TABLE OF CONTENTS

Related Party Transactions..2

(Lecture A248)

IFRSSME & FRSSE 2008...7

(Lecture A249)

Determining The Size Of Companies And Groups..11

(Lecture A250)

Exposure Draft Of Proposed Revisions To ISA (UK And Ireland) 700: The Auditor's Report On Financial Statements 21

(Lecture A252)

Bulletin 2008/08: Auditor's Reports For Short Accounting Periods In Compliance With Companies Act 2006 24

Bulletin 2008/9: Miscellaneous Reports By Auditors Required By Companies Act 2006 26

Consultation: should UK and Irish Auditing Standards Be Updated For New IASs? ..26

(Lecture A251)

ISQC 1 Quality Control..31

(Lecture A253)

The Audit Of Related Parties: Draft Guidance From The Audit And Assurance Faculty 40

(Lecture A248)

Summary Of Developments 41

(Lecture A254)
(Lecture A255)

Related Party Transactions

(Lecture A248 20.14 minutes)

Introduction

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 contain in paragraph 72(5) of schedule 1 the statement that in paragraph 72, the term "related party" has the same meaning as in international accounting standards.

This means that the ASB must amend FRS 8 to align the definition of a related party in UK standards with the definition in the International standard IAS 24. Without such an amendment to FRS 8 a conflict would arise between that standard and the Companies Act requirement.

FRED 41 was issued in 2007 and included proposals to replace FRS 8 with a Financial Reporting Standard based on the revised IAS 24. As well as ensuring consistency between the requirements of accounting standards and company law, FRED 41 was intended to improve convergence between UK and International Financial Reporting Standards.

In Inside Track Issue No 57, published in October, the ASB reported that the IASB has deferred the issue of the revised IAS 24 and as such, the ASB will now issue an amendment to FRS 8 to bring the definition of related parties into line with CA 2006.

Presumably this means that the goal of improved convergence has, for the foreseeable future, been abandoned.

The requirements of Companies Act 2006

These are contained in paragraph 72 of Schedule 1 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. This paragraph is reproduced in full below.

72.—(1) Particulars may be given of transactions which the company has entered into with related parties, and must be given if such transactions are material and have not been concluded under normal market conditions (see regulation 4(2) for exemption for medium-sized companies).

(2) The particulars of transactions required to be disclosed by sub-paragraph (1) must include—

(a) the amount of such transactions,

(b) the nature of the related party relationship, and

(c) other information about the transactions necessary for an understanding of the financial position of the company.

(3) Information about individual transactions may be aggregated according to their nature, except where separate information is necessary for an understanding of the effects of related party transactions on the financial position of the company.

(4) Particulars need not be given of transactions entered into between two or more members of a group, provided that any subsidiary undertaking which is a party to the transaction is wholly-owned by such a member.

(5) In this paragraph, "related party" has the same meaning as in international accounting standards.

For the full regulations see: http://www.opsi.gov.uk/si/si2008/uksi_20080410_en_1

Reminder of some of the key issues in FRS 8/FRSSE

As indicated above, it now seems that the only part of FRS 8 (and therefore the FRSSE) which will change is the definition. This is therefore a good time to remind ourselves of some of the problem areas that can arise when dealing with related parties. We will do this by a series of example case studies.

Definition of related party

ABC Ltd is owned equally by A, B and C who are also the three directors of the company.

ABC and Co is a partnership in which A, B and C are the three equal partners.

A Ltd is owned entirely by A who is also the sole director of the company.

a) Will the partnership be treated as a related party in the accounts of ABC Ltd?

b) Will A Ltd be treated as a related party in the accounts of ABC Ltd?

c) Will ABC Ltd be treated as a related party in the accounts of A Ltd?

Control disclosures

a) The sole director of A Ltd is Mrs A. The shares are owned equally by Mrs A and her husband. What control disclosure is required in the accounts?

b) The directors of B Ltd are Mr and Mrs B. They each own 50% of the shares in the company. What control disclosure is required in the accounts?

c) The directors of C Ltd are Mr X, Mrs Y and Ms Z who are not members of the same family. They each own one third of the shares in the company. What control disclosure is required in the accounts?

Disclosure of related party transactions

Assuming audit materiality of £25,000, are these disclosures appropriate?

a) During the year, the company sold goods to a value of £726,000 to subsidiaries.

b) During the year, the company sold goods to a value of £72,000 to companies controlled by Mr I Smith, a brother of Mr J Smith, the managing director and major shareholder of X Ltd.

c) During the year the company sold a motor vehicle to Ms M Smith the daughter of Mr J Smith the managing director and major shareholder of the company. The price charged was £10,000.

d) During the year, the company occupied premises owned by Mrs N, a director and major shareholder of the company. The deal was negotiated on an arm's length basis and the rent paid was £42,000 - a rent which the directors consider to be a market rent.

e) The total amount of dividends paid to directors during the year was £52,000.

f) Directors incurred expenses on behalf of the company and were reimbursed by the company for this expenditure. The total amount paid to directors for this purpose was £32,000.

Limitation of scope

A potential off shore client has approached you. They are not willing to disclose in the accounts the name of the controlling parties behind the company. How do you react?

Background material: Extracts from FRS 8 (before amendment in December 2008)

When the reporting entity is controlled by another party, there should be disclosure of the related party relationship and the name of that party and, if different, that of the ultimate controlling party. If the controlling party or ultimate controlling party of the reporting entity is not known, that fact should be disclosed. This information should be disclosed irrespective of whether any transactions have taken place between the controlling parties and the reporting entity.

Financial statements should disclose material transactions undertaken by the reporting entity with a related party. Disclosure should be made irrespective of whether a price is charged. The disclosure should include:

- the names of the transacting related parties;
- a description of the relationship between the parties;
- a description of the transactions;
- the amounts involved;
- any other elements of the transactions necessary for an understanding of the financial statements;
- the amounts due to or from related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
- amounts written off in the period in respect of debts due to or from related parties.

Transactions with related parties may be disclosed on an aggregated basis (aggregation of similar transactions by type of related party) unless disclosure of an individual transaction, or connected transactions, is necessary for an understanding of the impact of the transactions on the financial statements of the reporting entity or is required by law.

Definitions

Related parties

(a) Two or more parties are related parties when at any time during the financial period:

  i. one party has direct or indirect control of the other party; or

  ii. the parties are subject to common control from the same source; or

  iii. one party has influence over the financial and operating policies of the other party to an extent that that other party might be inhibited from pursuing at all times its own separate interests; or

  iv. the parties, in entering a transaction, are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests.

(b) For the avoidance of any doubt, the following are related parties of the reporting entity:

  i. its ultimate and intermediate parent undertakings, subsidiary undertakings, and fellow subsidiary undertakings;

  ii. its associates and joint ventures;

  iii. the investor or venturer in respect of which the reporting entity is an associate or a joint venture;

  iv. directors (including shadow directors) of the reporting entity and the directors of its ultimate and intermediate parent undertakings; and

  v. pension funds for the benefit of employees of the reporting entity or of any entity that is a related party of the reporting entity;

(c) and the following are presumed to be related parties of the reporting entity unless it can be demonstrated that neither party has influenced the financial and operating policies of the other in such a way as to inhibit the pursuit of separate interests:

i. the key management of the reporting entity and the key management of its parent undertaking or undertakings;

ii. a person owning or able to exercise control over 20 per cent or more of the voting rights of the reporting entity, whether directly or through nominees;

iii. each person acting in concert in such a way as to be able to exercise control or influence over the reporting entity; and

iv. an entity managing or managed by the reporting entity under a management contract.

(d) Additionally, because of their relationship with certain parties that are, or are presumed to be, related parties of the reporting entity, the following are also presumed to be related parties of the reporting entity;

i. members of the close family of any individual falling under parties mentioned in a) - c) above; and

ii. partnerships, companies, trusts or other entities in which any individual or member of the close family in a) - c) above has a controlling interest.

Sub-paragraphs b), c) and d) are not intended to be an exhaustive list of related parties.

Related party transaction

The transfer of assets or liabilities or the performance of services by, to or for a related party irrespective of whether a price is charged.

Close family

Close members of the family of an individual are those family members, or members of the same household, who may be expected to influence, or be influenced by, that person in their dealings with the reporting entity.

Control

The ability to direct the financial and operating policies of an entity with a view to gaining economic benefits from its activities.

Key management

Those persons in senior positions having authority or responsibility for directing or controlling the major activities and resources of the reporting entity.

Persons acting in concert

Persons who, pursuant to an agreement or understanding (whether formal or informal), actively co-operate, whether by the ownership by any of them of shares in an undertaking or otherwise, to exercise control or influence over that undertaking.

Materiality

The explanation section of the FRS includes the following:

Transactions are material when their disclosure might reasonably be expected to influence decisions made by the users of general purpose financial statements. The materiality of related party transactions is to be judged, not only in terms of their significance to the reporting entity, but also in relation to the other related party when that party is:

(a) a director, key manger or other individual in a position to influence, or accountable for stewardship of, the reporting entity; or

(b) a member of the close family of any individual mentioned in a) above; or

(c) an entity controlled by any individual in a) or b) above.

Definition of a related party in FRSSE

Two or more parties are related parties when at any time during the financial period:

(a) one party has direct or indirect control of the other party; or

(b) the parties are subject to common control from the same source; or

(c) one party has significant influence over the financial and operating policies of the other party. Significant influence would occur if that other party is inhibited from pursuing its own separate interests.

For the avoidance of doubt, related parties of the reporting entity include the following:

(i) parent undertakings, subsidiary and fellow subsidiary undertakings;

(ii) associates and joint ventures;

(iii) investors with significant influence and their close families; and

(iv) directors of the reporting entity and of its parent undertakings and their close families.

Close family are those family members, or members of the same household, who may be expected to influence, or be influenced by, that person in their dealings with the reporting entity.

Comments on case studies

ABC Ltd

a) Under FRS 8, ABC would be a related party because paragraph 13 states that common control is deemed to exist where the two entities have a nucleus of directors in common. Whilst FRSSE does not contain this explanation or even a definition of common control, I think that the same principles would apply.

b) A Ltd is a related party of ABC Ltd.

c) Apparently, ABC Ltd is not a related party of A Ltd - although more information is needed.

Control disclosures

There is considerable disagreement about control disclosures.

a) Most would agree that Mrs A should be disclosed as the controlling party of company A.

b) Many would suggest that Mr and Mrs B control B Ltd.

c) Some consider that X, Y and Z should be disclosed as the controlling party of C Ltd.

Under FRSSE, there is no definition of control. If we turn to FRS 8, the problems arise from two factors. Firstly, what exactly does paragraph 2.2 mean by “with a view to gaining economic benefits from its activities”?

Secondly, the standard does not explicitly state that it requires disclosure of parties who control an entity by acting in concert.

Interestingly, the international standard does not contain a requirement for a control disclosure so our best hope is that this requirement disappears from UK GAAP in the not too distant future.

Disclosure of related party transactions

a) When using aggregation, a list of the related parties should also be given. In the case of the subsidiaries, it could be argued that these are listed elsewhere in the accounts. One other issue about the transactions with subsidiaries. These need not be disclosed in the consolidated accounts as long as the transactions have been eliminated on consolidation. The assumption in the example is that the parent, for some reason, has not prepared consolidated accounts.

b) In the case of the companies controlled by the brother, the list should appear within the related party transactions note.

c) Under FRSSE, there is no need to disclose this transaction since materiality is judged purely by reference to the company. On the other hand, if the accounts are being prepared under FRS 8, then materiality should be judged by reference to the related party as well as the company, and the transaction with Ms Smith might need to be disclosed.

d) FRS 8 presumes that transactions are at arm's length. Therefore the disclosure in this note of the arm's length nature of the transaction is unnecessary. However, the inclusion of extra information is permitted – as long as it is true! On the other hand, if a transaction has taken place at an amount materially different from that obtainable on normal commercial terms then FRS 8 indicates in paragraph 22 that this should be disclosed under the requirement to disclose "any other elements of the transactions necessary for an understanding of the financial statements".

e) The amounts paid to directors in their capacity as shareholders are rarely disclosed in company accounts. Presumably this is because preparers of accounts consider that these are not transactions which need disclosure. However, paragraph 19 of FRS 8 does include as an example of a transaction requiring disclosure "provision of finance (including loans and equity contributions in cash or in kind)". If we are required to disclose in the circumstances where a director buys shares in the company then it is surely logical to require disclosure where the director receives payment (i.e. dividends) as a result of that shareholding.

f) The amounts paid to directors to reimburse expenses are rarely disclosed in company accounts. Whilst I have no justification from FRS 8 for my opinion, I do share the view of those who think that such disclosure is not necessary. To my mind, reimbursement is not a transaction with a director but rather a means of paying a supplier.

Off-shore Ltd

An audit assignment with an imposed limitation of scope should be refused (ISA 700 paragraph 41-1). If the potential client is audit exempt, the assignment should still be refused on the grounds that the accounts would be misleading.

International Financial Reporting Standard For Small And Medium-Sized Entities (IFRSSME)

(Lecture A249 10.49 minutes)

It is reported in Inside Track Issue No 57 that the IFRSSME has been tentatively rechristened the IFRS for Private Entities. If you recall, the ASB are likely to propose that this document will become the new UK GAAP for unquoted companies.

The IASB will be discussing the remaining outstanding issues during October and November. The standard is expected to be published in the first half of 2009. If this target is met, then the ASB's plan for converting from UK GAAP by 2011 still looks to be achievable.

It is expected that the ASB will release a document shortly which will set out their latest thinking on convergence.

FRSSE 2008: CHANGES FROM FRSSE 2007

(Note that it has been confirmed that small LLPs should not use FRSSE 2008 until accounting periods beginning on or after 1 October 2008.)

Introduction

FRSSE 2008 introduces no changes to the existing accounting requirements as contained in FRSSE 2007. FRSSE 2008 merely reflects the changed legal requirements arising under CA 2006 for periods beginning 6 April 2008 onwards. FRSSE 2008 cannot be adopted early since changes in the Companies Act cannot be anticipated.

Changes

Scope

There are no significant changes concerning scope.

Companies which are able to file small company abbreviated accounts with the Registrar are able to use the FRSSE. Other entities which satisfy the criteria for a small company are also within its scope, with the exception of building societies.

Changes in FRSSE 2008 mean that the following are not permitted to use the FRSSE:

- Companies preparing individual or group accounts in accordance with IAS;
- Companies in the financial sector including e-money issuers, MiFID investment firms, and UCITS management companies. Although this is a change in the wording of the FRSSE, there is no change to the substance as none of these entities would satisfy the criteria for small under CA 06.
- Persons who have permission under Part 4 FSMA 2000 to carry on a regulated activity. Note this does not apply if the entity is a small company. This restriction applies for entities which are not companies but otherwise would satisfy the small company criteria.

General

FRSSE 2008 removes the reference to accounts being laid before the company in general meeting as there is no longer a requirement for a private company to have an AGM.

The requirement to disclose liability limitation agreements has been included. In this case, the disclosure requirements are:

- Principal terms;
- The date of the resolution approving the principal terms or the date of the resolution waiving the need for such approval.

The FRSSE indicates that the disclosures should be made in the notes. However, s538 permits the disclosure to be made in the directors' report. The regulations (SI2007/489) do not define principal terms. However, the FRC guidance indicates these as:

- 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.

Financial instruments, share capital and share based payment

The requirement to disclose authorised share capital is deleted.

Related party disclosures

Where the company is a subsidiary the requirement to disclose information concerning the parent is unchanged. However, where the parent is outside the UK the requirement to disclose the country of incorporation has added the words “if known to directors”.

The wording for transactions with directors has been changed to “Directors’ benefits: advances and credits”. This reflects the terms used in CA 06. There are a number of important changes in the disclosure of directors’ transactions resulting from CA 06.

CA 85 required the disclosure of s330 transactions with directors and those connected with directors. CA 85 s330 was replaced by CA 06 which changed the wording of the transactions and also extended those who were connected with a director. Although this change was made on 1/10/07 there was no change to the disclosure requirements, except to refer to the new sections rather than s330. It should also be remembered that the CA 85 required the disclosure of these transactions in small company abbreviated accounts.

The disclosure of these transactions was required by both CA 85 and FRS8/FRSSE (if they satisfied the definition of related party transactions). For example, a loan to the spouse of a director would have been disclosable in the annual accounts (i.e. the accounts prepared for shareholders) under both CA 85 and the related party provisions of FRS8/FRSSE. However, it is important to distinguish the requirements of CA 85 from FRS8/FRSSE when determining whether disclosure is required in abbreviated accounts. Related party transactions do not need to be disclosed in the abbreviated accounts as these do not show a true and fair view. Whereas transactions required to be disclosed in accordance with CA 85 were required to be included in the abbreviated accounts. Given the sensitivity of these disclosures this was often an important consideration.

Example. The company makes a £20,000 loan to the son of a director. How would this be disclosed in the financial statements?

From CA perspective, prior to 1 October 2007, this is not a transaction with a connected person provided the son was over 18. After 1 October 2007, it is. Therefore for any year end after 1 October 2007, where accounts are being prepared in accordance with CA 85 (that is financial years commencing before 6 April 2008) this loan must be disclosed to comply with CA 85. The loan must also be disclosed in the abbreviated accounts.

From a related party perspective under FRS 8 or FRSSE, if the son is part of the close family then the transaction would have to be disclosed. This requirement would only extend to the annual accounts and not abbreviated accounts.

For financial years commencing on or after 6 April 2008, the disclosure of these transactions will be in accordance with s413 CA 06. This section makes no reference to connected persons and, assuming no amendment is made in the future, transactions between the company and the connected persons of directors will not be disclosed to comply with the Act. However, if the transaction is a related party transaction then it would be disclosed in the annual accounts under FRS 8 or FRSSE. Note that the requirements for abbreviated accounts contained in s444(3) and the regulations do not currently contain any requirement to disclose these transactions with directors.

FRSSE 2008 requires disclosure of advances and credits granted by the company to its directors and guarantees of any kind entered into by the company on behalf of its directors. For the purposes of these disclosures, the directors of a company are the persons who were a director at any time in the financial year to which the accounts relate.

The information required for an advance or credit is:

A. Its amount;

B. An indication of the interest rate;

C. Its main conditions; and

D. Any amounts repaid.

Disclosure is also required of the total of the amounts stated under A and D.

The information required for a guarantee is:

A. Its main terms;

B. The amount of the maximum liability that may be incurred by the company (or its subsidiary);

C. Any amount paid or any liability incurred by the company (or its subsidiary) for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

Disclosure is also required of the total of the amounts stated under B and C.

The above requirements apply to any transaction which subsisted at any time in the financial year to which the accounts relate.

The previous disclosure requirements under CA 85, as included in FRSSE 2007, were similar to, but more detailed than, the above. However, any relaxation in the disclosure requirements derived from the Companies Act would generally be made irrelevant by the requirements for the disclosure of related party transactions under FRS8 or FRSSE.

CA 06 requires disclosure of transactions with directors, not with any parties they may be connected with or in which they have an interest. Therefore, the disclosure of “material interest transactions” will only be required if they are related party transactions.

Group accounts

Most parent companies heading a small group take advantage of the exemption from preparing group accounts. For those that do not, the changes are:

- A requirement to show details in group accounts of directors’ benefits from subsidiaries is not required.

- A modification for the Profit and Loss account when preparing group accounts by replacing “income from participating interests” with “income from interests in associated undertakings” and “income from other participating interests”

Directors remuneration

FRSSE 2008 uses the term directors’ remuneration rather than emoluments.

Directors’ report

Consistent with CA 06, FRSSE 2008:

- Separates political donation disclosures from charitable donation disclosures and adds a new requirement to disclose donations to an independent election candidate, with a revised threshold of £2,000 (previously £200).

- Adds new text confirming that where the company is a parent and chooses to prepare group accounts, the directors’ report must be a group report.

- Deletes the requirements to disclose directors’ interests (change occurred in April 2007)

Definitions

A revised definition of a Director’s family for legal purposes – the definition is now (A) director’s spouse or civil partner (B) any other person (whether of a different sex or the same sex) with whom the director lives as a partner in an enduring family relationship (C) the director’s children or step-children (D) any children or step-children of a person within paragraph B (and who are not children or step-children of the director) who live with

the director and have not attained the age of 18, and (E) the director's parents. The above excludes a person who is a director of the company.

Legal aspects

FRSSE 2008 includes the new thresholds for companies and groups to qualify as small. This topic is dealt with in detail later in these notes.

For a copy of FRSSE 2008, go to www.frc.org.uk/asb/technical/frsse.cfm/

Determining the size of companies and groups

(Lecture A250 13.59 minutes)

Qualifying conditions for companies and groups

For periods commencing on or after 6 April 2008, the qualifying conditions to be small are met by a company (or group) in a year if it satisfies two or more of the following requirements:

	Turnover not more than	Balance Sheet total not more than	Average Employees not more than
Company	£6.5m	£3.26m	50
Group - net	£6.5m	£3.26m	50
Group - gross	£7.8m	£3.9m	50

In order to qualify as small in any financial year (other than its first) it must:

a) Meet the qualifying conditions in the current year and the previous year; or,

b) Meet the conditions in the current year and qualify as small in the previous year; or

c) Meet the conditions in the previous year and qualify as small in the previous year.

Note that, in the case of c), it does not have to satisfy the requirements in the current period.

The above is often referred to as the "years rule" and has the effect of delaying changes in size by one year. Therefore companies which fail to meet the qualifying conditions in any year, having satisfied them in previous periods continue to qualify as small in the first year that the conditions are not met. This can be beneficial for a company which is increasing in size but has a counter effect for companies going in the opposite direction.

For a group, the limits shown above are applied to the aggregate turnover and aggregate balance sheet total which are obtained by adding together the separate figures for each member of the group.

"Net" means after set-offs and other adjustments made to eliminate group transactions whereas "gross" means without those set-offs and adjustments. A company may satisfy any relevant requirement on the basis of either the net or gross figure.

The limits shown above are the new thresholds for accounting periods beginning on or after 6 April 2008. In deciding whether a company or group qualifies on the basis of satisfying the criteria for two consecutive years, the new limits are also applied to the comparatives.

Previous limits for small companies/groups:

	Turnover not more than	Balance Sheet total not more than	Average Employees not more than
Company	£5.6m	£2.8m	50
Group - net	£5.6m	£2.8m	50
Group - gross	£6.72m	£3.36m	50

New limits for medium-sized companies/groups (with effect from periods commencing on or after 6 April 2008):

	Turnover not more than	Balance Sheet total not more than	Average Employees not more than
Company	£25.9m	£12.9m	250
Group - net	£25.9m	£12.9m	250
Group - gross	£31.1m	£15.5m	250

Previous limits for medium-sized companies/groups:

	Turnover not more than	Balance Sheet total not more than	Average Employees not more than
Company	£22.8m	£11.4m	250
Group - net	£22.8m	£11.4m	250
Group - gross	£27.36m	£13.68m	250

Application of the qualifying conditions to companies

Example 1

The following data applies to X Ltd for the three years ending on 31 March:

	2007	2008	2009
Turnover	£4.5m	£5.2m	£6m
Balance sheet total	£2.1m	£2.5m	£3m
Number of employees	40	40	40

Does X Ltd qualify as a small company for 2009?

Yes, the company qualified as small for 2008 and therefore 2009 is the first year that it fails the requirements. Therefore in accordance with the "years rule" the company would qualify as small.

Would the company be entitled to audit exemption for 2009?

No. The company may qualify as small but it fails both the turnover and balance sheet total requirements for audit exemption.

Example 2a

The following data applies to X Ltd for the three years ending on 31 March:

	2008	2009	2010
Turnover	£5.2m	£6m	£6.2m
Balance sheet total	£2.5m	£3m	£3.1m
Number of employees	40	40	40

Does X Ltd qualify as a small company for 2010?

The new limits will apply for 2010.

This also requires consideration of the transitional provisions contained in SI 393.

(3) In determining whether a company or group qualifies as small or medium-sized under section 382(2), 383(3), 465(2) or 466(3) of the 2006 Act (qualification in relation to subsequent financial year by reference to circumstances in preceding financial years) in relation to a financial year ending on or after 6th April 2008, the company or group shall be treated as having qualified as small or medium-sized (as the case may be) in any previous financial year in which it would have so qualified if amendments to the same effect as those made by these Regulations had been in force.

The application of these transitional provisions requires the company to use the new limits in 2010 in order to determine whether the previous year requirements have been met. It would have satisfied the requirements for that year and therefore for 2010 it will still be small. If the limits had not increased then the company would have changed size as this would have been the second successive year of failing to satisfy the small company requirements.

Example 2b

Suppose now that the figures for 2010 are slightly different:

	2008	2009	2010
Turnover	£5.2m	£6m	£7m
Balance sheet total	£2.5m	£3m	£4m
Number of employees	40	40	40

Does X Ltd qualify as a small company for 2010?

Although X Ltd failed to satisfy the new limits for 2010, the transitional provisions of the regulations still apply. Applying the new limits to 2009 indicates the company would have qualified as small. Therefore the requirements have been satisfied in the previous year and the company was small in that year. Therefore the company is still small for 2010. Effectively the increase in the limits has delayed the size change for another year. If the company fails the requirements next year, 2011, then the size will change.

Eligibility rules for small and medium-sized companies and groups

Companies which are members of ineligible groups cannot be small or medium sized. Similarly, a parent company of an ineligible group is not entitled to take advantage of the exemption from preparing group accounts. Eligibility can have a significant impact on financial reporting requirements. There are a number of areas where Companies Act 2006 differs from Companies Act 1985. The new rules come into force for accounting periods commencing on or after 6/4/08.

Companies Act 1985

Groups

s248

(1) A parent company need not prepare group accounts for a financial year in relation to which the group headed by that company qualifies as a small or medium-sized group and is not an ineligible group.

(2) a group is ineligible if any of its members is -

(a) A public company or a body corporate which (not being a company) has power under its constitution to offer its shares or debentures to the public and may lawfully exercise that power,

(b) a person (other than a small company) who has permission under Part IV of the Financial Services and Markets Act 2000 to carry on a regulated activity,

(ba) a small company that is an authorised insurance company, a banking company, an e-money issuer, an ISD investment firm or a UCITS management company, or

(c) a person who carries on an insurance market activity.

Individual companies

s247A (1) If a company is, or was at any time within the financial year to which the accounts relate, an ineligible company, sections 246 and 246A do not apply.

(Note that sections 246/246A contain the accounting exemptions for small and medium-sized companies)

(1A) If a company does not fall within subsection (1) but is, or was at any time within the financial year to which the accounts relate, a member of an ineligible group -

(a) section 246(4) and (5)(b) and section 246A(2A) (provisions relating to directors' report) apply;

(b) the other provisions of sections 246 and 246A do not apply.

(1B) A company that qualifies as small in relation to the financial year to which the accounts relate is ineligible if-

(a) it is a public company,

(b) it is an authorised insurance company, a banking company, an e-money issuer, an ISD investment firm or a UCITS management company, or

(c) it carries on an insurance market activity.

(1C) A company that qualifies as medium-sized in relation to the financial year to which the accounts relate is ineligible if-

(a) it is a public company,

(b) it has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on a regulated activity, or

(c) it carries on an insurance market activity.

(2) A group is ineligible if any of its members is-

(a) a public company or a body corporate which (not being a company) has power under its constitution to offer its shares or debentures to the public and may lawfully exercise that power,

(b) a person (other than a small company) who has permission under Part IV of the Financial Services and Markets Act 2000 to carry on a regulated activity,

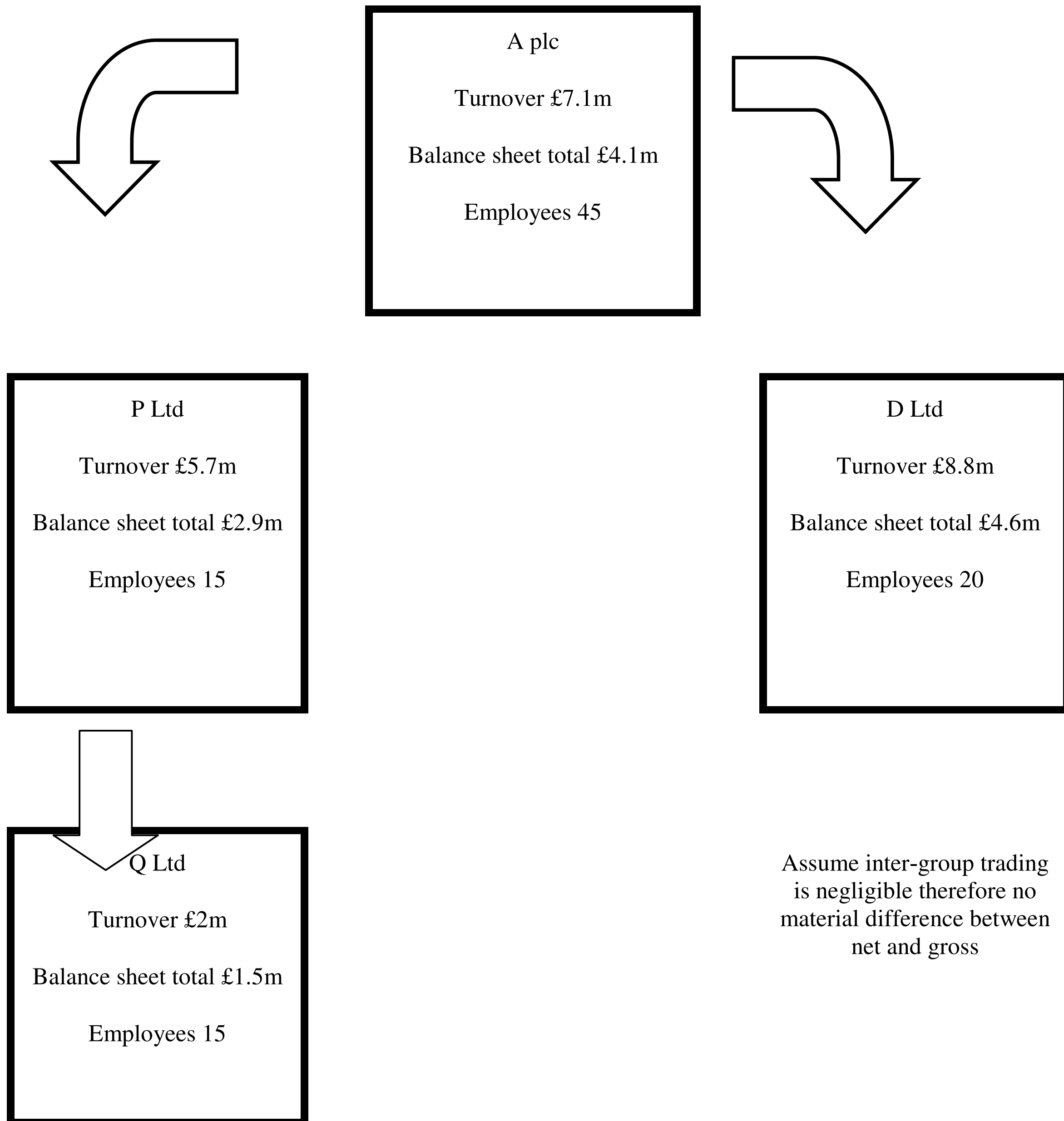
(ba) a small company that is an authorised insurance company, a banking company, an e-money issuer, an ISD investment firm or a UCITS management company, or

(c) a person who carries on an insurance market activity.

Determining the size of the group is a separate exercise from determining the size of the companies within the group. Probably the most important aspect of this is deciding whether the parent of the group is required to prepare group accounts. Under CA 85, provided the group satisfied the requirements of small or medium sized, then the parent of that group was not required to prepare group accounts.

Companies Act 2006 takes a different approach to this as we will see shortly.

Application of the eligibility rules to companies and groups



Example 1

Consider P in the above example. Assume the year end is 31/3/09 and that all figures are unchanged from the previous year.

Is P small or medium sized and is the group it heads small or medium sized?

The combined results for P and Q are: turnover £7.7m, balance sheet total £4.4m, and employees 30. The group fails two out of three for small but satisfies all three for medium. Remember the new limits will not apply to this financial year.

Considerations are as follows:

- The group comprises the parent company and its subsidiary undertakings. Therefore the group above is P and Q only. Their membership of a wider group is not considered in determining the size of this sub group.

- s248 above determines whether a group is ineligible. The wording “A group is ineligible if any of its members is....”. The emphasis indicates that one only considers the members of the group under consideration.

Therefore the group satisfies the requirements for medium sized. P would be eligible for the exemption from preparing group accounts under s248 as it heads a medium group. However, it is not a small or medium sized company as it is a member of a group which contains a public company and therefore fails to qualify under s247A. There is a link between the size of the group and the parent but only when determining the size of the parent. To qualify as small or medium sized a parent must head a small or medium sized group respectively. There is no requirement for a medium sized group to be headed by a medium sized company.

Even if A were not a public company P would not qualify as small. The group it heads is medium sized and therefore as above P would be medium sized. Even if P satisfied the small company requirements it would not be small as a small company cannot head a medium sized group.

This could be considered irrelevant since P will be consolidated in the group headed by A, and P would be entitled to exemption under s228 (intermediate parent). However there are other requirements to be satisfied under s228 which include the obligation to file the group accounts of A when P files its own accounts and if there is a minority in P they could require that group accounts be prepared. More detail is provided below on the subject of vertical groups.

Example 2

Consider P in the above example. Assume the year end is now 31/3/10 and that all figures are unchanged from the previous year.

Is P small or medium sized and is the group it heads small or medium sized?

We are now applying the new limits under CA 2006. Although exemption from the preparation of group accounts for parents of medium sized groups no longer exists the limits have changed and therefore, the group may be small.

The relevant sections are as follows.

383 Companies qualifying as small: parent companies

(1) A parent company qualifies as a small company in relation to a financial year only if the group headed by it qualifies as a small group.

(2) A group qualifies as small in relation to the parent company's first financial year if the qualifying conditions are met in that year.

(3) A group qualifies as small in relation to a subsequent financial year of the parent company-

(a) if the qualifying conditions are met in that year and the preceding financial year;

(b) if the qualifying conditions are met in that year and the group qualified as small in relation to the preceding financial year;

(c) if the qualifying conditions were met in the preceding financial year and the group qualified as small in relation to that year.

384 Companies excluded from the small companies regime

(1) The small companies regime does not apply to a company that is, or was at any time within the financial year to which the accounts relate-

(a) a public company,

(b) a company that-

(i) is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or

(ii) carries on insurance market activity, or

(c) a member of an ineligible group.

(2) A group is ineligible if any of its members is-

(a) a public company,

(b) a body corporate (other than a company) whose shares are admitted to trading on a regulated market in an EEA State,

(c) a person (other than a small company) who has permission under Part 4 of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity,

(d) a small company that is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or

(e) a person who carries on insurance market activity.

398 Option to prepare group accounts

If at the end of a financial year a company subject to the small companies regime is a parent company the directors, as well as preparing individual accounts for the year, may prepare group accounts for the year.

399 Duty to prepare group accounts

(1) This section applies to companies that are not subject to the small companies regime.

(2) If at the end of a financial year the company is a parent company the directors, as well as preparing individual accounts for the year, must prepare group accounts for the year unless the company is exempt from that requirement.

Applying the new "small" limits to the group:

Turnover	- group	£7.7m	limit	£7.8m
	- company	£5.7m	limit	£6.5m
Balance sheet total	- group	£4.4m	limit	£3.9m
	- company	£2.9m	limit	£3.26m
Employees		30	limit	50

The group satisfies turnover and employee requirements and would satisfy the requirements of s383. However, P is excluded from the small companies regime on the basis it is a member of a group which contains a public company. It is therefore required to prepare group accounts. This is subject to other exemptions which may be available and these are discussed below, This should be contrasted with the approach under the 1985 Act as outlined above.

What would be the position if A was not a plc?

If A was not a plc then P would not be a member of an ineligible group and would therefore qualify for the small regime.

Vertical groups

As commented above under both 1985 and 2006 requirements P would be entitled to the exemption on the basis A will be preparing group accounts.

If the exemption for vertical groups is to be used more often in the future what are the implications for P?

Exemption is conditional upon compliance with the following conditions:

- The company must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year;
- Those accounts must be audited;
- The company must disclose in its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;
- The company must state in its individual accounts the name of the parent undertaking that draws up the group accounts referred to above, and if this parent is incorporated outside the United Kingdom, the country in which it is incorporated;
- The company must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question copies of those group accounts, the parent undertaking's annual report, together with the auditor's report on them;
- Any requirement as to the delivery to the registrar of a certified translation into English must be met

Groups with changing composition

The 1985 and 2006 Act both refer to "was" and "is". The former would apply if the circumstances applied at any time during the financial period. The later applies to a single point in time. Therefore where there are changes to group members or change in the nature of group members this can have an impact on financial reporting requirements.

The following example considers the impact on the size of P if P joined the A group or left the A group at various dates. In each case P would continue to have Q as a subsidiary.

The example looks at the impact of the changes over a two year period. The first year is dealt with under the rules of CA 85 and the second year under CA 06. In each case, we are only discussing the size of the company P, not the size of the group.

As discussed above, under CA 85, the size of the group considers the members of the group only and not their membership of a wider group. Therefore whether P joins or leaves a wider group will be irrelevant in determining the size of the group. Conversely, the membership of the wider group does affect the size of the sub-group under CA 06.

However, there would be an impact on determining the size of the company. CA 85 s247A states that a company will not be entitled to any of the exemptions for small and medium sized companies (with the exception of items in the director's report) if it "is or was" a member of an ineligible group. Therefore if it joins the group after the year end and before its accounts are approved it is a member of an ineligible group. Similarly if it leaves the group it would be caught by the requirements. However, this only affects its own requirements for financial reporting. It does not change the size of the group it heads.

Date of change	**y/e 31/3/09 (CA 85)** Is P a member of an ineligible group?	**y/e 31/3/10 (CA 06)** Is P a member of an ineligible group?
P joined group 10/4/09?	Yes if accounts approved after 10/4/09, caught by "is"	Yes, not entitled to the small companies regime but would be entitled to exemption from preparation of group accounts under s400, see above
P joined group 1/1/09?	Yes	Yes, as above
P left group 10/4/09?	Yes caught by "was"	Yes caught by "was" in s384. Therefore the company would not be entitled to the small companies regime until y/e 31/3/11. There are also implications under s400. As the company is not a subsidiary at 31/3/10 and its results will not be fully consolidated into A, it would have to prepare group accounts.
P left group 1/1/09?	Yes caught by "was"	No

Groups with overseas members

Companies Act 1985

s247A

(2) A group is ineligible if any of its members is-

(a) a public company or a body corporate which (not being a company) has power under its constitution to offer its shares or debentures to the public and may lawfully exercise that power,

Example 1

Consider the previous example but with an overseas body as part of the group. Suppose that A is now A Ltd not A plc and is a wholly-owned subsidiary of X, which is incorporated overseas.

Is P a member of an ineligible group?

The constitution of X would have to be established to assess whether the entity has a right to issue shares to the public. This issue has caused problems for some UK based companies in the past. Like the UK there are instances of overseas entities which share the characteristics of a UK plc but do not exercise the power. For example an Italian SpA has the power under its constitution to issue shares to the public. Therefore a UK company which is a member of a group containing such a company belongs to an ineligible group under s247A. For the individual company this means that any exemptions available to small and medium sized companies cannot be used. P is therefore not eligible to be small or medium-sized. However, the P group can continue to be a medium-sized group.

Example 2

Suppose now that it is Q, the subsidiary of P, which is incorporated overseas.

Is P a member of an ineligible group?

The same considerations apply to this question as the previous one with the added implication that, if Q does have the power under its constitution to issue shares to the public then the P group cannot be a small or medium sized group.

Companies Act 2006

s384

(1) The small companies regime does not apply to a company that is, or was at any time within the financial year to which the accounts relate-

(c) a member of an ineligible group.

(2) A group is ineligible if any of its members is-

(a) a public company,

(b) a body corporate (other than a company) whose shares are admitted to trading on a regulated market in an EEA State,

s467

(1) A company is not entitled to take advantage of any of the provisions of this Part relating to companies qualifying as medium-sized if it was at any time within the financial year in question-

(c) a member of an ineligible group.

(2) A group is ineligible if any of its members is-

(a) a public company,

(b) a body corporate (other than a company) whose shares are admitted to trading on a regulated market,

2b in each of the above would apply to entities incorporated overseas. It should be noted that the requirements are different from 1985 and there is also a difference in respect of small and medium.

Again consider the previous example but with an overseas body as part of the group. As before, suppose that A is now A Ltd not A plc and is a wholly-owned subsidiary of X, which is incorporated overseas.

What would be the position if X is an Italian SpA which is not listed?

If the overseas entity is not listed on any market then none of the companies in the UK group are members of an ineligible group. Therefore A would head a medium sized group and P would head a small group. A would not be required to prepare group accounts provided X did. A would have to file these accounts with the Registrar and, if in Italian, a certified translation would have to be submitted as well. P would be entitled to exemption as it heads a small group. Each company could utilise exemptions appropriate to size.

This would also be the situation if X is incorporated anywhere in the world provided it was not listed. Therefore knowledge of the constitution of the entity is not required.

What would be the position if X is listed in an EEA state?

A would qualify as medium-sized but, since it is a member of a group which includes a listed entity, it is not entitled to the medium-sized company regime, S 467. P, Q, and D all belong to a group which contains an entity listed in an EEA state. Therefore they are not eligible for the small companies regime, s384.

What would be the position if X is listed outside the EEA?

There is no change for A. The group still includes a listed entity and therefore it is not entitled to the medium regime.

However, the position of the other companies is different. As the listed entity is outside the EEA they could qualify as small.

For a copy of CA 2006, go to http://www.opsi.gov.uk/acts/acts2006/pdf/ukpga_20060046_en.pdf

For details of commencement orders and statutory instruments see:

http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/made-or-before-parliament/page35232.html

Exposure draft of proposed revisions to ISA (UK and Ireland) 700: the auditor's report on financial statements

(Lecture A252 13.14 minutes)

The Auditing Practices Board (APB) has published an Exposure Draft of proposed revisions to ISA (UK and Ireland) 700 ‘The Auditor’s Report on Financial Statements’ in order to facilitate a more concise auditor’s report.

In 2007 the APB issued a Discussion Paper entitled ‘The Auditor’s Report: A time for change?’ which sought views on what steps were needed to be taken to reflect the changes introduced by the Companies Act 2006, and whether other, more wide ranging, changes should be made to the form and content of the auditor’s report.

In response to the views of institutional investors, preparer organisations, public sector bodies and some auditing firms and individuals, the Exposure Draft facilitates a much more concise auditor’s report.

The Exposure draft includes illustrative examples of the more concise auditor’s report for both UK and Irish publicly traded companies. The principal features of the more concise reports, compared to auditor’s reports being issued at the present time, are that they:

- Emphasise the primacy of the true and fair requirement, as the overarching concept in reporting on financial statements, by using bullet points to distinguish the three distinct elements of the auditor's opinion on the financial statements.

- Do not include much of the standard language relating to the responsibilities of the auditor and of those charged with governance, and of the basis of the auditor's opinion. They do, however, include a cross reference to a description of the responsibilities of the auditor and of the scope of an audit, which will be maintained on the APB's web site.

- State the auditor's responsibility to comply with APB's Ethical Standards.

- Separate the auditor's opinion on the financial statements from other opinions required by law and regulation (the so called two-part opinion required by ISA 700).

- Include a statement that the auditor has nothing to report in respect of those responsibilities where the auditor is required to report by exception.

A number of the accountancy bodies and auditing firms strongly expressed the view that global convergence, through compliance with ISAs, should be the APB's principal objective. In response to their concerns the proposed revision has been made so that it will not preclude auditors from asserting in the audit report that ISAs have been complied with. The proposed revision moves towards global convergence by requiring the auditor's opinion on the financial statements to be separate from other opinions required by law and regulation.

Comments on the Exposure Draft are invited by 28 November 2008. Subject to comments received, it is proposed that ISA (UK and Ireland) 700 (Revised) will take effect for accounting periods ending on or after 5 April 2009.

The APB intends to issue a complete revision of Bulletin 2006/6, including each of the illustrative examples therein, when ISA (UK and Ireland) 700 (Revised) has been finalised and in time to guide auditors when issuing auditor's reports for periods ending on or after 5 April 2009 (this will include accounting periods of a full year beginning on or after 6 April 2008).

The Exposure Draft's example of an auditor's report for a UK listed company preparing accounts under IFRS is reproduced below.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF XYZ PLC

REPORT ON THE FINANCIAL STATEMENTS

We have audited the financial statements of (name of entity) for the year ended ... which comprise [specify the financial statements, such as the Group and Parent Income Statements, the Group and Parent Balance Sheets, the Group and Parent Cash Flow Statements, the Group and Parent Statements of Changes in Equity], and the related notes. The financial statements have been prepared in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditors

In relation to these financial statements, the directors are responsible for their preparation and presentation and for being satisfied that they give a true and fair view.

Our responsibility is to audit the financial statements in accordance with the requirements of the Companies Act 2006 and International Standards on Auditing (UK and Ireland) and to express an opinion on the financial statements. In forming our opinion we are also required to comply with the Auditing Practices Board's Ethical Standards. A statement describing the scope of an audit and the auditor's reporting responsibilities in respect of a United Kingdom publicly traded company is available on the APB's web site [*insert reference to web page*].

Opinion

In our opinion the financial statements:

- have been properly prepared in accordance with IFRSs as adopted by the European Union;
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation; and
- give a true and fair view of the state of the group's and the parent company's affairs as at ... and of the group's and the parent company's profit for the year then ended.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

Opinion

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report is consistent with the financial statements.

We also have responsibilities:

- under the Companies Act 2006 to report to you if, in our opinion:
    - Adequate accounting records have not been kept, or that returns adequate for our audit have not been received from branches not visited by us.
    - The parent company financial statements are not in agreement with the accounting records and returns.
    - The part of the Directors' Remuneration Report to be audited is not in agreement with the accounting records and returns.
    - We have not received all the information and explanations we require for our audit.
- under the Listing Rules of the Financial Services Authority, to review:
    - The statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary.
    - The parts of the Corporate Governance Statement relating to the company's compliance with the nine provisions of the [2006]/[June 2008] Combined Code specified for our review.

We have nothing to report to you in respect of these responsibilities.

[Signature] *Address*

John Smith (Senior statutory auditor) *Date*

for and on behalf of ABC LLP, Statutory Auditor

The proposed wording for the statement of the scope of an audit and the auditor's reporting responsibilities, which if adopted will be published on the ASB's website and cross-referred to in the audit report as shown above, are not reproduced here. Suffice it to say that the wording is much more detailed than the wording in the existing audit report. For more details, see http://www.frc.org.uk/apb/publications/pub1681.html

BULLETIN 2008/08:

Auditor's reports for short accounting in compliance with Companies act 2006

Until we have revised versions of both ISA 700 and Bulletin 2006/6, the accounts and audit reports of companies with short accounting periods that commence on or after 6 April 2008 but end before 5 April 2009 are nevertheless required to comply with the Companies Act 2006.

APB Bulletin 2008/8 has been issued to provide illustrative auditor’s reports for use in the UK relating to those short periods of account. An example of such a report for a non-listed parent company preparing its accounts under UK GAAP is given below. The old wording has been struck through, and the new wording is in bold in order to highlight the differences between the two reports.

INDEPENDENT AUDITOR’S REPORT TO THE MEMBERS OF XYZ LIMITED

We have audited the group and parent company financial statements (the ‘‘financial statements’’) of (name of entity) for the ~~year~~ **period** ended ... which comprise [state the primary financial statements such as the Group Profit and Loss Account, the Group and Company Balance Sheets, the Group Cash Flow Statement, the Group Statement of Total Recognised Gains and Losses] and the related notes[1]. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of directors and auditors

The directors’ responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) **and for being satisfied that the financial statements give a true and fair view** are set out in the Statement of Directors’ Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements **have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, have been** prepared in accordance with the Companies Act **2006, and give a true and fair view**. We also report to you whether in our opinion the information given in the Directors’ Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept **adequate** accounting records, if we have not received all the information and explanations we require for our audit, or if **certain disclosures of directors’ remuneration specified by law are not made**.

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This other information comprises only [the Directors’ Report, the Chairman’s Statement and the Operating and Financial Review][2]. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

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

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

Opinion

In our opinion:

- **the financial statements 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**;
- **the financial statements give a true and fair view of the state of the group's and the parent company's affairs as at .... and of the group's profit for the period then ended; and**
- the information given in the Directors' Report is consistent with the financial statements.

[Signature]
John Smith (Senior Statutory Auditor)
Address
Date

for and on behalf of ABC LLP, Statutory Auditor

Notes

1 Auditor's reports of entities that do not publish their financial statements on a web site or publish them using 'PDF' format may continue to refer to the financial statements by reference to page numbers.

2 The other information that is 'read' is the content of the printed Annual Report other than the financial statements. The description of the information that has been read is tailored to reflect the terms used in the Annual Report.

For more details, see http://www.frc.org.uk/apb/publications/pub1682.html

BULLETIN 2008/9:

Miscellaneous reports by auditors required by the Companies Act 2006

The Auditing Practices Board (APB) issued Bulletin 2008/9 'Miscellaneous Reports by Auditors Required by the United Kingdom Companies Act 2006' at the end of October.

The purpose of the Bulletin is to provide guidance with respect to those reports and statements required to be made by a statutory auditor (or a person who is eligible to be appointed as statutory auditor) under the Companies Act 2006 that are not dealt with in other Bulletins published by the APB.

The Bulletin addresses the following reports:

- Statement by an auditor on ceasing to hold office (that is the statement under Section 519 of CA 2006, not the notification to the appropriate audit authority).
- Statement on a company's ability to make a distribution where the auditor's report was qualified.
- Auditor's statement with respect to net assets when a private company re-registers as a public company.
- Report when a private company redeems or purchases its own shares out of capital.
- Report when a public company allots shares otherwise than for cash.
- Report when non-cash assets transferred to a public company by certain of its members.

For a copy of the bulletin, go to http://www.frc.org.uk/apb/publications/pub1758.html

Consultation: Should UK and Irish auditing standards be updated for the new IASs?

(Lecture A251 14.19 minutes)

Background

The International Auditing and Assurance Standards Board (IAASB) have announced that they plan to adopt the new clarified International Standards in Auditing (Clarified ISAs) from periods commencing 14 December 2009. The UK Auditing Practices Board (APB) have now launched a consultation as to whether they should do the same and how the standards should be applied.

Clarity refers to two types of change – redrafting (i.e. the clarifications) and revising (i.e. changes).

What is Clarity?

The IAASB's Clarity Project was commenced in late 2005. It largely relates to the way that the standards are presented, including:

- Describing an objective for each ISA,
- Separating the requirements in each ISA from the application material,
- Clarifying the obligations imposed on auditors by the requirements of the ISAs, including eliminating ambiguity about the requirements an auditor needs to fulfil arising from the use of the present tense in the guidance to the current ISAs,
- Improving the overall readability and understandability of the ISAs through structural and drafting improvements and
- Reducing the complexity of the existing ISAs – this was seen as being especially important to smaller audit firms with limited technical resources.

What has been revised?

In addition to 'clarifying' all of the ISAs, 13 of the ISAs have also been revised and one new ISA (ISA 265 which addresses communicating deficiencies in internal control) is being introduced. Some of the revised ISAs increase the rigour of auditing standards in key areas such as accounting estimates (including fair values), related parties and group audits involving more than one audit team.

Revised ISAs

200	Objective and General Principles Governing an Audit of Financial Statements
260	Communication of Audit Matters With Those Charged With Governance
320	Materiality in Planning and Performing an Audit
402	Audit Considerations Relating to Entities Using Service Organisations
450	Evaluation of Misstatements Identified During the Audit
505	External Confirmations
540/545	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, And Related Disclosures.
550	Related Parties
580	Management Representations
600	The Audit of Group Financial Statements
620	Using the Work of an Expert
705	Modifications to the Opinion in the Independent Auditor's Report
706	Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report

How much more work will be needed under the Clarity ISAs

The APB have done some research on the impact of the Clarified ISAs by asking a number of firms to conduct audits under the IAASB Clarified standards to assess what difference the change will make.

The table overleaf summarises the results:

	Audits of small and mid-sized entities	Audits of listed and large private companies
Sample size	14 companies / charities	13 companies
Average increase in recurring cost of the audit of an individual entity	9.6%	1.9%
Average impact of ISA 600 on group audits	0.5%	3.0%
Total recurring costs for group audits	10.1%	4.9%
Average increase in 'year one' non-recurring costs	3.8%	0.1%
Total year one cost	13.9%	5.0%

The options being consulted upon:

Option 1 - To update the ISAs (UK & Ireland) for the new 'Clarity ISAs' and for the new standards to apply to UK and Irish audits as soon as practicable.

Option 2 - Leaving the existing ISAs (UK and Ireland) in issue until the EC has adopted the new ISAs. (timing to be agreed)

The consultation

Q1 Do you agree that ISAs (UK and Ireland) should be updated to reflect improvements in the underlying international auditing standards? If not, please explain your reasons.

Q2 If you agree that the ISAs (UK & Ireland) should be updated for improvements in the underlying international auditing standards, do you believe that this should be done by adopting the Clarity ISAs:

(a) as soon as practicable, or

(b) if and when they are endorsed by the EC?

Q3 If you believe the Clarity ISAs should be adopted as soon as practicable, do you believe it will be practicable to require the resulting new ISAs (UK & Ireland) to apply to audits of UK and Irish entities with accounting periods commencing on or after 15 December 2009?

Q4 Do you support APB's view that the same standards should apply to audits of entities of all sizes? If not, please explain your reasons for taking a different view.

Twin speed auditing

The consultation in question 4 opens the possibility of two sets of auditing standards. Should the new Clarity standards be applied only to listed and other public interest audits and the existing standards apply for other audits?

The current cost of UK auditing

In March 2008 the FRC published a paper which, in an appendix, contained an estimate of UK audit costs as follows:

Size of entity	Number of entities	Cost £m	Cost £m
Companies			
FTSE 100	100	400	
FTSE 250	250	150	
Other main market	2,000	300	
AIM	2,000	100	
Total listed			950
Large private	12,500		625
Mid-sized	25,000		250
Below statutory audit threshold[14]	1,300,000		60
Charities			
Large	10,000		300
Small [15]	150,000		-
Pension schemes	100,000		100
Estimated total cost of UK audit			**2285**

14 Only around 120,000 of these companies have an audit. In these cases, auditors are usually involved in preparing the financial statements, and the additional cost of audit (around £500) is, therefore small.

15 Exempt from audit (cost of independent examinations excluded)

The big changes identified

Estimated average % increase in work effort caused by Clarity ISAs

	265	540	550	600	620	Other	Total
Audits of small and mid-sized entities	0.9	2.5	3.5	0.3	0.5	1.7	9.4
Audits of listed and large private companies	0.1	0.5	0.4	3.0	0.3	-	4.3

ISA 265

ISA 265 is a proposed new ISA that addresses communication of deficiencies in internal control. The requirement within ISA 265 that mandates communication of significant deficiencies that have come to the auditor's attention to those charged with governance is broadly similar to the current requirement to communicate material weaknesses to those charged with governance.

However, ISA 265 will also require auditors to communicate deficiencies that have come to their attention, other than those that are clearly trivial, to management. Although the communication to management may be made orally it was generally believed that the underlying approach may need to be more rigorous and more documentation would be needed to demonstrate that this had been done – especially on smaller audits.

ISAs 540 and 550

The Clarity ISAs with the greatest impacts on auditor work effort were 540 (which addresses estimates and fair values), and 550 (which addresses related parties). Both cover important topics, especially in the context of current economic conditions. In particular ISA 540 emphasises the need for auditors to consider estimation uncertainty and management bias when auditing accounting estimates.

Both revised ISA 540 and 550 have an increased focus on management's processes (e.g. for making estimates and for identifying related party relationships and transactions) and stipulate audit procedures that are not in the current ISAs (e.g. the requirement in ISA 540 to review the outcome of prior year estimates). Some audit firms already perform these procedures but, even in these cases, it was typically believed that more audit documentation would be needed.

ISA 600

The revised ISA 600 clarifies how the risk model underpinning the current ISAs (UK and Ireland) 315 and 330 applies in a group context. In particular, there are significant new requirements relating to the relationships between the 'group engagement team' and 'component auditors' and communications between them. Consequently the impact is expected to be most significant on audits where group components are audited by different teams, particularly for large transnational group audits. Because of this the impact on small group audits is likely to be small as the same engagement team often audits all group components.

ISA 620

ISA 620 addresses the use of experts by auditors to help obtain audit evidence, and is therefore only relevant where experts (other than experts in accounting or auditing) are used. It was generally felt that the Clarity ISA

would drive more rigour and formality, and consequently documentation, with respect to the relationships with experts and evaluating the results of an expert's work.

Other ISAs

For the other ISAs, the impacts were generally much less significant. However, some firms believe that to satisfy the requirements of external audit inspectors they may need to incorporate more mandated procedures in to their methodologies and may need to produce more audit documentation to demonstrate compliance with the increased numbers of mandatory requirements.

For the background and current status of the clarity project, go to
http://www.frc.org.uk/apb/publications/iaasb.cfm?cat=14

ISQC 1 QUALITY CONTROL

(Lecture A253 18.51 minutes)

Introduction

During the recent audit faculty roadshow, it was reported that firms are not always documenting how they apply quality control procedures. Requirements for quality control procedures at the whole firm level are covered by ISQC1 and at individual audit level by ISA 220. We covered ISA 220 in a recent update and so today we are looking at ISQC 1.

ISQC1 - general requirements

The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances.

A system of quality control consists of policies designed to achieve the objectives set out above and the procedures necessary to implement and monitor compliance with those policies.

The firm's system of control should include policies and procedures addressing each of the following areas covered by the standard:

- Leadership responsibilities for quality within a firm
- Ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

Quality control procedures must be properly documented and communicated to the firm's personnel.

Effective date

Audit firms were initially required to establish systems of quality control in compliance with ISQC (UK and Ireland) 1 by 15 June 2005. ISQC 1 was revised by ISA 230 and firms were required to be compliant with the revised standard by 15 June 2006.

Leadership responsibilities for quality within a firm

The standard requires audit firms to be led from the very top. It is the firm's chief executive officer or managing partner, or if appropriate the management committee who assume ultimate responsibility for the firm's system of quality control.

The firm's leadership set the example and significantly influence the culture within the firm. By their emphasis on the importance of quality, management encourages a culture that recognises and rewards high quality work. The firm's view of the importance of quality and how it is to be achieved will be communicated and reinforced by training, meetings, internal communications, appraisal procedures etc.

ISQC 1 places particular importance on the need for a firm's leadership to recognise that a firm's business strategy is subject to the overriding requirement for a firm to achieve quality in all engagements that a firm performs, and in doing so stresses that:

- Commercial considerations should never override the quality of work performed;

- Performance evaluation, compensation and promotion are designed to demonstrate a firm's commitment to quality

- Sufficient resources are devoted for the development, documentation and support of its quality control policies and procedures.

Previously SAS 240 required one partner to assume a role as quality control partner, but that is no longer the case. The firm's management, however, will usually assign operational responsibility for the firm's quality control system to a person or persons who have sufficient and appropriate experience and ability. They must also have the necessary authority to assume the responsibility.

Ethical requirements

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Note that these ethical requirements are those of the IFAC code supplemented by any national requirements that are more restrictive. In the UK, auditors are required to follow the Auditors' Ethical Standards which will ensure compliance with the IFAC code.

The standard gives particular guidance on the subject of independence. Firms should have policies and procedures that require:

- engagement partners to provide a firm with details such as the scope of other services to enable a firm to evaluate the overall impact, if any, on independence requirements;

- personnel to promptly notify a firm of circumstances and relationships that create a threat to independence so that action can be taken including prompt communication within a firm to those who need to take remedial action;

- the accumulation and communication of relevant information to appropriate personnel so that:

    - a firm and its personnel can readily determine whether they satisfy independence requirements

    - a firm can maintain and update its records relating to independence; and

    - a firm can take appropriate action regarding identified threats to independence.

At least annually, firms should require written confirmation of compliance with its policies and procedures on independence, from all relevant audit personnel. Firms are also required to consider the effect of the familiarity threat that might arise where senior personnel work for a prolonged period on an assignment. Criteria should be

established for determining the need to implement safeguards. Firms auditing listed entities will also need to consider the requirements for engagement partner rotation.

Acceptance and continuance of client relationships and specific engagements

Auditors should consider the following factors when accepting or continuing audit relationships or engagements:

- the integrity of the client;
- the firm’s competence to perform the engagement; and
- ethical requirements.

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and reputation of the client and key personnel.
- The client's business activities.
- The client’s attitude towards matters such as aggressive earnings management.
- The control environment.
- Attitude to audit fees.
- Attempts to limit the scope of audit work.
- Any indications that the client might be involved in money laundering etc.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

On the subject of competence, the firm will consider knowledge and experience of staff as well as their availability.

Where further information comes to light which, had it been known earlier, would have caused the firm to refuse the engagement then they should consider whether they should continue the engagement.

Human resources

The scope of this standard on audit quality extends further than before. In particular firms must ensure that they have sufficient staff with the capabilities, competence and commitment to ethical standards necessary to perform audit work properly.

They should address the following areas:

- Recruitment;
- Performance evaluation;
- Capabilities;
- Competence;
- Career development;
- Promotion;
- Compensation; and
- The estimation of personnel needs.

Capabilities and competence are developed through a variety of methods including:

- Professional education;
- CPD;
- Work experience; and
- Coaching by more experienced staff.

Also, there should be evaluation of, and counselling on, performance, progress and career development. Underlying all this is that the drivers of progress and promotion should include performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

The firm should assign responsibility for each engagement to an engagement partner. The firm should monitor the workload and availability of engagement partners so as to enable these people to have sufficient time to adequately discharge their duties.

Engagement performance

Using manuals, checklists and other formal or informal tools, firms should establish procedures to ensure that audit engagements are properly carried out.

All members of the engagement team should understand the objectives of their work. Team-working and training is required to ensure this occurs.

Work performed by less experienced team members should be reviewed by more experienced engagement team members, including the engagement partner.

Reviewers consider whether:

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

Consultation should take place when appropriate and be documented. The firm should have policies and procedures for dealing with differences of opinion – within the audit team, with persons consulted and between the engagement partner and the engagement quality control reviewer.

ISQC 1 also has a number of requirements relating to the "Engagement Quality Control Review", sometimes known as the second partner review or independent review.

An engagement quality control review must be undertaken for all listed entities. In addition, firms should have procedures for identifying other audits requiring such a review.

The following criteria should be used for selecting engagements that require an engagement quality control review:

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

The eligibility of the reviewer depends upon both their technical qualifications and the degree to which the reviewer can be consulted on the engagement without compromising the reviewer's independence.

Paragraph 70 of ISQC1 states:

The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:

(a) Is not selected by the engagement partner;

(b) Does not otherwise participate in the engagement during the period of review;

(c) Does not make decisions for the engagement team; and

(d) Is not subject to other considerations that would threaten the reviewer's objectivity."

Suitably qualified external persons or other firms may be contracted by sole practitioners or small firms.

Nature, Timing and Extent of the Engagement Quality Control Review

An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

An engagement quality control review for audits of financial statements of listed entities includes considering the following:

- The engagement team's evaluation of the firm's independence in relation to the specific engagement.
- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
- The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.

Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

Documentation

This section of ISQC 1 was inserted by ISA 230 and took effect from June 2006.

It requires that the firm should have policies and procedures:

- To ensure that the file is compiled on a timely basis after the audit report has been signed. In the absence of any national requirement, ISQC 1 suggests 60 days.

- To maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

- For the retention of documentation for a period sufficient to meet the needs of the firm and as required by law or regulations.

Monitoring

A firm should have procedures in place designed to provide reasonable assurance that the system of quality control is relevant, adequate, operating effectively and complied with in practice. Such procedures should include an ongoing consideration and evaluation of the system as well as a periodic inspection of a selection of completed engagements.

Similar to SAS 240, firms can entrust responsibility for the monitoring process to a partner or partners.

Deficiencies in the quality control system noted as a result of the review should be categorised between those that do not undermine the integrity of the system and those that represent a systematic, repetitive or other significant deficiency that requires prompt corrective action.

Deficiencies noted should be communicated to the engagement partner and other relevant personnel with recommendations for remedial action.

The standard specifies certain aspects of the review that must be carried out:

Ongoing consideration and evaluation of the system of quality control includes matters such as the following:

- Analysis of:

    - New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;

    - Written confirmation of compliance with policies and procedures on independence;

    - Continuing professional development, including training; and

    - Decisions related to acceptance and continuance of client relationships and specific engagements.

- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.

- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.

- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.

- The number and geographical location of offices.

- The results of previous monitoring procedures.

- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).

- The nature and complexity of the firm's practice and organization.

- The risks associated with the firm's clients and specific engagements.

The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program."

ISQC 1 has a number of specific requirements relating to the reporting and follow up of monitoring reviews:

The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:

(a) Taking appropriate remedial action in relation to an individual engagement or member of personnel;

(b) The communication of the findings to those responsible for training and professional development;

(c) Changes to the quality control policies and procedures; and

(d) Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.

At least annually, a firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within a firm, including a firm's chief executive officer or, if appropriate, its managing board of partners. Such communication should enable a firm and these individuals to take prompt and appropriate action where necessary in accordance with their roles and responsibilities.

Information communicated should include the following:

- A description of the monitoring procedures performed
- The conclusions drawn from the monitoring procedures.
- Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.

Complaints and allegations

A firm should have policies and procedures to enable it to deal properly with complaints and allegations. These may relate to non-compliance with professional standards and regulatory and legal requirements or non-compliance with the firm's system of quality control.

Documentation

A firm should have policies and procedures in place requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.

ICAEW Audit and Assurance Faculty Booklet - Quality Control in the Audit Environment - May 2006

The Audit and Assurance Faculty have published this booklet as part of the Audit Quality series. Whilst useful to firms of all sizes, much of the central input to the booklet has come from small and medium sized practices and practitioners. It has been written to reflect the requirements of ISQC 1 (revised).

It describes the key features of ISQC 1 as being:

- the requirement to document is specific, prescriptive and detailed;
- the firm's chief executive or managing board (or equivalent) is to assume ultimate responsibility for the firm's system of quality control;
- emphasis on the content and detail of the firm's formal policies and procedures; and
- a list of what needs to be considered during an engagement quality control review (EQCR) and requirements regarding its nature, timing and documentation.

Overall when applying ISQC 1 to their own circumstances, firms need to consider:

- the level of detail needed;
- the nature of the communications to principals and staff required; and
- the appropriate level of documentation necessary.

The structure adopted by the booklet is that of seven key actions

1. Document the operation of the quality control system so that the firm complies with ISQC 1's documentation requirements.
2. Lead from the top giving consistent messages on the importance of quality control.
3. Always act ethically in accordance with the relevant standards and pronouncements.
4. Focus on the right clients being matched by the right skills with emphasis on integrity and competencies.
5. Maintain capable and competent staff giving due attention to the firm's human resources policies and procedures.

6. Deliver quality audits consulting when needed and meeting requirements for engagement quality control review.
7. Monitor the firm's system of quality control and carry out a periodic objective inspection of a selection of completed audit engagements.

ISQC 1 Case study

ISQC 1 requires audit firms to document their quality control procedures. The following is based on the example provided by the audit faculty roadshow and shows an example of what this could look like in a straightforward situation.

Leadership Responsibilities

The firm's managing partner takes overall responsibility for audit quality and A is the audit compliance partner.

Ethics

B is the firm's ethics partner. Compliance with the APB Ethical Standards should be ensured by using the xxxx audit system for all audits.

The firm's staff manual sets out the rules on gifts from clients.

Acceptance and continuance

The acceptance/reacceptance checklists from the xxxx audit system are used for all audits.

The Money Laundering compliance checklist should be used for all new appointments. Ongoing monitoring is performed in accordance with the firm's procedures as laid down in the money laundering procedures manual. Queries should be addressed to the Money Laundering Compliance Officer, B.

Human resources

The firm's staff manual deals with recruitment, appraisal etc.

Procedures are in place to ensure that only staff and partners with the appropriate and relevant experience and knowledge undertake audit work. This is considered during the planning of every audit as required by the planning checklist.

Audit related training is provided by xxxx and audit staff are expected to attend at least 3 out of the 4 quarterly update course and any relevant topical courses.

All audit staff are expected to read Audit & Beyond which is available in the library.

Engagement performance

The audit approach is set out in the xxxx audit system.

Engagement quality control reviews are carried out by A. Audit assignments where A is the audit engagement partner will be reviewed by B. Where necessary external quality control reviews are carried out by xxxx Training.

Monitoring

The Audit Compliance Review and the cold file reviews are carried out for the firm by the xxxx Training Group.

For a copy of ISQC 1, go to http://www.frc.org.uk/apb/publications/pub0713.html

The audit of related parties: draft guidance issued by the Audit and Assurance faculty

(Lecture A248 20.14 minutes)

The following five point action plan focuses on the specific areas where existing audit work on related parties and related party transactions could be developed to enhance the quality of the audit.

1 Plan your work on the audit of related parties and related party transactions thoroughly

Plan the audit of related parties and related party transactions.

Where possible obtain a list of related parties from clients or compile a list based on discussions with clients and knowledge of the business.

Update previous knowledge of related parties and related party transactions.

Ensure that the client understands what a related party is and why the relevant disclosure requirements are necessary.

Speak to the right person 'in authority' at the client who can answer your questions.

Plan for specific related party issues or concerns, such as those raised by audit team members, to be considered and reviewed by suitably experienced staff on the audit team.

Brief all audit team members about related parties and related party transactions and the risks of material misstatement due to fraud or error that could result from the entity's related party transactions.

Ensure that all staff are informed about changes to related party relationships throughout the engagement.

2 Focus on the risk of material misstatement that might arise from related party transactions

Understand the business, including the nature, size and complexity of the business and transactions.

The use of family trees and group structures can help to identify related parties and understand relationships between client and related parties.

Follow up potential related party indicators and issues identified.

Consider fraud risk and the risk of undisclosed related parties and related party transactions.

Consider materiality.

Emphasise the importance of the audit team remaining alert for related parties and related party transactions as the audit proceeds.

Discuss awareness of related party relationships with others within the firm involved in providing services to the client, e.g. tax/accounting/corporate finance departments.

3 Understand the internal controls in the entity to identify related parties and to record related party transactions

Understand the controls, if any, that management has put in place to identify, account for and disclose related party transactions and to approve significant transactions with related parties, or significant transactions outside the normal course of business.

If few or no processes are in place for dealing with related party relationships and related party transactions, seek to obtain an understanding of related party relationships and related party transactions through inquiry of management.

4 Design procedures to respond to risks identified

Perform procedures to confirm/identify related party relationships not yet identified including:

- Inspecting bank and legal confirmations
- Inspecting minutes of meetings of shareholders and management
- On becoming aware of any undisclosed related parties perform appropriate substantive audit procedures as set out in the application material to ISA 550 (Revised and Redrafted) (paragraph A 36).

Consider any arms length assertions and obtain evidence to support them.

Consider the use of corroborative evidence such as third party confirmations.

Consider significant related party transactions outside the normal course of business.

Document the identity and, if unclear, the nature of related parties.

Document risk assessment and any additional procedures performed.

Obtain a management representation letter.

Communicate any significant matters to management and those charged with governance.

5 Perform completion procedures

Ensure that the disclosures on related party transactions are appropriate.

Consider implications of work performed and findings for the audit opinion.

For a pdf of the full Audit Faculty draft guidance, go to http://www.icaew.com/index.cfm/route/159920/icaew_ga/The_Audit_of_Related_Parties_in_Practice_Exposure_Draft_Audit_and_Assurance_ICAEW/pdf

Summary of developments

(Lecture A254 13.25 minutes)

(Lecture A255 13.27 minutes)

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)

Findings of the Financial Reporting Review Panel in respect of the accounts of Wilmington Group plc for the year ended 30 June 2007

The Financial Reporting Review Panel ("the Panel") has had under review the report and accounts of Wilmington Group plc ("the company") for the year ended 30 June 2007.

The Panel concluded that the company's treatment of minority put options as contingent liabilities was not in accordance with paragraph 23 of IAS 32 "Financial instruments: presentation" which requires a liability to be recorded for all contracts that contain an obligation to purchase own equity instruments for cash.

The directors have accepted the Panel's conclusions and, in the preliminary results for the year to 30 June 2008 announced today, have corrected the treatment of the minority put options by way of a prior period adjustment. The effect of the adjustment at 30 June 2007 is to increase liabilities from £59.3m to £65.6m with corresponding adjustments to minority interests and goodwill.

The Panel welcomes the action taken by the directors today. On the basis that the required adjustments are made in the full published accounts for the year to 30 June 2008, the Panel regards its concerns as satisfied.

Wilmington Group plc's treatment of minority put options

The company has written a number of put options each of which contains an obligation on the company to purchase the minority holdings in the company's subsidiaries. The options are exercisable during specified periods at prices determined by reference to the performance of the relevant subsidiary. In its accounts for the year to 30 June 2007 the company disclosed a contingent liability for the best estimate of the value of the redemption amount of the minority put options using current levels of profitability.

Under IAS 32, minority put options are contracts which contain an obligation for an entity to purchase its own equity instruments for cash or another financial asset. As these contracts give rise to a financial liability for the present value of the redemption amount, this liability is required to be recognised in the balance sheet itself rather than as a contingent liability in the notes to the accounts.

18 September 2008

The Financial Reporting Review Panel's Annual Review and the challenges of current financial markets

The Financial Reporting Review Panel ('the Panel') today published its activity report and comments on the challenges to corporate reporting arising from current conditions in financial markets.

The report is based on findings from the Panel's review of accounts in the year to 31 March 2008 in which:

- 300 sets of accounts were reviewed
- 138 companies were approached by the Panel for further information or explanation
- 88 companies undertook to reflect the Panel's comments in their future reporting.

These accounts were mainly for financial periods ending from December 2006 to June 2007, shortly before the onset of the current dislocation in the markets.

Directors are advised to pay particular attention to the following areas of reporting where market conditions may require changes in accounting or in the nature and extent of disclosures:

- sources of uncertainty affecting management's estimates which carry a risk of causing a material adjustment to the carrying value of assets and liabilities
- revenue recognition criteria where unreliability of measurement may lead to deferral of income

- relationship with special purpose entities which may have been amended during the year resulting in changes in the shape of consolidation.

The report also trails two reviews by the Financial Reporting Council on impairment and liquidity, which will be published shortly.

The report includes early findings from the Panel's reviews of directors' reports, including business reviews, following the extension to the Panel's remit during the year. Issues raised most frequently with companies related to the disclosure of the principal risks and uncertainties which they face. Given the speed and pervasiveness of the financial crisis and other market changes, including rising prices and pressures on supply, directors may need to contemplate risks and uncertainties previously thought to be too remote to have warranted serious consideration.

02 October 2008

FRC publishes revised Guidance on Audit Committees

The Financial Reporting Council today published updated Guidance on Audit Committees. The revised guidance encourages audit committees to consider the risks associated with their external auditor leaving the market and to disclose more information about the process by which the auditor was selected in the company's annual report, and provides guidance on the factors to be considered if a group is considering engaging firms from more than one network to work on the audit.

These changes have been made in response to the recommendations of the Market Participants Group's report on promoting choice in the audit market, published in October 2007.

The Guidance on Audit Committees (formerly known as the Smith Guidance) was first published in 2003 and provides guidance to listed companies on the composition, role and responsibilities of the audit committee. Boards are not required to follow the guidance, but it is intended to assist them when implementing the relevant provisions of the Combined Code on Corporate Governance.

15 October 2008

ASB issues Amendments to Permit Reclassification of Financial Instruments

The Accounting Standards Board (ASB) has approved amendments to FRS 26 (IAS 39) 'Financial Instruments: Recognition and Measurement' and FRS 29 (IFRS 7) 'Financial Instruments: Disclosures' that would permit the reclassification of certain financial instruments.

The amendments arise as a consequence of the amendments to IAS 39 and IFRS 7 published by the International Accounting Standards Board (IASB) on 13 October 2008. The amendments issued by the IASB address the desire expressed in a number of quarters, including EU leaders and finance ministers, to reduce the differences between IFRS and US Generally Accepted Accounting Principles.

The amendments permit the reclassification of:

- certain held-for-trading non-derivative financial assets out of the Fair Value Through Profit or Loss (trading) category in rare circumstances. What is meant by 'rare' is not dealt with in the amendments, but in its press release of 13 October, the IASB notes that the deterioration of the world's financial markets that has occurred during the third quarter of the year is a possible example of rare circumstances; and

- certain financial assets to the loans and receivables category (and so measured on a cost basis) if the entity has the intention and ability to hold them for the foreseeable future or until maturity.

In moving to issue the amendments, the ASB – like the IASB – has not followed its normal due process, given the need to take urgent action to address the rare circumstances of the current credit crisis. The ASB wants to

ensure that entities applying FRS 26 and FRS 29 have the same ability to be able to make reclassifications as those applying IFRS. Entities may use the reclassification amendments, if they so wish, from 1 July 2008.

16 October 2008 and 24 October 2008

FRC reviews Goodwill Impairment Disclosures

The Financial Reporting Council (FRC) has today published the results of a review of information disclosed by a sample of UK listed companies on their testing for impairment of goodwill.

Economic conditions have deteriorated significantly during the past year. This underscores the importance of the information that companies disclose about goodwill and goodwill charges. It is likely that many companies will need to reduce their forecasts of future business growth and operating margins. We have already seen an increased incidence of goodwill impairment charges and that trend is highly likely to continue.

Responding to these market conditions, the FRC has reviewed the goodwill impairment disclosures made by a sample of UK companies, with a view to providing feedback on the quality of disclosures in this area and helping those who will be preparing and approving financial statements in the near future.

The review covered goodwill impairment disclosures made during 2007 by 32 UK listed companies, and assessed the completeness and clarity of disclosures that were being made to comply with the requirements of International Financial Reporting Standards.

IAS 36 *'Impairment of assets'* requires companies with material amounts of goodwill to disclose the key assumptions and the approach adopted to make those assumptions when using valuation models to check that goodwill does not need to be written down.

IAS 36 also requires more detailed quantified and narrative disclosures when a "reasonably possible change" in a key assumption would have caused a material goodwill impairment loss to arise.

IAS 1 *'Presentation of financial statements'* requires companies to provide additional information about key assumptions and other key sources of estimation uncertainty that have a "significant risk" of causing a material goodwill impairment loss within the next financial year.

The review found that the most useful and informative disclosures were those that provided information specific to the business. It also concluded that the majority of companies disclosed more generic than specific information, which limited the understanding and insight that could have been conveyed to investors.

The review identified significant areas of good practice. For example, eight companies gave additional sensitivity information about the level of changes that would be required before a goodwill write down would arise.

Ian Wright, Director of Corporate Reporting at the FRC, said:

"Many businesses will find that deteriorating economic conditions have triggered the need for additional disclosures required by IFRS in respect of goodwill. Investors and other users of financial statements are likely to find these disclosures particularly useful in the coming months."

23 October 2008

UITF 46: Hedges of a Net Investment in a Foreign Operation

UITF Abstract 46 has the effect of implementing the International Accounting Standards Board's (IASB's) International Financial Reporting Interpretations Committee (IFRIC) Interpretation 16 'Hedges of a Net Investment in a Foreign Operation' in the UK and Republic of Ireland.

When implemented the Abstract will be applicable to entities preparing their financial statements in accordance with UK accounting standards and, in doing so, applying FRS 23 'The Effects of Changes in Foreign Exchange Rates' and FRS 26 'Financial Instruments: Recognition and Measurement'. FRS 26 implements IAS 39 in UK

GAAP for listed entities and those preparing their financial statements in accordance with the fair value accounting rules set out in either:

- the Companies Act 1985 for accounting periods beginning on or after 1 January 2005; or
- SI 2008/410 for accounting periods commencing on or after 6 April 2008.

An entity with many foreign operations may be exposed to a number of foreign currency risks. This Abstract provides guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation. It also provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.

23 October 2008

The Financial Reporting Review Panel announces priority sectors for 2009/10

The Financial Reporting Review Panel today announced the areas its work will focus on in 2009/10.

The Panel's monitoring activity is currently biased towards the following industry sectors:

- Banking
- Retail
- Travel and leisure
- Commercial property
- House builders

The Panel will continue to review accounts from companies in these industries in 2009-10 and, in view of the deteriorating economy, will extend its selection to include other entities which derive significant revenue from the provision of services such as advertising, media, recruitment and technology.

The Panel's work continues to cover the business review, where the Companies Act 2006 has introduced two important changes. The purpose of the review now includes helping shareholders assess how the directors have performed their statutory duty to promote the company's success. In addition, the business reviews of quoted companies are now required to refer to the main trends and factors likely to affect the future development and performance of the company.

All business reviews must contain a description of the principal risks and uncertainties facing the company.

The Panel will consider the adequacy of these disclosures in terms of what a reasonable board might be expected to conclude on the basis of information available when the accounts are approved, and will expect to see, where appropriate, an account of how the directors are managing the risks which the company faces.

Accounts selected for review will be drawn from across the full range of companies within the Panel's remit, which includes large private companies.

The Panel will shortly be updating its website to reflect the new business review requirements.

30 October 2008

Oversight Board publishes Report on Practical Training for Auditors

The Oversight Board today publishes its review of practical training for auditors. The objective of the review was to consider the effectiveness of the arrangements for the practical training of auditors in the UK in light of increases in audit exemption thresholds and resulting changes in the market structure for audit in the UK.

The review included all aspects of practical training including the approval and monitoring of training firms, student training records requirements, and the completion and monitoring of student training records. A research team from the University of Glamorgan, led by Professor Marriot, was jointly appointed by the Professional Bodies and the Oversight Board to independently gather the views of students and mentors.

The Oversight Board's review drew seven conclusions which may be divided into profession wide and operational issues. The most significant profession wide issue, following increases in audit exemption thresholds, is the lack of availability of audit work in small audit firms to ensure trainees and audit staff can be provided with sufficient audit experience to achieve the audit qualification or to maintain competence at a reasonable cost once qualified. The review also found that the Bodies generally had effective operational procedures governing the arrangements for the practical training of auditors although the application of these procedures could be improved in certain areas. We will monitor progress by the Bodies in meeting our recommendations on their operational procedures during our routine compliance monitoring visits.

The ability for some students, in particular in smaller practices, to gain and maintain sufficient competence in audit is a complex cross-profession issue which is recognised by the Bodies. The next stage of this review will be the establishment of a working group of representatives from the Bodies and the Oversight Board to begin the process of identifying, assessing and prioritising possible actions. The outcome of these discussions will be shared with firms.

Review of Practical training for auditors is available on the FRC website at:
http://www.frc.org.uk/pob/publications/index.cfm?mode=list&cID=7

05 November 2008

ASB issues Amendment on Financial Instruments: Eligible Hedged Items

The Accounting Standards Board (ASB) has today issued an amendment to FRS 26 (IAS 39) 'Financial Instruments: Recognition and Measurement – Eligible Hedged Items'. This follows the same amendment issued in July 2008 by the International Accounting Standards Board (IASB).

The amendment clarifies how the existing principles underlying hedge accounting should be applied in two particular situations, namely the designation of (a) a one-sided risk in a hedged item, and (b) inflation in a financial hedged item. The amendment has been made in the light of responses to an exposure draft of proposed guidance (published in September 2007 by the IASB and October 2007 by the ASB), which indicated that diversity in practice existed, or was likely to exist, in these two situations.

The amendment provides additional application guidance to illustrate how the principles underlying hedge accounting should be applied in the above two situations.

Entities are required to apply the amendment retrospectively for annual periods beginning on or after 1 July 2009, with earlier application permitted. The amendment ensures that FRS 26 remains in line with International Accounting Standard (IAS) 39.

13 November 2008

FRC alerts directors to the corporate reporting challenges arising from current economic conditions

The FRC recognises that the global liquidity squeeze and its impact on the wider economy increases the challenges for directors in preparing corporate reports this year. This means that more time may need to be spent by directors and audit committees planning the year-end activities, reviewing key assumptions and models used in financial reporting and in reviewing the significant accounting and disclosure judgements.

In response to these challenges, the Financial Reporting Council (FRC) has today published:

- An analysis of some of the challenges for audit committees arising from current economic conditions and some suggested questions that audit committees may need to address.

- An update for directors of listed companies on reporting on going concern and liquidity risk.

The purpose of the documents is to assist directors by identifying key questions that they may wish to consider when preparing for the year-end and in meeting their responsibilities in relation to annual reports and accounts. These documents do not impose any new requirements on companies or their auditors.

Paul Boyle, FRC Chief Executive, said:

"There is a variety of standards and guidance which companies need to take into account in preparing their annual reports and we hope that directors will find our material useful in highlighting some of the key issues. We recognise that going concern assessments may be particularly sensitive this year and will require thorough preparation and balanced judgements."

The FRC update on going concern brings together the key accounting requirements and the disclosures relevant to going concern and liquidity risk and sets out the main points of interaction between the judgements made by directors and auditors. The update highlights the challenges for all of the parties involved:

- directors will need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures;

- auditors will need to ensure that they fully consider going concern assessments and only refer to going concern in their audit reports when appropriate; and

- investors and lenders will need to be prepared to read all of the relevant information in annual reports and accounts before making decisions.

The update also notes that the absence of confirmations of bank facilities does not of itself necessarily cast significant doubt on a company's ability to continue as a going concern nor necessarily require auditors to refer to going concern in their reports.

The FRC has also published the results of a study of companies' disclosures on going concern and liquidity risk, with conclusions and recommendations for improvements.

Ian Wright, FRC Director of Corporate Reporting said:

"Today's initiative is the latest in a series of actions taken by the FRC and its Operating Bodies during 2007 and 2008 to help mitigate the increased risk of errors and omissions in annual reports which have the potential to adversely affect confidence in corporate reporting. We will continue to monitor developing issues and will be seeking to help the market whenever possible".

27 November 2008

For more details on any of the topics covered in the summary of developments, go to the list of press releases on the FRC website using this address: http://www.frc.org.uk/press/

Or more conveniently, go to the FRC homepage and follow the links to the body you are interested in http://www.frc.org.uk/index.cfm