



AUDIT &
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FACULTY

TECHNICAL RELEASE

re:Assurance

ASSURANCE ENGAGEMENTS: MANAGEMENT OF RISK AND LIABILITY

Technical Release AAF 04/06

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This guidance is issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) in November 2006 to assist accountants in managing their risk and liability when undertaking assurance engagements. This guidance does not constitute an auditing standard. AAF 04/06 is best practice guidance and professional judgement should be used in its application.

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INTRODUCTION

- 1 In 2004, the International Auditing and Assurance Standards Board published the *International Framework for Assurance Engagements* (the Framework) and the first International Standard on Assurance Engagements (ISAE) 3000, *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*. These pronouncements provide high level principles for assurance engagements other than audits and reviews of historical financial statements.
- 2 The Framework defines the elements of assurance engagements and describes objectives for such engagements. ISAE 3000 provides generic guidance on the principal aspects of assurance engagements and refers to an assurance engagement involving three separate parties. Together these two international pronouncements provide the appropriate framework within which to develop specific guidance covering subject areas and topics such as internal control where, before now, no specific guidance has existed.
- 3 This technical release provides some principles for reporting accountants to consider around managing their risk and liability when agreeing to undertake assurance engagements and providing assurance reports to third parties. The scope of the guidance is laid out in paragraphs 11 and 12.

TYPES OF ASSURANCE

- 4 Clients are increasingly asking accountants to provide assurance reports on specific operations/functions within their organisation or on information prepared by the client, in order to enable the client to provide comfort to other parties who have an interest in the client's operations/functions or information (for example a customer of the client). A convenient way of facilitating this provision of client comfort to others may be for clients to seek to engage the accountants to issue an assurance report. In an assurance report, the accountants express their conclusions, based on the outcome of their evaluation or measurement over the operations/functions or information against criteria, designed to enhance the degree of confidence of the intended users. An assurance engagement involves three separate parties: the accountants, the client (who is responsible for the operations/ functions or information) and the other parties or intended users¹ (for whom the accountants are preparing the assurance report).
- 5 In an assurance engagement, reporting accountants are asked to express an opinion or conclusion where sufficient and appropriate evidence has been gathered and evaluated against criteria specific to that function. This assurance is provided through either reasonable assurance engagements or limited assurance engagements. The extent of work required differs based on the type of assurance that the client requires.
- 6 In a reasonable assurance engagement, reporting accountants seek to obtain sufficient appropriate evidence that enables them to express a positive conclusion. In a limited assurance engagement, reporting accountants seek to gather evidence sufficient to obtain a meaningful level of assurance as the basis for a negative form of expression.
- 7 When providing these reports, reporting accountants will need to be clear about why the report has been requested, the purpose for which it will be used, and who may obtain access to the report and assert rights against the accountants. This guidance considers the steps that reporting accountants may take to manage the risks associated with such reporting.

¹ The intended users are those for whom the accountants prepare the assurance report. The client may be one of the intended users, but not the only one.

RELATED GUIDANCE

- 8 The Institute of Chartered Accountants in England and Wales (ICAEW) has issued general guidance as part of its *Members' Handbook*, Statement 1.311² on *Managing the professional liability of accountants*. This includes:
- Defining the scope and responsibilities of the engagement;
 - Defining the purpose of the accountants' report;
 - Restricting the use of the accountants' name;
 - Identifying the authorised recipients of report;
 - Limiting (or excluding) liability;
 - Obtaining an indemnity³; and
 - Defining the scope of professional competence.
- 9 The Audit and Assurance Faculty (the Faculty) has over recent years also provided general guidance to assist accountants who have had requests for reports from third parties to manage the resulting risks. General guidance on reporting to third parties can be found in the following publications:
- Technical Release Audit 4/00 *Firms reports and duties to lenders in connection with loans and other facilities to clients and related convents*;
 - Technical Release Audit 1/01 *Reporting to third parties*; and
 - Technical Release Audit 1/03 *The audit report and the auditors duty of care to third parties*.
- 10 In addition, the Faculty has also recently developed specific guidance with relevant stakeholders, which includes model engagement terms and addresses specific risk issues including limitations of liability. These are:
- Technical Release AAF 01/06, *Assurance reports on internal controls of service organisations made available to third parties*.
 - Technical Release AAF 03/06, *The ICAEW Assurance Service on Unaudited Financial Statements*.

SCOPE OF THIS GUIDANCE

- 11 This guidance does not seek to provide detailed advice or practical steps on the planning and conduct of the work, nor on how to manage risk and liability in particular circumstances because much will depend on the purpose of the request for the report and the likely users of the report. The intention is that this guidance will provide the over arching principles, whilst the practical steps will be considered in the development of separate technical releases for specific topics and areas. Where appropriate, new assurance technical releases will cross-refer to this guidance and suggest how this guidance can be applied to the particular circumstance.
- 12 This guidance is also not intended as a substitute for independent legal advice. Reporting accountants will need to exercise judgement in assessing the risks for each particular engagement having regard to any relevant commercial considerations, their own appetite for risk, their internal quality control procedures and risk management policies, and the level of professional indemnity insurance that they have in place.

² Statement 1.311 will be renamed Statement 9.1 in the rewrite of the *Members' Handbook*.

³ It may be appropriate to obtain an indemnity from the client in respect of claims from third parties arising from the contents of the assurance report. The risk of such claims may arise, for example, where the accountants' report is widely circulated, in breach of confidentiality and disclosure restrictions that have been agreed or where, with the accountants' consent, the report is attached to the financial statements filed with Companies House. However, it must be remembered that an indemnity does not prevent a claim from being brought against the indemnified party. It merely gives him/her the right to pass on the liability to the indemnifier. It follows, therefore, that if the indemnity is in some way ineffective or the indemnifier does not have adequate resources to meet the liability, the indemnified party may be left unprotected.

This guidance also does not replace, rather supplements, firms' usual client and engagement acceptance procedures, so reporting accountants need to satisfy themselves that the client and work sought are suitable and that they can provide that service.

- 13** This guidance does not consider the independence considerations, ethical standards or any other regulatory considerations that may apply to assurance engagements.
- 14** The guidance in this technical release is set out under the following headings that describe the process accountants take when considering requests for assurance reports:
- Accepting an engagement;
 - Managing professional liability;
 - Agreeing on the terms of the engagement; and
 - Form of report.

ACCEPTING AN ENGAGEMENT

- 15** When requested to provide any services, the reporting accountant needs to clarify the purpose for which the work is being sought, the party/parties seeking to benefit from the work, and the use that will be made of the work. It is important that there is a clear understanding and agreement concerning the scope and purpose of the engagement between the reporting accountants and the client and, if applicable, the other parties or users that may also be party to the engagement.
- 16** Reporting accountants consider whether the engagement team collectively possesses the necessary professional competencies having regard to the nature of the assignment. As part of the engagement acceptance process reporting accountants also consider relevant ethical requirements.⁴
- 17** Where an assurance report may be received by a range of persons who are not party to the engagement, and whilst the reporting accountants may not intend to assume responsibility to others who are not party to the engagement, legal actions from such other parties may nonetheless occur. The following are examples of circumstances that may arise:
- a the third party requires a report to be prepared (e.g. in accordance with obligations between the client and the third party) and the third party intends to rely on it because it has an interest in the work that is aligned to the client's or a common interest; or
 - b the reporting accountants and client have already entered into an engagement contract which allows for a third party to have sight of and rely on the report at a later date; or
 - c the third party requires sight of the report but is not willing to or it is unsuitable for them to sign up to an engagement contract; or
 - d an engagement with the client alone restricting the client from making the report available to any others.

⁴ Section 210 *Professional Appointments* of the *Code of Ethics* specifically deals with changes in a professional appointment. Consideration may also be given, where relevant, to section 290, *Independence – Assurance Engagements* and section 220, *Conflicts of Interest*. Reporting accountants may also refer to the APB Ethical Standards (ES), in particular ES2 (Financial, business, employment and personal relationships) and ES5 (Non audit services provided to audit clients).

- 18** The reporting accountants will therefore need to apply appropriate engagement acceptance procedures in order to assess the risks associated with taking on a particular engagement. They will then determine whether in the light of those risks, it is appropriate to take on the engagement and, if so, on what terms. Where the reporting accountants do accept an engagement, they need to apply suitably rigorous internal risk management policies to manage any increased level of risk. Relevant steps for managing professional liability are covered in the following section.

MANAGING PROFESSIONAL LIABILITY

- 19** Depending on the engagement circumstances, reporting accountants enter into one or a combination of the following arrangements.
- a A tri-partite or multi-partite engagement contract with the client and the third parties, accepting that they owe a duty of care not only to the client but also to those third parties, including provisions limiting liability if appropriate (recognising that such a contract may not be achievable where there are numerous third parties).
 - b An engagement with the client, with the facility for other third parties to enjoy a duty of care from the reporting accountants if they accept the relevant terms of the engagement letter previously agreed with the client as if they had signed that letter when originally issued, including the same provisions limiting liability⁵.
 - c An engagement with the client alone but before allowing the third parties access to the assurance report, requiring the third parties:
 - (i) to acknowledge in writing that the reporting accountants owe the third parties no duty of care; and
 - (ii) to agree in writing that no claims shall be brought against the reporting accountants by the third party in relation to the assurance report⁶.
 - d An engagement with the client alone disclaiming any liability or duty to others (including third parties) by notice in the assurance report. Reporting accountants also consider supporting this disclaimer with an indemnity from the client to apply where a third party claim is made (recognising that such an indemnity may not be attractive commercially, may not be effective if the client is not financially stable, and may not operate to prevent a claim see further paragraph 30 below)⁷.
 - e If the risks are considered to be too high e.g. because the engagement itself is very complex or the reporting accountant is unable to agree acceptable terms with the client (and/or the third party), then the reporting accountants decline to accept the engagement.
- 20** It is also open to reporting accountants to consider with their legal advisers the use of the Contract (Rights of Third Parties) Act 1999 to manage the risk of liability to third parties.
- 21** Reporting accountants disclaim responsibility and liability to third party auditors, having regard to responsibility of the third party auditors for their own audit reports and for determining to what extent (if any) the assurance report amounts to sufficient appropriate audit evidence for the purposes of their audit of relevant third parties' financial statements.

⁵ This will require the consent of the client/original addressees which should be obtained in the engagement letter.

⁶ Reporting accountants may wish to have regard to the principles outlined in Audit 04/03 *Access to working papers by investigating accountants*, when developing a written form of such acknowledgment and agreement, bearing in mind that Audit 04/03 addresses different circumstances and the third party issues are also different.

⁷ Reporting accountants consider the legal effectiveness of disclaiming liability and of the proposed disclaimer in light of the particular circumstances of their engagement (see for example, the guidance in Statement 1.311 on *Managing the professional liability of accountants*). Reporting accountants may need to seek their own independent legal advice.

- 22** Reporting accountants may become aware of other third parties that are not customers of the client, such as banks and other lenders or prospective purchasers of the client, who may also request access to the assurance report. The client or one of the third parties may approach the reporting accountants for consent to make the assurance report available to such other third parties, as the engagement contract agreed with the client contains disclosure and use restrictions. The assurance report is not prepared for third parties or with their interests or needs in mind, and the reporting accountants may decline this request. The reporting accountants will have set out the purpose of their report in the assurance report, and will have included a disclaimer of liability to third parties in line with paragraph 19 (d) above in that report. If the request is not declined, the reporting accountants will advise the third party that the assurance report was not prepared for the third party or the third party's benefit, that consent to their report being made available to a third party will only be given if the third party agrees that the third party should not rely on the report and acknowledges in writing that the reporting accountants do not owe it a duty of care and agrees that no claims may be brought against the reporting accountants by the third party in relation to the report⁸.
- 23** Reporting accountants may also receive requests from the client for consent to the release of the assurance report to other potential third parties with whom the client may be exploring the possibility of a relationship or reporting accountants may become aware that contrary to disclosure and use restrictions agreed with the client in the engagement contract, such potential third parties are gaining access to the assurance report. The reporting accountants may decline any such request. If the request is not declined, the written acknowledgement and agreement described in paragraph 22 above in relation to these third parties may be a practical solution to the management of risk in relation to these other third parties. Where that is not practical, the reporting accountants require the client (as a condition for giving consent, where requested) to send all such potential third parties a written statement, to accompany the assurance report, pointing out that the reporting accountants did not undertake the work for them and do not accept any responsibility to them and deny liability to them. Reporting accountants may wish to provide the client with a pro-forma statement and may wish to include reference to this in their engagement letter.
- 24** If correspondence between the reporting accountants and other third parties results from a disclaimer notice or otherwise, the reporting accountants decide (with independent legal advice if appropriate) how to bring such correspondence to a satisfactory close before it becomes protracted or undermines the original objective.

AGREEING ON THE TERMS OF ENGAGEMENT

- 25** Right at the outset, accountants will need to manage their relationship for assurance engagements with the client and any third parties. They will also need to make clear to clients and third parties that engagements to provide such assurance reports are separate from statutory audit engagements.
- 26** Prior to accepting the engagement, the reporting accountants will also need to establish that the directors of the client will acknowledge in writing their responsibilities on behalf of the organisation for the subject matter of the report (e.g. for the design and operation of effective internal controls over its activities to achieve control objectives).

⁸ See Paragraph 19.b.

- 27** The reporting accountants will need to agree on the terms of engagement with all the parties to the engagement in accordance with the contractual relationship that is decided upon from paragraph 19. The agreed terms are recorded in writing in an engagement letter.
- 28** The reporting accountants consider the following for inclusion in their engagement letter:
- the purpose of the report and its agreed use, with accompanying disclosure restrictions setting out the extent to which, the context in which, and the basis on which, the report may be made available by the client to third parties;
 - the directors' and the reporting accountants' respective responsibilities;
 - the nature of the engagement and the type of assurance required (i.e. reasonable or limited assurance);
 - scope of the work to be performed by the reporting accountants;
 - the timescales within which the report will be provided (allowing the accountant sufficient time to plan and complete all the necessary work);
 - a reference to any likely need for management representations;
 - an explanation of the inherent limitations of the work, and for whom the work is being undertaken;
 - limitations to the liability of the reporting accountants, including an appropriate liability cap;
 - provisions for an indemnity if considered appropriate⁹;
 - the criteria used for the evaluation and measurement of the operations/functions or information (and how this information has been prepared);
 - reference to the appropriate guidance, if any, that the accountants are using to perform the engagement; and
 - once the engagement has already been entered into, the scope of work or terms of engagement are only varied after reasonable justification.
- 29** In particular, the reporting accountants exclude liability in respect of any loss or damage caused by, or arising from fraudulent acts, misrepresentation, and concealment of information or deliberate default on the part of the client, its directors, employees or agents.
- 30** If, before the completion of the engagement, the reporting accountants receive a request from the client, to change an assurance engagement to a non-assurance engagement or to change, for instance, the scope of the engagement, the reporting accountants will consider whether this has reasonable justification. They consider also whether the change will undermine any risk protections in place or add new risks. The engagement parties' misunderstanding in relation to the nature of the engagement or a change in circumstances that affects the third parties' requirements may justify a change to be requested by the client. Where accepting a request for a change, the reporting accountants will not disregard evidence that was already obtained prior to the change, and the details of the change should be documented and agreed in writing with all the parties to the engagement letter.

⁹ It may be appropriate to obtain an indemnity from the client in respect of claims from third parties arising from the contents of the assurance report. It must be remembered that an indemnity does not prevent a claim from being brought against the indemnified party. It merely gives him a right to pass on the liability to the indemnifier. It follows, therefore, that if the indemnity is in some way ineffective or the indemnifier does not have adequate resources to meet the liability, the indemnified party may be left unprotected.

FORM OF REPORT

31 The report by the reporting accountants reflects the agreement set out in the engagement. Reporting accountants will describe in their report for whom their work was done, the procedures performed, including the description of the tests and the purpose for which the work was done. Reporting accountants should take care to use clear and precise language to describe any specific terms used (such as 'enquiry' or 'inspection').

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