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GUIDANCE FROM THE FRC: AN UPDATE FOR COMPANIES THAT ADOPT THE FRSSE

(Lecture A264 13.12 minutes)

Introduction

The FRC are not expecting an increase in smaller companies preparing accounts other than on a going concern basis. They do however expect that many accounts may benefit from a short note explaining how credit market and other economic difficulties have an impact, if any, on the company's particular circumstances.

The guidance refers to the requirements for smaller companies which are contained in Companies Act 2006 and the FRSSE.

SI 2008 No 409 The Small Companies and Groups (Accounts and Directors' Reports) Regulations 2008 states in Schedule 1 at paragraph 11:

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

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.

Procedures for assessing going concern

The guidance goes on to talk about the procedures which directors may undertake.

The extent of the procedures undertaken by directors should depend on the individual company's specific facts and circumstances. For example, directors of a company with significant borrowings and uncertainties about future sales will need to conduct significantly more analysis than for a company with substantial cash balances and a committed order book.

1. Directors should prepare a budget, trading estimate, cash flow forecast or a similar analysis covering the period up to twelve months from the date of approval of their annual accounts, or for a longer period.
2. If directors decide to prepare a budget, trading estimate or cash flow forecast they may:
    a. analyse income, costs or cash flows by month or by quarter. This may depend on the cyclical nature or otherwise of the business;
    b. identify the most significant assumptions that underlie their forecast and prepare a short note on those assumptions;
    c. identify reasonably possible adverse changes to income, costs or cash flows; and
    d. consider whether there is a need to take action, for example by negotiating better terms with creditors, including HMRC.
3. Directors may summarise the key conditions contained in any existing bank facilities or credit arrangements made available by suppliers and consider the impact of reasonably possible adverse changes in these terms and conditions.
4. Directors may discuss with their bankers and other lenders whether it is reasonable to assume that loans and/or overdrafts will continue to be available. The absence of confirmations, particularly in the current environment where banks are having to deal with a significant increase in workload, does not of itself necessarily cast significant doubt upon the ability of a company to continue as a going concern.
5. Directors then assess all of the information that they have obtained and make and document their decision on whether to use the going concern basis of accounting for preparing their annual accounts.
6. Directors then assess the need for disclosures about uncertainties in their annual accounts if they represent material uncertainties about the ability of the company to continue as a going concern. The

FRC point out that the going concern basis of accounting is fundamental to a company's balance sheet. If directors have included a specific disclosure about going concern in their annual accounts then that note should also be included in any abbreviated accounts filed at Companies House.

Practical examples

The most interesting part of this new guidance is the section covering practical examples. According to the FRC, the following two examples illustrate the nature of disclosures that could be appropriate to a smaller company. However, such disclosures should always be tailored to the specific facts and circumstances of each company.

"There has been a significant reduction in requests for estimates for new decorating work and the directors expect sales to reduce significantly next year. However, costs are expected to reduce accordingly and the company should be able to operate within its overdraft. The directors are not aware of any reason why the overdraft facility should not be extended. As a result they have adopted the going concern basis of accounting."

"The company has a contract for all of its available consulting capacity for the next six months and negotiations are at an advanced stage for a three month extension. The director believes that the company will be able to maintain positive cash flows for the foreseeable future. As a result the going concern basis of accounting has been adopted.

The full document for users of FRSSE may be found at:

www.frc.org.uk/press/pub1881.html

FRS 11: IMPAIRMENT OF FIXED ASSETS AND GOODWILL

(Lecture A265 19.50 minutes)

Introduction: Reminder of requirements

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

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

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

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

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

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

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

Income generating units

Income-generating units should be identified by dividing the total income of the entity into as many largely independent income streams as is reasonably practicable. Subject to the comments below concerning central assets, each of the identifiable assets and liabilities of the entity, excluding deferred tax balances, interest-bearing debt, dividends payable and other items relating wholly to financing, should be attributed to (or apportioned between) one (or more) income-generating unit(s).

To perform impairment reviews as accurately as possible:

- the groups of assets and liabilities that are considered together should be as small as is reasonably practicable, but
- the income stream underlying the future cash flows of one group should be largely independent of other income streams of the entity and should be capable of being monitored separately.

Income-generating units are therefore identified by dividing the total income of the business into as many largely independent income streams as is reasonably practicable in the light of the information available to management.

In general terms, the income streams identified are likely to follow the way in which management monitors and makes decisions about continuing or closing the different lines of business of the entity. Unique intangible assets, such as brands and mastheads, are generally seen to generate income independently of each other and are usually monitored separately. Hence they can often be used to identify income-generating units. Other income streams may be identified by reference to major products or services.

The examples 1 to 4 below are taken from paragraph 29 of FRS 11.

Example 1: Transport company

A transport company runs a network comprising trunk routes fed by a number of supporting routes. Decisions about continuing or closing the supporting routes are not based on the returns generated by the routes in isolation but on the contribution made to the returns generated by the trunk routes. An income-generating unit comprises a trunk route plus the supporting routes associated with it because the cash inflows generated by the trunk routes are not independent of the supporting routes.

Example 2: Manufacturer

A manufacturer can produce a product at a number of different sites. Not all the sites are used to full capacity and the manufacturer can choose how much to make at each site. However, there is not enough surplus capacity to enable any one site to be closed. The cash inflows generated by any one site therefore depend on the allocation of production across all sites. The income-generating unit comprises all the sites at which the product can be made.

Example 3: Restaurant chain

A restaurant chain has a large number of restaurants across the country. The cash inflows of each restaurant can be individually monitored and sensible allocations of costs to each restaurant can be made. Each restaurant is an income-generating unit by itself. However, any impairment of individual restaurants is unlikely to be material. A material impairment is likely to occur only when a number of restaurants are affected together by the same economic factors. It may therefore be acceptable to consider groupings of restaurants affected by the same economic factors rather than each individual restaurant.

Example 4: Producer of timber and wooden furniture

An entity comprises three stages of production, A (growing and felling trees), B (creating parts of wooden furniture) and C (assembling the parts from B into finished goods). The output of A is timber that is partly transferred to B and partly sold in an external market. If A did not exist, B could buy its timber from the market. The output of B has no external market and is transferred to C at an internal transfer price. C sells the finished product in an external market and the sales revenue achieved by C is not affected by the fact that the three stages of production are all performed by the entity (unlike example 1, where the sales revenue of the trunk routes is affected by the existence of supporting routes run by the same entity). A forms an income-generating unit and its cash inflows should be based on the market price for its output. B and C together form one income-generating unit because there is no market available for the output of B. In calculating the cash outflows of the income-generating unit B+C, the timber received by B from A should be priced by reference to the market, not any internal transfer price.

Income generating units in the small business

In the small business, it may be the case that there is only one income stream and therefore all of the assets of the business contribute to that income stream.

Example 5: A simple impairment review

This example has been written for the purpose of these notes – it is not taken from FRS 11.

The accounts for Year 0 for X Ltd show a loss before tax of £100,000.

This is after charging depreciation of £120,000 and interest of £40,000.

The balance sheet shows net assets of £200,000.

In arriving at the figure for net assets, liabilities included loans and overdrafts amounting to £300,000 and deferred tax liabilities of £20,000. Net current assets are immaterial.

The directors expect performance for Year 1 to be in line with Year 0. Thereafter, they predict annual growth of 5%.

Are the assets impaired?

Answer

Operating cash flow for Year 0 is £60,000 (-£100,000 + £120,000 + £40,000).

The directors are therefore projecting cash flow in year 1 of £60,000 with growth of 5% thereafter.

The present value of future cash flows can be calculated by the following formula:

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

If we assume a discount rate of 10% and growth rate of 5% this would give an NPV of £1.2million (£60,000/(0.1- 0.05)).

If you are uncertain as to what discount rate to use, consider the sensitivity of this calculation to the discount rate. For example, a discount rate of 15% would give rise to an NPV of £600,000.

The book value of the net assets of the company for the purposes of the impairment test is £520,000 (£200,000 + £300,000 + £20,000).

Therefore the assets are not impaired – even at a 15% discount rate.

Comments on the above:

The above example has been designed to show that an impairment test does not necessarily require complicated analysis. It also shows that a company may have suffered a significant loss for the year but this does not necessarily translate into a need for an impairment write-down of the assets.

However, there are a number of possible objections to the answer provide above. For example:

- Are the estimates of future cash flows reliable? In particular, will the company be able to stabilise performance so as to achieve the same level of operating cash flow in Year 1 as earned in year 0?
- Is it acceptable to assume growth of 5% when FRS 11 limits the growth rate to the long-term average growth rate of the country (or countries) in which the business operates? A footnote to the standard indicates that the appropriate figure for the UK is 2.25% - but remember that this is in real terms (ie excluding inflation) whereas the cash flows predicted for the business should include inflation.
- The cash flows assumed in the answer do not include any allowance for the replacement of fixed assets as they wear out. Presumably, this would mean either that it is necessary to include the purchase of fixed assets in the cash flow or to cut the period of the projections short so that the timescale considered matches the remaining useful life of the assets.

Impairment reviews and property

Example 6: Investment property

My client holds a number of investment properties (as defined by SSAP 19). There is clear evidence of significant adverse change in the property market. Do the directors need to perform an impairment review of those properties?

Investment properties are outside the scope of FRS 11. In accordance with paragraph 11 of SSAP 19, the directors should continue to include investment properties in the balance sheet at their open market value.

Example 7: Trading stock

My client is a property developer and holds land and trading properties in stock. There is clear evidence of significant adverse change in the property market. Do the directors need to perform an impairment review to consider whether the land and properties need to be written down?

FRS 11 is titled "Impairment of fixed assets and goodwill". It does not apply to stock which is included in the accounts at the lower of cost and net realisable value in accordance with SSAP 9.

Paragraph 5 of SSAP 9 indicates that net realisable value is the estimated proceeds from the sale of items of stock less all further costs to completion and less all costs to be incurred in marketing, selling and distributing directly related to the items in question.

The above paragraph means that net realisable value should not be determined based on an emergency sale of the trading stock at the balance sheet date. Rather, the application of the going concern basis of accounting means that the directors should consider the revenue from the eventual sale of the properties (possibly a long time in the future) less the costs involved in developing and selling them. In many cases, this will mean that the net realisable value of land/property held in stock by a property developer will exceed cost.

Example 8: Head office property

My client has a number of operating divisions as well as a head office which deals purely with administrative matters. There is clear evidence of significant adverse change in the client's market. How do the directors perform an impairment review on the assets of head office?

Paragraphs 30 to 32 of FRS 11 deal with this problem. Central assets, such as group or regional head offices, and working capital may have to be apportioned across the units on a logical and systematic basis. The resulting income-generating units will be complete and non-overlapping, so that the sum of the carrying amounts of the net assets of the units equals the carrying amount of the net assets (excluding tax and financing items) of the entity as a whole

Example 8A: An entity has three independent income streams, A, B and C, with net assets directly involved in the income streams with carrying amounts of £100 million, £150 million and £200 million respectively. In addition there are head office net assets with a carrying amount totalling £18 million. The relative proportion of the head office resources used by the income streams is 2:3:4. The income-generating units are defined as follows:

Income-generating unit	A	B	C	Total
Net assets directly attributable to income-generating unit (£ million)	100	150	200	450
Head office net assets (£ million)	4	6	8	18
Total (£ million)	104	156	208	468

If there were an indication that a fixed asset in income-generating unit B was impaired, the recoverable amount of B would be compared with £156 million, not £150 million. Similarly, the cash flows upon which the value in use of B is based would include the relevant portion of any cash outflows arising from central overheads.

Paragraph 32 goes on to say that if it is not possible to apportion certain central assets meaningfully across the income-generating units to which they contribute, these assets may be excluded from the individual income-generating units. However, an additional impairment review should be performed on the excluded central assets. In this review, the income-generating units to which the central assets contribute should be combined and their combined carrying amount (including that of the central assets) should be compared with their combined value in use.

Example 8B: Alternative approach to allocation of head office assets to income-generating units

With this approach, in example 8A above the recoverable amount of B would be compared with £150 million, not £156 million. Then a further impairment test would be required on the whole entity comparing its recoverable amount with the total carrying value of £468 million.

Impairment Review: Subsequent monitoring of cash flows

Paragraph 54 of FRS 11 says that for the five years following each impairment review where the recoverable amount has been based on value in use, the cash flows achieved should be compared with those forecast. If the actual cash flows are so much less than those forecast that use of the actual cash flows could have required recognition of an impairment in previous periods, the original impairment calculations should be re-performed using the actual cash flows. Any impairment identified should be recognised in the current period unless the impairment has reversed and the reversal of the loss is permitted to be recognised by the standard.

LIMITED LIABILITY PARTNERSHIP REGULATIONS

(Lecture A266 12.40 minutes)

Application of Companies Act 2006 to LLPs

Comparison of companies with LLPs

The commencement orders 1 to 8 only affect companies. Regulations associated with the Companies Act 2006 that have an impact on LLPs are:

- SI 2008/497 – the filing period was reduced from 10 months to 9 months for financial years commencing on or after 6/4/08
- SI 2008/497 – the penalty for late filing of accounts and the auditor's report (if required) is revised to
  - Not more than 1 month £150
  - More than one month but not more than three months £375
  - More than three months but not more than 6 months £750
  - More than 6 months £1,500

  This applies to all late filings on or after 1 February 2009, when the financial year commences or finishes is irrelevant. Note that the "doubling regime" which was included in these regulations was not extended by the SI to LLPs.
- SI 2006/3429 – Trading disclosures. The amendments made to the CA 85 concerning disclosures to be made on business letters, websites etc. also apply to LLPs.

It should be noted that the changes introduced in SI 2008/393 concerning the qualifying conditions (size thresholds) for small and medium sized companies do not apply to LLPs. The Regulations amended the thresholds for companies for financial years commencing on or after 6/4/08.

Statutory instruments applying to LLPs

The application of the Companies Act 2006 to LLPs is now covered by the following Regulations:

- SI 2008/1911 – applies the accounting and auditing aspects of the CA 06 to LLPs, effectively Parts 15 and 16 of the Act
- SI 2008/1912 – the regulations applying to small limited liability partnerships for the preparation of accounts. These are the equivalent of the small company regulations.
- SI 2008/1913 – as 1912 but for large and medium sized LLPs.

Trading disclosures

The 2006 Regulations (SI 2006/3429) made amendments to s349 and s351 of CA 85. Effectively, the disclosure of certain information was extended to all communications, hard copy or electronic, and order forms, and websites were added to the list of locations. These Regulations came onto force on 1 January 2007. The 2001 LLP regulations required LLPs to comply with s349 and s351. Therefore LLPs were required to comply with the 2006 regulations. The amendments made to CA 85 by the 2006 Regulations are revoked by the 2008 Regulations (SI 2008/495). However, commencement order 5 (which commences the trading disclosure sections of the CA 06) states that nothing in the order affects the application of the CA 85 to LLPs. Therefore LLPs should continue to comply with the 2006 regulations.

Accounts and audit regulations

The regulations apply to financial years commencing on or after 1 October 2008. The formatting of the new regulations is different from the 2001 regulations. The new regulations reproduce the sections from CA 06 as applied to LLPs. This is likely to be more "user friendly" than the previous approach which was to only show the amendments to each section.

LLPs subject to small regime

The requirements applied to LLPs are identical to companies. In particular, to qualify as small the LLP must satisfy the years rule. This requires the LLP to a) satisfy the conditions in the year and proceeding year, or b) meet the conditions in the current year and qualify as small in the previous year, or c) meet the conditions in the previous year and qualify as small in the previous year.

There is no change to this aspect from the CA 85. However, it is noted that preparers often misinterpret these provisions.

The qualifying conditions are the same as for companies:

Condition	**from 1/10/08**	**Previous**
Turnover	£6.5m (£7.8m)	£5.6m (£6.72m)
Balance sheet total	£3.26m (£3.9m)	£2.8m (£3.36m)
Employees	50	50

The gross figures are shown in brackets and only apply if the LLP is a parent.

Eligibility

Certain LLPs are excluded from the small regime. In essence, the rules are the same as for companies and, with the exception of the following, are identical to the CA 85 requirements:

- LLPs which are members of ineligible groups cannot take advantage of the small regime.
- Determining the eligibility of the group has changed in respect of overseas entities. LLPs are excluded from the small regime if a member of the group is listed in an EEA state. Previously an overseas entity which had the same characteristics as a UK public company made the group ineligible.

Lack of transitional provisions

The qualifying conditions in CA 06 were originally identical to the equivalent qualifying conditions in CA 85. However, the limits were revised in SI 2008/393. The SI included transitional provisions which allowed, in the first year, the application of the new qualifying conditions to the previous year. This is shown in the following example which shows the data for X Ltd for the three years ending on 31 March:

	2008	2009	2010
Turnover	£6m	£6m	£6m
Balance sheet total	£3m	£3m	£3m
Number of employees	40	40	40

<u>Does X Ltd qualify as a small company for 2010?</u>

The new limits will apply for 2010 and so the company satisfies the qualifying conditions in 2010.

The application of the transitional provisions requires the company to use the new limits in order to determine whether the qualifying conditions were met in the previous year. On the basis of the new limits the company satisfied the qualifying conditions in 2009. It is therefore a small company in 2010.

Now consider the same example which assumes that X is an LLP

Years ending on March:

	2008	2009	2010
Turnover	£6m	£6m	£6m
Balance sheet total	£3m	£3m	£3m
Number of employees	40	40	40

<u>Does X LLP qualify as a small LLP for 2010?</u>

The new limits will apply for 2010 (periods commencing on or after 1 October 2008) and so the LLP satisfies the qualifying conditions in 2010. However, it would not have done so for 2008 and 2009.

There are no transitional provisions for LLPs as exist for companies. In fact, regulation 2 of SI 2008/1911 states that the requirements of CA 85 should apply to periods commencing before 1 October 2008.

Therefore, the LLP was not small in 2009 and did not satisfy the qualifying conditions in 2009. Therefore the LLP is not small in 2010.

Accounting records

The requirement to keep accounting records is unchanged from CA 85. The requirement for proper accounting records is replaced by adequate accounting records. There is no further guidance on what "adequate" means but it is unlikely to be significantly different from the previous term "proper". As before, the records must be kept for three years. However, to comply with other legal requirements, e.g., HMRC, a longer period is likely.

Financial years

There are no changes to the requirements. A financial year starts on the first day after the previous year ends and ends at the accounting reference date, plus or minus seven days. The accounting reference date can be changed by either extending the period or shortening it. As before LLPs can only extend if they have not done so in the last five years. Any changes have to be made before the filing date for the current period.

Annual accounts

There is a new requirement that members of a LLP must not approve accounts unless they are satisfied they show a true and fair view. This applies to both individual accounts and group accounts. The auditor, if there is one, is required to have regard to this duty.

The accounting basis can be either UK or IAS. As before, if the LLP prepares IAS accounts there has to be a change of circumstances to allow the LLP to return to UK standards. The circumstances are stipulated in the Regulations.

These notes do not include the requirements for IAS accounts on the basis that the number of LLPs following this route is likely to be very small.

Non IAS accounts must comply with either the small regulations or large and medium sized regulations.

LLPs which are parents of small groups may prepare group accounts, all others are required to do so unless one of the exemptions in s400 to s402 would apply. These only apply where the LLP is an "intermediate" parent or is permitted to omit all subsidiaries from the group accounts. These requirements are identical to those applied to companies.

Subsidiary undertakings may be excluded from consolidation on the same basis as applied to companies. These are;: severe long term restriction; information cannot be obtained without disproportionate expense or delay; and interest is held for resale.

Disclosure of information

s410 allows the information on related undertakings to be reduced if full disclosure is of excessive length.

s410A, disclosure of off-balance sheet arrangements applies in the same way to LLPs as companies. Small LLPs are excluded altogether from the requirement and medium-sized LLPs are not required to disclose the financial impact. This is identical to companies and there is no further guidance on what an off-balance sheet arrangement is.

s411 will apply to LLPs. The requirements are identical to companies requiring the disclosure of employee numbers and costs. This does not apply to LLPs subject to the small regime. This replicates the requirements under CA 85.

S412 and s413 do not apply to LLPs. There are no requirements to disclose remuneration of members or transactions with members. This replicates CA 85. LLPs are under no obligation to disclose information concerning member emoluments, advances, credits and guarantees in favour of members. The requirement to disclose the amount attributable to the member with the largest entitlement is retained and is contained in the accounting Regulations. This is not required for small LLPs.

Approval and signing

The accounts must be approved by the members and signed on their behalf by a designated member. If the LLP has used the small regime then a statement must be included on the balance sheet above the signature.

Members' report

Part 5 (Directors' reports) does not apply to a LLP. The 2001 Regulations did not require an equivalent to the Directors' Report to be prepared. If the LLP decides to prepare such a report then the contents are not covered by any statutory requirements.

The SORP suggests a members' report should be prepared and provides a list of items which should be included. There is no obligation to file this report with the Registrar.

A common misunderstanding is to prepare a members' report and add a reference to preparation in accordance with the small regime. This disclosure is not correct as there is no statutory obligation.

There is also no reference to a directors' remuneration report.

Publication of accounts

Accounts must be sent out to the members at the earlier of the filing deadline and the date the accounts are filed with the Registrar.

The balance sheet must show the name of the person who signed it on behalf of the members.

There is no provision to allow LLPs to send out summary accounts in place of statutory accounts.

There is no reference to laying of accounts.

Filing of accounts

Designated members are obliged to file accounts with the Registrar. The obligation is to file:

- Small LLP accounts; or
- Medium sized LLP accounts; or
- Large LLP accounts.

The period allowed is 9 months. The period is calculated by reference to the specified date. If the specified date is the end of a month then the filing date is the end of the corresponding month.

Small regime

Non IAS accounts are required to comply with either the small, or medium and large regulations.

Small LLP must file, either:

- Its individual accounts but it may omit the profit and loss account. The wording of this section is different from CA 85. The requirement is to deliver a copy of the balance sheet but the designated member "may also" deliver a copy of the profit and loss account. In these circumstances the balance sheet must contain a statement to the effect that the accounts have been "delivered" in accordance with the provisions applicable to small LLPs. These accounts do not constitute abbreviated accounts which are described separately in 444(3).

  or

- Abbreviated accounts prepared in accordance with the regulations for abbreviated accounts. This is only available if the LLP has prepared non IAS accounts. A statement is required on the balance sheet, this is referred to below.

In comparison to companies there is no requirement to file the equivalent of the directors' report. As discussed above there is no statutory requirement to prepare such a report and therefore if one is prepared there is no statutory obligation to file it.

It is important to clarify the filing position. These requirements are identical to companies and are different from the requirements under the CA 85. s444 distinguishes between abbreviated accounts and those which are filed and omit the profit and loss account. This is clear from s444(5) which refers to a specific balance sheet statement for the latter and states they are not abbreviated accounts. It is presumed that such a document would exclude the profit and loss account notes as to include these without the profit and loss account would not be helpful.

There are no examples provided of balance sheet statements. Companies House recently issued examples for companies from which it would be reasonable to propose that the following statements might be acceptable.

The accounts have been delivered in accordance with the provisions applicable to limited liability partnerships subject to the small limited liability partnerships regime.

These accounts have been prepared in accordance with the provisions applicable to limited liability partnerships subject to the small limited liability partnerships regime.

The person who signed the balance sheet must be stated. It must be signed by a designated member.

If the LLP has not taken advantage of audit exemption then an audit report must also be filed. If the LLP files abbreviated accounts then a special report is required in accordance with s449. If the option is taken to omit the profit and loss account then the full audit report, not the "special" report, must be delivered. The audit report must state the name of the senior statutory auditor and be signed by someone who has the authority of the audit firm to "authenticate" the report.

Medium-sized LLPs

Medium-sized LLPs must deliver LLP accounts and audit report. They can file abbreviated accounts in the same way as a company. In these cases a special audit report will be required. As discussed above there is no requirement to file a members' report.

Other requirements relating to signing and the inclusion of names are the same as for small LLPs as described above.

Large LLPs

The same requirements apply as for medium-sized LLPs except that there are no abbreviated accounts.

Special auditor's report

A special auditor's report will be required where the LLP files abbreviated accounts and the LLP is not exempt from audit.

The special report must include additional information if the report on the accounts was qualified or included aspects concerning adequate accounting records, information and explanations, etc.

There are some differences on the signing of the audit report. For companies s449(4) states that the requirements on the signing of the special report are the same as those that apply to auditor's reports under s503. This requires the audit report to be signed by the senior statutory auditor on behalf of the auditor (the firm). This is reflected in Bulletin 2008/4.

45. Where the auditor is an individual the special report is signed by the individual. Where the auditor is a firm, the report must be signed by the senior statutory auditor in his own name for and on behalf of the auditor (See Bulletin 2008/6 *The 'Senior Statutory Auditor' under the United Kingdom Companies Act 2006).*

This requirement is not clear in the Regulations for LLPs. The reference to s449(4) is included as the Regulations state the whole section will apply unless modified by the Regulations. However, they have inserted s449(4A) until s1068 is fully in force. (Section 1068 deals with the Registrar's requirements as to form, authentication and manner of delivery). This section, for which there is no equivalent for companies, requires the report to be signed by the auditor and where this is a firm it should be in the name of the firm. However, s503 also applies to LLPs and so the purpose behind 4A is unclear. The inclusion of 4A makes it uncertain as to who should sign the special audit report: the senior statutory auditor or the firm.

Abbreviated accounts

The abbreviated accounts must be approved and signed by a designated member.

The balance sheet must contain a statement to the effect they have been prepared in accordance with the special provisions.

Failure to file accounts

Penalties for failing to deliver documents to the Registrar are applied to LLPs on the same basis as companies, see above. The "doubling regime" will be applied to LLPs for accounting periods commencing on or after 1/10/08. Both the periods have to commence on or after this date.

Medium sized LLPs

To qualify as medium the LLP must satisfy the years rule. This is applied in the same way as for small LLPs above.

The new conditions are:

Condition	from 1/10/08	Previous
Turnover	£25.9m (£31.1m)	£22.8m (£27.36m)
Balance sheet total	£12.9m (£15.5m)	£11.4m (£13.68m)
Employees	250	250

The gross figures shown in brackets only apply where the LLP is a parent.

LLPs are excluded from the medium regime on broadly the same basis as companies. However, whereas a company is ineligible to be small or medium-sized if it is a plc, the equivalent for the LLP is that it is ineligible if it is admitted to trading on a regulated market in an EEA state. The exclusions are identical with those in CA 85 with the exception of the following:

- LLPs which are members of ineligible groups cannot take advantage of the small or medium regime.
- Determining the eligibility of the group has changed in respect of overseas entities. LLPs are excluded from the medium regime if a member of the group is listed on a regulated market. This is different from small LLPs which restricted this to an EEA state. Previously an overseas entity which had the same characteristics as a UK public company made the group ineligible.

Audit requirement

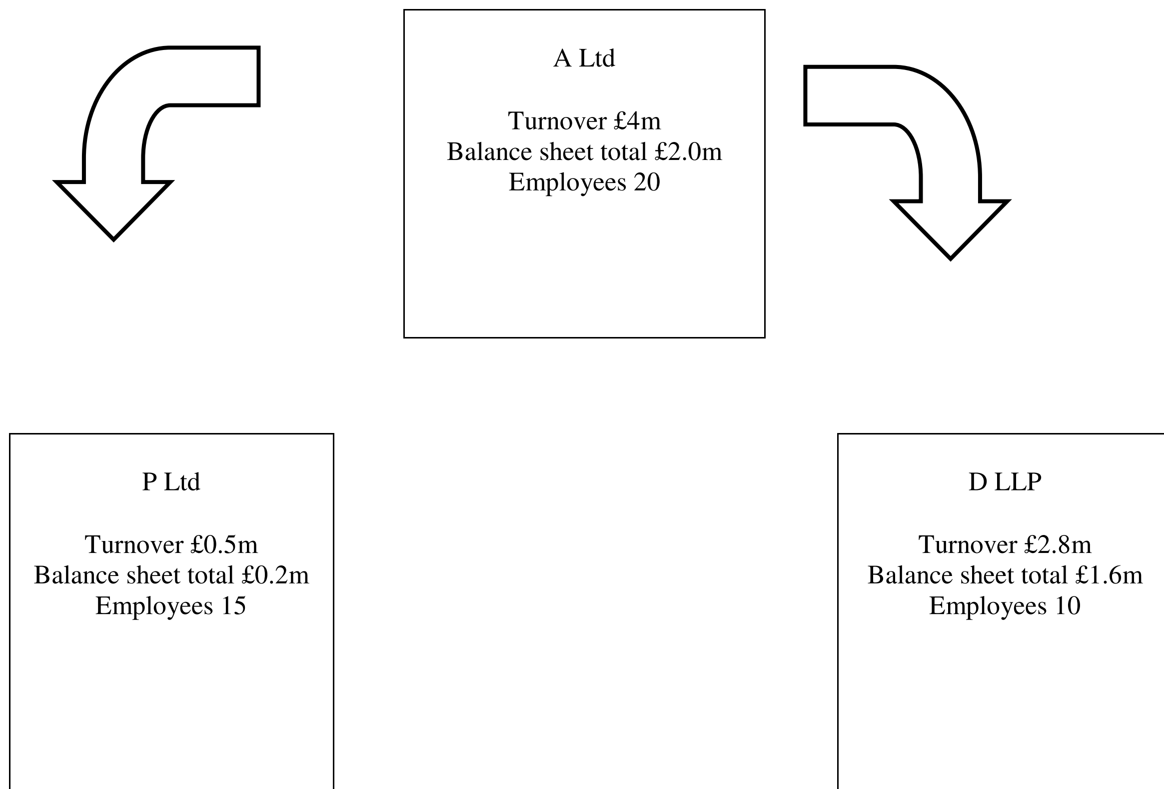
The requirement for audited accounts is applied in the same way as companies. LLPs taking advantage of audit exemption are required to include a statement on the balance sheet. The following may be appropriate:

> For the year ending............... the limited liability partnership was entitled to exemption from audit under section 477 of the Companies Act 2006 as applied to limited liability partnerships.
>
> Members' responsibilities:
>
> The members acknowledge their responsibilities for complying with the requirements of the Act (as applied to limited liability partnerships) with respect to accounting records and the preparation of accounts.
>
> These accounts have been prepared in accordance with the provisions applicable to limited liability partnerships subject to the small limited liability partnership regime.

There is no requirement to include a reference to members requiring an audit as s476 does not apply to LLPs. This is no different to the fact that s249B(2) did not apply under the CA 85. Whether a LLP takes advantage of audit exemption or not would have to be subject to a determination of the members and may be included in the members' agreement.

The conditions that need to be satisfied are identical to companies; LLP must be small; turnover must not exceed £6.5m; and balance sheet total must not exceed £3.26m. If the period is more or less than a year then the turnover is time apportioned.

Where the LLP is a member of a group the group must satisfy the requirements for a small group and the turnover must not be more than £6.5 m net (£7.8m gross) and balance sheet total must not be more than £3.26m net (£3.9m gross). Where the LLP is a member of a group which includes companies there may be transitional aspects given the timing of the new requirements since the LLP might still be using the criteria from CA 85. This issue can be explained using the following example which is for the year ended 30 June 2009. Assume that there is no trading within the group and that balances with other group entities are negligible



In the above example the aggregate values are: turnover £7.3m, balance sheet total £3.8m, and 45 employees. The companies will be using the new thresholds under CA 06 whereas the LLP will be using CA 85. Under CA 06 criteria, the group satisfies the qualifying conditions to be a small group. Subject to the years rule, both of the companies would be entitled to audit exemption. However, the LLP is using CA 85 criteria and it should be noted that the changes in the limits made under SI393 did not change the limits in CA 85. As the group does not satisfy the criteria under s249B CA 85 the LLP would not be entitled to audit exemption. This is a transitional problem. Once the companies and the LLP are all using the same criteria, this problem will not arise.

Dormant LLPs can take advantage of audit exemption irrespective of whether the group is eligible or not. They cannot do so if s481 applies, insurance company etc.

Appointment of auditors

Auditors must be appointed if required. Re-appointment is similar to that for companies. Reappointment will be automatic unless:

- LLP agreement requires re-appointment. For a company this would be a requirement within its Articles.
- Re-appointment is prevented by the members, the requirement is 5% or lower if otherwise specified in the agreement. This is similar to the 5% members for companies.
- Members determine that the auditor is not to be reappointed
- No auditor to be appointed

There is no reference to appointment to fill a casual vacancy.

Functions of an auditor

This is identical to companies with the following changes:

- there is no obligation to give an opinion on the directors' report, or any equivalent
- there is no reference to the remuneration report.

Signing of the report

This is the same as for companies. However, auditors will need to be aware of the timing difference in the introduction of the requirements for companies and LLPs. Consider two entities both with 30/6/09 year ends. One is a company the other an LLP. The company audit report will need to be signed in accordance with CA 06 (ie by the senior statutory auditor on behalf of the firm) but the LLP audit report will continue to be signed under CA 85.

Removal and resignation of auditors

A "statement of circumstances" must be sent by the auditor to the LLP under s519. In addition, it may be necessary to notify the appropriate audit authority. As with companies there is a distinction between the rules for major audits and other audits. There is also, like companies, an obligation for the LLP to notify the appropriate audit authority where the auditor ceases to hold office before the end of his term of office.

Accounting regulations

There are no significant changes from the requirements of CA 85.

For the LLP Accounts and Audit Regulations see http://www.opsi.gov.uk/si/si2008/pdf/uksi_20081911_en.pdf

REVISION TO ISA (UK AND IRELAND) 700: THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

(Lecture A267 18.03 minutes)

The Auditing Practices Board (APB) has published a revision to ISA 700. This follows the ED published last year and previously the Discussion Paper entitled "The Auditor's Report: A time for change?". The changes are wide ranging and have been referred to as an evolution of the audit report. This was in response to the views of institutional investors, preparer organisations, public sector bodies and some auditing firms and individuals who preferred a more concise (shorter) auditor's report.

The ISA includes some illustrative examples of auditor's reports for UK companies. More examples are contained in Bulletin 2009/2 which is dealt with later in these notes.

Features

The principal features of the new form of report when compared with auditors' reports being issued under CA 85, are that the new report:

- Separates the opinion on the financial statements from opinions on other matters required by legislation, and from matters which are reported by exception. This results in three distinct sections to the part of the audit report dealing with opinions.
- Emphasises the primacy of the true and fair requirement, as the overarching concept in reporting on financial statements.
- Makes a significant change to what was previously described as the ''basis of opinion''. ISA (UK and Ireland) 700 (Revised) changes the heading of this section to ''Scope of the audit'' and allows three approaches. In the case of UK companies, the report can:
    - cross refer to a ''Statement of the Scope of an Audit'' that is maintained on APB's web site; or
    - cross refer to a ''Statement of the Scope of an Audit'' that is included elsewhere within the Annual Report; or
    - include a prescribed description of the scope of an audit. Where auditors decide to include a description of the scope of the audit within the auditor's report, APB believes the description should be as short as possible and use the prescribed words (see below).
- States the auditor's responsibility to comply with APB's Ethical Standards.

Application

Application will be in two stages:

1. Companies will use the new format for financial years ending on or after 5 April 2009;
2. Other entities will use the new format for financial years ending on or after 15 December 2010.

The reason for this is the delay in providing information on the APB website. As indicated above, the scope of the audit section (the old basis of audit opinion section) may include a reference to information on the APB website. Initially the information available on the website will only refer to companies and not other entities.

The position with regard to LLPs is unclear. They are required to comply with the new provisions of the Companies Act for accounting periods commencing on or after 1 October 2008.

New example audit report for UK non-publicly traded company

This report is to be used for the audits of accounting periods commencing on or after 6 April 2008 and ending on or after 5 April 2009.

Assumptions:

- Group and parent company financial statements not presented separately
- Company prepares group financial statements
- Company is not a quoted company

- UK GAAP used for group and parent company financial statements
- Section 408 exemption taken for parent company's own profit and loss account
- The scope of the audit is described on the APB website or elsewhere in the annual report (see notes 4 and 5 below)

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF XYZ LIMITED

We have audited the financial statements of XYZ Limited for the year ended ... which comprise [specify the financial statements, such as the Group Profit and Loss Account, the Group and Parent Company Balance Sheets, the Group Cash Flow Statement, the Group Statement of Total Recognised Gains and Losses,] and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement [set out [on pages...]], the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit

A description of the scope of an audit of financial statements is [provided on the APB's web- site at www.frc.org.uk/apb/scope/UKNP] / [set out [on page x] of the Annual Report].

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the group's and the parent company's affairs as at ... and of the group's profit [loss] for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

[Signature] Address

John Smith (Senior statutory auditor) Date

for and on behalf of ABC LLP, Statutory Auditor

Notes:

1. It is acceptable to use page numbers rather than referring to the various parts of the financial statements.
2. The new form of the Directors' Responsibilities Statement is included in Bulletin 2009/02.
3. The APB never include a Bannerman style disclaimer but the ICAEW still recommend this.

4. The wording for the statement of the scope of an audit and the auditor's reporting responsibilities, which is published on the ASB's website and cross-referred to in the audit report as shown above, is not reproduced here. Suffice it to say that the wording is much more detailed than the wording in the existing audit report.

5. As an alternative to the above paragraph "Scope of the audit", the following paragraph may be used:

Scope of the audit

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's and the parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

For more details, see http://www.frc.org.uk/apb/press/pub1903.html

Modified reports

There are no examples of modified reports in ISA 700; these are to be found in Bulletin 2009/2.

Short periods

For periods commencing on or after 6 April 2008 which end before 5 April 2009, the appropriate form of the audit report is to be found in Bulletin 2008/08.

BULLETIN 2009/2: AUDITOR'S REPORTS ON FINANCIAL STATEMENTS IN THE UNITED KINGDOM

The purpose of this Bulletin is to provide illustrative examples of both unmodified and modified auditor's reports on financial statements of companies incorporated in the United Kingdom for years ending on or after 5 April 2009.

The example auditor's reports included in the Bulletin take account of the applicable requirements of the Companies Act 2006 and the requirements of ISA (UK and Ireland) 700 (Revised) which was issued during March 2009.

The equivalent bulletin for reports under the 1985 Act is Bulletin 2006/06.

The following example reports are included in the appendices of Bulletin 2009/02:

Appendix 1 Unmodified auditor's reports where company does not prepare group financial statements

1. Non-publicly traded company preparing financial statements under the FRSSE
2. Non-publicly traded company preparing financial statements under UK GAAP
3. Publicly traded company preparing financial statements under UK GAAP
4. Publicly traded company preparing financial statements under IFRSs as adopted by the European Union

Appendix 2 Unmodified auditor's reports where group and parent company financial statements reported on in a single auditor's report

5. Non-publicly traded group preparing financial statements under UK GAAP
6. Publicly traded group - Parent company financial statements prepared under UK GAAP
7. Publicly traded group - Parent company financial statements prepared under IFRSs as adopted by the European Union

Appendix 3 Unmodified auditor's report on group financial statements reported on separately from the parent company financial statements

8. Publicly traded group - Auditor's report on group financial statements prepared under IFRSs as adopted by the European Union

Appendix 4 Unmodified auditor's reports on parent company financial statements reported on separately from the group financial statements

9. Publicly traded group - Auditor's report on parent company financial statements prepared under UK GAAP
10. Publicly traded group - Auditor's report on parent company financial statements prepared under IFRSs as adopted by the European Union

Appendix 5 Modified auditor's reports - Emphasis of matter paragraphs

11. Emphasis of matter: Material uncertainty that may cast significant doubt about the company's ability to continue as a going concern

12. Emphasis of matter: Possible outcome of a lawsuit

Appendix 6 Modified auditor's reports - Qualified opinion on financial statements

13. Qualified opinion: Disagreement - Inappropriate accounting treatment of debtors
14. Qualified opinion: Disagreement - Non-disclosure of a going concern problem
15. Qualified opinion: Scope Limitation - Auditor not appointed at the time of the stocktake
16. Qualified opinion: Scope Limitation - Directors did not prepare cash flow forecasts sufficiently far into the future to be able to assess the going concern status of the company

Appendix 7 Modified auditor's reports - Adverse opinion on financial statements

17. Adverse opinion: No provision made for losses expected to arise on long term contracts
18. Adverse opinion: Significant level of concern about going concern status that is not disclosed in the financial statements

Appendix 8 Modified auditor's reports - Disclaimer of opinion on financial statements

19. Disclaimer of opinion: Auditor unable to attend stocktake and confirm trade debtors
20. Disclaimer of opinion: Multiple uncertainties

Appendix 9 Descriptions of the "Scope of an Audit" that may be cross referenced from auditor's reports

- UK Publicly Traded Company (issued 26 March 2009)
- UK Non-Publicly Traded Company (issued 26 March 2009)

Appendix 10 Modified auditor's report - Modified opinion on the directors' report

Appendix 11 Illustrative Directors' Responsibilities Statement for a non-publicly traded company preparing its financial statements under UK GAAP

For more information see http://www.frc.org.uk/apb/press/pub1964.html

CLARITY IS COMING – THE NEW AUDITING STANDARDS

Background

Clarity is coming! The International Auditing and Assurance Standards Board (IAASB) have announced that they plan to adopt the new clarified International Standards in Auditing (Clarified ISAs) for periods commencing on or after 15 December 2009. It is now clear that the UK Auditing Practices Board (APB) will adopt these standards at much the same time.

What is Clarity?

On 31 October 2005 the IAASB announced that it intended to improve the clarity of its ISAs by:

- Setting an overall objective for each ISA;
- Clarifying the obligations imposed on the auditor by the requirements of the ISAs, and by using the word "shall" instead of the current "should" to emphasise the expectation that these requirements are applicable in virtually all engagements to which the ISA is relevant;
- Eliminating any ambiguity about the status of the existing ISAs by modifying the language of current present tense statements, either by elevating them to "shall" statements or by eliminating the present tense to make it clear that there is no intention to create a requirement; and
- Improving the overall readability and understandability of the ISAs through structural and drafting improvements.

Clarification of the standards is not the same as revision of the standards, although some standards have also been revised as well as clarified. However, clarity might mean auditors doing things differently and will almost certainly require fuller documentation to demonstrate compliance with the standards. In essence the changes are driven by a new drafting convention:

- introduction – i.e. scope, effective date
- objective – brief explanation of purpose
- definitions – key words that undefined may confuse
- requirements – regulators will expect these to be done
- application and other explanatory material

Requirements

One of the most spoken about changes is the use of the world "shall". This word is used throughout the clarified Standards and indicates a requirement of the Standards. It replaces the paragraphs previously using the present tense which confused many auditors because it was unclear whether it was imperative to follow such statements. The Exposure Draft of ISA 200 (UK and Ireland) "Overall objectives of the independent auditor, and the conduct of an audit in accordance with International Standards on Auditing (UK and Ireland)" issued by the APB says in paragraph 18:

"The auditor shall comply with all ISAs (UK and Ireland) relevant to the audit. An ISA (UK and Ireland) is relevant to the audit when the ISA (UK and Ireland) is in effect and the circumstances addressed by the ISA (UK and Ireland) exist."

Distinction between requirements and guidance

The auditing standards currently applicable (ISAs UK and Ireland) contain bold text indicating a requirement and grey text indicating guidance. Under clarity this distinction is no longer relevant. The auditor has to read the whole standard in order to understand/interpret the requirements. See again the clarified ISA 200 (UK and Ireland) paragraph 19:

"The auditor shall have an understanding of the entire text of an ISA (UK and Ireland), including its application and other explanatory material, to understand its objectives and to apply its requirements properly."

Current status of the project in the UK

Exposure drafts of ISAs (UK and Ireland) have been issued which incorporate the pluses for UK and Ireland (see below). The new UK standards will be applicable at much the same time as the IAASB suggested. However, the new Standards will not initially apply to short accounting periods which means that the standards will apply in the UK and Ireland for periods ending on or after 15 December 2010.

The APB intends to allow early adoption, although it is not encouraged. The possibility of early adoption is useful because it allows firms to pilot new audit systems and to have a smooth transition to new audit methodologies.

Pluses

The current arrangement of "pluses" is largely going to end. The APB currently enhances the ISAs in the UK by the addition of more onerous additional requirements applicable only to the UK and Ireland. The APB intend, as far as possible, to amend the clarified standards only where necessary to comply with UK legislation such as Companies Act 2006.

The pluses are changing as follows:

Number of supplementary requirements in current ISAs (UK and Ireland)	Number of supplementary requirements rendered unnecessary by the Clarity Project and revision of particular ISAs	Legal/Regulatory supplementary requirements to be kept	Proposed audit quality supplementary requirements to be kept
61	39	17	5

The proposed audit quality supplementary requirements are:

Proposed clarified ISA (UK and Ireland)	Audit quality plus
450 Evaluation of misstatements	Requiring the auditor to seek to obtain a written representation from those charged with governance that explains their reasons for not correcting misstatements brought to their attention by the auditor. (paragraph 14-1)
510 Opening balances	Extending the requirements relating to opening balances on initial engagements to all audits. (paragraph 3)
570 Going concern	Requiring the auditor to plan and perform procedures specifically designed to identify any material matters which could indicate concern about the entity's ability to continue as a going concern. (paragraph 13-2)
	Requiring the auditor to document the extent of the auditor's concern (if any) about the entity's ability to continue as a going concern. (paragraph 17-1)
720 A Other information	Requiring the auditor to consider including an "Other Matters" paragraph in the auditor's report when an amendment is necessary in the other information and the entity refuses to make the amendment. (paragraph 16-1)

What will audit clients see?

Under clarity audit clients might notice changes to:

- engagement letters
- reports to those charged with governance
- content of discussions with management and board
- representation letters
- form of report

In addition, clarified ISAs may alter the nature and extent of audit work and documentation. This will affect the cost of audits.

How much more work will be needed under the Clarity ISAs

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

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

Implementation issues

The clarified Standards will require auditors to have a complete command of the requirements of the standards, so that audit documentation can record not just how the audit was done but how the work complied with requirements of the standards. The clarified standards might be similar to the current ISAs - but did all UK auditors read the current standards?

Because of the above there will be significant training requirements and the correct timing of this will be crucial to good implementation.

As the Clarified ISAs contain much more detail it will be necessary to redraft audit methodologies and standard working paper systems.

The revised and clarified standards are more onerous. There is a significant one-off cost in the first year of adoption followed by a smaller ongoing increase in audit costs. Audit fees will go up again.

Examples of the changes resulting from Clarity

It is easy to talk about Clarity in abstract terms but sometimes this does not convey the substance of the changes that are coming. In this section we will look at a few examples of how the standards will change under clarity.

There are 13 revised (rather than just Clarified Standards) and one new Standard.

Revised ISAs

200 Objective and General Principles Governing an Audit of Financial Statements

260 Communication of Audit Matters With Those Charged With Governance

320 Materiality in Planning and Performing an Audit

402 Audit Considerations Relating to Entities Using Service Organizations

450 Evaluation of Misstatements Identified During the Audit

505 External Confirmations

540/545 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, And Related Disclosures.

550 Related Parties

580 Management Representations

600 The Audit of Group Financial Statements

620 Using the Work of an Expert

705 Modifications to the Opinion in the Independent Auditor's Report

706 Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report

The new standard is ISA 265: Communicating deficiencies in internal control to those charged with governance and management.

The above revised/new standards do not provide an exhaustive list of the changes although they represent a number of the major new requirements. We include below some examples of the changes.

ISA 220 Quality Control for an Audit of Financial Statements

The current ISA 220 is not specific on the requirements for the form of an Engagement Quality Control Review (EQCR), unless it is a listed client. The clarified ISA has increased specificity regarding the EQCR. It shall include:

- Discussion of significant matters with the engagement partner.
- Review of financial statements, proposed auditor's report and selected working papers.
- Evaluation of conclusions reached
- For listed entities, consideration of the firm's independence, consultations on difficult matters, consideration of whether documentation reviewed reflects the work done re significant judgments and conclusions reached.

Most audit firms will have been doing this sort of work already when conducting an EQCR but the new requirements mean that it is vital to document properly what has been done.

ISA 550 - Related parties

One of the changes in the standard extends the requirements for what business must be conducted at the audit team planning meeting.

The engagement team discussion required by ISAs 315 (Redrafted) and 240 (Redrafted) shall include specific consideration of the susceptibility of the financial statements to material misstatements due to fraud or error that could result from the entity's related party relationships and transactions. (Paragraph 12)

The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team. (Paragraph 17)

In paragraph 18 of the standard an additional significant risk is identified when the auditor identifies significant related party transactions outside the normal course of business.

ISA 501 Audit evidence regarding specific financial statement account balances and disclosures

It remains mandatory for the auditor to attend the physical stock take but clarity is more specific as to what the auditor does at stock attendance:

"4. If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding its existence and condition by:

(a) attendance at physical inventory counting, unless impracticable to

  i. Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

  ii. Observe the performance of management's count procedures;

  iii. inspect the inventory; and

  iv. perform test counts; and

(b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results."

Here are new requirements in relation to litigation.

"10. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs (UK and Ireland), seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures."

ISA 240 - The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

There are some significant new requirements in this standard. The clarified standard is more specific about testing journal entries and other adjustments, accounting estimates and unusual transactions, including:

- Making inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
- Testing journal entries and other adjustments made at the period end, and considering the need to test journal entries and other adjustments throughout the period.
- Reviewing accounting estimates for bias, even if individually reasonable.
- Performing retrospective review of management judgements and assumptions.
- Evaluating the business rationale of significant transactions outside the normal course of business or that otherwise appear unusual.

ISA 560 - Subsequent Events

In this clarified standard there are new requirements on what the auditor must do when considering post balance sheet events:

- Obtain understanding of management's procedures to ensure subsequent events are identified
- Read minutes of meetings of owners, management and those charged with governance
- Read latest subsequent interim financial statements, if any
- Inquire of management.

ISA 600: The Audit of Group Financial Statements

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

ISA 620: Using the Work of an Expert

ISA 620 addresses the use of experts by auditors to help obtain audit evidence, and is therefore only relevant where experts (other than experts in accounting or auditing) are used. It is generally felt that the Clarity ISA will drive more rigour and formality, and consequently documentation, with respect to the relationships with experts and evaluating the results of an expert's work.

Other ISAs

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

The press release announcing the publication of the exposure drafts of the ISAs (UK and Ireland) can be found at:

http://www.frc.org.uk/apb/press/pub1957.html

From here, you can click through to download free copies of the EDs.

CONSULTATION PAPER: AMENDMENTS TO ETHICAL STANDARDS

(Lecture A268 minutes)

The APB has proposed a number of amendments to the ethical standards as summarised below.

Financial interests in a client

In ES 2 an amendment is proposed so that, where a person joins the audit firm as a partner, he or she is not required to dispose immediately of financial interests in a client in the circumstances where there is no market for such interests, or the individual has no entitlement to sell the interest, and the individual is not able to influence the affairs of the entity.

There are conditions as follows:

(a) The financial interests were acquired before the individual joined the audit firm; and

(b) The partner in question:

- is not in a position to influence the conduct and outcome of the audit;
- does not work in the same part of the firm as the audit engagement partner; and
- is not involved in the provision of a non-audit service to the audit client.

Such a financial interest should be disposed of as soon as possible after the individual becomes able to make a disposal. The audit firm maintains a record of individuals with such financial interests containing a description of the circumstances.

Using the work of internal audit

It is proposed to clarify ES 2 to make it clear that the ban on 'dual employment' is not intended to preclude internal audit personnel directly assisting the external auditor in carrying out external audit procedures provided that appropriate quality control arrangements are established, as described in ISA (UK and Ireland) 610.

Serving as a director or officer of the client

In order to ensure compliance with the IFAC code, it is proposed that Paragraph 53 of ES2 should be amended to state:

A partner, or employee of the audit firm shall not accept appointment:

(a) to the board of directors of the audited entity;

(b) to any subcommittee of that board; or

(c) to such a position in an entity which holds directly or indirectly more than 20% of the voting rights in the audited entity, or in which the audited entity holds directly or indirectly more than 20% of the voting rights.

Previously, this paragraph only applied to a partner or employee who undertakes audit work.

Rotation requirements

A number of changes are proposed in this general area which only affects listed entities. The consultation paper contains the following proposals:

1. The engagement quality control reviewer should be treated in the same way as a key audit partner. This would require rotation after seven years not five years.
2. In circumstances where the audit committee (or equivalent) of the audited entity and the audit firm have agreed that a degree of flexibility over the timing of rotation would safeguard the quality of the audit, the audit engagement partner may continue in this position for an additional period of up to two years, so that no longer than seven years in total is spent in the position of audit engagement partner. An audit committee and the audit firm may consider that such flexibility safeguards the quality of the audit, for example, where:
    - the audited entity is so large and either complex or diverse that the audit partner's cumulative knowledge of the business is critical to the audit; or

- substantial change has recently been made or will soon be made to the nature or structure of the audited entity's business; or
- there are unexpected changes in the senior management of the audited entity.

In these circumstances alternative safeguards are applied to reduce any threats to an acceptable level. Such safeguards may include ensuring that an expanded review of the audit work is undertaken by an audit partner, who is not involved in the audit engagement.

Where it has been determined that the audit engagement partner may act for a further period (not to exceed two years), this fact and the reasons for it, are to be disclosed to the audited entity's shareholders, (preferably in the corporate governance statement within the annual report). If the audited entity is not prepared to make such a disclosure, the audit firm does not permit the audit engagement partner to continue in this role.

3. The audit engagement partner shall review the safeguards put in place to address the threats to the auditor's objectivity and independence arising where partners and staff have been involved in the audit in senior positions for a continuous period longer than seven years and shall discuss those situations with the engagement quality control reviewer. Any unresolved problems or issues shall be referred to the ethics partner.

Selling non-audit services

It is proposed to strengthen paragraph 38 of ES4 to clarify that it applies also to key partners involved in the audit. The new paragraph would read:

The audit firm shall establish policies and procedures to ensure that, in relation to each audited entity:

(a) the objectives of the members of the audit team and key partners involved in the audit do not include selling non-audit services to the audited entity;

(b) the criteria for evaluating the performance or promotion of members of the audit team and key partners involved in the audit do not include success in selling non-audit services to the audited entity; and

(c) no specific element of the remuneration of a member of the audit team and key partners involved in the audit is based on his or her success in selling non-audit services to the audited entity.

Non-audit services

It is proposed to revise paragraph 6 of ES 5. The new paragraph would read:

'Non-audit services' comprise any engagement in which an audit firm provides professional services to an audited entity other than:

(a) the audit of financial statements; and

(b) pursuant to those other roles which are required by legislation or regulation to be performed by the auditor of the entity (for example, considering the preliminary announcements of listed companies, complying with the procedural and reporting requirements of regulators, such as requirements relating to the audit of the audited entity's internal controls and a report in accordance with Section 714 of the Companies Act 2006).

Previously, (b) above read "pursuant to those other roles which legislation or regulation specify can be performed by the auditor of the entity".

Securitisations

In order to make it clear where assurance services on transactions, such as those relating to securitisations are covered, the APB believes that adding a further example to paragraph 116 (and deleting one from paragraph 104) would clarify that any agreed upon procedures in connection with a transaction (including securitisations) are dealt with under transaction related services.

Restructuring services

A new section to ES 5 (Revised) is proposed, providing examples of the type of services included in the category of restructuring services and setting out the requirements and guidance associated with their provision to an audited entity. The new section would read as follows:

1. The potential for the auditor's objectivity and independence to be impaired through the provision of non-audit services in relation to a refinancing or restructuring engagement varies depending on the

nature of the service provided. The main threats to auditor objectivity and independence arising from the provision of restructuring services are the self-review, management and advocacy threats.

2. Examples of restructuring services that the audit firm may be requested to undertake 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.

3. The audit firm shall not undertake an engagement to provide restructuring services in respect of an audited entity where:

   a. the engagement would involve the audit firm undertaking a management role in the audited entity; or

   b. the engagement would require the auditor to act as an advocate for the entity in relation to matters that are material to the financial statements.

4. When providing restructuring services to an audited entity, there is a self-review threat associated with any advice provided to assist the audited entity in that regard and the auditor's assessment of whether it is appropriate for the financial statements to be prepared on a going concern basis. Appropriate safeguards are applied to reduce the self-review threat to an acceptable level.

5. Examples of safeguards that may be appropriate when restructuring services are provided to an audited entity include:

   - The restructuring advice is provided by partners and staff who have no involvement in the audit of the financial statements.
   - A review by a partner or other senior staff member with appropriate expertise who has no involvement in the audit of the financial statements of the assessment as to whether it is appropriate for the financial statements to be prepared on a going concern basis.
   - Additional procedures undertaken as part of an Engagement Quality Control Review.

6. Where the audit firm is engaged to provide restructuring services to an audited entity there is a threat that the audit firm undertakes a management role, unless the audit firm ensures that the entity has informed management capable of taking responsibility for the decisions to be made.

7. 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.

In order to meet concerns that a change to ES 5 (Revised) might disadvantage smaller companies in their negotiations with banks, the APB also proposes to make it clear in ES - Provisions Available for Small Entities (Revised) that a similar exemption to the advocacy threat associated with tax services would also apply to restructuring services.

Glossary of terms

In the feedback paper on the 2007 review of the ESs, the APB agreed to reconsider what actions might be taken with a view to bringing the definition of an affiliate more into line with the IFAC Code definition of a related entity. The proposed definition goes some way towards the IFAC code definition and reads as follows:
An affiliate is any entity which, directly or indirectly,:

(a) is controlled or significantly influenced by the audited entity;
(b) has control or significant influence over the audited entity;
(c) is under common control with the audited entity;

except where, in (b) or (c) above, the relationship between the audited entity and the other entity, or between the audit firm and the relevant entity, is clearly insignificant in relation to auditor independence.

For more information, see http://www.frc.org.uk/apb/press/pub1886.html

LAWS & REGULATIONS – WHAT DOES ISA 250 REQUIRE?

(Lecture A269 19.34 minutes)

Background

Based upon feedback from QAD reviewers and cold file reviews it is clear that there are some misunderstandings about the requirements of ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements. These notes are intended to clarify these requirements and provide practical examples.

The impact of Clarity

Given the imminent changes to the ISAs (UK and Ireland), it is also worthwhile to look at what might change for periods ending 15 December 2010.

The clarified ISA 250 is redrafted not revised. This means that there was no intention to change the Standard and it is just reformatted. There were 19 mandatory paragraphs before and there remain the same 19 requirements. There are some small changes in Section B of the Standard, on reporting to regulators, but these notes do not deal with that area.

Note, however, that the pluses referred to below in the existing ISA (UK and Ireland) have not been repeated in the exposure draft of the new ISA (UK and Ireland)

The impact on every audit

The auditor is always required to consider the impact of Laws and Regulations. See the following requirement of the Standard:

"2 **When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements.** However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit."

In other words the auditor is not interested in compliance with Laws and Regulations as an end itself but to form an opinion on whether the financial statements show a true and fair view. The central issue is the consideration of whether non-compliance might lead to material errors in the accounts or even threaten the validity of the going concern basis.

The work on Laws and Regulations starts at the planning stage:

"15 **In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework.**

16 In obtaining this general understanding, the auditor would particularly recognize that some laws and regulations may give rise to business risks that have a fundamental effect on the operations of the entity. That is, noncompliance with certain laws and regulations may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, noncompliance with the requirements of the entity's

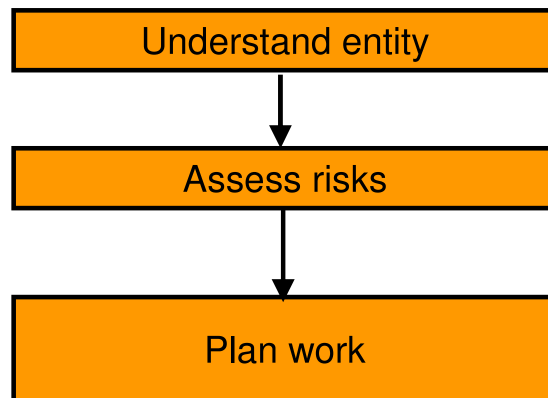
license or other title to perform its operations could have such an impact (for example, for a bank, noncompliance with capital or investment requirements)."

The auditor is required to identify those Laws and Regulations which are central to the entity's ability to continue as a going concern. A number of years ago the ICAEW Audit & Assurance Faculty called these "showstoppers".

On **every** audit the auditor must document their general understanding of Laws and Regulations but only where there are "showstoppers" might a more detailed knowledge be needed. More importantly only where there are showstoppers or other risks of material error in the accounts arising from non-compliance, does the auditor have to plan and perform audit work on compliance with Laws and Regulations. Otherwise, auditors need do nothing except record their general understanding of the framework that the entity operates in and that there are no "showstoppers".

Where there are "showstoppers"

The amount of work that the auditor needs to do in response to showstoppers will vary from audit to audit. Like any other audit issue the evidence obtained is based upon the auditor's understanding of the entity and the risk of error in the accounts:



The standard suggests that the auditor could go about this as follows:

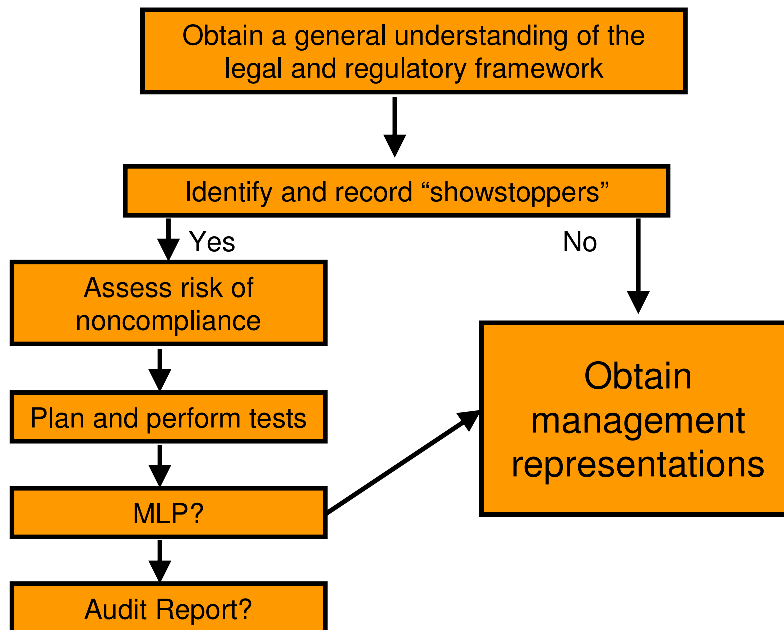
18-1. In the UK and Ireland, the auditor's procedures should be designed to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the entity's ability to conduct its business and hence to its financial statements.

19 Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient

understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.

Where there are “showstoppers” a starting point in understanding the issues and risks will be a discussion with management. This sometimes reveals very low risks and consequently the auditor does not need a very detailed understanding of the area and very little work will be required. Often a simple corroboration of the directors’ assertion of low risk will be all that is required. For instance if the directors say that the regulators visited recently and gave the business a clean bill of health then as part of the audit work, the auditor reviews the correspondence from the regulator.

A summary of the auditor’s approach is shown below:



Examples

Examples	Audit impact
1. Airline An airline is required to comply with Civil Aviation Authority (CAA) regulations. The auditor becomes aware that routine maintenance on the aircraft is being delayed beyond the specified number of flying hours.	
2. Workshop A joinery workshop is required to comply with Health and Safety legislation. The directors employ external consultants to advise on compliance and conduct 6 monthly risk assessments. The directors represent that compliance is very strong.	
3. School A private school is subject to OFSTED inspections and has been performing satisfactorily.	
4. Restaurant A restaurant is required to comply with Environmental Health Laws. The restaurant has had an EH visit and been warned that its cooker range and fridges are not up to standard and need to be replaced within a specified period.	
5. Office A firm of lawyers perform regular Health and Safety risk assessments on their office environment.	
6. Shop A company operates large outlet stores.	
7. Radio station A company operates a talk radio station concentrating on news, current affairs and sport. It has a 24 year licence to broadcast.	
8. Light engineering A company manufactures electrical connectors for use by the MOD in military aircraft. There are traceability requirements placed upon all component suppliers.	

Written representations

The ISA requires that written representations are obtained as follows:

23 The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements.

23-1. Where applicable, the written representations should include the actual or contingent consequences which may arise from the non-compliance.

Money Laundering

The ISA reminds the auditor about the requirements of the Proceeds of Crime Act 2003 and the Money Laundering Regulations 2007. Where a crime has been committed that results in criminal proceeds a report will be needed to the Serious Organised Crime Agency, if the auditor either knows or becomes suspicious that it has been committed.

"22-1 In the UK and Ireland, when carrying out procedures for the purpose of forming an opinion on the financial statements, the auditor should be alert for those instances of possible or actual noncompliance with laws and regulations that might incur obligations for partners and staff in audit firms to report money laundering offences."

AIU REPORT ON AUDIT QUALITY INSPECTIONS 2007/8

(Lecture A270 11.52 minutes)

The Audit Inspection Unit visited seven major firms in 2007/8 and produced an individual report on each of those firms. They have also published an overview report which includes a summary of their key findings arising from all of their visits and a separate appendix of their conclusions arising from visits to nine smaller firms. (A smaller firm is one which audits less than ten entities within the AIU's scope – there are about 40 such firms in total). The overview report can be found at: http://www.frc.org.uk/pob/audit/reports.cfm

These notes provide a summary of the AIU findings along with comments as to how the AIU criticisms apply to the audit of the typical medium or small client.

Audit evidence and related judgments

A key aspect of the AIU's work is the review of significant audit judgments, including the acceptability of accounting treatments adopted, the reasonableness of assumptions used in accounting estimates and judgments relating to the nature and extent of the audit work performed and the adequacy of the audit evidence obtained. While the AIU was generally satisfied with the basis on which significant audit judgments were made, the public reports all comment specifically on issues arising in this area. The areas in which issues arose included the appropriateness of audit judgments relating to valuations, impairment and provisioning; the basis on which reliance was placed by the auditors on the work of third parties; and the adequacy of the audit evidence obtained in relation to material stock balances.

The AIU continues to believe that the thought processes underlying significant audit judgments need to be properly evidenced at the time and that failure to do so increases the risk of them being incomplete or misguided and of inappropriate audit judgments being made as a result. Firms need to continue their efforts to achieve improvements in this key area which, in the AIU's view, is central to the principles-based approach to auditing in the UK.

In a number of instances, when reviewing the work of smaller firms, the AIU was unable to conclude that sufficient audit evidence had been obtained to support certain account balances and audit judgments. These included the adequacy of work undertaken on the profit and loss account and the sufficiency of the testing of controls where the audit approach placed reliance on their operating effectiveness.

The AIU will be undertaking follow-up reviews of the following year's audits in two cases where it had concerns as to the sufficiency of the audit evidence obtained to support material account balances.

Comment re other audits

All of the above comments are relevant to audits of all sizes. Audit judgements are made throughout the audit – on individual tests, on audit areas such as debtors and at the finalisation stage. The quality of completion documentation (known in different systems by various names such as Audit summary, Report to Partner, Audit Highlights, Completion memo etc) is often particularly weak.

Testing of controls is also an area where many firms are still failing to meet the enhanced requirements of ISAs.

Risk assessment

Auditing Standards require the identification and assessment of the risks of the financial statements being materially misstated, including those risks which require special audit consideration (such risks are termed "significant risks"). A proper assessment of the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

The AIU raised issues relating to the identification of significant risks at most firms, concerning either the appropriateness of the firm's guidance or the application of that guidance on individual audits. The AIU also raised issues at a number of firms relating to the evaluation of the design and implementation of related internal controls.

While the AIU noted that improvements had been achieved in this area at a number of firms, it considers that there is scope for further improvement at all firms to ensure that the requirements of Auditing Standards relating to risk assessment procedures are fully complied with.

Turning to the smaller firms, in most audits, the AIU identified a number of deficiencies in the evidence on file to demonstrate that the requirements of the audit risk and fraud standards had been adequately addressed. Common issues included an inadequate assessment of the risks of material misstatement at the assertion level, a lack of clarity over the identification of significant risks, insufficient consideration of fraud risks and a failure to evaluate the design and implementation of controls over significant risks. Compliance with the requirements of the audit risk and fraud standards continues to be challenging for smaller firms.

Comment re other audits

Very few auditors identify significant risks – indeed many assume that the terms "high risk" and "significant risk" mean the same thing.

ISA 315 paragraph 108 requires the auditor to determine which of the risks identified are risks that require special audit consideration (such risks are defined as "significant risks"). The standard says that significant risks arise on most audits and when considering the nature of the risks identified, the auditor should consider the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
- The complexity of the transaction.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk, especially those involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

It is in paragraph 113 that we have the bold print requirement: "For significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented."

Analytical review

The AIU continues to identify weaknesses at most firms in the use of analytical procedures to obtain audit evidence. In the majority of cases the issues identified by the AIU related to a failure to set appropriate expectations and/or thresholds for investigation of variances from those expectations, together with insufficient corroboration by the audit teams of explanations obtained. In a number of audits, the AIU concluded that there were significant weaknesses in analytical procedures performed to obtain audit evidence.

The AIU notes that most firms have appropriate guidance on how to undertake analytical review procedures and that this has been recently enhanced at some firms. The issue primarily relates to the application of the firms' procedures and supporting guidance in practice. The AIU considers this to be an area where continued efforts to achieve improvements are required.

Comment re other audits

Almost every cold file review is critical of some aspect of analytical review. In particular, there is frequently confusion between the different types of analytical review.

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

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

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

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

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

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

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

I suggest that the final review can be limited to a review of the statutory accounts since these are the accounts on which an audit opinion is expressed. If the final review provides the auditor with unexpected results, then further work would be required.

Reporting to those charged with governance

Appropriate communication with audit committees or other relevant governance bodies contributes to the quality of an audit and assists both parties in discharging their responsibilities effectively. Generally the AIU considered the quality of reporting to audit committees by the large firms to be of a good standard. However, the AIU has observed that where the corporate governance arrangements, particularly the role of the audit committee, is less formalised this can adversely impact on the quality of communications with those charged with governance.

Turning to the smaller firms, on most of the audits reviewed, the AIU identified instances where the reporting to those charged with governance did not meet all the requirements of Auditing Standards. Shortcomings identified included the failure to communicate a firm's independence in writing and insufficient communication of audit planning and audit findings. In some cases, there was a lack of clarity over to whom the communications should be made, with communications being made for example to an individual rather than the audit committee or the directors as a whole.

Comment re other audits

The above comments re smaller firms are all relevant for other audits. In particular, letters of comment are mandatory under ISAs. They should be sent to the client before the accounts are approved and should have as attachments a schedule of uncorrected errors and the draft letter of representation.

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

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

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

(b) The final draft of the representation letter, that the auditor is requesting management and those charged with governance to sign. The communication should specifically refer to any matters where management is reluctant to make the representations requested by the auditor;

(c) Uncorrected misstatements;

(d) Expected modifications to the auditor's report;

(e) Material weaknesses in internal control identified during the audit;

(f) Matters specifically required by other ISAs (UK and Ireland) to be communicated to those charged with governance; and

(g) Any other audit matters of governance interest.

Ethical Standards

While the AIU identified very few clear breaches of the specific requirements of the Ethical Standards at the seven major firms, it identified certain areas where the underlying principles of the Ethical Standards were, in its view, not being fully observed by some of the firms. A number of examples are set out below.

The number of issues relating to independence requirements under the Ethical Standards which the AIU identified at smaller firms was higher. The AIU partly attributes this to a lack of familiarity on the part of some smaller firms with the additional requirements under the Ethical Standards for listed entities. Independence issues identified by the AIU at smaller firms included long association with the audit client, involvement in the preparation of the client's financial statements and fee dependency.

Long association with audit clients

Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. This reflects the need to avoid auditor independence being compromised by the familiarity threat arising from a long period of service in a senior role. For listed company audits, the audit engagement partner is required to rotate after having served for a maximum period of five years and "key audit partners" (KAPs) are required to rotate after seven years.

The AIU has previously commented on the adequacy of firms' systems for monitoring compliance with the specific rotation requirements for audit engagement partners and KAPs. While the AIU considers that there is still work to be done in some cases to improve the completeness and integrity of rotation databases, the AIU was generally satisfied with the progress the firms have made in this area.

The AIU noted that there has generally been an increase in the number of partners identified as KAPs, although there is some variation in practice between the firms particularly in relation to specialist partners involved in major listed group audits. The change in the definition of a KAP (now referred to as a "key partner involved in the audit") under the revised Ethical Standards issued in April 2008 should, in the AIU's view, provide firms with a catalyst to review their identification of KAPs on major listed group audits.

The AIU has previously commented on the issue of long involvement on large group audits by the audit engagement partner. Such long involvement, which will have been in varying capacities and often continuous, may not be precluded by the Ethical Standards but nonetheless gives rise to familiarity threats. In the AIU's view, firms continue to give insufficient consideration to the independence threats arising and, as a consequence, have often not applied appropriate additional safeguards to mitigate them. While the AIU believes that the new definition of a "key partner involved in the audit" under the revised Ethical Standards should help to address this issue, it considers that firms nevertheless need to look beyond the specific requirements under the Ethical Standards and to take a more principles-based approach in assessing the threats arising from such long involvement.

Two further issues arose from the inspections of two smaller firms. On two audits of listed entities, the AIU identified that the requirement for rotation of the audit engagement partner in ES 3 had not been complied with. On one of those audits, the manager had been involved for 17 years and there was no evidence that the firm had considered whether appropriate safeguards were in place, as required by the Standards.

On an audit of a significant unlisted entity, the AIU identified that the audit engagement partner, the firm's chairman, had acted for this client (the firm's largest) for in excess of ten years. In such situations the AIU expects firms to ensure that the safeguards in place are strengthened over time in line with the increasing threats to independence and ultimately that firms should have a succession plan in place.

Comment re other audits

Whilst rotation is not a requirement for other audits, the monitoring of long service remains an important issue. The “ten year rule” in paragraph 9 of ES 3 is as follows:

“Once an audit engagement partner has held this role for a continuous period of ten years, careful consideration is given as to whether a reasonable and informed third party would consider the audit firm's objectivity and independence to be impaired. Where the individual concerned is not rotated after ten years, it is important that:

(a) safeguards other than rotation, such as those noted in paragraph 8 are applied (paragraph 8 refers to the involvement of an additional partner or applying an independent internal quality review); or

(b)

(i) the reasoning as to why the individual continues to participate in the audit engagement without any safeguards is documented; and

(ii) the facts are communicated to those charged with governance of the audited entity in accordance with paragraphs 56 - 63 of APB Ethical Standard 1."

Rewarding KAPs for selling non-audit services to audit clients

The AIU identified that some firms permit senior specialist personnel from outside the audit function who are involved in audits, including those identified as KAPs on those audits, to be rewarded for selling non-audit services or for their performance to be evaluated based on their success in selling non-audit services.

While the Ethical Standards do not explicitly address this issue, in the AIU's view the underlying principles of the Standards indicate that such KAPs should be treated in the same way as other audit partners responsible for key audit decisions or judgments and that they should not be rewarded for selling non-audit services to the audit clients concerned.

Comment

Note that this issue has now been addressed by the proposed amendments to ethical standards published recently.

Direct assistance from internal audit staff

The AIU identified that some firms have policies and practices which permit the use of staff from a client's internal audit department to perform external audit procedures directly for the audit team.

While Standards permit firms to place appropriate reliance on the work of clients' internal audit functions, they do not specifically address the use of internal audit staff to provide direct assistance to the external auditors in this way.

In the AIU's view, the practice of including staff from clients' internal audit departments in external audit teams may be inconsistent with the underlying principles of the Ethical Standards because it is not possible for such staff to be independent of their employers. The AIU considers that firms should review the appropriateness of this practice and what safeguards should be applied to address the threats to their independence arising.

Comment

Note that this issue has now been addressed by the proposed amendments to ethical standards published recently.

Assistance with preparation of financial statements

The AIU identified one audit by a smaller firm of a listed group where the firm had provided assistance with the preparation of the statutory accounts of all the subsidiaries. The AIU considered that the assistance provided was not permitted under the Ethical Standards for listed entities.

Comment re other audits

This comment has no direct relevance for the audit of smaller entities. However, do the auditors of such entities appreciate that a management threat arises when the auditor assists the client by drafting notes to the statutory accounts?

Fee dependency

In relation to a significant charity audit by a smaller firm, the AIU noted that fees earned from that client and related entities exceeded 10 percent of the firm's total fee income. In such situations the Ethical Standards require the firm to arrange for an external independent quality control review of the audit to be carried out. The AIU noted that while the firm had an external reviewer in place, the individual concerned had acted in this role for in excess of eleven years. The AIU considered, in light of this, that the firm needed to refresh the external review role. More generally the AIU considers that in situations of this nature firms need to consider and observe the principles underlying the Ethical Standards as well as the specific requirements thereof.

Comment re other audits

This comment is relevant to audits of clients of all sizes.

Audit report

On four audits conducted by smaller firms, the AIU identified that the audit report was dated before all necessary work had been completed. In each case a number of amendments were made to the annual report after the audit report date, in some cases several weeks after that date.

Comment re other audits

This comment arises because of the pressure which is sometimes placed on auditors of listed companies to sign their audit report at the date of the preliminary announcement. There should be no similar problem for auditors of other entities.

SUMMARY OF DEVELOPMENTS

(Lecture A271 11.31 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 Constituents back economic cycle reserving

The idea of an "economic cycle reserve" (ECR) to bolster bank balance sheets, as proposed in the Turner Review, is supported by a wide range of UK investors, auditors and preparers of accounts.

The Financial Reporting Council (FRC) has been promoting the idea of an ECR both within the UK and through the international Financial Stability Forum. Just before the Turner review was published, the Accounting Standards Board (ASB) organised a meeting of about 40 representatives of investors, accountancy firms, the banking industry and regulators to discuss counter-cyclical measures.

An ECR would be built up during the upswing of the economic cycle through an appropriation from retained profits. It would be an undistributable balance sheet reserve, limiting a bank's ability to pay dividends and make share buybacks during the upswing and available to be released in the bad times. It is a "rainy day" provision.

The consensus view of the meeting was:

- there is support for economic cycle reserving if it is agreed between the bank and its regulator;
- provisions should not be implemented in a way that impacts the P&L of a company;
- the International Accounting Standards Board (IASB) should look at the requirements of IAS 39, particularly the relative merits of the incurred loss and expected loss models; and
- there are likely to be unforeseen circumstances affecting all the potential solutions being considered.

Ian Mackintosh, Chairman of the ASB, set out two routes to implementing "dynamic" provisions, or reserves, that would help alleviate downturns in the economy: a change in accounting requirements or a change in regulatory requirements. From an accounting standard setter's point of view, the latter was more advisable.

Ian Wright, Director of Corporate Reporting at the FRC, explained that ECR required judgment to be applied by the management of the bank and the regulator when setting the reserve levels, and for ongoing monitoring of that initial judgment. It allowed a holistic view to be taken of a bank's balance sheet and the amounts that should be set aside in the good times to help it survive the bad. Among the points made by participants were:

In relation to economic cycle reserving

The Spanish model of Dynamic Provisioning (DP) is attractive to those who suspect that banks are not as profitable as they appeared in recent years. But the prudential regulators will need to take a lead in this issue and set the levels of ECR or DP.

The ECR should not be formula-based, it should require some judgment. It is a bridge between accounting capital and regulatory capital and may require a change in the law. It needs to be fleshed out as to the legal requirements and how it would be implemented in a group situation.

The credit spread is a key judgment for bank balance sheets and management must ascertain and set aside the correct amount. They do not seem to have done so. When the entire market has been mispricing the credit risk, a single institution and its auditor find it difficult to contradict the market. A regulator is better placed to make this point to the market as a whole.

If DP relies on statistical modelling then it may not be a real solution. The problem with modelling is often that the model may not best reflect the complex products being priced/provided for, nor the risk of an extreme event.

The capacity for banks to leverage has an important impact on its provisioning and the credit risk. Regulators have permitted banks to leverage to a very high level. Pro-cyclicality cannot be countered without resolving the issue of how much banks are permitted to leverage.

In relation to the impact on the P&L

It cannot be assumed that accounting and regulatory lessons arising from this recession can be married together. Financial statements are produced for the benefit of investors. Transparency is important to users. Measures that amount to profit smoothing or providing a pretence of cushions when none exist do not convey transparency.

Loan provisions are an important part of a bank's balance sheet and have a direct impact on its profit or loss. By implementing dynamic provisions through the loan provisions and thus through the P&L you build an additional judgment on the economic cycle into this most important figure. Economic cycles tend to last between seven to ten years and the average duration of a loan on a bank's balance sheet tends to be two to three years. Trying to marry these two together to arrive at the DP figure through the P&L would be extremely complex.

In relation to the provisions of IAS39

The IASB was supported in considering whether improvements can be made to the incurred loss model of IAS 39. In particular, it will be helpful to consider a separation between losses calculated by the incurred loss method and those on the expected loss model; the expected loss component would need to be built into the fair value concept.

The expected loss model requires foresight and, in nature, is very close to the fair value model. It is therefore likely to have the same problems as the fair value models and attract similar criticisms.

Regulators are most concerned about the pro-cyclicality of loss reserves. The expected loss model by itself will not allow enough capital to be built up to ensure a bank's viability during a recession.

Accounting currently looks at the relationship between the borrower and the lender at the transaction level. Provisioning or reserving that takes the economic cycle into account operates at a much higher level and is likely to change accounting as it currently stands.

19 March 2009

Status of Adoption into UK GAAP of IFRIC Interpretations

The Urgent Issues Task Force (UITF) has reviewed the implementation of International Financial Reporting Interpretations Committee (IFRIC) Interpretations into UK Financial Reporting Standards as UITF Abstracts.

Information Sheet 86 lists the IFRIC interpretations and shows how they have been incorporated into UITF abstracts. Where IFRIC interpretations have not been adopted into UK GAAP the Information Sheet provides an explanation.

27 April 2009

ISA 250 EXAMPLES – SHOWING POSSIBLE AUDIT IMPACT

Examples	Audit impact
1. Airline An airline is required to comply with Civil Aviation Authority (CAA) regulations. The auditor becomes aware that routine maintenance on the aircraft is being delayed beyond the specified number of flying hours.	CAA regulations are a "show stopper". Airlines are required to maintain aircraft at set intervals and failure to do so might result in the fleet being grounded The greater the risk that there is non-compliance the more evidence the auditor will obtain and consequently the better the regulations need to be understood. The auditor will need to understand the maintenance schedules and design audit procedures to test compliance with CAA regulations. Those responsible for governance will be informed and **specific** management representations might be obtained.
2. Workshop A joinery workshop is required to comply with Health and Safety legislation. The directors employ external consultants to advise on compliance and conduct 6 monthly risk assessments. The directors represent that compliance is very strong.	Most auditors would consider this to be a "showstopper" so audit procedures need to be planned. Risk would appear to be low so the audit procedures might be limited to reviewing the risk assessments to corroborate the directors' representations.
3. School A private school is subject to OFSTED inspections and has been performing satisfactorily.	It is unlikely that these would have a material impact on the financial statements. Therefore, the auditor is only required to document their understanding of the regulatory environment of the school to justify that there are no "showstoppers"
4. Restaurant A restaurant is required to comply with Environmental Health Laws. The restaurant has had an EH visit and been warned that its cooker range and fridges are not up to standard and need to be replaced within a specified period.	This is a "showstopper". The auditor will need to obtain an understanding of these Laws and Regulations and plan and perform sufficient audit tests to address the noncompliance.
5. Office A firm of lawyers perform regular Health and Safety risk assessments on their office environment.	Most auditors would agree that most of the time the office environment does not give rise to Health and Safety legislation "showstoppers". Regulation by the Solicitors' Regulatory Authority on the other hand may often be a "showstopper". Representations will be needed from management and these may be corroborated by a review of correspondence.
	As in many businesses there are Laws and Regulations that apply and these should be recorded. These include Health & Safety, Fire Safety, Employment law

6. Shop A company operates large outlet stores.	etc. However, there are no obvious "showstoppers" in this case.
7. Radio station A company operates a talk radio station concentrating on news, current affairs and sport. It has a 24 year licence to broadcast.	The licence will have terms and conditions which will make it a "showstopper". For instance, playing music will breach the licence and it may be taken away by the relevant licensing authority. Therefore, the auditor will have to understand the terms of the licence and plan some work (commensurate with the risk) to look for non-compliance.
8. Light engineering A company manufactures electrical connectors for use by the MOD in military aircraft. There are traceability requirements placed upon all component suppliers.	The MOD requirements are showstoppers. Therefore the auditor will need to have a better understanding of these requirements and plan audit tests.