 'A company incorporated in the United Kingdom must state in its annual report and accounts for accounting periods ending after 30 June 1993 whether or not it has complied throughout the accounting period with the Code of Best Practice published in December 1992 by the Committee on the Financial Aspects of Corporate Governance.
>
> A company that has complied with only part of the Code or has complied (in the case of requirements of a continuing nature) during only part of an accounting period, must specify the paragraphs with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.
>
> A company's statement of compliance must be reviewed by the auditors before publication insofar as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3 and 4.3 to 4.6 of the Code.'

It will be noted that this requires that listed companies *must* report whether or not they have complied with the Code, rather than the Cadbury Report recommendation that they *should* report.

8 The auditors' review of the statement of compliance is intended, in time, to include consideration of those provisions of the Code which specify that the directors should report:

- on the effectiveness of the company's system of internal control (Code 4.5), and
- that the business is a going concern (Code 4.6),

In addition, the Cadbury Report recommends that the auditors should report on these two statements (Report 4.32 and 5.22).

9 However, with reference to reporting on the effectiveness of systems of internal control,the Cadbury Report acknowledges that 'a great deal of detailed work is ... necessary to develop these proposals' (Report 5.16); in particular, it states that:

> 'the accountancy profession, in conjunction with representatives of preparers of accounts should take the lead in:
>
> (a) developing a set of criteria for assessing effectiveness,
>
> (b) developing guidance for companies on the form in which directors should report ....' (Report 5.16).

Similarly, it is acknowledged that companies need guidance in order for directors to make the recommended statement on going concern (Report 5.22).

10 Accordingly, the Cadbury Committee recognises that companies will not be able to comply with these particular requirements of the Code until the necessary guidance *for companies* has been developed. Such guidance is currently being prepared by two Working Groups comprising members put forward by the Hundred Group of Finance Directors, the Institute of Chartered Accountants of Scotland and The Institute of Chartered Accountants in England and Wales.

11 Guidance *for auditors* on these subjects, for the purposes of the reporting on the directors' statements on internal control and on going concern will be developed by the Auditing Practices Board. However, guidance for auditors on these subjects will not be finalised until the nature and extent of the directors' responsibilities have been clarified in the guidance for companies.

12 Until the necessary guidance for both companies and auditors is finalised, it is not expected that auditors will extend the scope of their procedures relating to internal

control and going concern beyond those they consider necessary for the purpose of the audit of the financial statements, nor that they will report specifically on any statements by the directors on these issues.

THE AUDITORS' REVIEW OF THE STATEMENT OF COMPLIANCE

OBJECTIVE

13 The objective of the review of the statement of compliance is to enable the auditors to conclude whether, in relation to the provisions of the Code which are within the scope of the review, the directors have made the statement with due care. In forming this opinion, the auditors need to consider whether there is any area of non-compliance with those provisions of the Code which has not been properly disclosed by the company.

14 The auditors will in all cases report the findings of their review of the statement of compliance in writing to the board of directors. Where requested by the board of directors, the auditors will also issue a separate report to the company which may be included in the annual report.

PROCEDURES

15 In order to avoid misunderstanding regarding the objective and scope of the engagement, and the means of reporting by the auditors, appropriate reference will need to be made in an engagement letter to the auditors' review of the statement of compliance prepared by the directors.

16 The auditors will need to obtain sufficient appropriate evidence to enable them to conclude whether, in relation to those provisions of the Code which are within the scope of their review, the statement of compliance has been made with due care and whether there is any area of non-compliance with those provisions which has not been properly disclosed.

17 The results of procedures performed for the purpose of the audit of the financial statements will often provide evidence relevant to the review. To the extent that such evidence is not provided by their audit procedures, the auditors will need to plan and perform specific additional procedures. In addition, the auditors will normally:

- review the minutes of the meetings of the board of directors, and of the audit and remuneration committees established by the board, and review supporting documents relevant to matters dealt with in the Code;

- meet the chairman of the board, the chairmen of the audit and remuneration committees and the company secretary, to discuss procedure and its implementation, to satisfy themselves on matters dealt with in the Code; and

- attend meetings of the directors at which the report and accounts, including the statement of compliance, are considered and approved (Report 4.35(c)).

18 Where the statement of compliance identifies provisions of the Code with which the company does not comply, and which are within the scope of the auditors' review, the auditors will need to satisfy themselves that the departures are fairly described and explained.

OTHER MATTERS

19 The directors may include with the statement of compliance with the Code other comments, for example concerning their responsibilities for the financial statements, the adoption of appropriate accounting policies and compliance with applicable accounting standards. Such matters will be dealt with by the auditors in their work on the audit of the financial statements.

20 In addition to considering the statement of compliance insofar as it relates to those provisions of the Code which are specified as being within the scope of the review, the auditors will also consider whether any other matters have been identified in the course of the review, or in the course of the audit of the financial statements, which cast doubt upon the appropriateness of the statement of compliance. The auditors are not expected to search for such other matters, but would not wish to be associated with the statement of compliance if they have reason to believe it may be misleading. Any such matter will need to be discussed with the directors. If the matter is not resolved, the auditors will need to consider the implications for their reporting responsibilities. It may be necessary for the auditors to take legal advice on any proposed course of action.

REPORTING

DISCLOSURES BY THE DIRECTORS IN THE ANNUAL REPORT

21 It is anticipated that, in many cases, the boards of directors of listed companies will include within their annual report a single integrated statement, separate from the financial statements, dealing with all of the new disclosures relating to corporate governance resulting from the recommendations in the Cadbury Report. This statement might include, for example:

- the statement of compliance with the Code (required by the London Stock Exchange);

- the directors' statement of their responsibility for the financial statements (Code 4.4);

- the directors' statements on the effectiveness of the system of internal control and on going concern (Code 4.5 and 4.6 - *when the necessary guidance has been issued*); and

- a description of other features of the company's corporate governance arrangements (at the directors' discretion).

THE AUDITORS' REPORT TO THE BOARD OF DIRECTORS

22 The Cadbury Report states that the auditors:

> 'should not be required to report formally a satisfactory conclusion to their review [of the statement of compliance], but if they identify an area of non-compliance which is not properly disclosed, they should draw attention to it in their report on the financial statements.' (Report 3.19)

Similarly, the London Stock Exchange does not require auditors to report on the review of the statement of compliance. Therefore, unless the auditors identify an area of non-compliance which has not been properly disclosed, there are no requirements for them to report, either in the form of letter to the board of directors or in the form of a report to the company to be included in the annual report.

23 However, since the auditors are required to review the statement of compliance, the Auditing Practices Board recommends auditors to make a written report of their findings to the board of directors of the company, in order to avoid any misunderstandings as to the nature and extent of the auditors' responsibilities and the assurance which is provided.

24 In such a report to the board of directors, it will generally be most helpful for the auditors to set out, as a minimum, the specific provisions of the Code which were considered by them, together with a brief factual statement of their findings in respect of each of these requirements. The auditors may also include a description of the procedures performed by them and, when appropriate, the form of report they intend to provide for inclusion in the annual report.

25 The Appendix to this Bulletin contains illustrative examples of a structure and style of report which auditors may wish to adopt when reporting to boards of directors on the review of the statement of compliance.

A separate report by the auditors

26 Although there is no requirement for the annual report to include any form of report from the auditors on the review of the statement of compliance, the directors may decide to request the auditors to provide a report for this purpose. In such cases, the report would preferably appear directly following the directors' statement dealing with the disclosures relating to corporate governance, separate from the report containing the auditors' opinion on the financial statements. (*When the necessary guidance has been issued, this report by the auditors could be integrated with their reports on the directors' statements on internal control and going concern*).

27 The auditors' report to the board of directors (see paragraphs 23 to 24 above) would not normally be intended for inclusion in the annual report. Any publication of such a report by the company would require the auditors' explicit consent to the form and context in which it would be used.

28 The following is an illustration of a shorter form of report that would normally be appropriate for publication in the annual report when the auditors are satisfied that the statement of compliance, in so far as it relates to the matters the auditors are required to consider, conforms with the recommendations of the Cadbury Report and the requirements of the London Stock Exchange:

REPORT BY THE AUDITORS TO XYZ PLC

We have examined the above statement by the company's directors concerning the company's compliance with the Code of Best Practice [published in December 1992 by the Committee on the Financial Aspects of Corporate Governance][1], insofar as it relates to those matters which we are required to consider by the Continuing Obligations for companies listed on the London Stock Exchange. Those matters are set out in paragraphs 1.4, 1.5, 2.3, 2.4, 3.1, 3.2, 3.3, 4.3 and 4.4 of the Code[2].

The directors are responsible for preparing the statement of compliance, and for specifying and giving reasons for any non-compliance. It is our responsibility to examine the statement of compliance, insofar as it relates to the specified matters, and to consider whether there is any area of non-compliance which has not been properly disclosed.

Our examination was carried out having regard to the Bulletin 'Disclosures relating to corporate governance' issued by the Auditing Practices Board; this included making enquiries of the chairman of the board of directors, the chairmen of the audit and remuneration committees and the company secretary, and examination of documentation relating to the specified matters.

Based on our examination, in our opinion the directors' statement of compliance, in so far as it relates to those matters we are required to consider, has been made with due care.

Auditors (name, address, qualification)

Date

29 If there are matters to which the auditors wish to draw attention as a result of the review of the statement of compliance (for example, non-compliance with the Code which has come to the auditors' attention but which has not been properly disclosed), this report would be modified by the inclusion of a separate paragraph, clearly identifying the matter in question.

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1 These words may not be needed if the Code is adequately described in the statement of compliance.

2 When the necessary guidance has been issued, this sentence would also refer to paragraphs 4.5 and 4.6 of the Code.

No separate report by the auditors

30 The Auditing Practices Board considers that it is preferable for the annual report to include a separate report from the auditors on the review of the statement of compliance, as illustrated above. However, when the directors do not intend to include a separate report from the auditors, they may nevertheless wish to make some reference in the statement of compliance to the auditors' review. In such cases the auditors will need to be satisfied with, and give their consent to, the form and context of the words which the directors intend to use.

31 If there are matters to which the auditors wish to draw attention as a result of the review of the statement of compliance, but the directors do not intend to include a separate report from the auditors, the auditors will need to consider including an additional paragraph in their report on the financial statements, clearly identifying the matter in question.

INTERNAL CONTROL AND GOING CONCERN

32 As indicated above, the Cadbury Committee did not expect that companies would be able to comply with paragraph 4.5 and 4.6 of the Code (statements by the directors on the effectiveness of internal control and on going concern) until the necessary guidance for companies had been developed as recommended in the Cadbury Report.

33 However, the directors of a listed company may nevertheless decide to include reference to these issues in the corporate governance disclosures even before the nature and extent of their responsibilities for doing so have been clarified in the guidance for companies.

34 The Auditing Practices Board *strongly advises* auditors not to report publicly on any statements by the directors concerning the effectiveness of the company's systems of internal control or the company's status as a going concern until both the guidance for companies and the guidance for auditors have been finalised and issued. Similarly, until such guidance becomes available, the auditors will need to ensure that any reports issued as a result of the review of the statement of compliance make no reference to paragraphs 4.5 and 4.6 of the Code.

APPENDIX - EXAMPLES OF AUDITORS' REPORTS TO THE BOARD OF DIRECTORS

Example 1 - Company in compliance with the specified provisions

To the Board of Directors of XYZ Plc

Dear ....

We have examined the statement by the Board dated .... concerning the company's compliance with the Code of Best Practice published by The Committee on the Financial Aspects of Corporate Governance. As required by the Continuing Obligations for companies listed on the London Stock Exchange, our examination was confined to the matters specified below; our findings in each case are set out alongside the respective requirement of the Code.

Requirement of the Code		Comments
1.4	The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands	A formal schedule intended for this purpose exists.
1.5	There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense	An agreed procedure exists.
2.3	No-executive directors should be appointed for specified terms and reappointment should not be automatic	All non-executive directors are appointed for specified terms.
2.4	Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole	New non-executive directors are selected through a formal process. Their appointment has been considered by the Board as a whole.
3.1	Directors' service contracts should not exceed three years without shareholders' approval	No directors' service contract exceeds three years.

3.2	There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance related elements and the basis on which performance is measured should be explained	All this information is disclosed in the annual report.
3.3	Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors	A remuneration committee with a majority of non-executive directors have made recommendations to the Board which were accepted.
4.3	The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authorities and duties	Such an audit committee has been established.
4.4	The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities	This has been explained in the annual report.

We have not carried out any procedures relating to the other provisions of the Code, or relating to the effectiveness of the company's corporate governance arrangements, which the Board will have considered in preparing the statement of compliance.

(Signed)

Example 2 - Company not fully in compliance

To the Board of Directors of XYZ Plc

Dear ....

We have examined the statement by the Board dated .... concerning the company's compliance with the Code of Best Practice published by The Committee on the Financial Aspects of Corporate Governance. As required by the Continuing Obligations for companies listed on the London Stock Exchange, our examination was confined to the matters specified below; our findings in each case are set out alongside the respective requirement of the Code.

	Requirement of the Code	**Comments**
1.4	The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands	A formal schedule intended for this purpose exists.
1.5	There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense	An agreed procedure exists.
2.3	No-executive directors should be appointed for specified terms and reappointment should not be automatic	All non-executive directors are appointed for specified terms.
2.4	Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole	New non-executive directors are selected through a formal process. Their appointment has been considered by the Board as a whole.
3.1	Directors' service contracts should not exceed three years without shareholders' approval	The chief executive was given a five year service contract when he joined the company in 1992. All other directors' service contracts do not exceed three years.

3.2	There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance related elements and the basis on which performance is measured should be explained	All this information is disclosed in the annual report.
3.3	Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors	A remuneration committee with a majority of non-executive directors have made recommendations to the Board which were accepted.
4.3	The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authorities and duties	Such an audit committee has been established.
4.4	The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities	This has been explained in the annual report.

In our opinion, the reasons for non-compliance with paragraph 3.1 are properly disclosed in the statement of compliance. However, we do not express any opinion on the appropriateness of those reasons.

We have not carried out any procedures relating to the other provisions of the Code, or relating to the effectiveness of the company's corporate governance arrangements, which the Board will have considered in preparing the statement of compliance.

(Signed)

RC/KTB/1 July 1993
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THE AUDITING PRACTICES BOARD

BULLETIN:

REVIEW OF INTERIM FINANCIAL INFORMATION

Contents

The Ryan Report included the following recommendation:

> "It is our view that the auditors' role in relation to interim .... statements should be extended, and that the benefits to users would outweigh any additional costs to companies. We recommend that The Irish Stock Exchange should require interim statements to be reviewed by the auditors."

The Ryan Report also recommended that the auditors should report on the interim statements.

This Bulletin is the APB's response to the recommendation in the Cadbury Report that it should develop appropriate review guidance. The principal objective of the Bulletin is to enhance the consistency of review reports by auditors on interim financial information and the procedures carried out to support those review reports.

Benefits of review by auditors

Involvement by auditors in reviewing the interim financial information may provide benefits for both the company and the users, as follows:

(a) *Increased credibility of interim financial information.* The auditors review the application of accounting principles and standards to interim financial information for consistency and consider management's processes in arriving at judgments and estimates.

(b) *Increased consistency between annual financial statements and interim financial information.* Although the requirements of the London Stock Exchange expressed in its "Continuing Obligations/Listing Rules" (the "Stock Exchange requirements") are that interim financial information uses accounting policies consistent with the annual financial statements, the nature of interim reporting may result in difficulties in applying consistent policies. The auditors can assist the company in the identification of any inconsistencies and can advise as to their correction or, if appropriate, their proper disclosure.

(c) *Provision of current information about the adequacy of the system for preparing interim financial information.* The processes through which a company prepares interim financial information may be different from and less precise than those used for the annual financial statements. As a result of any involvement with the interim financial information, the auditors may be able to comment to management on the adequacy of the system in place and recommend improvements.

Introduction

This Bulletin provides guidance to auditors on procedures appropriate to an engagement to review (but not to audit) and report on interim financial information. This guidance does not represent basic principles or essential procedures. Also, the Bulletin does not necessarily comprise all those procedures which might prove to be necessary, nor is it suggested that all of the procedures would necessarily be required. The auditors use their judgment to select the most appropriate procedures taking into account the circumstances of the review engagement.

The term 'auditors' is used throughout this Bulletin. The review will invariably be carried out by the company's auditors. References to auditors are not intended to imply that an audit is being or has been undertaken or that an audit opinion is expressed.

1 This Bulletin provides guidance to auditors in reviewing and reporting on interim financial information produced by UK and Republic of Ireland incorporated companies listed on The London Stock Exchange to comply with the Stock Exchange requirements. The Stock Exchange requirements currently state that profit and loss information and an explanatory statement must be produced. Additionally, companies may choose to present balance sheet and cash flow information and a statement of total recognised gains and losses; these items are not currently dealt with by the Stock Exchange requirements.

2 The Bulletin is not intended to apply to situations where the auditors review and report on interim financial information which is prepared by companies for purposes other than compliance with the Stock Exchange requirements applicable to interim reporting; however some of the procedures in the Bulletin might be relevant to such engagements.

3 The review procedures outlined in this Bulletin assume that the auditors have audited the annual financial statements for the previous financial year and have reviewed the corresponding interim financial information for the previous six monthly period. Where this is not the case, for example if it is a new engagement or the engagement is performed other than by the auditors of the company, the auditors are likely to have significantly less knowledge of the company's business organisation and accounting and control systems. Accordingly, in such circumstances, significantly more review procedures than envisaged by this Bulletin are likely to be needed. In those rare circumstances where the engagement is performed other than by the company's auditors, reference to that fact in the title of the review report may be appropriate.

4 An alternative to a published review report on the interim financial information is for the auditors to issue a private review report to the audit committee or to the directors. The scope of such a review might be more limited than that

auditors review the interim financial information and discuss their findings with the audit committee. This is consistent with the Cadbury Report's objective of raising standards of corporate governance.

10 In some countries, auditors generally report on review engagements by providing a "negative assurance" report that on the basis of the results of their review nothing has come to their attention to indicate that the financial statements do not give a true and fair view or, in relation to interim financial information, to indicate that material modification is required. The assurance that the auditors express in such a conclusion depends on the nature and extent of the underlying work that the auditors have carried out and provides only a moderate level of assurance.

11 In the context of reviewing interim financial information the auditors seek to express assurance in relation to the process of preparation. Such assurance normally takes the form of a positive assurance conclusion. A positive assurance conclusion expresses greater assurance than a negative assurance conclusion regarding the same matter. In the absence of guidance for accounting and disclosure requirements there is no clear assertion against which auditors can judge the interim financial information. This lack of a benchmark, together with the absence of verification procedures of an audit nature, precludes the auditors from satisfactorily providing positive assurance on the interim financial information itself as a result of a review. However, the auditors are in a position based on the review procedures included in this bulletin to express a positive assurance conclusion on the process of preparation of the interim financial information.

12 The objective of a review of interim financial information differs significantly from the objective of an audit of annual financial statements. The objective of an audit of financial statements is to provide a basis for expressing an opinion on whether the financial statements taken as a whole give a true and fair view. The objective of a review of interim financial information is to provide the auditors with a basis for reporting whether in their opinion the interim financial information has been prepared with due care using accounting policies consistent with those used in the company's preceding annual financial statements.

13 A review of interim financial information is substantially less in scope than an audit, because, inter alia, a review does not include:

(a) tests of accounting records through inspection, observation, or confirmation;

(b) obtaining corroborating evidence in response to enquiries; or

(c) the application of certain other procedures normally performed during an audit, for example verification of assets and liabilities.

(c) the scope of the review, including sufficient description of the procedures to explain the extent of the auditors' involvement and the consequences of any limitations in scope;

(d) an explanation that such procedures are substantially less in scope than an audit performed in accordance with Auditing Standards; and

(e) a description of the form of the review report expected to be given.

18 An illustrative engagement letter for a review of interim financial information is given in Appendix 1.

Planning

19 In planning a review of interim financial information, the auditors update their knowledge of the business and consider the company's organisation, accounting and control systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses. As part of this process the auditors focus on areas of potential risk.

20 The review procedures outlined in this Bulletin assume that profit and loss, balance sheet and cash flow information is produced even though only profit and loss information is currently required to be published. Where such other information is not available for analytical procedures, the auditors may not necessarily obtain sufficient evidence from reviewing the profit and loss information in isolation in order to issue an unqualified review report.

21 Where the auditors are reporting on the interim financial information for a group, they establish the scope of work required, if any, for each division and subsidiary and associated undertaking. If this requires the involvement of other auditors, the review programme is tailored to take this into account. The principal auditors send letters of instruction to other auditors which set out:

(a) the nature and extent of work required;

(b) the report required; and

(c) the reporting timetable.

The principal auditors need to satisfy themselves that the work of other auditors is adequate for the purposes of the review.

22 For multilocation engagements the auditors consider the need to visit operating locations. There might be benefit in visiting significant operating locations to facilitate the review of the process of preparation of divisional interim financial data, but generally it is not necessary to visit all locations. The decision whether to visit operating locations will be based on the auditors' assessment of risk

(b) obtaining an understanding of the company's business and the industry in which it operates, by discussion with management and from other relevant sources of information;

(c) enquiring whether there have been any significant changes during the interim period (for example, changes in ownership or capital structure, changes in accounting policies, and, in groups, significant acquisitions or disposals);

(d) considering the results of the subsequent events review carried out for the preceding annual audit where these are relevant to the interim financial information;

(e) enquiring whether significant changes are planned, for example disposals of major assets or divisions and subsidiary and associated undertakings;

(f) updating the assessment of the company's control environment, responding to any significant changes;

(g) enquiring of management whether there have been any changes in the financial reporting systems (including computer systems) or internal controls, or any breakdowns in systems and controls, which might affect the reliability of the interim financial information;

(h) enquiring about the company's procedures for recording, classifying and summarising transactions, accumulating information for disclosure, and preparing the interim financial information;

(i) checking significant balances in the interim financial information to the trial balance, management accounts or the accounting records from which the interim financial information is derived.

(j) performing analytical procedures designed to identify relationships and individual items that appear unusual, including comparison of the interim financial information with profit and loss account and balance sheet information for prior periods and with anticipated results and financial position. In applying these procedures, the auditors consider the types of matters that required accounting adjustments in prior periods;

(k) enquiring about actions taken at meetings of shareholders, the board of directors, audit committee and other committees of the board of directors and other relevant meetings;

(l) considering whether the interim financial information is prepared on a basis consistent with generally accepted accounting principles appropriate to the preparation of interim financial information, and on

(c) a detailed review of stock for obsolescence;

(d) performance of cut-off testing;

(e) enquiry of the company's solicitors concerning litigation and other claims pending;

(f) examination of reconciliations of balances with major suppliers;

(g) for material account balances, agreeing the general ledger to the detailed subsidiary records and obtaining explanations for any discrepancies; and

(h) independent confirmation of banking facilities or other procedures where the auditors have doubts concerning the appropriateness of the going concern basis.

28 The auditors inform the directors and the audit committee of any additional procedures which are required and the reasons why such procedures are considered necessary.

Subsequent events

29 The auditors enquire about events up to the date of approval of the interim financial information, such as significant changes to the business, that may require adjustment of, or disclosure in, the interim financial information, taking into account management's procedures for identifying such events.

(e) other matters, if any, for which the auditors consider written representations are appropriate in the circumstances. Such matters might include, for example, the substance of particular estimates or judgments, or interpretations of facts, by the directors that have a significant effect on the interim financial information.

An illustrative management representation letter is given in Appendix 3. The auditors develop a management representation letter to meet the specific circumstances of the review engagement.

Other information in documents containing interim financial information

33 A company may publish other information with the interim financial information. Although the auditors do not report thereon, they read the other information in order to establish whether or not it contains any matters which are inconsistent with the interim financial information.

Discussion of findings with audit committee

34 The auditors communicate the results of their findings from the interim review to the company's audit committee. This process takes the form of a written report or a meeting or a combination of both. Matters which might require discussion with the audit committee include the following:

(a) the scope and the results of the procedures undertaken by the auditors including the extent of visits undertaken, if any, to operating locations;

(b) the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditors' conclusions regarding the reasonableness of those estimates;

(c) changes in significant accounting policies affecting the interim financial information; and

(d) issues which have been discussed with management such as:

(i) any matters that cause the auditors to believe that the interim financial information is probably materially misstated as a result of a departure from generally accepted accounting principles applicable to interim financial information;

(ii) an update on any significant weaknesses in internal control reported to the audit committee during the most recent statutory audit;

(iii) any significant adjustments resulting from the review; and

39 Similarly a report addressed to the members might be misunderstood as a report to them as individual investors when it should properly be regarded as a report to them in their capacity as members. It should be noted that the auditors have no statutory rights or duty to report to members on interim financial information.

Basis of the review

40 The report on a review of interim financial information describes the scope of the engagement to enable the reader to understand the nature of the work performed and to make it clear that an audit was not performed and, therefore, that an audit opinion is not expressed.

41 The auditors report that their conclusion is based on a limited review of the process by which the interim financial information has been prepared. The auditors' explanation of the basis of their review includes a statement that a review:

(a) is limited primarily to making enquiries of management and applying analytical procedures;

(b) includes an assessment of whether accounting policies have been consistently applied;

(c) does not include the verification of assets and liabilities; and

(d) is substantially less in scope than an audit performed in accordance with Auditing Standards.

Fundamental uncertainties

42 In forming their review conclusion on interim financial information, auditors consider whether the view given by the interim financial information could be affected by inherent uncertainties which, in their opinion, are fundamental.

43 When an inherent uncertainty exists which:

(a) in the auditors' opinion is fundamental; and

(b) is adequately disclosed in the interim financial information;

the auditors include an explanatory paragraph referring to the fundamental uncertainty in the section of their report setting out the basis of their review.

44 When adding an explanatory paragraph, auditors use words which clearly indicate that their review conclusion on the interim financial information is not qualified in respect of the fundamental uncertainty.

failure to prepare the interim financial information with due care in respect of the matter giving rise to the disagreement.

Appendix 4 - Example 5 illustrates an adverse review report and Example 6 illustrates a qualified review report arising from a disagreement.

Previous period qualifications

Annual financial statements

47 If the matter that gave rise to the qualification in the previous annual financial statements has been properly resolved, the auditors ensure that the interim financial information explains how the matter was resolved and the resulting effects.

48 If the matter that gave rise to the qualification has not been resolved, the review report refers to the qualification on the annual financial statements and discusses the current status of the matters giving rise to the qualification.

Interim financial information

49 If the matter that gave rise to the qualification in the prior period interim financial information review report has been properly resolved, the auditors ensure that the interim financial information explains how the matter was resolved and the resulting effects.

50 If the matter that gave rise to the qualification has not been resolved, the review report refers to the qualification on the previous interim financial information and discusses the current status of the matter giving rise to the qualification.

Qualifications of auditors

51 The auditors include their qualifications (for example, "Chartered Accountants"). The auditors need not use the term "Registered Auditors". This term is only needed for reports which are required by the Companies Act 1985 and which require those giving the report to be the company's auditors appointed under that Act. Reports on interim financial information are not required by the Companies Act 1985. Furthermore, although it is normal that the review is performed by those appointed as statutory auditors, it is not a requirement.

Date of review report

52 The date of the auditors' review report on a company's interim financial information is the date on which the auditors sign their report. Auditors do not date their review report earlier than the date on which the interim financial information was approved by the directors.

ILLUSTRATIVE ENGAGEMENT LETTER - to be tailored to the company's circumstances

Board of Directors
XYZ PLC

Date

XYZ PLC interim financial information for the six months ended 30 June 19..

Dear Sirs

1 As discussed with .... at our meeting on .... this letter sets out our understanding of the terms of our engagement to review your interim financial information for the six months ended 30 June 19.. . This letter explains the scope of the work which we will undertake and the form of our proposed review report and draws attention to the inherent limitations of a review.

Directors' responsibilities

2 As directors of XYZ plc you are responsible under the Companies Act 1985 for keeping proper accounting records. You are also responsible for presenting interim financial information complying as a minimum with the requirements of the Continuing Obligations for companies listed on The London Stock Exchange in respect of interim information.

3 For the purpose of our review you will make available to us all of the company's accounting records and all other related information, including minutes of directors' and shareholders' meetings and of all relevant management meetings, that we consider necessary.

4 We expect the interim financial information to be approved by the Board and that this fact and the signature on behalf of the Board will appear in the interim financial information.

Scope and limitations of our review

5 We will review the interim financial information of XYZ PLC for the six months ending 30 June 19.. . This financial information will comprise [specify the content, for example: balance sheet information as at 30 June 19.. , and profit and loss and cash flow information for the six months then ended].

6 Our work will be substantially less in scope than an audit in accordance with Auditing Standards. It will involve a limited review of the process by which the interim financial information has been prepared. It will consist principally of obtaining an understanding of the process involved in the preparation of the financial information, applying analytical procedures to financial data, assessing whether accounting policies have been consistently applied, and making enquiries of [group][1] management responsible for financial and accounting matters. It will not include verification of assets and liabilities. Our review will have regard to the guidance contained in the Bulletin "Review of interim financial information" issued by the Auditing Practices Board.

[1] Reference to group management may be appropriate for a group with multiple locations

Fees

16 Our fees are computed on the basis of the time spent on your affairs by the partners and our staff, and on the levels of skill and responsibility involved. Our fees will be billed [on completion of/at intervals during] the engagement.

Agreement of terms

17 We shall be grateful if you could confirm in writing your agreement to the terms of this letter by signing and returning the enclosed copy. If you wish to discuss the terms of this engagement letter further before replying, please let us know.

Yours faithfully

ABC & Co

[Qualifications]

debts, stock obsolescence, etc have been reviewed by management since the end of the previous full financial year); and

(c) consider the appropriateness of *interim* accounting policies where these differ from the preceding annual financial statements (eg taxation).

Prior period items

6 Review the status of matters raised in the audit of the preceding annual financial statements including:

(a) significant business and accounting issues; and

(b) significant errors requiring adjustment;

and consider the need for adjustment to the interim financial information for significant errors or other historical problem areas.

7 Review the adjustments made between the management accounts and the annual financial statements for the preceding financial year. Ensure that adjustments of a recurring or comparable nature are made in order that the interim financial information is comparable to such annual financial statements.

Agreement to underlying accounting records

8 For interim financial information reviewed at an 'individual company' level, agree balances in the interim financial information to the trial balance, management accounts or other accounting records from which the interim financial information is derived.

9 Review significant adjustments between accounting records and the interim financial information for consistency with the preceding annual financial statements and enquire into adjustments of a large and unusual nature.

10 For interim financial information reviewed at a 'consolidated' level, test balances in the interim financial information to the consolidation packages of the individual entities which have been included in the consolidation from which the interim financial information is derived.

11 Review significant consolidation adjustments for consistency with the preceding annual financial statements, and enquire into adjustments of a large and unusual nature.

Analytical procedures

12 Perform analytical procedures on the interim profit and loss account, balance sheet, cash flow statement, movements on reserves and statement of recognised gains and losses. Compute key financial ratios and compare with:

(a) the corresponding interim period of the previous financial year;

(b) the preceding annual financial statements;

(c) the current interim period budget; and

(d) available non-financial data.

13 Review significant suspense accounts at the interim balance sheet date.

27 Discuss with management the additions and deletions to fixed asset accounts and accounting for gains and losses on disposals. Enquire whether all such transactions have been accounted for.

28 Enquire about the consistency with which the depreciation method and rates have been applied and compare depreciation provisions with prior periods.

29 Discuss whether leasing transactions have been properly reflected in the interim financial information in conformity with accounting standards.

Investments

30 Obtain a schedule of investments at the interim balance sheet date and determine whether the total agrees with the trial balance.

31 Enquire about the accounting policy applied to investments.

32 Enquire from management about the carrying values of investments. Consider whether there are any realisation problems.

33 Consider whether there has been proper accounting for gains and losses and investment income.

34 Enquire whether long-term and short-term investments have been properly classified.

Prepaid expenses, intangibles and other assets

35 Obtain schedules identifying the nature of these accounts, determine whether they agree with the trial balance and discuss with management the recoverability thereof.

36 Enquire about the basis for recording these accounts and the amortisation methods used.

37 Compare balances of related expense accounts with those of prior periods and discuss significant variations with management.

Stocks

38 Obtain the stock list and determine whether:

(a) the total agrees with the balance in the trial balance; and

(b) the list is based on a physical count of stock.

39 Enquire about the method for counting stock.

40 Where a physical count was not carried out at the interim date, enquire whether:

(a) a perpetual stock system is used and whether periodic comparisons are made with actual quantities on hand; and

(b) an integrated cost system is used and whether it has produced reliable information in the past.

41 Discuss adjustments made resulting from the last physical stock count.

Cash and bank

61 Obtain the bank reconciliation for the end of the period under review. Enquire about any old or unusual reconciling items with company personnel.

62 Enquire about transfers between bank accounts for the period before and after the interim date.

63 Enquire whether there are any restrictions on bank accounts.

64 Review the cash book for large or unusual transactions in the interim period and where appropriate obtain documentation and explanations of such items from the company.

Loans payable

65 Obtain a schedule of loans payable and determine whether the total agrees with the trial balance.

66 Enquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, enquire as to management's actions and whether appropriate adjustments have been made in the interim financial information.

67 Consider the reasonableness of interest expense in relation to loan balances.

68 Enquire whether assets have been pledged as security for loans payable.

69 Enquire whether loans payable have been properly classified between non-current and current.

Trade creditors

70 Obtain a schedule of trade creditors and determine whether the total agrees with the trial balance.

71 Enquire about the accounting policies for initially recording trade creditors and whether the company is entitled to any allowances given on such transactions.

72 Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.

73 Enquire whether balances are reconciled with the creditors' statements and compare with prior period balances.

74 Consider whether there could be material unrecorded liabilities.

75 Enquire whether amounts due to shareholders, directors and other related parties are separately disclosed.

Accrued and contingent liabilities and commitments

76 Obtain a schedule of the accrued liabilities and determine whether the total agrees with the trial balance.

77 Enquire about the method for determining accrued liabilities.

78 Compare major balances of related expense accounts with similar accounts for prior periods.

Going concern

93 Enquire of management concerning the latest forecast operating results and net asset position for the period up to the expected date of approval of the next annual financial statements.

94 Enquire of management whether there have been any significant changes in banking arrangements.

Subsequent events

95 Enquire of management concerning their procedures for identifying material subsequent events.

96 Obtain the latest management accounts and compare them with the interim financial information.

97 Enquire about events after the interim balance sheet date that would have a material effect on the interim financial information and, in particular, whether:

(a) any substantial commitments or uncertainties have arisen subsequent to the interim balance sheet date;

(b) there have been any changes in the status of items included in the interim financial information that were accounted for on the basis of tentative, preliminary, or inconclusive data;

(c) there have been any unusual seasonal results or business combinations between the date of the interim financial information and the date of enquiry;

(d) any significant changes in the share capital, long-term debt or working capital have occurred up to the date of enquiry; and

(e) any unusual adjustments have been made during the period between the interim balance sheet date and the date of the enquiry.

Consider the need for adjustments or disclosure in the interim financial information.

98 Read the minutes of meetings of shareholders, the board of directors, the audit committee and other appropriate committees subsequent to the interim balance sheet date.

7 Events since 30 June 19.. :

(a) have been fully taken into account insofar as they have a bearing on the amounts attributable to assets and/or liabilities at that date; and

(b) have not made the present financial position substantially different from that shown in the interim financial information.

Yours faithfully

Director
on behalf of the board

XYZ PLC

EXAMPLE 2 - Unqualified review report with explanatory paragraph describing a fundamental uncertainty

REVIEW REPORT BY THE AUDITORS TO XYZ PLC

We have reviewed the interim financial information in respect of the six months ended 30 June 19.. set out on pages to . This interim financial information is the responsibility of, and has been approved by, the directors. Our responsibility is to express a conclusion based on a limited review of the process by which the interim financial information has been prepared.

Our review was carried out having regard to the bulletin, Review of Interim Financial Information, issued by the Auditing Practices Board. A review of interim financial information consists principally of obtaining an understanding of the process involved in the preparation of the interim financial information, applying analytical procedures to the underlying financial data, assessing whether accounting policies have been consistently applied, and making enquiries of [group][1] management responsible for financial and accounting matters. A review does not include verification of assets and liabilities. A review is substantially less in scope than an audit performed in accordance with Auditing Standards, and accordingly we do not express an audit opinion on the interim financial information.

Fundamental uncertainty

In forming our conclusion, we have considered the adequacy of the disclosures made in the interim financial information concerning the possible outcome to litigation against B Limited, a subsidiary of the company, for an alleged breach of environmental regulations. The future settlement of this litigation could result in additional liabilities and the closure of B Limited's business, whose net assets included in the balance sheet total £... and whose profit before tax for the period is £.... . Details of the circumstances relating to this fundamental uncertainty are described in note .... . Our conclusion is not qualified in this respect.

Review conclusion

In our opinion the interim financial information has been prepared with due care using accounting policies consistent with those adopted by XYZ PLC in its financial statements for the year ended 31 December 19...[2]

ABC & Co

Qualifications Address

Date

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1 Reference to group management may be appropriate for a group with multiple locations

2 Where there is a change in accounting policy, add the words "exchange for the change in accounting policy referred to in note .."

EXAMPLE 4 - **Qualified review conclusion: limitations on the auditors' review procedures**

REVIEW REPORT BY THE AUDITORS TO XYZ PLC

We have reviewed the interim financial information in respect of the six months ended 30 June 19.. set out on pages to . This interim financial information is the responsibility of, and has been approved by, the directors. Our responsibility is to express a conclusion based on a limited review of the process by which the interim financial information has been prepared.

Our review was carried out having regard to the bulletin, Review of Interim Financial Information, issued by the Auditing Practices Board. A review of interim financial information consists principally of obtaining an understanding of the process involved in the preparation of the interim financial information, applying analytical procedures to the underlying financial data, assessing whether accounting policies have been consistently applied, and making enquiries of [group][1] management responsible for financial and accounting matters. A review does not include verification of assets and liabilities. A review is substantially less ~~in scope than an~~ audit performed in accordance with Auditing Standards, and accordingly we do not express an audit opinion on the interim financial information.

The evidence available to us for the purposes of our review was limited because information relating to the determination of provisions on long-term contracts in [Overseas country] was not available to us during our review.

Qualified review conclusion arising from limitation on the scope of the review

Except for any adjustments that might have been found to be necessary had we been able to obtain sufficient evidence concerning the manner in which the provisions were determined, in our opinion the interim financial information has been prepared with due care using accounting policies consistent with those adopted by XYZ PLC in its financial statements for the year ended 31 December 19...[2]

ABC & Co

Qualifications | Address

Date

1 Reference to group management may be appropriate for a group with multiple locations

2 Where there is a change in accounting policy, add the words "except for the change in accounting policy referred to in note .."

EXAMPLE 6 - **Qualified review report: disagreement**

REVIEW REPORT BY THE AUDITORS TO XYZ PLC

We have reviewed the interim financial information in respect of the six months ended 30 June 19.. set out on pages to . This interim financial information is the responsibility of, and has been approved by, the directors. Our responsibility is to express a conclusion based on a limited review of the process by which the interim financial information has been prepared.

Our review was carried out having regard to the bulletin, Review of Interim Financial Information, issued by the Auditing Practices Board. A review of interim financial information consists principally of obtaining an understanding of the process involved in the preparation of the information, applying analytical procedures to the underlying financial data, assessing whether accounting policies have been consistently applied, and making enquiries of [group][1] management responsible for financial and accounting matters. A review does not include verification of assets and liabilities. A review is substantially less in scope than an audit performed in accordance with Auditing Standards, and accordingly we do not express an audit opinion on the interim financial information.

Qualified review conclusion arising from disagreement about accounting treatment

Included in debtors shown on the balance sheet is an amount of £Y due from a company which has ceased trading. XYZ plc has no security for this debt. In our opinion the company is unlikely to receive any payment and full provision of £Y should have been made, reducing profit before tax and net assets by that amount.

Except for the failure to make the provision indicated above, in our opinion the interim financial information has been prepared with due care using accounting policies consistent with those adopted by XYZ PLC in its financial statements for the year ended 31 December 19...[2]

ABC & Co

Qualifications | Address

Date

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1 Reference to group management may be appropriate for a group with multiple locations

2 Where there is a change in accounting policy, add the words "except for the change in accounting policy referred to in note .."

THE AUDITING PRACTICES BOARD

BULLETIN:

DISCLOSURES RELATING TO CORPORATE GOVERNANCE

DECEMBER 1993

The purpose of Bulletins issued by the Auditing Practices Board is to provide auditors with timely guidance on new or emerging issues.

They are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for Statements of Auditing Standards.

ISBN

THE AUDITING PRACTICES BOARD

DISCLOSURES RELATING TO CORPORATE GOVERNANCE

Contents | *Paragraphs*

Introduction

1 On 1 December 1992 the Committee on The Financial Aspects of Corporate Governance ('the Cadbury Committee') published its report ('the Cadbury Report'). The recommendations contained in the Cadbury Report included several having a direct impact on the responsibilities of auditors of listed companies'; some of these have subsequently been incorporated into the continuing obligations for companies listed on the London Stock Exchange.

2 This Bulletin provides preliminary guidance for auditors on these new responsibilities; it also indicates areas where further guidance will require development.

3 The Auditing Practices Board ('the Board') recognises that this is a new and evolving area, and that auditing practices will need to respond appropriately to developments in the way in which companies report publicly on corporate governance issues. Accordingly the Bulletin reflects the initial views of the Board: the Board intends to re-visit the topic at a future date and to reconsider the guidance in the light of experience.

4 The Board will issue further Bulletins, giving guidance on auditors' responsibilities arising from other recommendations contained in the Cadbury Report as and when guidance for directors is developed regarding these matters (namely, reporting on going concern and reporting on internal control).

Invitation to comment

5 **The Auditing Practices Board would welcome any comments on the Bulletin, particularly those based on practical experience of its use, at any time prior to 31 December 1994. Letters of comment should be addressed to**

The Secretary
The Auditing Practices Board
PO Box 433
Moorgate Place
London EC2P 2BJ

All letters of comment will be regarded as being on the public record unless confidentiality is requested.

The responsibilities of directors and of auditors

6 On 23 April 1993, the London Stock Exchange adopted the following listing rule as an addition to the continuing obligations for listed companies:

> 'A company incorporated in the United Kingdom must state in its annual report and accounts for accounting periods ending after 30 June 1993 whether or not it has complied throughout the accounting period with the Code of Best Practice published in December 1992 by the Committee on the Financial Aspects of Corporate Governance.'

'A company that has complied with only part of the Code or has complied (in the case of requirements of a continuing nature) during only part of an accounting period, must specify the paragraphs with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.'

'A company's statement of compliance must be reviewed[1] by the auditors before publication insofar as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3 and 4.3 to 4.6 of the Code.'

7 On 8 July 1993 the London Stock Exchange modified the listing rule set out above by the following transitional provision:

'Companies reporting on their first financial year ending after 30 June 1993 may limit their statement of compliance to that part of the financial year which begins after that date. However, both the Cadbury Committee and the Exchange would like to encourage companies to give the statement of compliance for the financial year as a whole.'

8 Appendix 1 to this Bulletin discusses the background to this continuing obligation in the Cadbury Report, and sets out the paragraphs of the Code which are within the scope of the auditors' review of the company's statement of compliance.

9 Companies traded on the Unlisted Securities Market are expected to comply with the modified listing rule. Accordingly, references in this Bulletin to 'listed companies' should be read as including companies traded on the Unlisted Securities Market.

Disclosures by the directors in the annual report

10 The annual reports of listed companies are to include several new disclosures relating to corporate governance as the recommendations in the Cadbury Report are implemented, for example:

- the directors' statement of compliance with the Code;
- the directors' statement of their responsibility for preparing the financial statements (Code 4.4);
- the directors' statements on the effectiveness of the system of internal control and on going concern (Code 4.5 and 4.6 - *when the necessary guidance has been issued*); and
- a description of other features of the company's corporate governance arrangements (at the directors' discretion).

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[1] The Continuing Obligations, the Notes to the Code and this Bulletin all refer to the auditors' 'review' of the directors' statement of compliance. Such a review does not constitute a review in the sense that the word is used in the Board's paper 'Auditing and related services' in referring to the review of financial statements which are intended to give a true and fair view, or to the review of interim financial statements.

11 It is anticipated that, in many cases, the boards of directors of listed companies will deal with these matters in a single integrated statement, separate from the financial statements. However practice is only beginning to develop, and it is possible that the presentation adopted might vary between companies. For example, the directors might include their statement regarding going concern within the Operating and Financial Review, rather than including it with the disclosures regarding corporate governance.

The auditors' review of the statement of compliance

Objective of the review

12 The purpose of the directors' statement of compliance, including the disclosures regarding any areas of non-compliance with the Code, is to give readers information which assists them in forming their own view as regards the governance of the company. The objective of the auditors' review of the statement of compliance is to enable them to conclude whether, in relation to the paragraphs of the Code which are within the scope of the review, they are satisfied that the statement appropriately reflects the company's compliance with those paragraphs of the Code. In forming this conclusion the auditors consider whether there is any area of non-compliance with those provisions of the Code which the company has not properly disclosed, and whether the directors' statement is factually correct as regards certain matters specified for the auditors' consideration. The auditors are not required to review the effectiveness of the company's procedures for ensuring compliance with the Code, nor to investigate the appropriateness of the reasons given for any non-compliance. These are matters upon which readers form their own views on the basis of the directors' statement.

Procedures

13 In order to avoid misunderstanding regarding the objective and scope of the engagement, and the method of reporting by the auditors, an appropriate reference to the auditors' review of the directors' statement of compliance is included in the audit engagement letter. Appendix 2 contains an example of a relevant extract from an audit engagement letter.

14 The auditors plan procedures to obtain sufficient appropriate evidence to enable them to satisfy themselves that the directors' statement of compliance appropriately reflects the company's compliance with the Code insofar as that statement relates to the paragraphs of the Code that are within the scope of the auditors' review. The results of procedures performed for the purpose of the audit of the financial statements often provide evidence relevant to the review. To the extent that such audit procedures do not provide sufficient appropriate evidence, the auditors plan and perform specific additional procedures.

15 In all cases, the auditors:

- review the minutes of the meetings of the board of directors, and of the audit, nomination and remuneration committees established by the board, and review supporting documents relevant to matters specified for the auditors' review;

- make enquiries of certain directors (such as the chairman of the board of directors and the chairmen of the audit, nomination and remuneration committees) and the company secretary, regarding procedure and its implementation, to satisfy themselves on matters dealt with in the Code; and

- attend meetings of the audit committee at which the annual report and accounts, including the statement of compliance, are considered and approved for submission to the board of directors.

16 Where the auditors become aware of any provision of the Code with which the company does not comply, and which is within the scope of the auditors' review, the auditors satisfy themselves that the fact of departure is described in the directors' statement of compliance. However, the auditors are not required to perform additional procedures to investigate the appropriateness of reasons given for non-compliance with the Code.

17 The auditors may request the directors to provide written confirmation of oral representations made during the course of the review.

Other matters

18 Auditors would not wish to be associated with the statement of compliance if they have reason to believe that it may be misleading. Therefore, in addition to considering the statement of compliance insofar as it relates to those paragraphs of the Code which are specified as being within the scope of the review, the auditors also read the entire statement of compliance. They then consider if any information in the statement of compliance is inconsistent with other information of which they have become aware. In particular the auditors consider whether any other matters have been identified in the course of the review, or in the course of the audit of the financial statements, which may indicate that the directors have not properly disclosed any areas of non-compliance with the Code.

19 The auditors are not expected actively to search for such other matters. However, if the auditors become aware of a matter with which they would not wish to be associated, they discuss it with the directors to seek to establish the significance of the lack of proper disclosure. If such lack of disclosure is considered significant by the auditors and the directors cannot be persuaded to disclose the non-compliance to the auditors' satisfaction, the auditors consider the implications for their reporting responsibilities and may need to take legal advice.

Reporting

20 The Cadbury Committee proposed that auditors:

> 'should not be required to report formally a satisfactory conclusion to their review [of the statement of compliance], but if they identify an area of non-compliance which is not properly disclosed, they should draw attention to it in their report on the financial statements.' (Report 3.9)

21 The London Stock Exchange listing rule is silent as to whether auditors should report on their review, and whether any such report should be made public. However, the listing rule was introduced on the basis that any non-compliance with the Code would be made public either by the directors or by the auditors.

22 The Auditing Practices Board is concerned about the possibility of ambiguities or misunderstandings arising if auditors are known to have reviewed information but readers of that information are unaware of the scope of the review and its conclusion. The Board therefore considers it desirable, but not obligatory, for the annual report to include a report from the auditors, preferably separate from their report on the financial statements, regarding their review of the statement of compliance with the Code[2].

23 Alternatively, a report from the auditors regarding their review of the statement of compliance may be included as an additional section of their report on the financial statements provided it is clearly identified by an appropriate heading such as 'Corporate governance matters', and provided it is made clear that the review is additional to and separate from the audit of the financial statements.

24 An acceptable alternative to a published review report is for the directors to include in the statement of compliance a reference to the fact that the auditors have reviewed that statement. In such cases the auditors satisfy themselves as to the form and context of the directors' reference, taking into account the need to ensure that readers of the directors' statement are not misled as to the scope of the auditors' review and its conclusions.

25 If the auditors are not satisfied as to the form and context of the directors' reference, or if they are not satisfied that the directors' statement appropriately reflects the company's compliance with the paragraphs of the Code specified for the auditors' review they should include their views either in a separate report or in an additional section in their report on the financial statements.

26 Appendix 3 sets out examples of forms of report that would normally be appropriate for inclusion in the annual report. Appendix 4 sets out an example of an auditors' report where they consider that there is not proper disclosure of a departure from the Code.

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[2] The report from the auditors on the review of the statement of compliance and (as and when the necessary guidance has been issued) any reports on the directors' statements on internal control and going concern, could be presented within a single statement.

Communicating with the directors

27 Practice regarding reporting on compliance with the Code is in its early stages; auditors might therefore decide it is helpful to inform directors, as a confidential matter, of the specific provisions of the Code which they considered, together with brief statements indicating their procedures and factual findings in respect of each of these provisions. The auditors might conveniently include with this letter the text of their review report intended for inclusion in the annual report. Appendix 5 includes an example of such a letter.

Internal control and going concern

28 The Cadbury Committee did not expect that companies would be able to comply with paragraph 4.5 and 4.6 of the Code (statements by the directors on the effectiveness of the system of internal control and on going concern) until, as recommended in the Cadbury Report, the necessary guidance for companies had been developed.

29 The directors of a listed company may nevertheless decide to include reference to these issues in the corporate governance disclosures even before the nature and extent of their responsibilities for doing so have been clarified in the guidance for companies.

30 Until both the guidance for companies and the guidance for auditors have been finalised and issued, the Auditing Practices Board strongly advises auditors not to report publicly on any statements by the directors concerning the effectiveness of the company's systems of internal control or the company's status as a going concern. Any reports issued as a result of the review of the statement of compliance should:

- (if the directors make no statements concerning internal control or going concern) make no reference to paragraphs 4.5 and 4.6 of the Code, or
- (if the directors do make such statements, or if the directors might be construed as referring to internal control or going concern) make it clear that the auditors' review does not include such statements, and that the auditors do not comment thereon; Appendix 3 includes a suggested form of words for the auditors to use in such situations.

THE CADBURY REPORT AND THE CODE OF BEST PRACTICE

1 The Cadbury Report includes a recommended Code of Best Practice ('the Code'), which is directed to the boards of directors of all listed companies and which is:

> '... designed to achieve the necessary high standards of corporate behaviour.' (Report 1.3).

2 The Cadbury Report recommends that:

> '... listed companies reporting in respect of years ending after 30 June 1993 should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance.' (Report 3.7).

This acknowledges that a listed company may not be able initially to comply with every provision of the Code, but that any area of non-compliance should be identified and the reasons given by the company in the statement of compliance.

3 With regard to the company's statement of compliance, the Cadbury Report states that:

> **'The continuing obligations laid down by the London Stock Exchange should require companies' statements of compliance to have been the subject of review by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified... ' (Report 3.9).**

4 **The provisions of the Code with which the Cadbury Report suggests compliance can be objectively verified, and which therefore are within the scope of the auditors' review, are specified as the following:**

> '1.4 The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.'
>
> '1.5 There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.'
>
> '2.3 Non-executive directors should be appointed for specified terms and reappointment should not be automatic.'
>
> '2.4 Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.'
>
> '3.1 Directors' service contracts should not exceed three years without shareholders' approval.'

'3.2 There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.'

'3.3 Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.'

'4.3 The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.'

'4.4 The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.'

'4.5 The directors should report on the effectiveness of the company's system of internal control.'

'4.6 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.'

5 As noted in paragraph 6 of this Bulletin, the London Stock Exchange has introduced a listing rule implementing these recommendations.

Internal control and going concern

6 The auditors' review of the statement of compliance is intended, in time, to include consideration of those provisions of the Code which specify that the directors should report:

- on the effectiveness of the company's system of internal control (Code 4.5), and
- that the business is a going concern with supporting assumptions or qualifications as necessary (Code 4.6),

In addition, the Cadbury Report recommends that the auditors should report on these two statements (Report 4.32 and 5.22).

7 The Cadbury Committee recognises that companies will not be able to comply with these particular requirements of the Code until the necessary guidance for companies has been developed (Report 5.16 and 5.22). Such guidance is currently being prepared by two 'Joint Working Groups' comprising members of the Hundred Group of Finance Directors, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in England and Wales.

8 The Auditing Practices Board is developing guidance for auditors on these subjects, for the purposes of reporting on the directors' statements on internal control and on

going concern. However, the Board cannot finalise its guidance for auditors on these subjects until the nature and extent of the directors' responsibilities have been clarified in the guidance for companies.

9 Until both the guidance for companies and the guidance for auditors have been finalised and issued, the Auditing Practices Board strongly advises auditors not to report publicly on any statements by the directors concerning the effectiveness of the company's systems of internal control or the company's status as a going concern. Any reports issued as a result of the review of the statement of compliance should:

- (if the directors make no statements concerning internal control or going concern) make no reference to paragraphs 4.5 and 4.6 of the Code, or
- (if the directors do make such statements, or if the directors might be construed as referring to internal control or going concern) make it clear that the auditors' review does not include such statements, and that the auditors do not comment thereon; Appendix 3 includes a suggested form of words for the auditors to use in such situations.

EXAMPLE OF TERMS OF ENGAGEMENT

The following is an illustrative example of paragraphs in an audit engagement letter sent by the auditors to the directors of the audited company, where the directors have requested that the auditors review the company's statement of compliance with Code of Best Practice. In practice, auditors tailor their engagement letter to the specific circumstances of their engagement.

Review of the company's disclosures relating to corporate governance

As directors of the company, you are responsible for ensuring that the company complies with the listing rules adopted by the London Stock Exchange, including the rule adopted on 23 April 1993 (and modified with transitional provisions on 8 July 1993) regarding the directors' statement as to the company's compliance with the Code of Best Practice. The Rule states that 'a company's statement of compliance must be reviewed by the auditors before publication insofar as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3 and 4.3 to 4.6 of the Code.'

As you are aware, the necessary professional guidance for directors and for auditors regarding the application of paragraphs 4.5 and 4.6 of the Code has not yet been issued. Accordingly these aspects of the Code are not within the scope of our review.

You have requested us to review the company's statement of compliance. We conduct such reviews having regard to the Bulletin 'Disclosures relating to corporate governance' issued by the Auditing Practices Board. For this purpose you will provide us with such information and explanations as we consider necessary. We may request you to provide written confirmation of oral representations which you make to us during the course of our review. We shall request sight of all documents or statements which are due to be issued with the statement of compliance.

Having finalised our review we expect to write to you to inform you, as a confidential matter, of the specific provisions of the Code which we have considered, together with brief statements indicating our procedures and factual findings in respect of each of these provisions.

You have agreed to include our report on the company's statement of compliance directly following that statement. We expect to report on the company's statement of compliance as follows.

[Include text of report see Appendix 3, example 1]

EXAMPLE 1 - A SEPARATE REPORT FROM THE AUDITORS

REPORT BY THE AUDITORS TO XYZ PLC

In addition to our audit of the financial statements we have reviewed the directors' statement on page ... concerning the company's compliance with the Code of Best Practice, insofar as it relates to the paragraphs of the Code which the London Stock Exchange has specified for our review. We carried out our review having regard to the Bulletin 'Disclosures relating to corporate governance' issued by the Auditing Practices Board.

The purpose of the directors' statement is to give readers information which assists them in forming their own views regarding the governance of the company. In respect of the paragraphs of the Code specified for our consideration, we are required to draw attention to any aspects of the company's non-compliance with the Code which the directors have not properly disclosed. We are not required to review, and have not reviewed, the effectiveness of the company's governance procedures.

Through enquiry of certain directors and officers of the company, and examination of relevant documents, we have satisfied ourselves that the directors' statement appropriately reflects the company's compliance with the specified paragraphs of the Code.

Auditors   Address
Date

Note:

If relevant, the auditors insert the following paragraph immediately before the paragraph containing their conclusion:

'The directors have made comments on page ... concerning the effectiveness of the company's system of internal control and regarding matters relating to going concern. Having regard to the guidance in the Bulletin issued by the Auditing Practices Board, we have not reviewed nor do we express a conclusion in the following paragraph on those comments.'

EXAMPLE 2 - THE AUDITORS INCLUDE THEIR REVIEW REPORT WITH THEIR REPORT ON THE FINANCIAL STATEMENTS

AUDITORS' REPORT TO THE SHAREHOLDERS OF XYZ PLC

We have audited the financial statements on pages ... to ... which have been prepared under the historical cost convention and the accounting policies set out on page ... .

Respective responsibilities of directors and auditors

As described on page ... the company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit of those statements and to report our opinion to you.

Basis of opinion

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

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

Opinion

In our opinion the financial statements give a true and fair view of the state of the company's affairs as at 31 December 19.. and of its profit [loss] for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Corporate governance matters

In addition to our audit of the financial statements we have reviewed the directors' statement on page ... concerning the company's compliance with the Code of Best Practice, insofar as it relates to the paragraphs of the Code which the London Stock Exchange has specified for our review. We carried out our review having regard to the Bulletin 'Disclosures relating to corporate governance' issued by the Auditing Practices Board.

The purpose of the directors' statements is to give readers information which assists them in forming their own views regarding the governance of the company. In respect of the paragraphs of the Code specified for our consideration, we are required to draw attention to any aspects of the company's non-compliance with the Code which the directors have not properly disclosed. We are not required to review, and have not reviewed, the effectiveness of the company's governance procedures.

Through enquiry of certain directors and officers of the company, and examination of relevant documents, we have satisfied ourselves that the directors' statement appropriately reflects the company's compliance with the specified paragraphs of the Code.

Registered auditors *Address*
Date

EXAMPLE OF AN AUDITORS' REPORT WHERE THEY CONSIDER THERE IS NOT PROPER DISCLOSURE OF A DEPARTURE FROM THE CODE

REPORT BY THE AUDITORS TO XYZ PLC

In addition to our audit of the financial statements we have reviewed the directors' statement on page ... concerning the company's compliance with the Code of Best Practice, insofar as it relates to the paragraphs of the Code which the London Stock Exchange has specified for our review. We carried out our review having regard to the Bulletin 'Disclosures relating to corporate governance' issued by the Auditing Practices Board.

The purpose of the directors' statement is to give readers information which assists them in forming their own views regarding the governance of the company. In respect of the paragraphs of the Code specified for our consideration, we are required to draw attention to any aspects of the company's non-compliance with the Code which the directors have not properly disclosed. We are not required to review, and have not reviewed, the effectiveness of the company's governance procedures.

The company has two non-executive directors. They comprise the company's audit committee. Paragraph 4.3 of the Code states that the board should establish an audit committee of at least 3 non-executive directors. The directors' statement does not describe this departure from the Code.

Through enquiry of certain directors and officers of the company, and examination of relevant documents, we have satisfied ourselves that the directors' statement, with the exception of the matter of non-disclosure referred to above, appropriately reflects the company's compliance with the specified paragraphs of the Code.

Auditors
Date

Address

EXAMPLE OF AN AUDITORS' LETTER TO THE BOARD OF DIRECTORS

The following is an example, included in this Bulletin for illustrative purposes only, of a schedule which might be included with an auditors' letter to the board of directors. The procedures mentioned below are not exhaustive, nor is it intended that all the procedures mentioned apply to every engagement to review the directors' statement of compliance. In practice the auditors' professional judgment determines the nature and extent of procedures in the circumstances.

In accordance with your request, documented in our engagement letter dated ..., and as specified by the Continuing Obligations for companies listed on the London Stock Exchange, we have reviewed the company's compliance with the paragraphs of the Code of Best Practice set out below. We set out a brief statement of our procedures and factual findings in respect of each of these paragraphs.

Requirement of the Code	Procedures and findings
1.4 The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.	We have inspected a schedule dated ... setting out matters specifically reserved to the board for decision, and have inspected the board minute recording adoption of the schedule, and requiring it to be sent to all directors and to all those reporting to them. Our enquiries of the relevant personnel indicate that this has been done. We draw your attention to paragraph .. of our management letter to you dated ... which notes a possible weakness in the company's system of internal financial controls in this area. We also draw to your attention paragraph ... of that management letter, which states the inherent limitations in the scope of the letter.
1.5 There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.	We have inspected the board minute dated ... which sets out such a procedure, and which is included in directors' service contracts. In performing our audit of the financial statements, we became aware that one director has taken independent legal advice in accordance with that procedure.
2.3 Non-executive directors should be appointed for specified terms and reappointment should not be automatic.	We have inspected the service contracts of all directors who were members of the Board at any time during the period since the last balance sheet date. The non-executive directors' contracts state explicitly that they were appointed for a period of two years, and that, in accordance with regulation ... of the company's Articles of Association, re-appointment is not automatic.
2.4 Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.	We have inspected the board minute dated ... which states that all new non-executive directors are to be selected through the formal process that it sets out. The stated process involves interviews by a nomination committee comprising 5 directors, 3 of whom are non-executive, and consideration by the board as a whole of that committee's written recommendations. As evidenced by relevant board minutes, the nomination committee's written recommendations and our own enquiries of the nomination committee members, this process and the appointment of new non-executive directors has been considered by the board as a whole.
3.1 Directors' service contracts should not exceed three years without shareholders' approval.	Based on our inspection of service contracts mentioned under 2.3 above, no directors' service contract exceeds three years.

3.2 There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance related elements and the basis on which performance is measured should be explained.	All this information is disclosed in the annual report.
3.3 Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.	We have inspected the minutes dated ... of the remuneration committee, which comprises 5 directors 3 of whom are non-executive. The board minute dated ... shows that the remuneration committee made recommendations to the board which were accepted.
4.3 The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authorities and duties.	We have inspected minutes of meetings of such an audit committee, including minutes of meetings with ourselves. We have inspected the board minute dated ... approving the formation of the audit committee and setting out its authorities and duties.
4.4 The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.	This has been explained in the annual report.