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COMPANIES ACT 2006 – LATEST DEVELOPMENTS

Lecture A242 (9.21 Minutes)

Fifth Commencement Order
The fifth commencement order was laid before Parliament on 17 December 2007 and comes into force on a variety of dates during 2008. Most of the Sections enacted came into force at 6 April 2008 and were dealt with in previous quarterly notes.

We are now approaching the date when the rest of the fifth commencement order comes into force. These notes deal briefly with the Sections which will take effect from1 October 2008.

One other thing to remember from the Fifth Commencement Order is that The CA 1985 rules concerning financial assistance for acquisition of shares are repealed for private companies from 1 October 2008.

Directors: General issues

Section 155 contains the new requirement for at least one of the directors to be a natural person. The transitional provisions of the fifth commencement order say that this requirement does not apply until 1 October 2010 if a company had no natural persons as directors on 8 November 2006.

Section 157 is also new and sets the minimum age for appointment as a director to be 16. A director can be appointed before that age as long as the appointment does not take effect until the person appointed attains that age. An appointment in contravention of this section is void. Section 158 permits the Secretary of State to make exceptions to the minimum age requirement.

Under Section 159, existing under-age directors will cease to hold office on 1 October 2008 unless they are excepted under Section 158.

Directors' duties

Duty to avoid conflicts of interest (Section 175)
Directors must avoid a situation in which they have or could have a direct or indirect interest that conflicts with the interests of the company. This applies, in particular, to the exploitation of any property, information or opportunity whether or not the company could take advantage of the property, information or opportunity.

The duty is not infringed if the matter has been authorised by the board. In the case of a private company this is so long as there is nothing in the company's constitution invalidating the authorisation. In the case of a public company, the constitution must specifically permit authorisation.

Whenever authorisation is sought of the board, the interested director must not count in the quorum.

Note that Subsection 2 of Section 170 says that a person who ceases to be a director will continue to be subject to the duty in section 175 (duty to avoid conflicts of interest) as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director, and to the duty in section 176 (duty not to accept benefits from third parties) as regards things done or omitted by him before he ceased to be a director.

Duty not to accept benefits from third parties (Section 176)
A director must not accept a benefit from a third party conferred by reason of his being a director or his doing or not doing anything as a director. This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

Duty to declare interest in proposed transaction (Section 177)
If a director is in any way, whether directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors. Such declaration must be made before the company enters into the transaction or arrangement. The director need not declare an interest if it cannot reasonably be regarded as likely to give rise to a conflict of interest.

Objections to company's registered names (Sections 69 to 74)

A person (the applicant) may object to a company's registered name on the ground that it is the same as a name associated with the applicant in which he has goodwill or that it is sufficiently similar to such a name that its use in the United Kingdom would be likely to mislead by suggesting a connection between the company and the applicant.

The primary respondent to the application is the company concerned but it may be joined as respondents by any member or director.

If the ground specified above is established, it is for the respondents to show:

a) that the name was registered before the commencement of the activities on which the applicant relies to show goodwill; or

b) that the company:
    I. is operating under the name; or
    II. is proposing to do so and has incurred substantial start-up costs in preparation; or
    III. was formally operating under the name and is now dormant; or

c) that the name was registered in the ordinary course of a company formation business and the company is for sale to the applicant on the standard terms of that business; or

d) that the name was adopted in good faith; or

e) that the interests of the applicant are not adversely affected to any significant extent.

If none of those is shown then the objection shall be upheld.

If the facts mentioned in subsections a), b) or c) are established, the objection shall nevertheless be upheld if the applicant shows that the main purpose of the respondents (or any of them) in registering the name was to obtain money (or other consideration) from the applicant or prevent him from registering the name.

The Secretary of State shall appoint persons to be company names adjudicators. They must have such legal or other experience as, in the Secretary of State's opinion, makes them suitable for appointment. One of the adjudicators shall be appointed Chief Adjudicator.

The Secretary of State may make rules about proceedings before a company names adjudicator.

If an application under Section 69 is upheld, the adjudicator shall make an order requiring the respondent company to change its name to one that is not an offending name. All respondents must co-operate with the order.

Either the applicant or the respondent may appeal to the court against any decision of a company names adjudicator.

Trading disclosures (Sections 82 to 85)

Section 82 states that the Secretary of State may make regulations requiring companies to display specified information in both specified locations and specified documents and to provide specified information to those they deal with in the course of their business.

These regulations have now been published in the form of SI 2008 No 495 The Companies (Trading Disclosures) Regulations 2008 which come into force on 1st October 2008.
In these Regulations, a reference to any type of document is a reference to a document of that type in hard copy, electronic or any other form; and

A company (other than a dormant company) shall display its registered name at -

(a) its registered office; and

(b) any other location at which it keeps records available for inspection.

A company shall also display its registered name at any location at which it carries on business other than a location which is primarily used for living accommodation.

Regulation 5 deals with the manner of display of registered name. The registered name shall be displayed continuously but where any such office, place or location is shared by six or more companies, each such company is only required to display its registered name for at least fifteen continuous seconds at least once in every three minutes.

Every company shall disclose its registered name on -

(a) its business letters, notices and other official publications;
(b) its bills of exchange, promissory notes, endorsements and order forms;
(c) cheques purporting to be signed by or on behalf of the company;
(d) orders for money, goods or services purporting to be signed by or on behalf of the company;
(e) its bills of parcels, invoices and other demands for payment, receipts and letters of credit;
(f) its applications for licences to carry on a trade or activity; and
(g) all other forms of its business correspondence and documentation.

Every company shall disclose its registered name on its websites.

Every company shall disclose the following further particulars on -

(a) its business letters;
(b) its order forms; and
(c) its websites.

The further particulars are -

(a) the part of the United Kingdom in which the company is registered;
(b) the company's registered number;
(c) the address of the company's registered office;
(d) in the case of a limited company exempt from the obligation to use the word "limited" as part of its registered name under section 30 of the Companies Act 1985 or article 40 of the Companies (Northern) Ireland Order 1986, the fact that it is a limited company;
(e) in the case of a community interest company which is not a public company, the fact that it is a limited company; and
(f) in the case of an investment company within the meaning of section 833 of the Act, the fact that it is such a company.

If, in the case of a company having a share capital, there is a disclosure as to the amount of share capital on -

(a) its business letters;
(b) its order forms; or
(c) its websites, that disclosure must be to paid up share capital.

Where a company's business letter includes the name of any director of that company, other than in the text or as a signatory, the letter must disclose the name of every director of that company.

A company shall disclose -

(a) the address of its registered office;
(b) any inspection place; and
(c) the type of company records which are kept at that office or place, to any person it deals with in the course of business who makes a written request to the company for that information.

The company shall send a written response to that person within five working days of the receipt of that request.

SI 2008/886 Seventh commencement order

The seventh commencement order was laid before Parliament on 17 July 2008 and, with respect to the issue covered below, is in force from 1 October 2008.

The main topic dealt with by the Statutory Instrument is reduction of share capital.

Sections 641 to 644 of the 2006 Act introduce a new solvency statement procedure for capital reductions which enables private companies to reduce their share capital without having to go to court. This procedure – which may be used as an alternative to the court approved route – requires a special resolution of the company's members and a solvency statement made by the directors.

The conditions which must be satisfied in order for a private company to reduce its share capital using the new solvency statement procedure are set out in section 642 which provides, amongst other things, that the solvency statement must be made available to the members when they vote on the resolution to reduce the company's share capital. In addition the solvency statement must be filed with the Registrar of Companies.

The contents of the solvency statement are set out in section 643 of the 2006 Act which provides that each of the directors must confirm that they have formed the opinion, as regards the company's situation at the date of the statement, that there is no ground on which the company could then be found to be unable to pay (or otherwise discharge) its debts. The directors must also confirm that they have also formed the opinion that the company will be able to pay (or otherwise discharge) its debts as they fall due during the year immediately following that date (or alternatively, if it is intended that the company should commence winding-up proceedings within twelve months of the date that the directors make the solvency statement, the directors must confirm that the company will be able to pay (or otherwise discharge) its debts in full within twelve months of the commencement of the winding up). In all cases the directors must take into account all of the company's liabilities (including any contingent or prospective liabilities). The solvency statement must also state the date on which it is made and the name of each of the directors of the company.

Whilst the directors may put their name to a single document, this is not essential and each of the directors may make separate solvency statements if they wish. In either case the solvency statement or statements will need to be authenticated by each of the directors who have made it. The form of authentication will be a matter for the Registrar of Companies' rules in accordance with section 1068 of the 2006 Act. (It should be noted that if one or more of the directors is unable to make a solvency statement the company will not be able to use the solvency statement route to effect a reduction of capital unless the directors who are unable or unwilling to make the solvency statement resign.)

Where a director makes a solvency statement without having reasonable grounds for the opinions expressed in it he commits an offence.

Section 654 states that a reserve arising from a reduction of a company's share capital is not distributable subject to any provision made by order under the Section. However, SI 2008 No 1915 makes this reserve distributable in the case where capital has been reduced by the solvency statement route. The reserve is also distributable where capital has been reduced following court approval but this is subject to any contrary order by the court.

ACCESS TO INFORMATION BY SUCCESSOR AUDITORS: A&A FACULTY DRAFT TR

Lecture A243 (16.22 Minutes)

Background information
The Technical Release (TR) repeats the requirements of Schedule 10 of the Companies Act and the ICAEW regulations and guidance as well as clarifying what is meant by the term statutory audit (CA 2006 Section 1210).

Schedule 10 of the Companies Act 2006 requires that Recognised Supervisory Bodies must have adequate rules and practices designed to ensure that a person ceasing to hold office as a statutory auditor makes available to his successor in that office all relevant information which he holds in relation to that office. (CA 2006 Schedule 10 (9)(3)(c)).

The audit regulations and guidance have been amended to give effect to this requirement. These regulations were covered in a previous set of quarterly notes but the main issues arising are repeated below:

- The new regulation applies in respect of appointments for the audits of financial years starting on or after 6 April 2008.
- Information is for the purposes of the successor's audit and must not be disclosed to a third party unless the successor is required to do so by a legal or professional obligation. Third party includes the client – although the successor may discuss the information with the client where to do so is a necessary part of the audit work.
- BERR has confirmed its view that the Act does not alter the existing liability of each auditor in relation to its respective audit.
- The request by the successor auditor can only be made after formal appointment. The provision of information should be on a timely basis.
- The request must be in writing.
- The successor should consider the need for a request and the extent of that request. The successor should not request unnecessary information. There are references to reviewing the predecessor's audit work in ISA 510 (opening balances), ISA 710 (comparatives) and ISA 300 (planning) so information is likely to be necessary for these purposes.
- The successor should try to be as specific as possible in making a request and should avoid, wherever possible, a request for "all relevant information".
- Where the audit is an audit of financial statements, then ISAs will indicate the working papers to be prepared. It does not matter whether those working papers are filed on the current audit file, a permanent file or a systems file.
- The predecessor should be prepared to assist the successor by providing oral or written explanations on a timely basis.
- The period for which information is requested would normally be the period in respect of the last audit report signed by the predecessor and would include any subsequent interim review. If the successor considers that it needs information from a previous period then they should be prepared to provide a list of precisely what information is required and give reasons which demonstrate why such additional information is "relevant" in accordance with the regulations.
- It would be usual for the basis on which the information is to be provided to be documented in writing by an exchange of letters between the two auditors, copied to the audited entity. Guidance on suitable letters is provided in the technical release (see below).
- There is no obligation to allow copying of working papers but it would be usual to allow copying of extracts of the books and records of the audit client that are contained in the audit working papers.
- A request for information under the Regulation should not be made other than in connection with the successor's audit. The successor should refuse to accept an additional engagement, such as to act as an expert witness or to review the quality of the predecessor's audit work, where the engagement would involve the use of the information obtained by it under the Regulation. In any event, the successor should not comment on the quality of the predecessor's audit work unless required to do so by a legal or professional obligation.

The TR then goes on to provide extracts from ISA 300 (Planning an audit of financial statements), ISA 510 (Initial engagements – opening balances) and ISA 710 (Comparatives). The reason for providing these extracts is that those ISAs contain specific references to reviewing the predecessor's audit work and therefore are likely to be particularly helpful for the successor in deciding what is meant by the term relevant information.

Example letters

The successor should make the request in writing and the TR provides a proforma example of such a letter which is reproduced below. This is quite brief and contains a space for the successor to fill in what information is required. The TR says that this should be specified as precisely as possible and a broad request for "all relevant information...." should be avoided.

The TR also provides a proforma specimen letter from the predecessor responding to the successor's request for access (see below). This is a detailed letter containing extracts from the ICAEW guidance. It is designed to remind the successor of the restrictions on the use of the information and to disclaim any liability on the part of the predecessor. This letter should be copied to the client. Note that there is no requirement for the successor to countersign the letter.

Relevant information

In the case of an audit of financial statements under the Companies Act, ISAs will indicate the audit working papers to be prepared. It is likely that the successor will request access to some or all of those working papers.
Where files contain, for example, tax papers that relate to tax work rather than audit work then there is no obligation to provide access to those tax papers.

Information which is subject to legal professional privilege would not be disclosable without permission from the client.

Practicalities of access

Where working papers are held electronically then the predecessor will need to consider how to provide access to the relevant audit documentation without putting at risk the confidentiality of the firm's audit methodologies or confidential information of other clients.

It is reasonable for the successor to make notes of the review but there is no obligation to allow copying of audit working papers. The TR states that it would be reasonable to allow, as a minimum, the copying of extracts of the books and records of the client. It would also be reasonable and helpful to allow copying of papers such as breakdown of analyses of financial statement figures and documentation of the client's systems and processes.

If the successor does ask to copy documents then it would be sensible to check them and to keep a record of which items were copied.

Access can only be requested after the appointment of the successor. The predecessor should grant access within a reasonable time following receipt of the request. The location where access is to be provided is determined by the predecessor.

The TR goes on to consider the subject of recovery of costs and suggests that it would be reasonable to seek to recover costs but without any element of profit. There is no obligation on the successor to make any payment and therefore the predecessor may wish to look to the client for recovery of costs. The TR suggests that it might be appropriate, as a matter of policy, to amend engagement letters so as to provide for the recovery of costs of providing access to an eventual successor.

Confidentiality issues

The final section of the TR deals with confidentiality issues. Because the auditor is complying with a mandatory requirement, providing access to relevant information will not breach professional confidentiality or data protection laws.

However, because of the danger of tipping-off, any money laundering report and papers recording the predecessor's related consideration of apparently suspicious activities should not be provided by the predecessor to any person (including the successor) unless the predecessor has clear advice that to do so would be lawful.

Specimen letter from the successor requesting access
[Predecessor firm]

[Address]

For the attention of: [Name of Senior Statutory Auditor]

Dear Sirs,

Provision of Information pursuant to audit regulation 3.09 relating to the audit of [audit client]

This firm was duly appointed statutory auditor (as defined by section 1210 of the Companies Act 2006 ("the Act")) on [date] to [company] ("the Company") [and its UK subsidiaries as listed in the schedule to this letter (together "the Companies")].

Pursuant to paragraph 9(3) of Schedule 10 to the Companies Act 2006 and Audit Regulation 3.09, and in accordance with Technical Release AAF xx/08 issued by the Institute of Chartered Accountants in England and Wales, we request for the purposes of our audit work, access to the following information:

[Set out information necessary at this stage, noting the guidance under Audit Regulation 3.09 that wherever possible a request framed simply as a request for "all relevant information held by the predecessor and concerning the audited entity" or "all relevant information held by the predecessor in relation to the office of auditor" should be avoided. The successor should strive to identify the information required, or the type of information required, as precisely as possible.]

[Where the request is for access to audit working papers and subsequent interim review working papers, insert where applicable:

> [The working papers in respect of your audit report on the financial statements of the [Company/Companies] relating to [insert period between the beginning of the last financial statements on which the predecessor reported and the date of cessation of the predecessor's appointment].
> [Where in your capacity as auditor you conducted a review of interim financial information subsequent to the audit report referred to above, this request includes a request for access to the working papers relating to that review also.]

We may also request explanations from you in connection with our consideration of the above information, and on the same basis.

[We/ the Company will meet reasonable costs that you will incur in giving access/ providing copies, provided that a maximum amount is agreed first.]

We look forward to receiving your confirmation letter in response to this request, which should be addressed for the attention of [name of successor engagement partner].

Yours faithfully

[Successor]

[Schedule of UK subsidiaries to which this letter applies in addition to the Company]

Specimen letter from predecessor responding to the successor's request for access
[Successor firm]

[address]

Dear Sirs,

Provision of Information pursuant to audit regulation 3.09 relating to the audit of [audit client]

We refer to your letter dated [] following your appointment as statutory auditors of [company] ("the Company") [and its UK subsidiaries listed in the schedule to your letter (together "the Companies")].

We confirm we will provide access to the information requested, namely:

[This should reflect the information set out in the successor's request letter which is necessary at this stage, noting the guidance under Audit Regulation 3.09 that wherever possible a request framed simply as a request for "all relevant information held by the predecessor and concerning the audited entity" or "all relevant information held by the predecessor in relation to the office of auditor" should be avoided. The successor should have identified the information required, or the type of information required, as precisely as possible.]

[Where the request is for access to audit working papers and subsequent interim review working papers if applicable, the following language reflects that set out in the proforma request letter in Appendix B:

> [The working papers in respect of our audit report on the financial statements of the [Company/Companies] relating to [insert period specified by the successor, such as the period between the beginning of the last financial statements on which the predecessor reported and the date of cessation of the predecessor's appointment].
>
> [The working papers relating to our review of interim financial information for the period ended [insert period subsequent to the audit report referred to above, as specified by the successor].]

We understand that you may also request explanations from us in connection with your consideration of the above information, and on the same basis.

In accordance with the guidance under Audit Regulation 3.09 and Technical Release AAF 01/08 issued by the Institute of Chartered Accountants in England and Wales this letter sets out the basis on which the information and explanations (if any) are to be provided. Should you request or we provide any supplementary information to that set out above, such provision will be made on the same basis.

The access is provided to you:

(a) solely in your capacity as duly appointed statutory auditor (as defined by section 1210 of the Companies Act 2006 ("the Act")) of the [Company/Companies];
(b) solely because we are required to give you access to information pursuant to paragraph 9(3) of Schedule 10 to the Act and Audit Regulation 3.09.

The provision of access does not and will not alter any responsibility that we may have accepted or assumed to the [Company/Companies] or the [Company's/respective Companies'] members as a body, in accordance with the statutory requirements for audit, for our audit work, for our audit report or for the opinions we have formed in the course of our work as auditors.

To the fullest extent permitted by law we do not accept or assume responsibility to you or to anyone else:

(a) as a result of the access given;
(b) or the information to which we provide access;
(c) for any explanation given to you;
(d) in respect of any audit work you may undertake, any audit you may complete, and audit report you may issue, or any audit opinion you may give.

Where access is provided to audit [and interim review] working papers, those papers were not created or prepared for, and should not be treated as suitable for, any purpose other than the statutory audit that was the subject of our audit report [and respectively the interim review we carried out]. The statutory audit was planned and undertaken solely for the purpose of forming and giving the audit opinion required by the relevant statutory provision to the persons contemplated by that statutory provision. [The interim review was planned and undertaken solely for the purpose of meeting the requirements of the relevant standard.] The statutory audit [and the interim review] [was/were] not planned or undertaken, and the working papers were not created or prepared, in contemplation of your appointment as statutory auditor or for the purpose of assisting you in carrying out your appointment as statutory auditor.

Neither you nor anyone else should rely on the information to which access is provided, or any explanations given in relation to that information. The information cannot in any way serve as a substitute for the enquiries and procedures that you should undertake and the judgments that you must make for any purpose in connection with the audit for which you are solely responsible as the auditor.

If notwithstanding this letter you rely on the information for any purpose and to any degree, you will do so entirely at your own risk.

[Insert where applicable:]

> [We will remove/ have removed from the audit working papers all material in respect of which legal professional privilege is asserted.]
>
> [Thank you for your confirmation that you/ the Company will meet the reasonable costs that we will incur in giving access. [As already agreed] these will not exceed £*.]

In accordance with the guidance issued under Audit Regulation 3.09:

(a) you should refuse to accept an additional engagement, such as to act as an expert witness or to review the quality of our audit work, where the engagement would involve the use of the information obtained by you under the Regulation;
(b) you should not comment on the quality of our audit work unless required to do so by a legal or professional obligation;
(c) the information should not be disclosed beyond persons who have a need to access the information where to do so is a necessary part of your audit work, nor should the information be disclosed to a third party including the [Company/Companies] (although this does not prevent you discussing the information with the [Company/Companies] where to do so is a necessary part of your audit work, or providing information to any third party if that is required of you by a legal or professional obligation).

In the event that access to information involves your having access to any intellectual property of ours or any material in which we have copyright, we do not grant permission to you to use or exploit that intellectual property or copyright and you must respect the same at all times.

When in this letter we refer to ourselves, we include [any person or organisation associated with this firm through membership of the international association of professional service firms to which this firm belongs], our [and their] partners, directors, members, employees and agents. This letter is for the benefit of all those referred to in the previous sentence and each of them may rely on and enforce in their own right all of the terms of this letter

Yours faithfully

[Predecessor]

Cc The company/companies

LIABILITY LIMITATION AGREEMENTS: FINAL FRC GUIDANCE

Lecture A244 (6.18 Minutes)

The Financial Reporting Council has issued final guidance on auditor liability limitation agreements. Paragraph 1.13 states that the guidance aims to provide practical assistance to directors, auditors and shareholders on how to apply the new legislation. In particular, it aims to:

- Explain what is and is not allowed under the 2006 Act;
- Set out some of the factors that will be relevant when assessing the case for an agreement;
- Explain what matters should be covered in an agreement, and provide specimen clauses for inclusion in agreements; and
- Explain the process to be followed for obtaining shareholder approval, and provide specimen wording for inclusion in resolutions and the notice of the general meeting.

The guidance does not attempt to determine whether particular arrangements will be considered “fair and reasonable”. That is because every arrangement will need to be assessed in the context of the particular circumstances. That would ultimately be for the courts to decide in the event of a dispute.

Where an agreement is in place, the Act does not restrict the manner in which liability can be limited as long as it is fair and reasonable in the circumstances. Therefore contractual limits can be set in a number of ways:

- A limit based on the auditor’s proportionate share of the responsibility for any loss;
- Purely by reference to the “fair and reasonable” test;
- A cap on liability, expressed either as a monetary amount or calculated on the basis of an agreed formula;
- A combination of some or all of the above.

The fundamental question is whether it will be in the company’s interest to enter into a liability limitation agreement.

If the directors conclude that it is then they will need to decide how best to communicate that decision and the reasons for it to shareholders. This is likely to be a particular issue for listed companies.

The final version of the FRC guidance has been extended in this area and now gives at Section 3.6 a number of reasons why companies and their directors may conclude that it is appropriate for the company to enter into such an agreement. The guidance also contains a new Section 6 which is addressed specifically at private companies.
Under CA 2006, the company has the choice of whether to seek shareholder approval before or after entering into a limitation liability agreement. If seeking approval having already entered into an agreement then the shareholders must approve the whole agreement. Otherwise, they will approve the principal terms which specify:

- The kind of acts or omissions covered by the agreement;
- The year the agreement relates to; and
- The limit of the auditor’s liability however expressed.

Appendices B, C and D to the guidance contain specimen principal terms which have been drafted so that they can be referred to in the resolution and sent to shareholders with the notice of the meeting. The principal terms can then be incorporated into the agreement without the need for further drafting.

The appendices contain examples for each type of limitation liability agreement that may be entered into. One facet of the “proportional liability” terms is that they do not contain any suggested percentages. Rather, the agreement sets out the principle that the auditor’s liability will be limited based on proportionate liability. The actual percentages can be agreed later (if necessary) between the auditor and the company or by the courts.

SENIOR STATUTORY AUDITOR

Lecture A245 (11.42 Minutes)

Section 503(3) of the Companies Act 2006 requires, where the auditor is a firm, that the auditor's report must be signed by the senior statutory auditor in his own name for and on behalf of the auditor. The Auditing Practices Board issued Bulletin 2008/06 as guidance on Section 503 and a number of the issues arising were dealt with in a previous set of quarterly notes. Two further issues are dealt with below. Firstly, the presentation of the auditors signature under Section 503(3) and secondly the problem situation where a new partner is appointed as a replacement for the original senior statutory auditor

Illustrative example of presentation of signature of senior statutory auditor on the auditor's report where the auditor is a firm

Opinion

In our opinion:

- the financial statements give a true and fair view of the state of the company's affairs as at ... and of its profit[loss] for the year then ended;
- the financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice;
- the financial statements have been prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report is consistent with the financial statements.

[Signature]

Address

John Smith (Senior Statutory Auditor)

Date
for and on behalf of ABC LLP, Statutory Auditor

The problems arising from the situation where the senior statutory auditor is unable to sign the auditor’s report
In the bulletin, the APB said that the term "senior statutory auditor" has the same meaning as the term "engagement partner" when used in International Standards on Auditing (UK and Ireland). ISA (UK and Ireland) 220 Quality Control for Audits of Historical Financial Information contains the following definition of "engagement partner":

The partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Later on in bulletin 2008/06, the question arose as to what the implications would be if the senior statutory auditor were unable to be present to sign the auditor's report. In response, the bulletin says that, under section 503(3) of CA 2006, the senior statutory auditor must sign the auditor's report. Another partner, or responsible individual, is not able to sign for and on behalf of the senior statutory auditor.

If the senior statutory auditor is unable to continue to take responsibility for the direction, supervision and performance of the audit then the audit firm must appoint a replacement senior statutory auditor. The new senior statutory auditor must review the audit work performed to the date of the change. The review procedures must be sufficient to satisfy the new senior statutory auditor that the audit work performed to the date of the review has been planned and performed in accordance with professional standards and regulatory and legal requirements.

Personal responsibilities of the engagement partner
The purpose of this section of the course notes is to remind readers of the requirements under ISAs which must be met by the engagement partner personally.

The glossary of terms provides the following explanation of the term “auditor”.

Auditor - The engagement partner. The term "auditor" is used to describe either the engagement partner or the audit firm. Where it applies to the engagement partner, it describes the obligations or responsibilities of the engagement partner. Such obligations or responsibilities may be fulfilled by either the engagement partner or a member of the audit team. Where it is expressly intended that the obligation or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used.

With this in mind, we can now search the ISAs for all references to the term “engagement partner”. Most are in ISA (UK and Ireland) 220 Quality Control for Audits of Historical Financial Information

Quality Control
Leadership responsibilities for quality

The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned. (ISA 220.6)

The engagement partner sets an example regarding audit quality to the other members of the engagement team through all stages of the audit engagement. Ordinarily, this example is provided through the actions of the engagement partner and through appropriate messages to the engagement team. Such actions and messages emphasize:

(a) The importance of:
- (i) Performing work that complies with professional standards and regulatory and legal requirements;
- (ii) Complying with the firm's quality control policies and procedures as applicable; and
- (iii) Issuing auditor's reports that are appropriate in the circumstances; and

(b) The fact that quality is essential in performing audit engagements. (ISA 220.7)

Ethical requirements
The engagement partner should consider whether members of the engagement team have complied with ethical requirements. (ISA 220.8)

The engagement partner remains alert for evidence of non-compliance with ethical requirements. Inquiry and observation regarding ethical matters amongst the engagement partner and other members of the engagement team occur as necessary throughout the audit engagement. If matters come to the engagement partner's attention through the firm's systems or otherwise that indicate that members of the engagement team have not complied with ethical requirements, the partner, in consultation with others in the firm, determines the appropriate action. (ISA 220.10)

The engagement partner and, where appropriate, other members of the engagement team, document issues identified and how they were resolved. (ISA 220.11)

Independence
The engagement partner should form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner should:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
(b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement;
(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards. The engagement partner should promptly report to the firm any failure to resolve the matter for appropriate action; and
(d) Document conclusions on independence and any relevant discussions with the firm that support these conclusions. (ISA 220.12)

The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, the engagement partner consults within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement. Such discussion and conclusions are documented. (ISA 220.13)

Acceptance and continuance of client relationships and specific audit engagements
The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented. (ISA 220.14)

The engagement partner may or may not initiate the decision-making process for acceptance or continuance regarding the audit engagement. Regardless of whether the engagement partner initiated that process, the partner determines whether the most recent decision remains appropriate. (ISA 220.15)

Where the engagement partner obtains information that would have caused the firm to decline the audit engagement if that information had been available earlier, the engagement partner should communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (ISA 220.18)

Assignment of engagement teams
The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued. (ISA 220.19)

Engagement performance
The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances. (ISA 220.21)

The engagement partner directs the audit engagement by informing the members of the engagement team of:

(a) Their responsibilities;
(b) The nature of the entity's business;
(c) Risk-related issues;
(d) Problems that may arise; and
(e) The detailed approach to the performance of the engagement.

The engagement team's responsibilities include maintaining an objective state of mind and an appropriate level of professional scepticism, and performing the work delegated to them in accordance with the ethical principle of due care. Members of the engagement team are encouraged to raise questions with more experienced team members. Appropriate communication occurs within the engagement team. (ISA 220.22)

Review responsibilities are determined on the basis that more experienced team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether

(a) The work has been performed in accordance with professional standards and regulatory and legal requirements;
(b) Significant matters have been raised for further consideration;
(c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
(d) There is a need to revise the nature, timing and extent of work performed;
(e) The work performed supports the conclusions reached and is appropriately documented;
(f) The evidence obtained is sufficient and appropriate to support the auditor's report; and
(g) The objectives of the engagement procedures have been achieved. (ISA 220.25)

Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (ISA 220.26)

The engagement partner conducts timely reviews at appropriate stages during the engagement. This allows significant matters to be resolved on a timely basis to the engagement partner's satisfaction before the auditor's report is issued. The reviews cover critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement, significant risks, and other areas the engagement partner considers important. The engagement partner need not review all audit documentation. However, the partner documents the extent and timing of the reviews. Issues arising from the reviews are resolved to the satisfaction of the engagement partner. (ISA 220.27)

A new engagement partner taking over an audit during the engagement reviews the work performed to the date of the change. The review procedures are sufficient to satisfy the new engagement partner that the work performed to the date of the review has been planned and performed in accordance with professional standards and regulatory and legal requirements. (ISA 220.28)

Consultation
The engagement partner should:

(a) Be responsible for the engagement team undertaking appropriate consultation on difficult or contentious matters;
(b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
(c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are documented and agreed with the party consulted; and
(d) Determine that conclusions resulting from consultations have been implemented. (ISA 220.30)

Engagement Quality Control Review
For audits of financial statements of listed entities, the engagement partner should:

(a) Determine that an engagement quality control reviewer has been appointed;
(b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
(c) Not issue the auditor's report until the completion of the engagement quality control review.

For other audit engagements where an engagement quality control review is performed, the engagement partner follows the requirements set out in subparagraphs (a) to (c). (ISA 220.36)

Monitoring
ISQC 1 requires the firm to establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. The engagement partner considers the results of the monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms. The engagement partner considers:

(a) Whether deficiencies noted in that information may affect the audit engagement; and
(b) Whether the measures the firm took to rectify the situation are sufficient in the context of that audit. (ISA 220.41)

Planning, risk and fraud

The auditor should plan the audit so that the engagement will be performed in an effective manner. (ISA 300.2)
Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan, in order to reduce audit risk to an acceptably low level. Planning involves the engagement partner and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process. (ISA 300.3)

The members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements. (ISA 315.14)

The objective of this discussion is for members of the engagement team to gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures. (ISA 315.15)

The discussion provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity, and for the team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement. As required by ISA (UK and Ireland) 240, particular emphasis is given to the susceptibility of the entity's financial statements to material misstatement due to fraud. The discussion also addresses application of the applicable financial reporting framework to the entity's facts and circumstances. (ISA 315.16)

Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud. (ISA 240.27)

ISA (UK and Ireland) 315 requires members of the engagement team to discuss the susceptibility of the entity to material misstatement of the financial statements. This discussion places particular emphasis on the susceptibility of the entity's financial statements to material misstatement due to fraud. The discussion includes the engagement partner who uses professional judgment, prior experience with the entity and knowledge of current developments to determine which other members of the engagement team are included in the discussion. Ordinarily, the discussion involves the key members of the engagement team. The discussion provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud. (ISA 240.28)

The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion. All of the members of the engagement team do not necessarily need to be informed of all of the decisions reached in the discussion. For example, a member of the engagement team involved in audit of a component of the entity may not need to know the decisions reached regarding another component of the entity. (ISA 240.29)

The auditor’s responsibility for other information

The auditor should read the other information to identify material inconsistencies with the audited financial statements. (ISA 720.2)

When the auditor reads the other information, the auditor does so in the light of the knowledge the auditor has acquired during the audit. The auditor is not expected to verify any of the other information. The audit engagement partner (and, where appropriate, other senior members of the engagement team who can reasonably be expected to be aware of the more important matters arising during the audit and to have a general understanding of the entity's affairs), reads the other information with a view to identifying significant misstatements therein or matters which are inconsistent with the financial statements. (ISA 720.4-1)

ISSUES ARISING FROM RECENT COLD FILE REVIEWS

Lecture A246 (27.26 Minutes)

Re-appointment of auditors of private companies
Some files continue to include in the directors' report a reference to the appointment of auditors at the AGM. Subject to the articles of association, this is unlikely to be correct since private companies are no longer required to hold an AGM and, therefore, auditors are no longer appointed at the AGM.

Sections 485 - 488 of Companies Act 2006 deal with the appointment of auditors of private companies. They apply in relation to appointments for financial years beginning on or after 1 October 2007.

Section 485(2) states that for each financial year for which an auditor or auditors is or are to be appointed (other than the company's first financial year), the appointment must be made before the end of the period of 28 days beginning with-

(a) the end of the time allowed for sending out copies of the company's annual accounts and reports for the previous financial year (see section 424), or
(b) if earlier, the day on which copies of the company's annual accounts and reports for the previous financial year are sent out under section 423. This is the "period for appointing auditors".

It is in Section 487 that we get the change to the term of office of the auditors to bring in the default position whereby the auditors are deemed to be automatically re-appointed unless there is some reason to prevent this.

487(1): An auditor or auditors of a private company hold office in accordance with the terms of their appointment, subject to the requirements that-

(a) they do not take office until any previous auditor or auditors cease to hold office, and
(b) they cease to hold office at the end of the next period for appointing auditors unless re-appointed.

487(2): Where no auditor has been appointed by the end of the next period for appointing auditors, any auditor in office immediately before that time is deemed to be re-appointed at that time, unless-

(a) he was appointed by the directors, or
(b) the company's articles require actual re-appointment, or
(c) the deemed re-appointment is prevented by the members under section 488, or
(d) the members have resolved that he should not be re-appointed, or
(e) the directors have resolved that no auditor or auditors should be appointed for the financial year in question.

Section 488 states that an auditor of a private company is not deemed to be re-appointed if the company has received notices from members representing at least 5% (or lower if so specified in the company's articles) of the total voting rights of all members who would be entitled to vote on a resolution that the auditor should not be re-appointed.

Knowledge of the business
According to ISA 315, paragraph 20, the auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

(a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.
(b) Nature of the entity, including the entity's selection and application of accounting policies.
(c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
(d) Measurement and review of the entity's financial performance.
(e) Internal control.

Appendix 1 to ISA 315 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a) through (d) above and these are usually repeated in checklists included in most of the proprietary systems.

Firms frequently give too little attention to (c) and (d) above and audit risk can arise as a result of such factors. For example, in the audit of a subsidiary company, the parent may put pressure on the subsidiary to achieve kpis and this may affect the auditor's risk assessment.

However, before moving on from this area, we must remind ourselves of the advice from practice Note 26 which indicates that the main purpose of recording notes about the business is to assist in risk assessment. There is no point in recording information about a business which does not relate to the auditor's risk assessment. In order to make this link clear, it would be helpful to provide a section at the end of the notes about the business to deal with risks identified.

Internal control

ISA 315, paragraph 41 requires the auditor to obtain an understanding of internal control relevant to the audit. Paragraph 48 goes on to say that ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes that give a true and fair view in accordance with the applicable financial reporting framework and the management of risk that may give rise to a material misstatement in those financial statements. In paragraph 49, we read that controls over the completeness and accuracy of information produced by the entity may also be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures.

Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. (ISA 315. 54)

My recommendation is that you should provide good systems documentation of the main transaction cycles. These can either be narrative notes or flowcharts but in either case would document the process from "cradle to grave". The control activities should be highlighted. Having prepared your systems notes, you should then perform a single walk-through test to confirm that the system and controls are operating as recorded. Write down a reference for the item tested. Following this, you are in a position to evaluate the design of the control and determine whether it has been implemented as required by ISA 315 paragraph 54 above.

However, remember also that the main purpose of considering systems and internal controls is to assist in risk assessment. It would therefore be helpful to provide a comment at the end of each section of the systems notes to deal with any risks identified.

Justifying risk assessments

ISA 330 Paragraph 23 states that when the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.

In order to determine whether such tests are necessary, the auditor must document on file the reasons for believing inherent risk to be other than high.

Response to risk

ISA 330 Paragraph 7 states that the auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level.

The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the risk assessment

Many firms have a standard form which should be used to record all risks identified at the planning stage whether arising from: knowledge of the business; the team meeting; the risk assessment; the preliminary analytical review; or any other procedure.

The proper use of this standard form will then help to ensure that all risks identified are dealt with during the course of the audit. It is particularly important to remember to update this form at the end of the audit to indicate how the risks have been resolved.

If your firm does not use such a form at present then look at example 6 in the appendix to the APB's Practice Note 26.

Analytical review
There is frequently confusion between the different types of analytical review.

Planning analytical review should be filed in the planning section of the file. It should consist of, at least, a comparison between the current year and the previous year. In accordance with ISA 315 paragraph 7, planning analytical review is a risk assessment procedure which should be performed in order to obtain an understanding of the entity and its environment. This clearly requires that the planning analytical review should be performed before the audit is planned. To quote from ISA 315, paragraph 10:

Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures as risk assessment procedures, the auditor develops expectations about plausible relationships that are reasonably expected to exist. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement.

The use of analytical procedures as substantive evidence is not compulsory. If you wish to reduce substantive sample sizes by using substantive (or extensive) analytical review then this review should be filed in the sections of the file dealing with substantive evidence. Some audit systems have a section of the file dedicated to substantive analytical review (eg PCAS section D). If you are not planning to reduce substantive samples as a result of analytical procedures then this section of the file should be empty.

Paragraph 4 of ISA 520 states that analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Despite this, most firms only ever perform comparisons with prior period information and this means that they do not take advantage of the full power of what can be a cost-effective audit technique.

ISA 520 paragraph 13 says that the auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity. The conclusions drawn from the results of such audit procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements.

I suggest that the final review can be limited to a review of the statutory accounts since these are the accounts on which an audit opinion is expressed. For small clients, it may well be acceptable to simply copy the balance sheet and P&L account and then annotate these with comments.

If the final review provides the auditor with unexpected results, then further work would be required.

Accounting issues
UITF 40 is still causing problems. The majority of UK companies are now involved in service industries. Without question, such companies cannot hold stock and what was previously classed as work-in-progress should now be shown as "amounts recoverable on contracts".

Turning to industries where products are involved, if the client produces items speculatively in the hope of making sales then they will have work-in-progress while the stock is produced and finished goods when the goods are held for sale.

If, on the other hand, the client produces items to order then it could be argued that they do not have stock but rather "amounts recoverable on contracts". Whether or not the client agrees with this analysis, it is still an issue which should be discussed in the auditor's summary memo.

UITF 40 is considered in more detail later in these notes.

Deferred tax is an area which many clients and some auditors seem to want to ignore. Even if the amounts involved are considered to be immaterial, the auditor should prepare a calculation to evidence that fact. In particular, where there are deferred tax assets, these should be quantified and disclosed even if the directors decide that they should not be recognised in the balance sheet.

Going concern
Going concern is a particular problem at the moment in view of the current economic climate. Auditors should consider extending their work on going concern to reflect the issues raised by Bulletin 2008/1: Audit issues when financial markets are difficult and credit facilities may be restricted. The appendix to the bulletin sets out a number of risk factors for the auditor to consider. These factors are reflected in the following list:

- Has the entity experienced difficulty in the past in obtaining finance and/or complying with covenants?
- Have any covenants been breached recently which may lead to facilities being withdrawn?
- Are finance facilities due for renewal in the next year?
- Are there alternative plans if finance is not renewed?
- Do borrowing agreements (or other contracts) contain clauses that may trigger early repayment?
- Have facilities been renewed recently but with higher interest rates or charges?
- Is borrowing secured on assets which have decreased in value and may no longer cover the amounts owed?
- Financial institutions should also consider the possibility of reduced deposits from retail customers or reduced availability of financing from wholesale markets.
- Have management updated finance plans to reflect the current market conditions and the possibility that asset values may be reduced?*
- If the entity provides guarantees (eg for other group companies) might those guarantees be called in? Conversely, if the entity depends on guarantees from other entities then might the guarantor be unable to continue to provide the guarantee?
- If the entity provides loans (eg to other group companies) might those companies be unable to make repayments?
- Might there be a delay in collections from debtors or an increase in bad debts because customers are affected by the credit crunch?
- Might suppliers be affected by the current climate and be unable to provide essential goods and services? Are alternative suppliers available?

*If there is an indication that asset values may be impaired, then this would trigger an impairment test under FRS 11.

Subsequent events review
Surprisingly, the "gap" has re-emerged as a common weakness. There is a particular concern over subsequent events review in the situation where there is a delay between the date when the client approves the balance sheet and the date when the auditor signs the audit report. The audit file should address this issue and ensure that subsequent events review is updated to the date of signing the audit report.

Correspondence with the client
Letters of comment are mandatory under ISAs. They should be sent to the client before the accounts are approved and should have as attachments a schedule of uncorrected errors and the draft letter of representation.

The letter of comment should follow the layout prescribed by paragraph 11-12 of ISA 260:

The auditor should communicate the following findings from the audit to those charged with governance:

(a) The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting;

(b) The final draft of the representation letter, that the auditor is requesting management and those charged with governance to sign. The communication should specifically refer to any matters where management is reluctant to make the representations requested by the auditor;
(c) Uncorrected misstatements;
(d) Expected modifications to the auditor's report;
(e) Material weaknesses in internal control identified during the audit;
(f) Matters specifically required by other ISAs (UK and Ireland) to be communicated to those charged with governance; and
(g) Any other audit matters of governance interest.

ACCOUNTING ISSUES ARISING FROM COLD FILE REVIEWS

Lecture A247 (23.36 Minutes)

FRS 10: Intangible fixed assets
Situation
Your client owns a brand name and the associated trademark. It was previously included in the balance sheet as an intangible asset at its initial cost of £4,800. At the balance sheet date (31 December), the company was in advanced negotiations for the sale of the brand name for £250,000 and in fact the sale was completed on 14 February well before the accounts were due to be approved by the Board.

The client wishes to revalue the brand name to its market value at the balance sheet date. In justification, they quote paragraph 43 of FRS 10 which states "Where an intangible asset has a readily ascertainable market value the asset may be revalued to its market value." The client argues that the sale so soon after the year end is evidence that the market value at the year end is readily ascertainable.

What is your view?

FRS 11: Intangible fixed assets
Situation
FRS 11 paragraph 8 states that a review for impairment of a fixed asset or goodwill should be carried out if events or changes in circumstances indicate that the carrying amount of the fixed asset or goodwill may not be recoverable.

Paragraph 10 gives examples of events and changes in circumstances that indicate an impairment may have occurred and these include:

- a current period operating loss in the business in which the fixed asset or goodwill is involved or net cash outflow from the operating activities of that business, combined with either past operating losses or net cash outflows from such operating activities or an expectation of continuing operating losses or net cash outflows from such operating activities
- a significant decline in a fixed asset's market value during the period
- evidence of obsolescence or physical damage to the fixed asset
- a significant adverse change in:
    - the business or the market in which the fixed asset or goodwill is involved, such as the entrance of a major competitor
    - the statutory or other regulatory environment in which the business operates
    - any 'indicator of value' (for example turnover) used to measure the fair value of a fixed asset on acquisition
- a commitment by management to undertake a significant reorganisation
- a major loss of key employees
- a significant increase in market interest rates or other market rates of return that are likely to affect materially the fixed asset's recoverable amount.

In the current economic environment, it is likely that a number of clients will face circumstances which may indicate that impairment has taken place. In that case they need to perform an impairment review.

An impairment review should comprise a comparison of the carrying amount of the fixed asset or goodwill with its recoverable amount (the higher of net realisable value and value in use).

The value in use of a fixed asset is the present value of the future cash flows obtainable as a result of the asset's continued use, including those resulting from its ultimate disposal. In practice, it is not normally possible to estimate the value in use of an individual fixed asset: it is the utilisation of groups of assets and liabilities, together with their associated goodwill, that generates cash flows. Hence value in use will usually have to be estimated in total for groups of assets and liabilities. These groups are referred to as income-generating units.

The expected future cash flows of the income-generating unit, including any allocation of central overheads but excluding cash flows relating to financing and tax, should be based on reasonable and supportable assumptions. The cash flows should be consistent with the most up-to-date budgets and plans that have been formally approved by management. Cash flows for the period beyond that covered by formal budgets and plans should assume a steady or declining growth rate.

Example

Your client is a company providing various services to local and national businesses. They started in business six years ago by purchasing an unincorporated business - the goodwill that arose on that transaction is being amortised over ten years. After four good years the directors both had new cars and then the slide began.

Extracts from their draft accounts show the following:

Turnover	£5,800,000
Loss before tax	£20,200
Depreciation and amortisation	£149,000
Loan and other interest	£62,000

Fixed assets (at net book value):	
Office furniture	£302,000
Motor vehicles	£154,000
Goodwill	£40,000
Net current assets	£23,000
Long term loans (at 10%)	£400,000
Share capital	£1,000
Profit and loss account	£118,000

The directors predict that profitability will slowly improve and have made the following projections of cash flows before interest and tax:

Year	Cash flow
1	10,000
2	20,000
3	30,000
4	40,000

Thereafter they suggest cash flows will grow at 5% per annum.

In order to establish a discount rate you ask the directors whether they are aware of a similarity to any listed company and they proudly say that they see themselves as a mini version of PQR plc. You establish that PQR has a dividend yield of 4.6% and their historic growth rate in dividends is 8%. PQR are financed by 80% equity and 20% debt. PQR pays loan interest at 8% and suffers tax at 30%.

Are the assets impaired?

FRS 5 ANG/UITF 40: Revenue recognition

Situation 1

Your client AGH Ltd organises golfing holidays in Europe. Their brochure for 2009 is published in July 2008 and they get a large number of bookings for 2009 in the months leading up to the company year-end of 31 December 2008.

When a booking is received, AGH will immediately begin to arrange all elements of the trip including flights, transfers, hotels and even tee times. A confirmation will be sent to the customer when the arrangements have been concluded – usually within two weeks of the booking being received.

AGH has an accounting policy which is to recognise revenue on the date of departure. Is this acceptable?

Situation 2

BRC Ltd are recruitment consultants. They provide for interview a number of suitable candidates for various positions at their clients. BRC's terms and conditions state that the recruitment fee is payable on the commencement of employment. However, in the event that the employee leaves or proves to be unsuitable within one month then the fee will be refunded in full. There is then a sliding scale of refunds over the next six months.

When should BRC Ltd recognise income:

(a) On offer of employment?
(b) On acceptance of offer?
(c) On commencement of employment?
(d) 1 month after commencement of employment?
(e) 6 months after commencement of employment?

Situation 3

CPM Ltd produces quality plastic mouldings. They also design and produce tools to meet their customers' requirements. In this case, the customer will pay for and own the tool but usually CPM will retain the tool beyond the first production run in order to be able to meet future needs.

Most of CPM's work is produced to order. However, where a customer, for example, asks for a production run of 1,000 to meet their immediate needs, CPM may well produce, say 5000 units in order to achieve economies of scale. In this case, the excess units will be retained in stock to meet possible future orders. Generally, this approach works well but occasionally repeat orders are not received and CPM are left with surplus stock which has no other market.

CPM recognise revenue on delivery of goods and use a standard costing system to value all work-in-progress and finished goods. Is this acceptable?

SUMMARY OF DEVELOPMENTS

This section of the notes is designed to give you an overview of all recent developments announced by the various bodies under the control of the Financial Reporting Council (FRC). The bodies concerned are:

Accounting Standards Board (ASB)
Urgent Issues Task Force (UITF)
Financial Reporting Review Panel (FRRP)
Auditing Practices Board (APB)

Relevance of 'True and Fair' concept confirmed
The Financial Reporting Council has today published an Opinion by Martin Moore QC that confirms the continued relevance of the 'true and fair' concept to the preparation and audit of financial statements following the enactment of the Companies Act 2006 and the introduction of international accounting standards.

The 'true and fair' concept has been a part of English law for many decades and was the subject of two important Opinions written by Lord Hoffmann and Dame Mary Arden. Since those Opinions were written, there have been some significant changes in accounting standards and company law which have led some to question whether the views expressed in those Opinions remain applicable.

In his opinion, Mr Moore has endorsed the analysis in the Opinions of Lord Hoffmann and Dame Mary Arden and confirmed the centrality of the true and fair requirement to the preparation of financial statements in the UK, whether they are prepared in accordance with international or UK accounting standards.

In the future, the FRC and those of its operating bodies with responsibilities for accounting and auditing (i.e. the Accounting Standards Board, the Auditing Practices Board, the Financial Reporting Review Panel, the Professional Oversight Board and the Accountancy and Actuarial Discipline Board) will have regard to Mr Moore's Opinion.
19 May 2008

Financial Reporting Review Panel announces approach to qualified accounts

The FRRP has today announced its approach to the review of accounts whose audit report is qualified for failure to comply with the Companies Act 1985.

Last year the FRRP published a consultation paper in which it asked whether auditors would voluntarily report to the FRRP when they qualify a set of accounts. The responses are summarised in the Appendix to the press notice, and it can be seen that auditors were unwilling to make such a report. The FRRP has therefore arranged for other means of notification of qualified audit reports on accounts that fall within the Panel's remit. So far the FRRP has received notification of over 740 qualified accounts. All the companies involved, while substantial businesses, are private limited entities. In some cases they are subsidiaries of traded entities.

The FRRP is writing to more than 50 of the companies concerned, drawing attention to the directors' responsibilities under the Companies Act to prepare accounts that comply with the law and accounting standards. The FRRP will tell directors that, at this stage it will not be opening an enquiry into the accounts which have caused it to write, but the FRRP will review their next set of accounts and will take appropriate action in accordance with its operating procedures if the qualification remains.

The FRRP has power to apply to the court for an order seeking the revision of defective accounts. To date the FRRP has managed to agree appropriate resolution of issues raised with companies without recourse to court action. However the FRRP will be pointing out to directors that if the FRRP is successful in obtaining an order of the court requiring directors to prepare revised accounts it is open to the court to order that the costs of the action and the revision should be paid by the directors personally if they were party to the approval of the defective accounts.

The FRRP has a clear interest in company accounts which are qualified by their auditors for breach of accounting requirements. This is a strong indicator that the financial statements may not be properly prepared in accordance with the law and do not give a true and fair view.

The FRRP hopes that this approach will encourage directors who presently prepare accounts that do not comply with the law to address the non-compliance so that neither the audit qualification nor an FRRP enquiry is necessary in future.

Bill Knight, the FRRP Chairman said:

"The FRRP exists to enforce compliance with the law and accounting standards. We are giving directors of companies with qualified accounts an opportunity to put matters right. We are writing to some of the companies concerned, but our warning applies to all of them and, in future, we will not hesitate to take appropriate action where such qualified accounts come to our attention, whether or not we have previously written to the company concerned."

5 June 2008

ASB chooses enhanced disclosure as a way forward in Accounting for Heritage Assets

The Accounting Standards Board (ASB) has today issued a revised Financial Reporting Exposure Draft (FRED) that aims to improve the quality of the financial reporting of heritage assets. It applies to museums, galleries and other entities that house historic collections of art, antiques and books, or that own or manage land or buildings with important environmental or historical qualities.

The main feature of the proposals is that enhanced disclosures should apply to all entities that hold heritage assets, regardless of whether these assets are reported in the balance sheet. These disclosures should provide readers with an understanding of the asset values being reported as well as the entity's policies for managing its total holding of heritage assets.

The proposals also require heritage assets to be reported in the balance sheet where information is available on cost or value. The ASB remains of the view that heritage assets are assets and that the best financial reporting is secured when they are reported as such in the balance sheet.

Announcing the issue of FRED 42 'Heritage Assets', Ian Mackintosh, Chairman of the ASB, said:

"Accounting for heritage assets presents some very difficult and challenging issues and, having considered a number of alternative approaches, we are not persuaded there is a better accounting solution than the current FRS 15 based requirements. We do, however, expect the proposed enhanced disclosures to significantly improve the financial reporting of heritage assets and thereby contribute to better financial management in this important sector."

11 June 2008

ASB issues updated version of the FRSSE

The Accounting Standards Board (ASB) has today issued an updated version of the Financial Reporting Standard for Smaller Entities (FRSSE) to reflect changes in company law arising from the Companies Act 2006. No changes are being made to the requirements that are based upon Generally Accepted Accounting Practice.

The updated FRSSE applies to accounting periods beginning on or after 6 April 2008; the date from which the accounting and reporting regime for smaller companies in the 2006 Act becomes effective. Early adoption is not permitted; hence smaller companies should continue to use the FRSSE (effective January 2007) for earlier accounting periods.

The main impact of the 2006 Act is to set out the accounting and reporting requirements for small companies in a separate regulation. This is largely a tidying- up exercise with few substantive changes being made. Where changes have been made, the most significant include a 20 per cent increase in the thresholds for qualifying as a smaller company; a requirement to report separately political donations and charitable donations; and an increase in the threshold for reporting these donations to £2,000.

12 June 2008

APB issues Draft Guidance on the Audit of Credit Unions in the United Kingdom

The Auditing Practices Board (APB) has published a consultation draft of Practice Note (PN) 27 'The audit of credit unions in the United Kingdom'.

The draft PN 27 has been prepared to:

- provide guidance to auditors on the application of ISAs (UK and Ireland) to the audit of the financial statements of credit unions in the United Kingdom; and
- provide guidance to auditors on the various legal and regulatory requirements relating to credit unions, both in Great Britain and in Northern Ireland.

25 June 2008

ASB seeks views on proposed Improvements to Financial Reporting Standards

The Accounting Standards Board (ASB) has today issued a Financial Reporting Exposure Draft (FRED) of Improvements to Financial Reporting Standards.

The amendments proposed in the FRED arise as a consequence of the International Accounting Standards Board's (IASB) annual improvements process. In May 2008 the IASB issued an International Financial Reporting Standard, 'Improvements to IFRSs', which made amendments to a number of International Financial Reporting Standards (IFRS).

The ASB is issuing this FRED which seeks to maintain the existing levels of convergence between UK and International Financial Reporting Standards. The proposals set out in the FRED include the same improvements to UK FRS as those made to IFRS where the UK standard is based on its international equivalent.

In addition to the improvements arising from the IASB's annual improvements process the ASB has taken this opportunity to propose improvements to UK FRS which have been brought to its attention; to update UK IFRS-based FRS where the equivalent IFRS has been amended or updated; and finally to update UK FRS for editorial changes.

26 June 2008

Combined Code

The Combined Code on Corporate Governance sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders.

All companies incorporated in the UK and listed on the Main Market of the London Stock Exchange are required under the Listing Rules to report on how they have applied the Combined Code in their annual report and accounts. Overseas companies listed on the Main Market are required to disclose the significant ways in which their corporate governance practices differ from those set out in the Code.

The Combined Code contains broad principles and more specific provisions. Listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions or - where they have not - to provide an explanation.

The Combined Code was first issued in 1998 and has been updated at regular intervals since then. At present two versions are in effect: the 2006 edition, which applies to accounting periods beginning on or after 1 November 2006; and the June 2008 edition which applies to applies to accounting periods beginning on or after 29 June 2008.

The June 2008 edition incorporates changes made following a review of the impact and effectiveness of the Code held during 2007.

The changes:

- remove the restriction on an individual chairing more than one FTSE 100 company; and
- for listed companies outside the FTSE 350, allow the company chairman to sit on the audit committee where he or she was considered independent on appointment.

The June 2008 edition of the Code took effect at the same time as new FSA Corporate Governance Rules implementing EU requirements relating to corporate governance statements and audit committees. There is some overlap between the Rules and the Code, which is summarised in the Schedule to the Code. The full Rules can be found on the FSA website.

Associated guidance
The Turnbull guidance, which provides guidance to companies on how to apply the section of the Combined Code dealing with internal control (section C.2), can be found at www.frc.org.uk/corporate/internalcontrol.cfm
In addition the Higgs and Smith reports contain best practice guidance relating to non-executive directors and audit committees respectively. While company boards are not required to follow this guidance, it is intended to assist boards when implementing the relevant provisions of the Code.

As a result of the recommendations of the Market Participants Group looking at choice in the audit market, the FRC has recently consulted on possible amendments to the Smith guidance. Responses to the consultation are still being considered, and the outcome will be announced as soon as possible.
27 June 2008

Disclosure of off-balance sheet arrangements
The Accounting Standards Board's Urgent Issues Task Force (UITF) has been addressing the issue of what is the legal definition of an off-balance sheet arrangement.

The UITF received an enquiry expressing concern that the new requirement regarding off-balance sheet disclosures set out in section 410A of the Companies Act 2006, does not define off-balance sheet arrangements. Without such a definition, companies would not have clarity as to the adequacy of disclosures made to comply with the Act.

Section 410A of the Act applies to companies (other than small companies) that prepare their accounts in accordance with either the Companies Act and UK Financial Reporting Standards or International Financial Reporting Standards as adopted by the EU. The requirements for disclosures of off-balance sheet arrangements are derived from an EU Directive (2006/46/EC). This Directive arose from an Action Plan announced in May 2003, after the Enron and Parmalat scandals, which gave short-term priority to increasing inter-alia the transparency of off-balance sheet arrangements.

The UITF points out that the Department for Business, Enterprise and Regulatory Reform (BERR) has recently issued guidance on accounting and reporting provisions of the Companies Act 2006. The guidance includes a non-exhaustive list, extracted from the EU Directive, of the types of transaction that the EC envisaged for disclosure when the legislation was enacted. Recital 9 of the Directive states:

Such off-balance-sheet arrangements could be any transactions or agreements which companies may have with entities, even unincorporated ones, that are not included in the balance sheet. Such off-balance-sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address, inter alia, economic, legal, tax or accounting objectives. Examples of such off-balance-sheet arrangements include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase agreements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate companies and unincorporated entities, pledged assets, operating leasing arrangements, outsourcing and the like. Appropriate disclosure of the material risks and benefits of such arrangements that are not included in the balance sheet should be set out in the notes to the accounts or the consolidated accounts.

Neither the Directive nor, as a consequence, the Companies Act has provided a definition of an 'off-balance sheet arrangement'. The UITF agrees with the concern regarding the clarity of the requirements but concluded that it could not issue an Abstract without such a definition being in place. The UITF does, however, make the following points by way of guidance:

- when a company provides disclosures in accordance with s410A it should consider the types of transactions envisaged by the EC (as quoted above) and the aim of the legislation;
- s410A applies only where, at the balance sheet date, the risks or benefits arising from arrangements are material;
- disclosure need only be given to the extent necessary for enabling the financial position of the company to be assessed; and
- some Financial Reporting Standards, for example FRS 5 'Reporting the substance of transaction' and SSAP 21 'Accounting for leases and hire purchase contracts', require disclosures that address items not necessarily included in the balance sheet. Consequently companies are already required to provide some disclosures regarding off-balance sheet arrangements. Companies will, in addition, need to

consider whether arrangements outside of the scope of these standards require disclosure in accordance with s410A.

30 June 2008

FRC launches Complexity Project

The Financial Reporting Council has launched a project to review the complexity and relevance of current company reporting requirements.

The increasing size and complexity of company reports has become a subject of growing concern among investors, accountants, auditors and others with an interest in clear and relevant corporate reporting. Yet, attempts to date to simplify or streamline reporting requirements have often been met with stiff resistance from one or more groups of stakeholders.

Ian Wright, the FRC's Director of Corporate Reporting, and head of the project, says:

"We need to offer a vision of less complexity that stakeholders support so we can begin to move in the right direction."

The FRC, the UK's independent regulator responsible for promoting confidence in corporate reporting and governance, has identified the complexity issue as one of the more serious threats to confidence.

Following consultation with stakeholders earlier this year, the FRC has set up a project "to address the risk that corporate reporting requirements, and related influential guidance, are contributing to the increasing complexity of reports without making them more useful or understandable." The scope of the project includes requirements relating to financial statements, accompanying management commentary and other reports.

Ian Wright says: "As a first goal, we would like to understand the causes of complexity in corporate reporting and engage the community in a debate about how to stop complexity increasing further. To achieve this we need to understand the different perspectives of finance teams, directors, investors and analysts – what is it they find complex in what they do?"

The project team is initially seeking input from anyone who has suggestions about how to address the problem, and welcomes comments from all quarters. The team has an extensive consultation programme with key groups and individuals who prepare, present and read corporate reports.

The project team aims to publish a Discussion Paper later this year.

The project is being supported by a Complexity Advisory Panel – a group of senior executives experienced in the world of preparing, communicating and analysing corporate information – which held its first meeting on Tuesday, 15 July.

18 July 2008

Discussion Paper 'The Financial Reporting of Pensions'

The Accounting Standards Board (ASB) is delighted with the volume and quality of responses it has received to the discussion paper 'The Financial Reporting of Pensions'.

The paper was issued in January 2008 with the aim of stimulating debate and influencing international opinion on the reporting of pensions. The paper was published under the Pro-active Accounting Activities in Europe (PAAinE) initiative by the ASB, the European Financial Reporting Advisory Group (EFRAG) and a number of other European standard-setters. In developing the paper, the ASB was assisted by its Pensions Advisory Panel and a PAAinE working group.

To date over 90 responses have been received. The ASB is delighted with this level of response and considers the paper has achieved its first objective of stimulating debate.

The ASB will now spend some time considering the responses. It will also discuss the matters raised in the responses with interested parties. Redeliberation of the proposals set out in the discussion paper are expected to commence in September 2008.

A report setting out final recommendations for consideration by the IASB and FASB is not anticipated until the second half of 2009.

28 July 2008

Findings of the Financial Reporting Review Panel in respect of the accounts of The Investment Company PLC for the years ended 31 March 2007 and 31 March 2006

The Financial Reporting Review Panel ("the Panel") has had under review the report and accounts of The Investment Company PLC ("the company"), for the years ended 31 March 2007 and 31 March 2006.

The Panel's principal concern in both years was the treatment of the company's participating preference shares ("PPS") and the use in the March 2007 accounts of the provisions of IAS 1 "Presentation of Financial Statements" to support departure from the requirements of IAS 32 "Financial Instruments: Disclosure and Presentation".

The Panel found that the departure from paragraphs 28, 29 and 31 of IAS 32 in treating the PPS as equity instruments in the March 2007 accounts was not justified by the circumstances of the case and that a similar presentation in the March 2006 accounts did not comply with IAS 32 as it was based on a superseded version of the standard.

Treatment of the Participating Preference Shares

The PPS are non-redeemable instruments that entitle the holders to a fixed net cash dividend at the rate per annum of 7p per share. In addition, the holders are entitled to a participating dividend at the rate of 25% of any dividends paid on Ordinary shares in excess of 2p per share for any year, subject to a maximum participating dividend in respect of any year of 3p net per share.

Under IAS 32 (as revised in 2003), ("IAS 32"), which was applicable for accounting periods beginning on or after 1 January 2005, the PPS fall to be treated as compound financial instruments with both an equity and liability component. The value of the equity component is the residual amount after deducting the separately determined liability component from the fair value of the instrument as a whole.

Presentation in accordance with IAS 32 would have resulted in substantially all of the carrying value of the PPS being allocated to the liability component and the fixed net cash dividend being treated as an expense in profit and loss. The board, however, considered that this treatment would not fairly present the substance of the PPS as permanent capital in the company with participation in the future income and gains arising and would be so misleading that it would conflict with the objective of financial statements set out in the Framework for the Preparation and Presentation of Financial Statements.

The Panel found that the circumstances did not constitute an extremely rare case where compliance with a standard would be so misleading as to require departure from the requirements of paragraphs 28, 29, 31 of IAS 32. A fair presentation could have been achieved through full recognition of the liability component in compliance with the standard, supplemented by disclosures explaining the characteristics and permanent nature of the instruments.

The directors have accepted the Panel's findings and in the accounts for the year to 31 March 2008 published today have corrected the treatment of the PPS by way of a prior period adjustment. The accounts also include disclosures explaining that the departure from the requirements of IAS 32 in the presentation of the PPS as equity did not comply with paragraph 17 of IAS 1.

The company also discloses that the PPS were incorrectly accounted for in the accounts for the year ended 31 March 2006 where they were accounted for as equity in accordance with an earlier version of IAS 32 that was not applicable to the period in question.

The disclosures explain that the PPS should also have been treated in accordance with IAS 32 (as revised in 2003) in the 2006 accounts and that the statement in the original accounts that their presentation as equity instruments was in accordance with IAS 32 was incorrect.

Compliance with IAS 32 in the accounts to 31 March 2007 would have reduced net assets and shareholders' funds from £10,250,900 to £7,753,497 (2006: £10,456,336 to £7,958,933) and reduced net revenue after taxation of £349,201 (2006: £342,855) to a net loss after taxation of £435 (2006: £50,181).

The Panel also welcomes the revised accounting policy for the treatment of gains and losses on disposal of non-current asset investments. The original policy, adopted in both the March 2006 and 2007 accounts, of recognising the gain or loss on disposal in a capital reserve did not comply with IAS 39 "Financial Instruments: Recognition and Measurement" which requires the gain or loss on disposal to be recognised in profit or loss. The directors have corrected the treatment by way of a prior period adjustment.

The Panel welcomes the actions taken by the directors today in making the required adjustments and disclosures in the published accounts for the year to 31 March 2008, and regards its enquiry, started on 14 May 2008, as closed.
8 August 2008

ASB issues Amendment to FRS 25 'Financial Instruments: Presentation'
The Accounting Standards Board (ASB) has today issued an amendment to Financial Reporting Standard (FRS) 25 (IAS 32) 'Financial Instruments: Presentation', to change the classification from liabilities to equity of certain financial instruments.

The amendment relates to the liability-equity classification requirements of FRS 25 for puttable financial instruments. The amendments require equity classification for certain puttable financial instruments and for certain financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. These changes are in line with those made to IAS 32 by the IASB in February 2008 and, upon implementation, would ensure that no divergence between FRS 25 and IAS 32 occurs.

The amendment contained in this document will be effective for accounting periods beginning on or after 1 January 2010. Early adoption is only permitted for accounting periods beginning on or after 1 January 2009, the earliest date on which EU adoption is expected. The Board wanted to ensure that there were no discrepancies between EU-adopted IFRS (International Financial Reporting Standards) and UK GAAP (Generally Accepted Accounting Standards). As a result, the implementation date is later than that proposed in the exposure draft to allow for EU-adoption of the amendment to IAS 32 into the EU-adopted IFRS.
14 August 2008

FURTHER COMMENTS ON ACCOUNTING ISSUES ARISING FROM COLD FILE REVIEWS

FRS 10: Intangible fixed assets
A readily ascertainable market value is defined in paragraph 2 of FRS 10 as:

The value of an intangible asset that is established by reference to a market where:

- the asset belongs to a homogeneous population of assets that are equivalent in all material respects; and
- an active market, evidenced by frequent transactions, exists for that population of assets.

The brand name fails on both of these conditions. Brand names are, by their nature, unique and cannot possibly belong to a homogeneous population. Similarly, one transaction does not mean that there are frequent transactions.

The brand name should not be revalued.

FRS 11: Intangible fixed assets
Extracts from the standard
The present value of the income-generating unit under review should be calculated by discounting the expected future cash flows of the unit. The discount rate used should be an estimate of the rate that the market would expect on an equally risky investment. It should exclude the effects of any risk for which the cash flows have been adjusted and should be calculated on a pre-tax basis.

Estimates of this market rate may be made by a variety of means including reference to:

- the rate implicit in market transactions of similar assets;
- the current weighted average cost of capital (WACC) of a listed company whose cash flows have similar risk profiles to those of the income- generating unit; or
- the WACC for the entity but only if adjusted for the particular risks associated with the income-generating unit.

To the extent that the carrying amount of the income-generating unit exceeds its recoverable amount, the unit is impaired. In the absence of an obvious impairment of specific assets within the unit, the impairment should be allocated:

- first, to any goodwill in the unit;
- thereafter, to any capitalised intangible asset in the unit; and
- finally, to the tangible assets in the unit, on a pro rata or more appropriate basis.

Comments on the example
The comments that follow are extremely subjective and I do not guarantee that everything in this worked example would stand up to strict academic scrutiny. However, it does give a flavour of what the FRS requires.

Discount rate using the listed company:
Using the dividend model with growth we have the formula:
Cost of equity = (Next years dividend/current price) + growth rate
This gives us cost of equity = 4.6% x 1.08 + 8% = 13% approx
This, however, is a post-tax rate and needs to be adjusted to a pre-tax rate by dividing by .70. This gives 18.5%.
The cost of debt for the listed company is given as 8% so the weighted average is:
WACC = 0.8 x 18.5% + 0.2 x 8% = 16.4%

Discount rate for the company
The company's own weighted average cost of capital is difficult since they are not using equity capital. However, it may well be appropriate to use the rate for the loan - 10%. Note that this is already a pre-tax rate. In the workings that follow, I shall use 15% as a compromise.

Discounted cash flows
The first step is to discount the cash flows for years 5 to perpetuity. This is based on the following formula (which can be derived from the sum of a geometric progression to infinity):

Present value at year 0 = year 1 cash flow/(discount rate - growth rate)

Which adapted to year 5 gives

Present value at year 4 = (year 5 cash flow)/(discount rate – growth rate).

The real growth rate is restricted to 2.25% by the standard. However, after allowing for inflation at say 3% the actual maximum growth rate permitted is about 5.3%. Therefore, since it is lower, use the directors' figure of 5%.

So we obtain (40,000 x 1.05)/(.15 - .05) = £420,000.

Now we can do the final NPV calculation

Year	Cash flow	Discount rate (@ 15%)	Present value
1	10,000	0.87	8,700
2	20,000	0.76	15,200
3	30,000	0.66	19,800
4	420,000 +40,000	0.57	262,200
Total			£305,900

The book values were:

Office furniture	£302,000
Motor vehicles	£154,000
Goodwill	£40,000
Net current assets	£23,000
Total net assets	£519,000

Giving a required write down of £213,100

The goodwill is written down first. This leaves a further £173,100 to be spread pro-rata between office furniture and motor vehicles. However, it transpires that the market value of the motor vehicles exceeds their book value so this value is not impaired. Therefore office furniture is written down by £173,100 to £128,900.

The loss before tax is increased by £213,100 to £233,300.

The client is hardly likely to be happy that a moderately poor year should now be portrayed as a disaster. Further, the bank manager will be reaching for the rug to pull it out from under the client's feet. And all of the above are based on projected figures.

Note for example, that if the client had been more confident in their projections and had suggested cash flows over the next four years of £10,000, £30,000, £50,000 and £70,000 followed by 5% growth, then the NPV would have been about £524,000 and no impairment would have occurred!

FRS 5 ANG/UITF 40: Revenue recognition

Situation 1
"Date of departure" is a common policy used in the industry. Presumably the argument in favour of this approach is that the benefit to the customer is the holiday itself and that there is no benefit if the holiday is not taken.

However, I have doubts about this policy in the situation being discussed. AGH are not delivering a holiday to the customer. It is for the airline, hotel and golf courses to deliver the various elements of the holiday. AGH are delivering an administrative service which is virtually complete within two weeks of the booking. Under UITF 40, this means that almost the entire revenue should be recognised when the holiday is confirmed.

Situation 2
The normal application of UITF 40 would imply that revenue should be taken once all elements of the service have been provided – namely at stage (a) or (b).

However, the existence of a contingent event (does the employee turn up for work on day 1?) means that revenue should not be recognised until that event occurs (stage (c)).

Companies wishing to increase revenues may argue that the contingency has been resolved in the post-balance sheet period because all contingent income at the balance sheet date has either been confirmed or otherwise by events which occurred after the balance sheet date and before the accounts were approved. The Urgent Issues Task Force have confirmed that this argument is not valid and the position taken at the balance sheet date should not be amended following the resolution of the event in the post balance sheet period (see Inside Track No 56).
Conversely, companies wishing to reduce revenues may argue that the true contingency occurs when the guarantee period of 1 month has passed (stage (d)). In my opinion, this argument is incorrect. I would consider that the supply of an unsatisfactory employee is, in essence, no different from the supply of a defective product. Revenue should be taken on delivery with a provision for expected returns.

The problem that has not been resolved by the UITF is whether the costs incurred in providing a service should be included in the balance sheet as work-in-progress while awaiting the outcome of the contingent event.

Situation 3
It is tempting to think that UITF 40 does not affect a situation where a product is involved – as is the case for CPM which produces plastic mouldings. However, in my view, this conclusion would be incorrect.

There are two arguments that can be put forward to support my view:

1. The fact that CPM is producing items to the specification of its customer means that, in the widest sense of the term, this is a service. Therefore UITF 40 applies. Further support for this view is provided by the example in the CCAB guidance on UITF 40 concerning the joiner building a book-case to a customer's specification.

2. FRS 5 Application Note G paragraph G6 states the general principle: "A seller may obtain a right to consideration when some, but not all, of its contractual obligations have been fulfilled. Where a seller has partially performed its contractual obligations, it recognises revenue to the extent that it has obtained the right to consideration through its performance." There is no reference in AN G to products or services and therefore we must assume that the same principals apply to both situations.

In the case of CPM Ltd, I would suggest that any items produced to order should be recognised in the accounts as "amounts recoverable on contracts". They will be included in turnover and debtors at the fair value of the right to consideration based on the stage of processing that has been reached.

Where additional items are produced in the interests of efficiency then these should be included as work-in-progress or, on completion as finished goods, and valued at cost under SSAP 9.

FURTHER REFERENCE MATERIAL

Reference to course material	**Web references to obtain further detail** Note that what appear to be gaps in any of these addresses are in fact underscores (_)
SI 2007/3495: Companies Act Fifth commencement order	http://www.opsi.gov.uk/si/si2007/uksi_20073495_en_1
SI 2008/1886: Companies Act Seventh commencement order	http://www.opsi.gov.uk/si/si2008/uksi_20081886_en_1
ICAEW Audit regulations and guidance 2008	http://www.icaew.com/index.cfm?route=155206
Access to information by successor auditors - draft guidance from ICAEW Audit Faculty	http://www.icaew.com/index.cfm?route=157247
Liability limitation agreements: Final guidance from FRC	http://www.frc.org.uk/images/uploaded/documents/FRC%20ALLA%20Guidance%20June%202008%20final4.pdf
Bulletin 2008/06: Senior Statutory Auditor	http://www.frc.org.uk/apb/publications/pub1592.html
Inside Track – the magazine of the Accounting Standards Board	http://www.frc.org.uk/asb/publications/insidetrack.cfm
Summary of developments: more details may be accessed from the list of press releases on the FRC website using this address Or more conveniently, go to the FRC homepage and follow the links to the body you are interested in	http://www.frc.org.uk/press/ http://www.frc.org.uk/index.cfm
FRED 42: Heritage assets	http://www.frc.org.uk/asb/publications/
Changes to the combined code	http://www.frc.org.uk/corporate/2007review.cfm/
FRSSE 2008	www.frc.org.uk/asb/technical/frsse.cfm/
Combined code	www.frcpublications.com/
Turnbull guidance	www.frc.org.uk/corporate/internalcontrol.cfm/