Accounting and Auditing Update

April 2009

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DEVELOPMENTS FROM THE ACCOUNTING STANDARDS BOARD

Financial Reporting Standards (FRSs)

There have been no new FRSs issued in the last six months. In fact the most recent new standard was FRS 29 (Financial Instruments: Disclosures) which was issued in response to IFRS 7 in December 2005.

This apparent inactivity of the Board can be explained by an article in Inside Track, Issue No 54 (January 2008). In this article, Ian Mackintosh, the chairman of the ASB, expressed the view that there was no longer a case for retaining two sets of GAAP. He said that the debate had now moved on to whether there should be a three-tier or two tier system of reporting.

A three-tier system would see listed companies, and perhaps other large or important entities, applying full IFRS; unlisted companies other than the smallest would apply the IFRS for SMEs; and the smallest layer would continue to apply the FRSSE, amended to align with IFRS. A two-tier system would apply the IFRS for SMEs to both those last two categories.

Clearly, if the ASB see no point in continuing with UK standards, then there is no point in issuing new UK standards during the convergence period which was seen at that point in time as being completed by 2011.

A recent article in Inside Track 58 (January 2009) has updated the position. This says that the ASB has now approved a plan for the remaining stages of its consideration of the future of UK GAAP. Subject to the development of the IFRS for SMEs (now tentatively renamed the IFRS for Private Entities), the ASB plans to issue a discussion paper in the second quarter of this year. This will propose a three tier reporting structure. The ASB are still considering which entities would fall within each tier but have decided that all entities with public accountability should apply full IFRS. The ASB are now envisaging full implementation following a transitional period from 2010 to 2012.

For a copy of Inside Track go to: www.frc.org.uk/asb/publications/insidetrack.cfm

Improvements to Financial Reporting Standards

The ASB has issued a Financial Reporting Standard of Improvements to Financial Reporting Standards so as to maintain the existing levels of convergence between UK and International Financial Reporting Standards.

The amendments arise as a consequence of the International Accounting Standards Board's (IASB) annual improvements process.

The standard gives the following list of amendments:

FRS	**Amendment**
FRS 7 Fair Values in Acquisition Accounting	Contingent consideration
FRS 17 Retirement Benefits	Fair value of unitised securities
FRS 21 (IAS 10) Events after the Balance Sheet Date	Dividends declared after the end of the reporting period
FRS 24 (IAS 29) Financial Reporting in Hyperinflationary Economies	Description of the measurement basis in financial statements Consistency of terminology with other FRS
FRS 25 (IAS 32) Financial Instruments: Presentation	Amendment to the scope of the Standard
FRS 26 (IAS 39) Financial Instruments: Recognition and Measurement	Amendment to the scope of the Standard Reclassifications of derivatives into or out of

	the classification of 'at fair value' through profit and loss Designating and documenting hedges at the segment level Application of the effective interest rate on cessation of fair value hedge accounting
FRS 29 (IFRS 7) Financial Instruments: Disclosures	Amendment to the scope of the Standard Presentation of finance costs

As usual, most of these amendments will only affect larger companies, however, some readers of the notes may be interested in the reference to dividends declared after the end of the reporting period. This does not represent a change in the existing standard but is merely a clarification re-iterating that if dividends are declared (ie the dividends are appropriately authorised and no longer at the discretion of the entity) after the balance sheet date but before the financial statements are authorised for issue, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time. Such dividends are disclosed in the notes to the financial statements.

Amendments to Financial Reporting Standards for Companies Act 2006

The ASB has issued for public comment proposals to amend Financial Reporting Standard (FRS) 2 ‘Accounting for Subsidiary Undertakings’, FRS 6 ‘Acquisitions and Mergers’ and FRS 28 ‘Corresponding Amounts’. The amendments arise from the introduction of the ‘Companies Act 2006’ and from ‘The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008’.

The object of the Financial Reporting Exposure Draft (FRED) is not to amend the requirements of these FRS but to update them such that they correspond with the current legal requirements.

COMPANIES ACT 2006: LATEST DEVELOPMENTS

(Lecture A257 13.16 minutes)

Commencement order Number 8

The following provisions of the Companies Act 2006 come into force on 1st October 2009:

Part 1 (general introductory provisions)
- section 1 (companies);
- sections 3 to 6 (types of company);

Part 2 (sections 7 to 16) (company formation);

Part 3 (a company's constitution)
- section 17 (a company's constitution);
- sections 18 to 28 (articles of association);
- sections 31 to 38 (other provisions relating to a company's constitution);

Part 4 (a company's capacity and related matters)
- sections 39 to 42 (capacity of company and power of directors to bind it);
- sections 43 and 45 to 47 (formalities of doing business under the law of England and Wales or Northern Ireland);
- section 48 (formalities of doing business under the law of Scotland);
- sections 49 to 52 (other matters);

Part 5 (a company's name)
- sections 53 to 57 (general requirements);
- sections 58 to 65 (indications of company type or legal form);
- sections 66 to 68 (similarity to other names);
- sections 75 and 76 (powers of Secretary of State in relation to company names);
- sections 77 to 81 (change of name);

Part 6 (sections 86 to 88) (a company's registered office);

Part 7 (sections 89 to 111) (re-registration as a means of altering a company's status);

Part 8 (a company's members)
- section 112 (the members of a company);
- sections 113 to 115 and 120 and 122 to 127 (register of members);
- sections 129 to 135 (overseas branch registers);
- sections 136 to 144 (prohibition on subsidiary being member of its holding company);

Part 10 (a company's directors)
- sections 162 to 167 (register of directors);
- sections 240 to 246 (directors' residential addresses: protection from disclosure);
- section 247 (power to make provision for employees on cessation or transfer of business);

Part 12 (company secretaries), sections 275 to 279 (register of secretaries);

Part 17 (a company's share capital)
- sections 540 to 543 and 545 to 548 (shares and share capital);
- sections 549 to 559 (allotment of shares: general provisions);
- sections 560 to 577 (allotment of equity securities: shareholders' right of pre-emption);
- sections 578 and 579 (public companies: allotment where issue not fully subscribed);
- sections 580 to 592 (payment for shares);
- sections 593 to 609 (public companies: independent valuation of non-cash consideration);
- sections 610 to 616 (share premiums);

- sections 617 to 628 (alteration of share capital);
- sections 629 to 640 (classes of share and class rights);
- sections 641(1)(b) and 645 to 653 (reduction of share capital confirmed by the court);
- sections 655 to 657 (miscellaneous and supplementary provisions);

Part 18 (sections 658 to 737) (acquisition by limited company of its own shares);

Part 24 (sections 854 to 859) (a company's annual return);

Part 25 (sections 860 to 894) (company charges);

Part 31 (sections 1000 to 1034) (dissolution and restoration to the register);

Part 33 (UK companies not formed under companies legislation), sections 1040 to 1042 (companies not formed under companies legislation but authorised to register);

Part 34 (sections 1044 to 1059) (overseas companies);

Part 35 (the registrar of companies)

- sections 1060 to 1062 (the registrar);
- section 1063 (fees payable to registrar), so far as not already in force;
- sections 1064 to 1067 (certificates of incorporation and registered numbers);
- sections 1068(1) to (4), (6) and (7) and 1069 to 1071 (delivery of documents to the registrar);
- sections 1072 to 1076 (requirements for proper delivery);
- sections 1081 to 1084 (the register);
- sections 1093 to 1098 (correction or removal of material on the register);
- sections 1099 to 1101 (the registrar's index of company names);
- sections 1108 to 1110 (language requirements: transliteration);
- sections 1112 to 1120 (supplementary provisions);

Part 36 (offences under the Companies Acts)

- sections 1121 to 1123 (liability of officer in default);
- section 1125 (meaning of "daily default fine");
- sections 1127 to 1133 (other provisions);

Part 37 (companies: supplementary provisions)

- sections 1134 to 1136, 1137(2), (3) and (5)(a) and 1138 (company records);
- sections 1139 to 1142 (service addresses);
- sections 1149 to 1153 (requirements as to independent valuation);
- sections 1154 and 1155 (notice of appointment of certain officers);
- section 1156 (meaning of "the court");

Part 38 (companies: interpretation)

- section 1158 (meaning of "UK-registered company");
- sections 1159 and 1160 and Schedule 6 (meaning of "subsidiary" and related expressions);
- section 1163 (meaning of "non-cash asset");
- section 1166 (meaning of "employees' share scheme");
- sections 1168, 1171, 1173 (so far as not already in force) and 1174 and Schedule 8 (other definitions etc);

Part 39 (companies: minor amendments)

- section 1180 (repeal of certain provisions about company charges);
- section 1181 (access to constitutional documents of RTE and RTM companies);

Part 40 (sections 1182 to 1191) (company directors: foreign disqualification);

Part 41 (sections 1192 to 1208) (business names);

Part 44 (miscellaneous provisions)

- section 1275 (levy to pay expenses of bodies concerned with actuarial standards etc);
- section 1283 (commonhold associations);

Part 45 (sections 1284 to 1287) (Northern Ireland).

Full details are set out in a statutory instrument Companies Act 2006 commencement order number 8 www.opsi.gov.uk/si/si2008/uksi_20082860_en_1

In these notes we will consider Parts 1 to 4; we will then return to other areas in future updates.

Company formation and constitution

Part 1 General Introductory Provisions

This part defines what is meant by the terms "company" and "the Companies Acts". It goes on to define the types of companies as follows:

- Company limited by shares
- Company limited by guarantee
- Unlimited company
- Community interest company

A "private company" is any company that is not a public company.

A "public company" is a company limited by shares or limited by guarantee and having a share capital (see note) -

(a) whose certificate of incorporation states that it is a public company, and

(b) in relation to which the requirements of this Act, or the former Companies Acts, as to registration or re-registration as a public company have been complied with on or after the relevant date. (which, in Great Britain, is 22nd December 1980)

The two major differences between private and public companies are described in Part 20 of the Act as the prohibition of public offers by private companies and the requirement as to minimum share capital.

Note that, since 22nd December 1980, it has not been possible to form a company limited by guarantee with a share capital.

Part 2 Company Formation

A company is formed under the Act by one or more persons:

(a) subscribing their names to a memorandum of association (see section 8), and

(b) complying with the requirements of the Act as to registration (see sections 9 to 13).

A company may not be formed for an unlawful purpose.

S. 8 Memorandum of association

A memorandum of association is a memorandum stating that the subscribers

(a) wish to form a company under the Act, and

(b) agree to become members of the company and, in the case of a company that is to have a share capital, to take at least one share each.

The memorandum must be in the prescribed form and must be authenticated by each subscriber. It will not be possible to amend or update the memorandum of a company formed under the 2006 Act.

Requirements for registration

The memorandum of association must be delivered to the registrar together with an application for registration of the company, the documents required as shown below and a statement of compliance.

The application for registration must state

(a) the company's proposed name,

(b) whether the company's registered office is to be situated in England and Wales (or in Wales), in Scotland or in Northern Ireland,

(c) whether the liability of the members of the company is to be limited, and if so whether it is to be limited by shares or by guarantee, and

(d) whether the company is to be a private or a public company.

If the application is delivered by a person as agent for the subscribers to the memorandum of association, it must state his name and address.

The application must contain

(a) in the case of a company that is to have a share capital, a statement of capital and initial shareholdings (see section 10);

(b) in the case of a company that is to be limited by guarantee, a statement of guarantee (see section 11);

(c) a statement of the company's proposed officers (see section 12).

The application must also contain

(a) a statement of the intended address of the company's registered office; and

(b) a copy of any proposed articles of association (to the extent that these are not supplied by the default application of model articles: see section 20).

The statement of compliance required to be delivered to the registrar is a statement that the requirements of the Act as to registration have been complied with. The registrar may accept the statement of compliance as sufficient evidence of compliance.

Part 3: A company's constitution

Unless the context otherwise requires, references in the Companies Acts to a company's constitution include

(a) the company's articles, and

(b) any resolutions and agreements to which Chapter 3 applies.

Articles of association

A company must have articles of association prescribing regulations for the company. Unless it is a company to which model articles apply by virtue of section 20 (default application of model articles in case of limited company), it must register articles of association.

The Secretary of State may by regulations prescribe model articles of association for companies. Different model articles may be prescribed for different descriptions of company. A company may adopt all or any of the provisions of model articles. Any amendment of model articles by regulations under this section does not affect a company registered before the amendment takes effect.

A company may amend its articles by special resolution. In the case of a company that is a charity, this is subject to legislation affecting charities.

A company's articles may contain provision ("provision for entrenchment") to the effect that specified provisions of the articles may be amended or repealed only if conditions are met, or procedures are complied with, that are more restrictive than those applicable in the case of a special resolution.

Provision for entrenchment may only be made in the company's articles on formation, or by an amendment of the company's articles agreed to by all the members of the company.

Provision for entrenchment does not prevent amendment of the company's articles by agreement of all the members of the company, or by order of a court or other authority having power to alter the company's articles. The company must give notice to the registrar of the existence of any restriction on amendment of articles or of the removal of such a restriction.

Except where the member agrees in writing, a member of a company is not bound by an alteration to its articles after the date on which he became a member, if and so far as the alteration requires him to take or subscribe for more shares than the number held by him at the date on which the alteration is made, or in any way increases his liability as at that date to contribute to the company's share capital or otherwise to pay money to the company. Where a company amends its articles it must send to the registrar a copy of the articles as amended not later than 15 days after the amendment takes effect.

This section does not require a company to set out in its articles any provisions of model articles that are applied by the articles, or apply by virtue of section 20 (default application of model articles).

Provisions that immediately before the commencement of Part 3 were contained in a company's memorandum but are not provisions of the kind mentioned in section 8 (provisions of new-style memorandum) are to be treated after the commencement of Part 3 as provisions of the company's articles. This applies not only to substantive provisions but also to provision for entrenchment.

Other matters affecting the company's constitution

Chapter 3 requires that a copy of every resolution or agreement affecting a company's constitution, or (in the case of a resolution or agreement that is not in writing) a written memorandum setting out its terms, must be forwarded to the registrar within 15 days after it is passed or made.

Unless a company's articles specifically restrict the objects of the company, Section 31 states that its objects are unrestricted. In the case of a company that is a charity, the provisions of this section have effect subject to the legislation which applies to that charity.

Section 32 provides a list of constitutional documents which must be sent to a member on request.

The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions.

In the case of a company limited by guarantee and not having a share capital any provision in the company's articles, or in any resolution of the company, purporting to give a person a right to participate in the divisible profits of the company otherwise than as a member is void.

Part 4: A company's capacity

The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.

For companies that are charities, this section and the next have effect subject to section 42 (see below).

In favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise others to do so, is deemed to be free of any limitation under the company's constitution.

A person dealing with a company
(i) is not bound to enquire as to any limitation on the powers of the directors to bind the company or authorise others to do so,

(ii) is presumed to have acted in good faith unless the contrary is proved, and

(iii) is not to be regarded as acting in bad faith by reason only of his knowing that an act is beyond the powers of the directors under the company's constitution.

This section does not affect any right of a member of the company to bring proceedings to restrain the doing of an action that is beyond the powers of the directors. But no such proceedings lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.

This section does not affect any liability incurred by the directors, or any other person, by reason of the directors exceeding their powers.

Transactions involving directors or their associates

The section quoted above is subject to section 41 which deals with transactions involving directors or their associates. Where a company enters into a transaction, and the parties to the transaction include a director of the company or of its holding company, or a person connected with any such director, the transaction is voidable at the instance of the company.

Whether or not it is avoided, any such party to the transaction and any director of the company who authorised the transaction, is liable to account to the company for any gain he has made directly or indirectly by the transaction, and to indemnify the company for any loss or damage resulting from the transaction.

The transaction ceases to be voidable if restitution of any money or other asset which was the subject matter of the transaction is no longer possible, or the company is indemnified for any loss or damage resulting from the transaction, or rights acquired bona fide for value and without actual notice of the directors exceeding their powers by a person who is not party to the transaction would be affected by the avoidance, or the transaction is affirmed by the company.

A person other than a director of the company is not liable if he shows that at the time the transaction was entered into he did not know that the directors were exceeding their powers.

Nothing in the preceding provisions of section 41 affects the rights of any other party to the transaction. But the court may, on the application of the company or any such party, make an order affirming, severing or setting aside the transaction on such terms as appear to the court to be just.

Section 42: Transactions involving companies that are charities

Sections 39 and 40 (company's capacity and power of directors to bind company) do not apply to the acts of a company that is a charity except in favour of a person who

(a) does not know at the time the act is done that the company is a charity, or

(b) gives full consideration in money or money's worth in relation to the act in question and does not know (as the case may be)

(i) that the act is not permitted by the company's constitution, or
(ii) that the act is beyond the powers of the directors.

Where a company that is a charity purports to transfer or grant an interest in property, the fact that (as the case may be)

(a) the act was not permitted by the company's constitution, or

(b) the directors in connection with the act exceeded any limitation on their powers under the company's constitution,

does not affect the title of a person who subsequently acquires the property or any interest in it for full consideration without actual notice of any such circumstances affecting the validity of the company's act.
In any proceedings arising out of the above, the burden of proving that a person knew that the company was a charity, or that a person knew that an act was not permitted by the company's constitution or was beyond the powers of the directors, lies on the person asserting that fact.

In the case of a company that is a charity in England and Wales or Northern Ireland the affirmation of a transaction to which section 41 applies (transactions with directors or their associates) is ineffective without the prior written consent of the appropriate regulator.

Company contracts etc

Under the law of England and Wales or Northern Ireland a contract may be made by a company, by writing under its common seal, or on behalf of a company, by a person acting under its authority, express or implied.
Any formalities required by law in the case of a contract made by an individual also apply, unless a contrary intention appears, to a contract made by or on behalf of a company.

Under the law of England and Wales or Northern Ireland a document is executed by a company by the affixing of its common seal, or by signature in accordance with the following provisions.

A document is validly executed by a company if it is signed on behalf of the company by two authorised signatories (any director or company secretary), or by a director of the company in the presence of a witness who attests the signature.

A document executed in this way and expressed, in whatever words, to be executed by the company has the same effect as if executed under the common seal of the company.

The rest of section 44 gives more detail about the execution of documents.

A company may have a common seal, but need not have one. Section 45 deals with the nature and use of the common seal of the company. Section 49 is headed “Official seal for use abroad” and Section 50 “Official seal for share certificates etc”

Sections 46 and 47 cover execution of deeds and section 48 deals with the formalities of doing business under the law of Scotland

Pre-incorporation contracts, deeds and obligations and bills of exchange

A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.

This applies to the making of a deed under the law of England and Wales or Northern Ireland, and to the undertaking of an obligation under the law of Scotland, as it applies to the making of a contract.

A bill of exchange or promissory note is deemed to have been made, accepted or endorsed on behalf of a company if made, accepted or endorsed in the name of, or by or on behalf or on account of, the company by a person acting under its authority.

RELATED PARTY TRANSACTIONS

(Lecture A256 11.36minutes)

Introduction

The ASB were required to 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 would also 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 would now issue an amendment to FRS 8 to bring the definition of related parties into line with CA 2006.

The amendment to FRS 8 has now been published and the changes take effect for financial years beginning on or after 6 April 2008. The changes are discussed below.

Revised Definitions

Related party

A party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
(ii) has an interest in the entity that gives it significant influence over the entity; or
(iii) has joint control over the entity;

(b) the party is an associate (as defined in FRS 9, Associates and joint ventures) of the entity;

(c) the party is a joint venture in which the entity is a venturer (as defined in FRS 9, Associates and joint ventures);

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in subparagraph (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with directly or indirectly, any individual referred to in (d) or (e); or

(g) the party is a retirement benefit scheme for the benefit of employees of the entity, or of any entity that is a related party of the entity.

Comment: Notice that the format has been changed from the old definition and we no longer have reference to those who are deemed to be related parties and those who are presumed to be related parties. It is being suggested by commentators that the change in definition will have little impact in practice but it is interesting to note the following example which appeared in the previous set of quarterly notes:
ABC Ltd is owned equally by A, B and C who are also the three directors of the company.
A Ltd is owned entirely by A who is also the sole director of the company.
Q: Will ABC Ltd be treated as a related party in the accounts of A Ltd?
A: Apparently, under the existing version of FRS 8, ABC Ltd is not a related party of A Ltd. Once the revised FRS 8 comes into force, ABC Ltd will be a related party of A Ltd under part (f) of the definition

Key management personnel

Those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Comment: contrast this with the old definition of "Key management" as those persons in senior positions having authority or responsibility for directing or controlling the major activities and resources of the reporting entity.

The following definitions have not been changed:

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.

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.
Comment: it is interesting that the definition of "persons acting in concert" is included in the revised FRS 8 but the phrase itself is never actually used anywhere else in the standard.

Other changes

Scope

The revised FRS 8 does not require disclosure 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 a member of that group.

Reporting entities taking advantage of the exemption above are required to state that fact.

Comment: In the existing FRS 8, the exemption applied to subsidiary undertakings, 90% or more of whose voting rights were controlled within the group. The existing requirement for the subsidiary to be included in consolidated financial statements which are publicly available is not repeated in the revised FRS 8.

Transitional provision

FRS 28 Corresponding Amounts requires corresponding amounts in respect of every item stated in the notes to the financial statements. Entities, which previously took advantage of the exemption provided by FRS 8, and did not provide information for 90 per cent subsidiary undertakings may be unable to provide corresponding amounts in the first year of adopting this amendment. Corresponding amounts need not be provided where this information cannot be obtained in the first year of adopting this amendment. Entities that do not provide corresponding amounts should provide an explanation in the notes to the financial statements.

Disclosure of material transactions not concluded under normal market conditions

The Regulations include a requirement for particulars to be given in the notes to the accounts of transactions which an entity has entered into with a related party, where such transactions are material and have not been concluded under normal market conditions. The Amendment to FRS 8 clarifies that this requirement will be met by complying with FRS 8, which requires disclosure of all material related party transactions.

A NEW HMRC ATTACK ON PROVISIONS?

(Lecture A258 11.32 minutes)

Based on feedback from delegates on recent courses it seems that the Inspector of Taxes in certain locations around the country has started to challenge the provision for accountancy services in certain situations.
Situation

X Ltd starts trading on 1 January 2007 and has a year end of 31 March 2008. The directors have been working very hard in the business and have not given much thought to administrative issues. They do not get around to appointing accountants to help prepare their 31 March 2008 accounts until June 2008.

The accounts are prepared by a firm of qualified accountants in August 2008 and the accounts are then filed and used as the basis for the tax computation. In the accounts there is a provision for the preparation of the accounts of £3,000.

The Inspector has suggested that this is not an appropriate provision under FRS 12.

FRS 12 Provisions, Contingent Liabilities and Contingent Assets states that a provision should be recognised when:

a) an entity has a present obligation (legal or constructive) as a result of a past event,
b) it is probable that a transfer of economic benefits will be required to settle the obligation and
c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

The Inspector's challenge is based upon a) above not being met. That is to say that there is no obligation to appoint accountants to prepare the accounts at the year end. The company could have chosen to prepare them without help and free of charge.

Question 1: Is the Inspector right or is this an appropriate provision under FRS 12?

Question 2: Would it make any difference if the appointment had been made and an engagement letter had been signed before 31 March 2008?

Question 3: Would your answers to 1 and 2 differ if the company required an audit?

GOING CONCERN: THE ACCOUNTING REQUIREMENTS

(Lecture A259 22.16 minutes)

Companies Act

From CA 1985: Schedule 4 paragraph 10:

"The company shall be presumed to be carrying on business as a going concern."

Exactly the same wording is used for small companies in Schedule 8, paragraph 10.

Turning to CA 2006, we have, in SI 2008 No 410 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 in Schedule 1 at paragraph 11:

"The company is presumed to be carrying on business as a going concern"

Exactly the same wording is used in the Regulations for small companies and groups.

The other Companies Act section which is relevant in the context of going concern disclosures is CA 2006 S 417(3)

The business review must contain-

(a) a fair review of the company's business, and

(b) a description of the principal risks and uncertainties facing the company.

This section applies to directors' reports for financial years beginning on or after 1 October 2007. However, for this purpose, the requirement of S 417 is identical to the equivalent section from CA 1985 that is S 234ZZB(1).

Accounting Standards

Paragraph 21 of FRS 18 states:

An entity should prepare its financial statements on a going concern basis, unless

(a) the entity is being liquidated or has ceased trading, or

(b) the directors either intend to liquidate the entity or to cease trading, or have no realistic alternative but to do so,

in which circumstances the entity should prepare its financial statements on a basis other than that of a going concern.

FRS 18 does not contain a definition of going concern although some help with this point is provided by paragraph 3.6 of the Statement of Principles where we get this quote:

"There are a number of different perspectives from which an entity's financial performance and financial position could be viewed and the perspective adopted could have a significant effect on the assets and liabilities recognised and on their carrying amounts. In view of the objective of financial statements, the perspective that is usually most relevant is based on the assumption that the entity is to continue in operational existence for the foreseeable future. This perspective is commonly referred to as the going concern assumption."

Notice that there is no reference in current UK accounting standards or statements to a need to "curtail significantly the scale of business operations" as was present in the old SSAP 2. However, the IASB Framework continues to include this phrase and so we would expect, in due course for the UK to fall in line.

Another interesting quote is from paragraph 6 of Appendix III to FRS 18:

"IAS 1 (revised 1997) requires financial statements to be prepared on a going concern basis unless management either intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. The FRS includes a requirement that is similar except that management intent is not sufficient to justify a departure from the going concern basis. Accordingly, the FRS requires an entity's financial statements to be prepared on a going concern basis unless the entity is being liquidated or has ceased trading, or the directors have no realistic alternative but to liquidate the entity or to cease trading."

This is not consistent with paragraph 21 of the standard as quoted above. To explain this inconsistency, recall that when FRS 18 was first released, there was no reference to intention in paragraph 21. Under the original standard, the entity could only prepare financial statements on a basis other than going concern where the entity was being liquidated or had ceased trading, or the directors had no realistic alternative but to liquidate the entity or to cease trading." There was no reference in the original standard to intention. The change was introduced by FRS 21 in 2005. Clearly, when FRS 18 was updated, nobody thought to amend Appendix III.

The impact of events after the balance sheets date on the use of the going concern presumption is discussed in paragraphs 14 and 15 of FRS 21:

An entity shall not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Deterioration in operating results and financial position after the balance sheet date may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.

Returning to FRS 18, the standard requires that the directors, when preparing financial statements, should assess whether there are significant doubts about an entity's ability to continue as a going concern. If the directors, when making this assessment, are aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, then paragraph 61 requires them to disclose those uncertainties. In making their assessment, the directors take into account all available information about the foreseeable future.

Paragraph 25 of FRS 18 explains that the degree of consideration necessary to make the above assessment depends on the facts in each case. When an entity has a history of profitable operations, which are expected to continue, and ready access to financial resources, detailed analysis may not be necessary. In other cases, the directors may, in making their assessment, need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing. Such considerations also govern the length of time in respect of which the assessment should be made.

The disclosures required by paragraph 61 in relation to the going concern assessment are:

(a) any material uncertainties, of which the directors are aware in making their assessment, related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern.

(b) where the foreseeable future considered by the directors has been limited to a period of less than one year from the date of approval of the financial statements, that fact.

(c) when the financial statements are not prepared on a going concern basis, that fact, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern.

As always, the FRSSE expresses things more succinctly. Paragraph 2.12 of FRSSE 2008 states:

The company is presumed to be carrying on business as a going concern. When preparing financial statements, directors shall assess whether there are significant doubts about the entity's ability to continue as a going concern. Any material uncertainties, of which the directors are aware in making their assessment, shall be disclosed. Where the period considered by the directors in making this assessment has been limited to a period of less than one year from the date of approval of the financial statements, that fact shall be stated. The financial statements shall not be prepared on a going concern basis if the directors determine after the balance sheet date either that they intend to liquidate the entity or to cease trading, or that they have no realistic alternative but to do so.

Guidance from the Financial Reporting Council (FRC)

Introduction

To assist directors, the FRC has published guidance entitled "An update for directors of listed companies: going concern and liquidity risk" (Update for Directors). Its purpose is to bring together existing guidance in the context of recent developments relating to going concern and liquidity risk disclosures to assist directors, audit committees and finance teams of listed companies. It does not establish any new requirements but it does highlight the importance of clear disclosure about going concern and liquidity risk in current economic conditions. The FRC say that the update may also be useful for directors of unlisted companies who have similar responsibilities to assess going concern and make appropriate disclosures.

The notes that follow consist mainly of extracts from the Update for Directors. These extracts have been chosen because they are relevant for directors and accountants of unlisted companies. Those users of the notes who are involved with listed companies are advised to read the full document.

Going concern is a fundamental accounting concept that underlies the preparation of the annual report and accounts of all UK companies. Under both International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Principles (UK GAAP) directors are required to satisfy themselves that it is reasonable for them to conclude that it is appropriate to prepare financial statements on a going concern basis. These requirements are not intended to, and do not, guarantee that a company will remain a going concern until the next annual report and accounts is issued.

The economic conditions being faced by many companies will necessitate careful consideration by directors when assessing whether it is reasonable for them to use the going concern basis of accounting, and whether adequate disclosure has been given of going concern risks and other uncertainties. Addressing these challenges well before the preparation of annual reports and accounts may help avoid a last-minute problem that might unsettle investors and lenders unnecessarily.

Directors will need to plan their assessment of going concern as early as practicable including deciding on the information and analysis that will need to be produced (such as board papers) and the processes and procedures that will be undertaken. These plans should also address the evidence to be obtained to support their conclusion and develop, where necessary, any remedial action plan.

In 1994, the FRC issued guidance "Going concern and financial reporting: guidance for directors of listed companies registered in the United Kingdom". An exposure draft to update this guidance is expected early in 2009 but, in the meantime the FRC believes that the existing guidance contained in the 1994 Guidance is fit for purpose even in these times of significant economic stress. This guidance can be found on the FRC website at:
www.frc.org.uk/corporate/goingconcern.cfm

The 1994 Guidance indicates that directors may seek confirmation from their bankers regarding the existence and status of their finance arrangements. In the present economic environment bankers may be reluctant to provide positive confirmation that facilities will continue to be available. This reluctance may extend to companies with a profitable business and relatively small borrowing requirements. The absence of confirmations of bank facilities does not of itself necessarily cast significant doubt upon the ability of an entity to continue as a going concern nor necessarily require auditors to refer to going concern in their reports.

The effect of current market conditions on individual entities requires careful evaluation. The general economic situation at the present time does not of itself necessarily mean that a material uncertainty exists about a company's ability to continue as a going concern. However, it is important that annual accounts contain appropriate disclosure of liquidity risk and uncertainties such as are necessary in order to give a true and fair view.

Examples illustrating how directors might explain their going concern conclusion taking account of current economic conditions which would facilitate an understanding by readers of annual reports and accounts are included in an appendix to the update and are shown later in these notes.

Procedures to be followed by directors

The procedures that are necessary for the directors to comply with the requirements of IAS 1 or FRS 18 are likely to be similar to those adopted to meet their obligations under the Listing Rules. The 1994 Guidance places particular emphasis on the importance of the processes and procedures that directors carry out and highlights some major areas in which procedures are likely to be appropriate, including:

- forecasts and budgets;
- borrowing requirements;
- liability management;
- contingent liabilities;
- products and markets;
- financial risk management;
- other factors; and
- financial adaptability.

The 1994 Guidance notes that this list is not exhaustive and the significance of factors will vary from company to company. In the current economic climate many of these factors will have increased in significance which will require directors to consider them with more rigour and formality.

Further guidance is provided in relation to bank and other facilities. The facilities available to the company should be reviewed and compared to the detailed cash flow forecasts for the period to the next balance sheet date, as a minimum. Sensitivity analyses on the critical assumptions should also be used in the comparison. The directors should seek to ensure that there are no anticipated:

- shortfalls in facilities against requirements;
- arrears of interest; or
- breaches of covenants.

The directors have responsibility to manage borrowing requirements actively. Any potential deficits, arrears or breaches should be discussed with the company's bankers in order to determine whether any action is appropriate. This may prevent potential problems crystallising. The onus is on the directors to be satisfied that there are likely to be appropriate and committed financing arrangements in place.

Going concern disclosures

In forming their conclusion on going concern directors will need to evaluate which of three potential outcomes is appropriate to the specific circumstances of the group and company. The directors may conclude:

- there are no material uncertainties that lead to significant doubt upon the entity's ability to continue as a going concern;
- there are material uncertainties that lead to significant doubt upon the entity's ability to continue as a going concern; or
- the use of the going concern basis is not appropriate.

Directors will need to consider carefully the position in the light of the information available to them and the assumptions as to the future availability of finance. Their conclusion will generally result in one of the following three outcomes:

Outcome	**Consequence for the directors' statement on going concern**
No material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosure explaining the conclusion on going concern and how that has been reached. ***Examples 1 and 2 below illustrate this outcome.***

Material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosures explaining the specific nature of the material uncertainties and explaining why the going concern basis has still been adopted. ***Example 3 below illustrates this outcome.***
The directors conclude that the going concern basis is not appropriate.	Disclosures explaining the basis of the conclusion and the accounting policies applied in drawing up financial statements on a non-going concern basis.

The examples included in the FRC guidance bring together going concern and liquidity risk disclosures. As such, they are particularly relevant to companies required to follow FRS 29 (IFRS 7). For the purpose of these notes, I have extracted those elements of the examples relating just to going concern. These disclosures give an example of the disclosure that might be required in particular situations. In practice such disclosures should be specific to the individual circumstances of each company.

Example 1 - A group with significant positive bank balances, uncomplicated circumstances and little or no exposure to uncertainties in the current economic environment which may impact the going concern assumption.

The group has considerable financial resources together with long-term contracts with a number of customers and suppliers across different geographic areas and industries. As a consequence, the directors believe that the group is well placed to manage its business risks successfully despite the current uncertain economic outlook.
After making enquiries, the directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and accounts.

Example 2 - A group with uncomplicated circumstances, some exposure to the current economic uncertainties and either a current material bank overdraft or loan and a need to renew this facility in the foreseeable future albeit not imminently.

As highlighted in note B to the financial statements, the group meets its day to day working capital requirements through an overdraft facility which is due for renewal on [date]. The current economic conditions create uncertainty particularly over (a) the level of demand for the group's products; (b) the exchange rate between sterling and currency X and thus the consequence for the cost of the group's raw materials; and (c) the availability of bank finance in the foreseeable future.

The group's forecasts and projections, taking account of reasonably possible changes in trading performance, show that the group should be able to operate within the level of its current facility. The group will open renewal negotiations with the bank in due course and has at this stage not sought any written commitment that the facility will be renewed. However, the group has held discussion with its bankers about its future borrowing needs and no matters have been drawn to its attention to suggest that renewal may not be forthcoming on acceptable terms.

After making enquiries, the directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and accounts.

Example 3 - A group with complicated circumstances, considerable exposure to the current economic uncertainties and either a current material bank overdraft or loan which requires renewal and perhaps an increase in the year ahead.

As described in the directors' report on page X the current economic environment is challenging and the group has reported an operating loss for the year. The directors' consider that the outlook presents significant challenges in terms of sales volume and pricing as well as input costs. Whilst the directors have instituted measures to preserve cash and secure additional finance, these circumstances create material uncertainties over future trading results and cash flows.

As explained on page X, the directors are seeking to sell a property to provide additional working capital. The group is in negotiations with a potential purchaser but there can be no certainty that a sale will proceed. Based on negotiations conducted to date the directors have a reasonable expectation that it will proceed successfully, but if not the group will need to secure additional finance facilities.

As explained in the Business Review on Page Y, the group has commenced discussions with its bankers about an additional facility that may prove to be necessary should the sale of the property not proceed or should material adverse changes in sales volumes or margins occur. It is likely that these discussions will not be completed for some time. The directors are also pursuing alternative sources of funding in case an additional facility is not forthcoming, but have not yet secured a commitment.

The directors have concluded that the combination of these circumstances represent a material uncertainty that casts significant doubt upon the group's and the company's ability to continue as a going concern. Nevertheless after making enquiries, and considering the uncertainties described above, the directors have a reasonable expectation that the group and the company have adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis in preparing the annual report and accounts.

Other matters arising from accounting standards

Accounting standards do not define what constitutes a 'material uncertainty that may cast significant doubt upon the entity's ability to continue as a going concern'. This involves assessing both the probability of an event occurring and the impact it will have if it does occur. Assessment of these elements may require a high degree of judgment both by the directors, and subsequently by the auditors depending upon individual company and group circumstances.

Where the period considered by the directors has been limited, for example, to a period of less than twelve months from the date of the approval of the annual report and accounts, the directors need to consider whether additional disclosures are necessary to explain adequately the assumptions that underlie the adoption of the going concern basis.

Doubts upon the ability of a company to remain a going concern do not necessarily mean that the company is, or is likely to become, insolvent. The solvency of a company is determined by reference to a comparison of its assets and liabilities and by its ability to meet liabilities as they fall due. Where the directors are unable to state that the going concern basis is appropriate, they should consider taking professional advice.

FRS 29 requires an entity to make both qualitative and quantitative disclosures concerning liquidity risk, where it is a material financial risk. This part of the FRC document is not covered in these notes since most unlisted entities are not subject to the requirements of FRS 29. Interested readers should refer to the full document. The FRC has also published a study into going concern and liquidity risk disclosures in the financial statements of listed companies that have adopted IFRS 7. The study can be obtained from: www.frc.org.uk/corporate/goingconcern.cfm.

Business Review

Directors will need to explain in the Business Review the principal risks and uncertainties facing the company arising from the current difficult economic conditions. One of the purposes of the Business Review is to help the members assess how the directors have performed their duties so it is reasonable to expect that it will also contain an account of how the directors intend to respond to these risks and uncertainties. Issues which may require disclosure depend upon individual facts and circumstances and may include:

- uncertainties about current financing arrangements (whether committed or uncommitted);
- potential changes in financing arrangements such as critical covenants and any need to increase borrowing levels;
- risks arising from current credit arrangements (including the availability of insurance where relevant) with either customers or suppliers;
- a dependency on key suppliers and customers; and
- uncertainties posed by the potential impact of the economic outlook on business activities.

BULLETIN 2008/10: GOING CONCERN ISSUES DURING CURRENT ECONOMIC CONDITIONS

(Lecture A260 24.59 minutes)

Introduction

In January 2008 the Auditing Practices Board (APB) issued Bulletin 2008/1 to provide guidance on matters that auditors needed to consider when conducting audits in the economic environment that was, at that time, characterised as the 'credit crunch'.

Since then the economic environment has worsened and the UK and Irish economies are entering a period of recession. This economic environment leads to added uncertainty regarding:

(a) bank lending intentions and the availability of finance more generally;
(b) the impact of the recession on a company's own business; and
(c) the impact of the recession on counterparties, including customers and suppliers.

These conditions will create a number of challenges for the preparers of financial statements and their auditors.

The effect of the current market conditions on any particular entity requires careful evaluation. However, the general economic situation at the present time does not, of itself, necessarily mean that a material uncertainty exists about an entity's ability to continue as a going concern or justify auditors modifying their auditor's reports to draw attention to going concern. The auditor makes a judgment on the need, or otherwise, to draw attention to going concern on the basis of the facts and circumstances of the entity at the time of signing the auditor's report. Bulletin 2008/10 gives guidance on relevant factors to be considered and highlights certain requirements and guidance in the ISAs (UK and Ireland).

The Bulletin supplements Bulletin 2008/1 and in particular:

(a) updates the listing of risk factors included in that Bulletin. These notes include the appendix listing events or conditions that may affect going concern. However, appendix 3 from the bulletin which deals with risk factors arising from current economic conditions other than going concern has not been reproduced; and

(b) provides guidance on a number of going concern issues that auditors are likely to encounter during the forthcoming reporting cycle.

The guidance draws on ISA (UK and Ireland) 570 Going concern and does not establish any new requirements.

The APB believes that the FRC's publication of the Update for Directors will assist auditors as it emphasises the need for directors to apply an appropriate degree of rigour and formality when making their judgments and suggests that directors will need to plan their assessment of going concern as early as practicable, including deciding on the information that will need to be produced (such as board papers) and the processes and procedures that will be undertaken. Notwithstanding early discussions between the company and its auditors both directors and auditors need to take account of subsequent developments as final assessments of going concern need to be made at the date that the directors approve the annual report and accounts taking into account the relevant facts and circumstances at that date.

Planning

Risks arising from current economic circumstances are likely to impact a number of different aspects of the financial statements, for example the economic conditions may impact matters such as inventory obsolescence, goodwill impairments and cash flows, which may in turn affect whether the company is a going concern. It is important that auditor judgments on such matters are based on consistent underlying information and views.

Because of the significance and pervasive nature of the current economic circumstances auditors need to take account of them at all stages of forthcoming audits and in particular when:
(a) making risk assessments during the planning process and re-assessing those risks as the audit progresses;
(b) performing audit procedures to respond to assessed risks;
(c) evaluating the results of audit procedures (including as part of any engagement quality control review); and
(d) forming an opinion on the financial statements.

Considering The Directors' Assessment Of Going Concern

ISA (UK and Ireland) 570 requires the auditor to consider the appropriateness of the directors' use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. In order to meet this requirement the auditor's procedures will comprise the five elements shown below.

Evaluating how the directors have satisfied themselves that it is appropriate to adopt the going concern basis

Audit procedures that are likely to be relevant when evaluating the adequacy of the means by which the directors have satisfied themselves whether it is appropriate for them to adopt the going concern basis in preparing the financial statements include:

- Analysing and discussing cash flow, profit and other relevant forecasts with management.
- Reviewing the terms of loan agreements and determining whether any may have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for references to financing difficulties.
- Reviewing events after period end to identify those that may mitigate or otherwise affect the entity's ability to continue as a going concern.

If required, additional procedures are described in paragraph 28 of ISA (UK and Ireland) 570.

When analysis of cash flow is a significant factor in considering the future outcome of future events or conditions the auditor considers the reliability of the entity's information system for generating such information and whether there is adequate support for the assumptions underlying the forecast.

ISA (UK and Ireland) 570 Paragraph 26 requires that when events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:

(a) review the directors' plans for future action based on their going concern assessment;
(b) gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of the directors and other mitigating factors; and
(c) seek written representations from the directors regarding their plans for future action.

In general terms, the greater the risks arising from current economic circumstances the more audit evidence will be required.

Concluding whether or not to concur with the directors' view

Assessing the going concern assumption involves making a judgment, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. Generally, the degree of uncertainty associated with the outcome of an event or condition increases the further into the future a judgment is being made about the outcome. Any judgment about the future is based on available evidence and reasonable assumptions about the outcome of the future events made at the time at which the judgment is made.

The basis for the auditor's conclusion is the information upon which the directors have based their assessment and their reasoning, including, where applicable, advice obtained from external advisers including lawyers. In evaluating the assessment of the directors, the auditor considers the process they followed to make their assessment, the assumptions on which the assessment is based and their plans for future action. The auditor considers whether the assessment has taken into account all relevant information of which the auditor is aware as a result of the audit.

Where there are events or conditions that cast significant doubt on the ability of the entity to continue as a going concern, the auditor assesses the directors' plans for future action, including plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

Adequacy of disclosures

Developments in accounting standards, including those relating to liquidity risk, together with the current economic conditions can be expected to give rise to a greater number of company annual reports and accounts containing liquidity and going-concern related disclosures.

The Update for Directors emphasises the importance, in the current economic conditions, of appropriate disclosures regarding liquidity risk and uncertainties. In its Appendix, it provides three illustrative examples of how directors might explain their going concern conclusion in a manner that would facilitate an understanding by readers of annual reports and accounts. These examples were included earlier in these notes

An essential quality of the information provided in financial statements is that it is readily understandable by users. In reviewing the presentation of the disclosures the auditor considers whether the notes to the financial statements taken together with the primary financial statements present a true and fair view. The understandability of the disclosures is an important factor in determining whether the financial statements give a true and fair view.

Determining the implications for the auditor's report

ISAs (UK and Ireland) provide for a number of different auditor reports depending upon the specific facts and circumstances. For example, if auditors conclude that the disclosures regarding going concern are not adequate to meet the requirements of accounting standards, including the need for financial statements to give a true and fair view, they are required either to express a qualified or adverse opinion, as appropriate. The report is also required to include specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

If the auditor concludes that a material uncertainty exists that leads to significant doubt about the ability of the entity to continue as a going concern, and those uncertainties have been adequately disclosed in the financial statements, it is required to modify its report by including an emphasis of matter paragraph.

Referring again to the FRC's examples of disclosure, the table provided by the FRC goes on to consider the appropriate form of the auditor's report in each of the situations presented.

Outcome	**Consequence for the directors' statement on going concern**	**Consequence for the auditors' report**
No material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosure explaining the conclusion on going concern and how that has been reached. ***Examples 1 and 2 in the notes illustrated this outcome.***	Unmodified report (clean) - provided the auditors concur with the directors' assessment and supporting disclosures.
Material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosures explaining the specific nature of the material uncertainties and explaining why the going concern basis has still been adopted. ***Example 3 in the notes illustrated this outcome.***	Modified report including an emphasis of matter paragraph highlighting the existence of material uncertainties - provided auditors concur with the directors' assessment and supporting disclosures.
The directors conclude that the going concern basis is not appropriate.	Disclosures explaining the basis of the conclusion and the accounting policies applied in drawing up financial statements on a non-going concern basis.	Unmodified report (clean) - provided that the accounts contain the necessary disclosures and the auditors consider the basis to be appropriate to the specific facts and circumstances.

Examples of other conclusions that may be drawn by the auditor are illustrated in Appendix 3 to Bulletin 2006/6.

As a footnote, the bulletin deals with the inconsistency in terminology between ISA (UK and Ireland) 700 and ISA (UK and Ireland) 570 by saying that the term "material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern". Which is used in ISA (UK and Ireland) 570 is equivalent to the term "material matter regarding a going concern problem" used in ISA (UK and Ireland) 700.

The current economic circumstances are likely to increase the level of uncertainty existing when the directors make their judgment about the outcome of future events or conditions. However, whilst the effect of current market conditions on individual entities requires careful evaluation, it should not be assumed that the general economic situation at the present time in itself means that a material uncertainty, which casts significant doubt on the ability of the entity to continue as a going concern, exists. Nor are extensive disclosures necessarily indicative of the existence of a significant doubt on the entity's ability to continue as a going concern. Indeed an objective of the disclosures may be to explain why the going concern issues that affect the company do not give rise to a significant doubt.

What constitutes a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern is a judgment involving not only the nature and materiality of the events or conditions giving rise to uncertainty; but also the ability of the entity to adopt strategies that mitigate the uncertainty.

Nature and materiality of the events or conditions

Accounting standards do not define what constitutes a "material uncertainty". However, determining whether a "material uncertainty" exists involves assessing:

(a) the likelihood of events or conditions occurring; and
(b) their impact.

Assessment of these elements may require a high degree of judgment both by the directors and subsequently by the auditors depending upon the individual circumstances of the company and/or group.

Examples of possible events or conditions which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption are set out in ISA (UK and Ireland) 570 paragraph 8, these include:

- A net liability or current liability position.
- Negative operating cash flows.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Major debt repayment falling due where refinancing is necessary to the entity's continued existence.
- Inability to comply with the terms of loan agreements or to pay creditors on due dates.
- Loss of a major market, franchise, license or principal supplier.

A list of other possible events and conditions that may affect the auditor's assessment of going concern are set out in the Appendix below.

Paragraph 8 also notes that the existence of one or more of the factors does not always signify that a material uncertainty that casts significant doubt on the entity's ability to continue as a going concern exists.

A factor listed in ISA (UK and Ireland) 570 is that necessary borrowing facilities have not been agreed. In examining borrowing facilities the auditor could decide, for example, that it is necessary:

(a) to obtain confirmations of the existence and terms of bank facilities; and

(b) to make its own assessment of the intentions of the bankers relating thereto. This latter assessment could involve the auditor examining written evidence or making notes of meetings which it would hold with the directors and, where appropriate, with the directors and the entity's bankers.

As discussed earlier, in the present economic environment bankers may be reluctant to confirm to entities or their auditors that facilities will be renewed. This reluctance may extend to companies with a profitable business and relatively small borrowing requirements. The lack of a positive confirmation from a bank does not of itself provide evidence of a material uncertainty that casts significant doubt on the entity's ability to continue as a going concern. Auditors seek to differentiate between circumstances where the lack of a confirmation reflects the existence of a material matter regarding going concern (which, therefore, falls to be emphasised in the auditor's report) and increased caution on the part of bankers that is not indicative of a material matter regarding going concern (and which, therefore, does not fall to be emphasised in the auditor's report).

There may be a number of reasons why a bank may be reluctant to confirm that a facility will be available in the future, which would not be a material matter regarding going concern, including:

- The bank responding that in the current economic environment, as a matter of policy, it is not providing such confirmations to its customers or their auditors.
- The entity and its bankers are engaged in negotiations about the terms of a facility (e.g. the interest rate), and where there is no evidence that the bank is reluctant to lend to the company.
- The bank renewed a rolling facility immediately prior to the date of the issuance of the annual report and accounts and is reluctant to go through the administrative burden to confirm that the facility will be renewed on expiry.

However, if the auditor concludes that an entity's bankers may be refusing to confirm facilities for reasons that are specific to the entity the auditor considers the significance of this and, where appropriate, discusses with the directors whether there are alternative strategies or sources of financing that would enable the financial statements to be prepared on the going concern basis.

Ability to adopt alternative strategies that mitigate an uncertainty

The adverse factors described above may be mitigated by other favourable factors. For example, the effect of an entity being unable to make its debt repayments from operating cash flows may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly the loss of a principal supplier may be mitigated by the availability of another suitable source of supply. Where an entity contends that it has alternative strategies to overcome any adverse factors the auditor assesses the effectiveness of such strategies and the ability of management to execute them.

If the auditor, in assessing the alternative strategies, considers that they are realistic, have a reasonable expectation of resolving any problems foreseen and that the directors are likely to put the strategies into place effectively, the auditor may decide that it is unnecessary to include an emphasis of matter paragraph in the auditor's report.

Documentation

ISA (UK and Ireland) 230 (Revised) Audit Documentation requires the auditor to prepare audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit and the conclusions reached thereon. Significant matters include, amongst other things, findings that could result in a modification to the auditor's report. With respect to going concern, it is important, therefore, that the auditor documents its knowledge of conditions and events at the date of the auditor's report, and its reasoning with respect to the conclusions it has drawn.

Ethical Issues

The APB's Ethical Standards (ESs) are based on a "threats and safeguards approach" whereby auditors identify and assess the circumstances which could adversely affect the auditor's objectivity ("threats"), including any perceived loss of independence, and apply procedures ("safeguards"), which will either eliminate the threat or reduce it to an acceptable level, that is a level at which it is not probable that a reasonable and informed third party would conclude that the auditor's objectivity is impaired or is likely to be impaired.

In the current circumstances, where financial market conditions are difficult and credit facilities may be restricted, auditors need to be particularly alert to the possibility of self-review, management or advocacy threats arising from the provision of non-audit services in relation to a refinancing or restructuring that might jeopardise their objectivity and independence.

Examples of engagements that the audit firm may be requested to undertake in the current economic environment and which may give rise to threats to the auditor's independence and objectivity include:

- Undertaking a review of the business with a view to advising the audited entity on restructuring options.
- Advising on forecasts or projections, for presentation to lenders and other stakeholders, including assumptions.
- Advising the audited entity on how to fund its financing requirements, including debt restructuring programmes.

When such work is undertaken a threat arises from the risk that the audit team may not review objectively the work undertaken in relation to going concern for audit purposes. Accordingly, where audit firms (and, in particular, members of the audit team) do undertake such engagements, consideration should be given to safeguards such as:

- A review of the going concern assessment and the conclusion reached by a partner or other senior staff member with appropriate expertise who is not a member of the audit team.
- Additional procedures undertaken as part of an Engagement Quality Control Review.

ES 5 (Revised) states that it is unlikely that safeguards can eliminate a threat or reduce it to an acceptable level:

(a) in the absence of 'informed management' (paragraph 27 of ES 5 (Revised)) and
(b) when the non-audit service would require the auditors to act as advocates for the entity in relation to matters that are material to the Financial Statements (paragraph 30 of ES 5 (Revised)).

Consequently, where an audit firm is engaged to provide advice to assist an entity it audits to demonstrate that it is a going concern, the audit firm ensures that the entity has "informed management" capable of taking responsibility for the decisions to be made, thereby reducing the risk that the audit firm may be regarded as taking management decisions for the entity concerned. If the audit firm attends meetings with the entity's bank or other interested parties it takes particular care to avoid assuming responsibility for the entity's proposals or being regarded as negotiating on behalf of the entity or advocating the appropriateness of the proposals such that its independence is compromised.

Appendix: Possible events or conditions that may affect the auditor's assessment of going concern

Obtaining external finance

- Entity has experienced difficulties in the past in obtaining external finance facilities and/or complying with the related terms and covenants.
- Borrowing agreements or executory contracts include clauses relating to debt covenants or subjective clauses (e.g. a "material adverse change clause") that trigger repayment.
- Entity has breached some of the terms or covenants giving rise to the risk that the facilities may be withdrawn or not renewed.
- Finance facilities are due for renewal in the next year. Management have no plans for alternative arrangements should current facilities not be extended.
- Finance facility is secured on assets (e.g. properties) that have decreased in value below the amount of the facility.
- There are significant doubts about the financial strength of the entity's bankers.
- Financing is provided by a syndicate of banks and other financial institutions and there are concerns about the viability of one or more of the members of the syndicate.

Management plans to overcome financing difficulties include disposal of assets or possible rights issues

- Plans developed prior to current market conditions have not been updated or stress tested.
- Lack of evidence that management can realise the assets at the values arising from planned disposals or obtain the support of shareholders in relation to a rights issue.

Entity provides significant loans or guarantees

- Guarantees that may be called in.
- Borrowers who may be unable to make payments.

Entity dependent on guarantees provided by another party

- Guarantor no longer able/prepared to provide the guarantee.

Future cash flows

- Reduction in cash flows resulting from unfavourable economic conditions. Customers taking longer/unable to pay.
- Terms or covenants of renewed financing are changed and become more difficult to comply with (e.g. increased interest rates or charges).
- Entity is subject to margin calls as a result of a decrease in fair market value of financial instruments that it holds.
- Entities have issued loans (or received borrowings) having an introductory period during which favourable terms are in force which revert to normal market rates in the forthcoming year.

Entity heavily dependent on counterparties such as suppliers and customers

- Suppliers facing financial difficulties provide essential goods/services. Entity unable to find alternative suppliers.

REPORTING ON AUDIT EXEMPT COMPANIES

(Lecture A261 16.17 minutes)

Introduction

About three years ago, the Professional Oversight Board expressed the opinion that Accountants' reports should be filed with the accounts of audit exempt companies. Further, the POB suggested that the accountancy bodies should co-operate in the development of an agreed profession-wide report.

It was hoped that a draft of such a report would be made available towards the end of 2008. However, this has not occurred and, in the light of continuing delay, these notes include a reminder of the existing guidance from the ICAEW and ACCA.

Chartered Accountants' Reports on the Compilation of Financial Statements of Incorporated Entities (Audit 02/04)

The notes below give an outline of the guidance published by the ICAEW.

Professional ethics

This refers to the Fundamental Principles of: Integrity; objectivity; competence; performance; courtesy.

The guidance emphasises that members should not compile financial statements or permit their names to be associated with financial statements that they consider misleading. Compile is defined as: 'to make or compose from other sources'.

The guidance refers to ethical issues such as potential threats to objectivity, and conflicts of interest.

Compilation of financial statements

The guidance is not designed and does not enable the accountants to express any assurance on the financial statements. However users derive benefit from the financial statements because Chartered Accountants are subject to various ethical requirements of ICAEW.

Terms of engagement

The Technical Release sets out the various matters an engagement letter would normally be expected to deal with, and Appendix A includes example extracts to insert into an engagement letter. Accountants should review existing engagement letters, and amend as appropriate.

The engagement letter should be addressed to the Board of Directors.

Operational issues

The guidance refers to planning, procedures, documentation and management representations. There are no explicit requirements in any of these areas other than the need to obtain a general understanding of the business and to consider whether the financial statements are consistent with their understanding of the business and whether the financial statements are misleading. The accountant will also consider methods available to check that relevant disclosures have been made on the basis of information available.

Approval of financial statements

Financial statements should be approved and signed by the directors before the accountants' report is signed.

Companies Act 1985 requires that the directors approve the financial statements and that the balance sheet states the name of the director who has signed the financial statements on behalf of the board.

Directors of audit exempt companies must acknowledge on the face of the balance sheet their responsibilities for keeping proper accounting records and for preparing true and fair financial statements as well as entitlement of the company to exemption from audit.

Accountants' reports

The guidance sets out basic content as well as example reports (see below).

Misleading financial statements

The guidance on this area (see below) is particularly important in view of the potential size of an audit exempt company.

Contents of Accountants' reports

These should include the following:

- A title addressing the person to whom the report is addressed (usually the Board of Directors) and including the words 'Chartered Accountant's / Accountants' Report to…';
- A statement that, in accordance with the engagement letter, the accountants have compiled the financial statements which comprise [the primary financial statements] and the related notes from the accounting records and information and explanations supplied by the client;
- A statement that the report is made to the Company's Board of Directors as a body in accordance with the terms of engagement;
- An explanation as to the work involved and the purpose of that work, and that, to the fullest extent permitted by law, no responsibility will be accepted for the work, or the report to anyone other than the Company and the Company's Board of Directors, as a body;
- A statement that the accountants have carried out the engagement in accordance with the ethical guidance laid down by the Institute relating to members undertaking the compilation of financial statements;
- A statement that the directors have acknowledged their responsibility to prepare financial statements that give a true and fair view under the Companies Act 1985;
- A statement that the accountants have not carried out an audit of the financial statements, verified the accuracy or completeness of the accounting records or information and explanations supplied, and that the accountants do not express any opinion on the financial statements;
- The name and signature of the accountant and any appropriate designation (but not 'Registered Auditor');
- The date of the report.

Reference to 'unaudited'

The financial statements should contain a reference to the fact that they are unaudited. This reference should either be on the front cover or on each page of the financial statements.

Misleading financial statements

Paragraphs 24 to 27 of the guidance are particularly important as they are far more explicit than the superseded guidance in Audit 1/95. These paragraphs are reproduced below:

Paragraph 24

Financial statements prepared under the Companies Act 1985 are required to give a true and fair view. Without carrying out an assurance service, the accountants cannot form an opinion as to the truth and fairness of the view given by the financial statements.

During the course of the engagement, however, matters may come to light which appear to indicate that the financial statements may be misleading. In such cases the accountants discuss the matters with the directors with a view to agreeing appropriate adjustments and/or disclosures to be made in the financial statements. Where there are departures from accounting standards and appropriate disclosures are made in the financial statements [emphasis added], the accountants may wish to highlight these disclosures in their report by way of an explanatory paragraph (see Appendix B for example wording for such a report) [this is reproduced below].

Paragraph 25
In certain circumstances, adjustments and/or disclosures that the accountants consider appropriate may not be made in the financial statements or appropriate information may not be provided to the satisfaction of the accountants. If the accountants consider that the financial statements are therefore misleading then they should withdraw from the engagement and should not permit their name to be associated with the financial statements.

Paragraph 26
In considering whether financial statements are misleading, the accountants consider whether the financial statements appear to be appropriate in form and free from material misstatements that appear to be obvious to them as a result of, for example:

- misclassifications in the financial statements;
- mistakes in the application of, or non-disclosure of known departures from any relevant statutory, regulatory or other reporting requirements, including applicable accounting standards and non-disclosure of significant changes in accounting policies;
- other significant matters of which the accountants are aware.

Paragraph 27
When the accountants withdraw from an engagement, they should normally explain to their client their reasons for withdrawing, unless this would constitute a breach of legal or other regulatory requirement (such as the 'tipping off' provisions of the money laundering legislation).

Illustration – example report

Chartered Accountants' / Accountants Report to the Board of Directors on the Unaudited Financial Statements of …Limited

In accordance with the engagement letter dated …, and in order to assist you to fulfil your duties under the Companies Act 1985, we have compiled the financial statements of the company which are set out on pages…to…from the accounting records and information and explanations you have given to us.

This report is made to the Company's Board of Directors, as a body, in accordance with the terms of our engagement. Our work has been undertaken so that we might compile the financial statements that we have been engaged to compile, report to the Company's Board of Directors that we have done so, and state those matters that we have agreed to state to them in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's Board of Directors, as a body, for our work or for this report.

We have carried out this engagement in accordance with technical guidance issued by the Institute of Chartered Accountants in England and Wales and have complied with the ethical guidance laid down by the Institute relating to members undertaking the compilation of financial statements.

You have acknowledged on the balance sheet for the year ended…your duty to ensure that the company has kept proper accounting records and to prepare financial statements that give a true and fair view under the Companies Act 1985. You consider that the company is exempt from the statutory requirement for an audit for the year.

We have not been instructed to carry out an audit of the financial statements. For this reason, we have not verified the accuracy or completeness of the accounting records or information and explanations you have given to us and we do not, therefore, express any opinion on the financial statements.

[Signature]

[Name of firm]
[Description of accountants]

[Address]

[Date].

Illustration – Extract from example report showing explanatory paragraph

Paragraph 24 of Audit 02/04 (reproduced above) refers to 'an explanatory paragraph' – Appendix B includes the following example. This paragraph would appear immediately after the paragraph which states 'We have not been instructed to carry out an audit' [see previous example report, above].

[Explanatory paragraph:]

We draw your attention to note…in the financial statements which discloses and explains a departure from applicable standards. The company has not amortised its goodwill which is shown in the balance sheet, and this is a departure from the Financial Reporting Standard for Smaller Entities (effective June 2002) and from the Companies Act 1985.

Audit exemption – ACCA

The guidance from the ACCA was published more recently than the ICAEW guidance considered above. Whilst it covers the same aspects the guidance is different in a number of areas.

Terms of engagement

Whenever possible a letter of engagement should be issued. The contents should cover the actual services to be performed and an acceptance by the client of those terms. This minimises disputes and avoids misunderstandings.

The following should be covered in the letter of engagement.

- The respective responsibilities of the client and the accountant. The client will need to understand their responsibility for the accounts to show a true and fair view, to be prepared in accordance with the Companies Act 1985, and for assessing whether the entity is a going concern.
- The fact that management is responsible for the completeness and accuracy of the accounting records and for the information supplied to the accountant.
- The nature of the assignment and in particular the fact that no audit will be completed, therefore there is no review, and hence no assurance.
- The directors cannot rely on the assignment to detect errors, illegal acts and other irregularities arising from fraud and defalcations.
- The basis of accounting and the form of any report.
- The information to be supplied by the client by way of schedules and reconciliations.
- Any additional services to be provided.

Extracts from example engagement letter

2.4 We have a professional responsibility not to allow our name to be associated with accounts which we consider may be misleading. Therefore, although we are not required to search for such matters, should we become aware, for any reason, that the accounts may be misleading, and the matter cannot be dealt with by means of adjustments to the accounts, we shall withdraw from the engagement, and shall notify you in writing of the reasons.

5.2 If, in the circumstances described in paragraph 2.4 above, we do not issue any report, or if it becomes necessary for us to withdraw from the engagement, our fees for the work performed up to that point will be payable by the company.

Planning

Whilst a written plan is not mandatory such a plan would provide a useful reference point to ensure that any delegated work is completed. Some planning must take place to ensure that the assignment meets its objectives in the most efficient manner.

Documentation

Again there are no mandatory procedures for documentation but where disputes occur the existence of such documentation could be an advantage.

Procedures

The accountant should have a general understanding of the client and the business environment in which they operate. They should understand the accounting principles and be aware of any industry practices.

For those clients that were audit clients then this information should be on file. For new clients such information would be gained during the process of deciding whether to act for the client.

The information should be kept up to date and would be obtained through enquiry and experience.

The information should include:

- banking arrangements;
- borrowing arrangements;
- business operations;
- related parties;
- Accounting system.

The following are not required to be completed;

- enquiries of management to assess whether the information provided is reliable or complete;
- assessing the control environment, the accounting system or risk;
- verifying any matters;
- considering the concept of going concern outside of management's assessment;
- enquiring as to undisclosed related party transactions;

Verifying explanations.

The principle risk facing the accountant is name association with misleading accounts. To reduce this possibility there should be a critical review of the accounts by comparison with previous years and this should include margins and ratios. There should be discussion on other matters such as related parties.

There is no requirement for the accountant to complete any work on going concern. No evidence is required. However, if there are indications of a potential problem then management's attention should be drawn to the issue. In particular, directors should be warned of the potential legal implications of trading where the entity is unable to meet its debts. There should also be an explanation of the concept of true and fair to ensure proper disclosure is made. Where disclosures are considered necessary then ISA 570 could be used for guidance.

If the client refuses to make the necessary disclosures then the accountant should consider withdrawing from the assignment.

The professional requirement not to be associated with misleading accounts means that the accountant must react to information which indicates items may be incorrect, incomplete, or unsatisfactory. Where this arises the concerns should be raised with management, preferably in writing. This should explain the difficulties and request a written reply with either additional information or confirmation of oral representations. If the client refuses to supply the information then the accountant should consider withdrawing from the assignment and advise the client of the reasons.

To assess disclosures a checklist should be used.
If material misstatements exist adjustments should be agreed with the client. If the client refuses then the accountant would withdraw.

Reporting

There should be no report attached to the accounts filed at Companies House.

An example report

Accountant's report to the directors of XYZ Limited

You consider that the company is exempt from an audit for the year ended ...... You have acknowledged, on the balance sheet, your responsibilities for ensuring that the company keeps accounting records which comply with section 221 of the Companies Act 1985 and for preparing financial statements which give a true and fair view of the state of affairs of the company and of its profit or loss for the financial year.

In accordance with your instructions, we have prepared the financial statements on pages xx to xx from the accounting records of the company and on the basis of information and explanations you have given to us.

We have not carried out an audit or any other review, and consequently we do not express any opinion on these financial statements.

Date
Signed
Chartered Certified Accountant
Address

There is no `qualified' report. If the accountant considers that the financial statements contain errors or are misstated, he or she will not issue a report.

Assurance reports: 'The ICAEW Assurance Service on Unaudited Financial Statements'

This interim technical release gives guidance to members of the ICAEW when they perform an assurance engagement, but not a statutory or non-statutory audit, to provide a conclusion on unaudited financial statements of incorporated entities based on limited work procedures.

In theory this statement can only be used by members of the ICAEW to produce this style of report. It should not be used by members of other professional bodies such as the ACCA. However, the report is based on a document issued by the International Auditing and Assurance Standards Board (IAASB) called 'The International Framework for Assurance Engagements'. Any member of a recognised body within the UK could use this guidance to produce an assurance report.

The paper defines an assurance engagement as follows:

'In an assurance engagement, accounts express a conclusion designed to enhance the degree of confidence of intended users about the outcome of the evaluation or measurement of a subject matter against criteria. In other words, assurance is a conclusion drawn by accountants where sufficient appropriate evidence has been gathered and evaluated against criteria suitable for the subject.'

This effectively gives us three options for limited companies that are not required to have a statutory audit:

- The client can opt to have an audit. In this situation the auditor expresses a positive conclusion in the form of an audit opinion on the accounts based on standard auditing principles.
- The client can opt to have an assurance report. This is a negative form of conclusion on unaudited accounts based on a defined set of procedures.
- The client can have an accountants report (called a non-assurance report). This is a report on factual findings (following agreed upon procedures) or a report on collecting, classifying and summarising financial information such as reports produced under Audit 02/04 Chartered Accountants Reports on the compilation of financial statements of incorporated entities. No opinion is expressed in these reports.

Types of Assurance

The report draws a distinction between 'reasonable assurance' and 'limited assurance'. For a reasonable assurance assignment, the firm carries out the work by gathering sufficient appropriate evidence that will enable them to express a positive opinion on the report prepared for the users of the accounts (i.e. an audit).

In a limited assurance engagement the firm seeks to gather evidence sufficient to obtain a level of assurance which provides the basis for a negative form of conclusion on unaudited financial statements for example:

'….nothing has come to our attention to refute the directors' confirmation that the financial statements give a true and fair view…'

Engagement Terms for Assurance work

An assurance engagement involves three separate parties: the accountants; the directors who are responsible for the preparation of the company's financial statements; and the users of the accountant's report. This could give rise to a tri-partite engagement letter similar to those used for reporting to ABTA for travel agents. However, in most cases the engagement will be between the firm and the directors who are the members of the limited company. The technical release assumes that this will be the case and the example engagement terms contained in the appendix to the release is a bi-partite agreement between the firm and the directors.

The engagement letter sets out the scope of the engagement as being a report produced on a limited assurance basis on the unaudited financial statements of the company. The work is carried out in accordance with AAF 03/06 issued by the ICAEW. If you are not a member of the ICAEW then you could carry out the work in accordance with the guidance issued by the IAASB but you would need to get a copy of this statement to ensure the work has been done in accordance with its recommendations.

The letter sets out the responsibilities of the directors under the Companies Act 1985 and also their responsibilities under UK GAAP.

The letter also has a limitation of liability paragraph.

For a full copy of the letter you should refer to Appendix B of the technical release.

Procedures required for an Assurance Engagement
Overview of the procedures

An assurance engagement carried out under this guidance has the following main activities:

- Making enquires of management and the directors.
- Applying analytical procedures to the financial statements.
- Assessing whether the accounting policies are appropriate to the circumstances and have been properly disclosed.
- The approach may involve some work in areas which, after performing the above work, indicate that there might be a risk of material misstatement in the accounts.

The above procedures would fall short of being a full audit under the ISAs.

Appendix F to the technical release then gives a detailed breakdown of the approach firms would be expected to adopt. This is summarised below.

Planning

Ethical requirements – The firm must comply with the ICAEW's code of ethics and the requirements in 'Independence for Assurance Engagements'. These are similar to audit engagements and require the firm to identify any independence threats and consider if any safeguards are needed. For example, a threat might be the preparation of the accounts for the client but this could be covered by having the assurance work carried out by a member of staff who was independent of the accounts preparation team.

Understanding the entity – The firm has to demonstrate that it has sufficient understanding of the entity to establish the accounting policies used and their relevance to the client's business, to consider materiality and to plan further enquires. The understanding of the client's business is also applied to the analytical procedures adopted and the review of the results obtained.

Understanding the entity may involve:

- discussions with the management and, if appropriate, the staff;
- reviewing minutes of board meetings to ascertain details of major events, plans and decisions;
- obtaining details of accounting records maintained and methods used to record financial transactions;
- understanding areas in which accounting estimates have been made; and
- walkthrough tests of the accounting records.

The accountant needs to establish that the accounting policies are appropriate to the client. The file should consider the effect of any recent changes to accounting requirements or disclosure that may affect the client. The file should also identify any areas where the accounts use accounting estimates or the management has exercised their judgement.

As part of this procedure the accountants must consider any inconsistencies highlighted by the analytical review procedures and management enquiry. If matters do come to their attention they should discuss the matter with the management and consider performing substantive procedures to gain a better understanding of the position. Materiality should be considered along the same lines as audit materiality.

Performance of the work

Performing analytical procedures – These would be similar to analytical procedures used for an audit. The approach should focus on comparison with last year's figures, budgets for the current year and industry statistics and some consideration of the interrelationships between changes in balances and other fluctuations and significant events during the period.

Enquiry of Management – The firm should obtain explanations from management for changes in the accounts as identified from the analytical review. The firm should also consider asking to see any documentation that supports the management's explanations of the movements.

Performing substantive procedures – Substantive procedures are not required on all material balances and relevant financial statement assertions, as would be expected in an audit. However, the firm should exercise professional judgement in deciding the extent of substantive procedures to support their conclusions. This would be based on the results of the analytical review and discussions with the management. Areas where the firm considers there may be a significant risk of material misstatement should be subject to substantive procedures.

Post balance sheet events – The firm should ask the client if there have been any post balance sheet events that may require adjustment or disclosure within the accounts. The firm may request sight of supporting documentation for post balance sheet events.

Reviewing the financial statements – The firm may wish to ensure that the accounts are in compliance with the adopted accounting principles. This can be achieved through the use of a disclosure checklist.

Letter of Representation – The process of completing an assurance review means that a number of management representations will be relied on. The firm should consider obtaining those representations in the form of a management representation letter to avoid any misunderstandings. An example letter is contained in the appendix to the guidance.

Example Report
Chartered accountants independent assurance report on the unaudited financial statements of XYZ Ltd.

To the Board of Directors of XYZ Ltd ('the Company')

We have performed certain procedures in respect of the Company's unaudited financial statements for the year ended 31 December 2006 as set out on pages 3 to 12, made enquires of the Company's directors and assessed accounting policies adopted by the directors, in order to gather sufficient evidence for our conclusion in this report.
This report is made solely to the Company's directors, as a body, in accordance with the terms of our engagement letter dated 20 December 2006. It has been released to the directors on the basis that this report shall not be copied, referred to or disclosed, in whole (save for the directors' own internal purposes or as may be required by law or by a competent regulator) or in part, without our prior written consent. Our work has been undertaken so that we might state to the directors those matters that we have agreed to state to them in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's directors as a body for our work, for this report or the conclusions we have formed.

Respective responsibilities

You have confirmed that you have met your duty as set out in the directors' statement on page 1. You consider that the Company is exempt from the statutory requirement for an audit for the year ended 31 December 2006. Our responsibility is to form and express an independent conclusion, based on the work carried out, to you on the financial statements.

Scope

We conducted our engagement in accordance with the Institute of Chartered Accountants in England & Wales Interim Technical Release AAF 03/06. Our work was based primarily upon enquiry, analytical procedures and assessing accounting policies in accordance with Generally Accepted Accounting Practice in the UK and the Financial Reporting Standard for Smaller Entities. If we considered it to be necessary, we also performed limited examination of evidence relevant to certain balances and disclosures in the financial statements where we became aware of matters that might indicate a risk of material misstatement in the financial statements.
The terms of our engagement exclude any requirement to carry out a comprehensive assessment of the risks of material misstatement, a consideration of fraud, laws, regulations and internal controls, and we have not done so. We are not required to, and we do not, express an audit opinion on these financial statements.

Conclusion

Based on our work, nothing has come to our attention to refute the directors' confirmation that, in accordance with the Companies Act 1985, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 2006 and of its profit for the year then ended and have been properly prepared in accordance with Generally Accepted Accounting Practice in the UK and the Financial Reporting Standard for Smaller Entities.

AB & Co
Chartered Accountants
Any Town
2 August 2008

NEW AUDITING STANDARDS - CLARITY ON CLARITY

(Lecture A263 14.14 minutes)

The APB Announcement

Following the APB consulation there was the following announcement from the APB on 2 March 2009:

Following a period of consultation, the Auditing Practices Board (APB) is announcing its intention to update its auditing standards for the new, clarified, International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). The new UK and Irish auditing standards will be effective for audits of financial statements for periods ending on or after 15 December 2010.

The APB is announcing its intention at the earliest possible opportunity so as to provide auditors, and those third parties that support them, with as much time as possible to prepare for the implementation of the new standards.

Background

In 2004 the APB made the strategic decision to base UK and Irish auditing standards on ISAs, supplemented with additional standards and guidance where necessary to maintain the requirements and clarity of the previous UK and Irish auditing standards.

One of the reasons for adopting ISAs was to benefit efficiently from future improvements in them. The IAASB has recently completed an important project to update and reformat the ISAs. This, so called, 'Clarity Project' was undertaken with international regulatory support in order to improve the understandability of the ISAs and make them more compatible with regulatory frameworks, including the EC's Statutory Audit Directive.

In parallel with the Clarity Project, ISAs on important topics such as auditing groups, estimates (including fair values) and related party transactions have been revised and improved to reflect the latest developments and thinking.

The intention of the IAASB is that all the ISAs redrafted in the Clarity format, including those that have been revised, should come into effect internationally on the same date – for audits of financial statements for periods beginning on or after 15 December 2009. The EC is debating adoption of the ISAs under the provisions of the Statutory Audit Directive. Although the decision and timetable for endorsement of the new ISAs within the EU has not yet been established, the APB anticipates that such endorsement, if any, will be at a later date than the effective date established by IAASB.

As the improvements that have been made are designed to improve audit quality and the Clarity Project has been undertaken primarily to improve the understandability of the ISAs, the APB believes that it is appropriate to introduce these new standards in the UK and Ireland as soon as is practicable.

In October 2008 the APB published a consultation paper seeking views on this proposal.

Responses to the consultation

The responses to the consultation paper contained very strong support for:

- Updating the ISAs (UK and Ireland) to adopt the new ISA
- Such adoption to be as soon as practicable having regard to the date set by the IAASB
- The view that the same standards should apply to all audits

Respondents made clear that this course of action was important to:

- Enable UK and Irish auditors to benefit from the clarification of the requirements and guidance

- Ensure that UK and Irish auditing standards reflect the leading audit practices as embodied by the IAASB in the new ISAs

- Support international harmonisation of auditing standards and prevent the UK and Ireland lagging behind other countries that have already made the decision to adopt the new ISAs

The view that the same standards should apply to all audits was considered important as otherwise there would be a risk of creating a two tier level of auditing which could undermine the credibility of smaller audits, and possibly cause confusion for companies and investors as well as for auditors.

Smaller audits

In its Consultation Paper the APB provided some information about the possible costs of adopting the Clarity ISAs. The APB's view is that, particularly for smaller audits, any cost impact can be minimised if there is effective training and support provided to audit firms. Whilst training is not part of the APB's remit, the APB has been liaising with the accountancy bodies on this and is committed to providing appropriate support to them. As part of this exercise, the APB will consider the nature of guidance it can provide to help apply the new standards to the audit of smaller entities.

Future timetable

Publication by the IAASB of all the finalised ISAs is expected in March 2009. Before the end of April APB plans to issue an exposure draft of a complete set of proposed new ISAs (UK and Ireland) with a three month consultation period. The goal is to finalise the ISAs (UK and Ireland) in the autumn.

The proposed new ISAs (UK and Ireland) will adopt the new ISAs as issued by the IAASB with some supplementary requirements and guidance. Supplementary material will be proposed where considered necessary to:

- Address specific UK and Irish legal and regulatory requirements

- Provide other guidance relating to legal and regulatory matters relevant to an audit

- Maintain other current APB requirements and guidance that are, in the APB's view, necessary to prevent changes in audit practice to the detriment of audit quality

Because of the improvements in the new ISAs, the quantity of supplementary material is expected to be reduced significantly from that in the current ISAs (UK and Ireland).

Auditor's Reports

The new ISAs include three standards relating to auditor's reports; ISA 700, "Forming an Opinion and Reporting on Financial Statements," ISA 705, "Modifications to the Opinion in the Independent Auditor's Report," and ISA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report."

The APB will be adopting the new ISAs 705 and 706 but will not be adopting the new ISA 700. It has recently completed a process of review and public consultation on the form of auditor's reports and in early April will be issuing a revision of its own ISA (UK and Ireland) 700 that takes account of the conclusions reached. ISA (UK and Ireland) 700 (Revised) has, however, been designed to ensure that compliance with it will not preclude the auditor from being able to assert compliance with the ISAs issued by the IAASB.

Richard Fleck, Chairman of the APB, commented:

"Since its inception APB has worked to establish UK and Irish auditing standards as being regarded as the strongest in the world. In recent years, recognising both the importance and the inevitability of convergence of auditing standards internationally, we have worked closely with the IAASB in the clarification and reinforcement of its standards. Now that IAASB has completed this work, APB has concluded that the Clarity ISAs are the most robust set of standards currently available.

Throughout IAASB's Clarity Project we have been conscious of the impact that the new standards might have on smaller audits. Our SME audit sub-committee has been heavily involved in helping us respond to exposure drafts and achieve important changes in the final standards.

The responses to our consultation demonstrate how committed the profession is to having a single set of standards for audits of all sizes.

For these reasons APB has concluded that the benefits of implementing the new standards exceed initial costs and have decided that they should be applied as soon as is practicable.

Responses to our consultation emphasise the importance of high quality training and implementation support being provided to auditors if the new standards are to be implemented in a cost effective manner. APB is committed to providing appropriate support to the profession to help achieve this."

Commentary

Short periods

Whilst the Clarity ISA will come into force for periods commencing 15 December 2009 they will not be applied to short accounting periods. Therefore, they are only truly effective for periods ending on or after 15 December 2010.

Early adoption

The APB have indicted that early adoption, whilst not encouraged, will be permitted. Given that the Clarity ISAs are more onerous than the existing Standards it might initially look inadvisable to adopt the standards early. However, early adoption allows firms to test new audit methodologies and documentation live before the new Standards become mandatory.

In addition to this, early adoption allows firms of auditors to smooth the transition from old to new Standards, For instance a firm might plan a series of 31 December 2010 engagements before planning a 30 September 2010 engagement. Would the staff really want to go back to the old system? Would the IT systems support this?

Article Supplied By John Selwood

SUMMARY OF DEVELOPMENTS

(Lecture A262 5.48 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)

For more details of any topic go to www.frc.org.uk and then click through to the appropriate body. Click on the press release in which you are interested and that will give you a link to further information.

ASB proposes Amendments to Financial Instrument Disclosures

The Accounting Standards Board (ASB) has today issued for public comment proposals to improve information disclosed about the fair value of financial instruments and liquidity risk. These proposals are based on an exposure draft issued by the International Accounting Standards Board (IASB) in October 2008 as part of its response to the credit crisis.

The Exposure Draft (ED) 'Improvements to Financial Instrument Disclosures' proposes amendments to Financial Reporting Standard FRS 29 'Financial Instruments: Disclosures'. These proposed changes are necessary to maintain convergence with International Financial Reporting Standard IFRS 7 'Financial Instruments: Disclosures'.

The ED proposes two principal changes:

- improving the basis for disclosing information about the fair value of financial instruments; and
- clarifying the disclosures on liquidity risk.

28 November 2008

AIU Inspections: Public Reporting

The Professional Oversight Board, part of the Financial Reporting Council, has today published reports on the Audit Inspection Unit's (AIU) inspections for 2007/8 of the following seven audit firms:

- BDO Stoy Hayward LLP
- Deloitte & Touche LLP
- Ernst & Young LLP
- Grant Thornton UK LLP
- KPMG LLP and KPMG Audit PLC
- PKF (UK) LLP
- PricewaterhouseCoopers LLP

These reports are available on the Professional Oversight Board website.

The reports cover reviews of firm-wide procedures and individual audits undertaken by the AIU in the period from April 2007 to March 2008. The individual audits reviewed related to financial years ending between June 2006 and August 2007.

These reports should be read in conjunction with '2007/8 Audit Quality Inspections: An Overview', also published today, which summarises key overall findings from the AIU's inspection work in 2007/8 and includes specific commentary on the findings of inspection work undertaken by the AIU at smaller firms. This report is available on the Professional Oversight Board website

This is the first occasion that AIU reports on the findings of inspections of individual audit firms have been made publicly available. In addition, reports on individual audits reviewed by the AIU since January 2008 are now being issued to the audit firms concerned, with a view to them being made available by the firms to the directors of the audit clients concerned.

The reports on the AIU's inspections of individual audit firms published today, together with the AIU reports on individual audits being issued to the audit firms, are part of our programme to support the continuous improvement of audit quality and mark an important milestone in the transparency of reporting on the work of the audit profession in the UK. We believe that these new reporting arrangements make the UK's auditor oversight regime the most transparent in the world.

The public reports support the Board's view that the quality of auditing in the United Kingdom remains fundamentally sound with no systemic weaknesses. However, they identify some important issues in certain areas in relation to which further improvements need to be made by the audit firms.

The AIU's inspection process is both rigorous and challenging for firms. The firms' acceptance of the need to appropriately address the AIU's findings is key to the continued effectiveness of its work in safeguarding and enhancing audit quality.

08 December 2008

APB issues Draft Updated Guidance on Auditing Complex Financial Instruments

APB today issued a Consultation Draft of an update of Practice Note (PN) 23 providing guidance for auditors on 'Auditing Complex Financial Instruments.'

The current PN 23 was issued in April 2002 to provide guidance on auditing derivative financial instruments and is based on an International Auditing Practice Statement (IAPS) issued by the International Auditing and Assurance Standards Board (IAASB). The APB considers that it is helpful to widen the scope of PN 23 to cover other complex financial instruments, as well as derivatives, as many of the audit considerations are the same. Also, there have been a number of recent developments that make this an opportune time to update PN 23, in particular:

- The current difficult financial market conditions give rise to particular considerations in relation to valuations and to financial statement disclosures about risks and uncertainties pertaining to complex financial instruments. The consultation draft includes guidance that draws on the IAASB Staff Audit Practice Alert on 'Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment' issued in October 2008. This guidance supplements that given in Bulletin 2008/1, 'Audit Issues when Financial Market Conditions are Difficult and Credit Facilities may be Restricted.'
- There have been changes to the financial reporting frameworks used by entities in the UK and Ireland to account for complex financial instruments, including the recent amendments to accounting standards to permit the reclassification of certain financial assets.

The opportunity has also been taken to align the guidance in PN 23 with the APB's International Standards on Auditing (ISAs) (UK and Ireland).

18 December 2008

ASB to issue clarification amendments to FRS 26 and FRS 29

At its meeting today the Accounting Standards Board (ASB) agreed to issue amendments to FRS 26 (IAS 39) 'Financial Instruments: Recognition and Measurement' and FRS 29 (IFRS 7) 'Financial Instruments: Disclosures'. These amendments would clarify the effective date and transition requirements of the amendment to those two standards issued by the ASB on 24 October 2008 'Reclassification of Financial Assets' permitting the reclassification of certain financial instruments.

The ASB amendments arise as a consequence of the clarification amendments published by the International Accounting Standards Board (IASB) on 1 December 2008 to the wording of the original 13 October 2008 amendment to IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial

Instruments: Disclosures'. This updated version of the 'Reclassification of Financial Assets' amendment to IAS 39 and IFRS 7 clarified the effective date and transition arrangements.

In moving to issue the amendments, the ASB – like the IASB – will be issuing them in final form. The ASB wants to ensure that FRS 26 and FRS 29 remain converged with IAS 39 and IFRS 7 and its view is that the amendments do not alter the effect of the standards but remove a potential ambiguity in the effective date.

The ASB is mindful of other related changes to IAS 39 that are currently being considered by the IASB. Therefore, it intends to hold back the above amendments to FRS 26 until the beginning of 2009 when it has given due consideration to the further changes that may be required.

18 December 2008

APB issues Revised Guidance on the Audit of Charities

The Auditing Practices Board (APB) has published a revision of Practice Note (PN) 11: 'The Audit of Charities in the United Kingdom'. The revised PN 11 was issued for public consultation in July 2008.

The previous version of PN 11 was issued in 2002 and supplemented by Bulletin 2005/1: 'Audit risk and fraud – supplementary guidance for auditors of charities'.

The update to PN 11 reflects:

- the replacement of Statements of Auditing Standards by ISAs (UK and Ireland);
- changes to the Charities Act 1993 (which apply to charities in England and Wales) as a result of the implementation of the Charities Act 2006 on 1 April 2008;
- changes to the legal and regulatory arrangements for charities in Scotland, including the establishment of the Office of the Scottish Charity Regulator (OSCR) which apply to accounting periods commencing on or after 1 April 2006;
- changes to the guidance on the Charity Commission's interpretation of 'material significance' in the context of whistleblowing responsibilities.

Illustrative auditor's reports for charities in both England and Wales and in Scotland were included in the consultation draft of the revision. These will now be included in a supplementary Bulletin to be issued shortly.

22 December 2008

The Financial Reporting Review Panel announces Review of Impairment Disclosures

The Financial Reporting Review Panel ('the Panel') intends to review impairment disclosures in 2008 accounts and will notify a number of listed companies in advance that their accounts will be subject to review in this respect.

Companies should review their assets for impairment when they draw up their accounts and this is particularly important during an economic downturn. The companies selected for review by the Panel have substantial intangible assets and may be looked to as illustrating best practice.

It is unusual for the Panel to notify companies in advance that their accounts will be subject to review, but these are unusual times. The Panel aims to encourage reporting of the highest standard, not to catch people out, and in this difficult economic climate it seems fair to warn these companies that the extent and clarity of their impairment disclosures, and the assumptions on which they are based, will be subject to scrutiny.

Following review of this aspect of these accounts in accordance with its usual operating procedures, the Panel will write to the companies again either setting out any additional information or clarification it needs to determine compliance with the law or advising that there are no matters that it wishes to pursue.

In October the FRC published a review of information disclosed by 32 listed companies on their testing for impairment of goodwill in their 2007 accounts. The companies whose 2008 accounts are reviewed in this respect will be about the same number and selected on the same basis, namely that they have substantial intangible assets.

The Panel reviews some 300 accounts a year and, in addition to this targeted review, the Panel will consider the adequacy of impairment disclosures in other accounts as part of its usual monitoring routine. The Panel conducts targeted reviews of this nature from time to time. Although it is notifying companies in advance on this occasion it will not necessarily do so in the future.

22 December 2008

Professional Oversight Board publishes Report to the Secretary of State for Business, Enterprise and Regulatory Reform

The Professional Oversight Board, a part of the Financial Reporting Council, today publishes its Report to the Secretary of State for Business, Enterprise and Regulatory Reform for the year to 31 March 2008. This was the third full year in which the Oversight Board exercised statutory responsibility for the oversight of audit regulation delegated to it by Order.

Paul George, Director of the Oversight Board, said:

"The primary purpose is to report on our oversight of audit regulation carried out by the professional accountancy bodies that we recognise for this purpose. We focused in 2007/08 on key areas of risk at each body and on those regulatory systems where there had been significant recent change. Overall we conclude that the recognised bodies take their responsibilities extremely seriously and that much regulatory practice is of a high standard. However, the detailed comments in the report highlight those aspects of regulatory activity that are less strong or where there is room for improvement."

The report also summarises the Board's work to meet its other responsibilities, in particular for the inspection of the quality of audits of economically significant entities, on which we separately published reports on seven larger audit firms on 8 December, and for oversight of the regulation by professional bodies of the actuarial and accountancy professions.

22 December 2008

ASB to issue Amendment to FRS 26 and UITF Abstract 42

At its meeting today the Accounting Standards Board (ASB) agreed to issue an exposure draft (ED) proposing amendments to FRS 26 (IAS 39) 'Financial Instruments: Recognition and Measurement' and UITF Abstract 42 (IFRIC 9) 'Reassessment of Embedded Derivatives'. The amendments would clarify the treatment of embedded derivatives when an entity reclassifies a hybrid financial asset out of the fair value through profit or loss category.

The ASB amendments arise as a consequence of the amendments proposed by the International Accounting Standards Board (IASB) ED 'Embedded Derivatives' published on 22 December 2008. The proposed amendment to IAS 39 and IFRIC 9 would require that an entity which is reclassifying a hybrid financial asset out of the fair value through profit or loss category would need to assess whether to separate the embedded derivative on the date of the reclassification but on the basis of the circumstances that existed when the entity first became a party to the contract. If the fair value of the embedded derivative that is to be separated cannot be reliably measured then the entire financial instrument must remain in the fair value through profit or loss category.

The ASB wants to ensure that FRS 26 and FRS 29 remain converged with IAS 39 and IFRS 7. In the Board's view, the amendments do not alter the effect of the standards but remove a potential ambiguity.

The ASB intends to issue the above ED of amendments to FRS 26 and UITF 42 when the IASB has finalised its proposals.

15 January 2009