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ACCOUNTING POLICIES AND OTHER DISCLOSURES

Lecture A280 (15.03 Minutes)

The following notes are adapted from a factsheet entitled “Small company reporting issues” published in February 2009 by the Financial Reporting Faculty of the ICAEW.

The process of preparing company accounts has become increasingly automated with many preparers relying on standard financial reporting software packages to generate their statutory accounts. While these packages are extremely useful it is important to recognise that they have their limitations. In particular, they cannot anticipate and provide templates for all the issues that may be relevant to a company.

Therefore, users have to be alert to situations where a more proactive approach is required. This is particularly relevant in relation to small companies who may lack the knowledge and experience to make adjustments and so require more assistance from their accountants and auditors in developing appropriate disclosure.

Some common or topical examples of issues to consider are set out below, together with illustrative examples of the way these issues might be dealt with in the notes to the accounts.

Income recognition – accounting policy

Many standard packages contain a boiler-plate wording along the following lines:

‘Turnover represents sales made net of VAT and trade discounts’.

This explains what is included in turnover but not the basis on which income is recognised. In most cases it is necessary to expand the policy to describe the method used by the particular business. The important point is that the wording has to be representative of how income is recognised in practice.

Therefore, companies that receive payments in advance from customers or provide services that may be incomplete at the year-end will require a more detailed policy than companies that simply deliver goods.

Example disclosure: Income recognition (1)

Turnover represents sales of goods net of VAT and trade discounts. Turnover is recognised when the goods are physically delivered to the customer.

Example disclosure: Income recognition (2)

Turnover represents the value of services provided under contracts to the extent that there is a right to consideration and is recorded at the value of the consideration due.

Where a contract has only been partially completed at the balance sheet date turnover represents the value of the service provided to date based on a proportion of the total expected consideration at completion. Where payments are received from customers in advance of services provided, the amounts are recorded as Deferred Income and included as part of Creditors due within one year.

Valuation of stock – accounting policy

Many packages provide a simple wording for a stock policy along the following lines:

'Stock is valued at the lower of cost and net realisable value'.

However, this does not address the question of how cost and net realisable value are determined. Where stock is material there may be a number of possible ways that 'cost' could be calculated that would result in a significantly different value. Therefore, it is often necessary to expand the policy to comment on the policy for determining cost and net realisable value.

Example disclosure: stock

Stock is valued at the lower of cost and net realisable value. Cost is determined on a first in first out basis. Net realisable value represents estimated selling price less costs to complete and sell. Provision is made for slow moving, obsolete or damaged stock where the net realisable value is less than cost.

Note that companies with more complex businesses will require detailed stock valuation policies, for example to encompass any labour and/or overhead element included in stock. Work in progress should only be referred to where a company makes or creates items for stock rather than for a specific customer. Where there is a contract with a specific customer in advance of goods and services being supplied then this should be dealt with in the income recognition policy.

Investment properties and the true and fair override

Investment properties are required to be carried at their market value, with the inference that this should be an up to date market value. Unlike other tangible assets they are not subject to depreciation as required by the Companies Act unless they are held on a lease with fewer than 20 years unexpired.

The replacement of depreciation with annual revaluation is required in order to give a true and fair view and so represents an operation of the 'true and fair override'. Particulars of any true and fair override, the reason for it and its effect must be given in a note to the accounts and the accounting policy note is an appropriate place to provide this disclosure in the case of investment properties as the override is effectively the consequence of properly applying the revaluation rules.

Example disclosure: investment properties

Investment properties are revalued annually at their open market value in accordance with FRSSE (effective April 2008). The surplus or deficit on revaluation is transferred to a revaluation reserve except where the deficit reduces the property below its historical cost, in which case it is taken to the profit and loss account.

No depreciation is provided on investment properties which is a departure from the requirements of the Companies Act 2006. In the opinion of the directors these properties are held primarily for their investment potential and so their current value is of more significance than any measure of consumption and to depreciate them would not give a true and fair view. The provisions of the FRSSE (effective April 2008) in respect of investment properties have therefore been adopted in order to give a true and fair view. If this departure from the Act had not been made, the [profit/loss] for the year would have been reduced by depreciation.

However, the amount of depreciation cannot reasonably be quantified and the amount which might otherwise have been shown cannot be separately identified or quantified.

The wording would need to be changed if the FRSSE 2007 and CA 1985 were being followed.

Transactions with directors and other related parties

Many small companies are owned and managed by the same individual or small group of individuals. It is not uncommon to find transactions or arrangements in place between a company and its directors, their families and other entities that they control.

However, these are not always immediately apparent from the trial balance that is used to generate the financial statements and so particular care is needed to ensure that appropriate disclosure is given of such matters.

Loans to directors

CA 2006 requires the accounts to disclose advances and credits granted by the company to directors where those advance or credits existed during the financial year. It is a common misconception among small companies that no disclosure is required where a loan or other advance has been cleared at the balance sheet date, whether by repayment or offset against a bonus or dividend. This is not the case.

The CA requires disclosure of the amount of the advance or credit, the interest rate, main conditions and any amounts repaid. Two particular problems to note are set out below.

- Accounts preparers may need to scrutinise the nominal ledger in order to identify advances during the year as the pattern of transactions may mean that at the balance sheet date there is no outstanding amount due from the director. This is particularly common where a director maintains a 'current account' with the company which records both company obligations settled by the director and director's private expenditure paid by the company.

- Where a bonus due to the director is offset against an advance that bonus must represent an obligation of the company at the balance sheet date and must have been allocated to the director at that point.

Example disclosure: loans to directors

During the year the company made advances totalling £3,562 to director X (2008 - £5,785). This amount was cleared by offset against the bonus voted to the director on 22 December 2009 and so the balance outstanding at the year-end, 31 December 2009, was £nil (2008 - £nil).

Ultimate controlling party

FRS 8 and FRSSE both require companies to disclose the name of their ultimate controlling party, if there is one. If the name is not known the accounts must say so, but if there is no controlling party no such statement is required. Historically, many small companies relied on the disclosure of the directors' interests in shares in the directors' report to provide details of the ultimate controlling party. However, as there is no longer a requirement to state directors' interests in shares this approach is no longer valid (if indeed it ever was).

Some small companies have still not established a replacement note of their controlling party. Others have assumed that if there is not a single majority shareholder then there is no controlling party.

Preparers of accounts should consider whether two or more director-shareholders might be regarded as acting 'in concert' because they co-operate to exercise management or control. If this is the case then the appropriate disclosure would be as follows:

Example disclosure: ultimate controlling party The company is controlled by its directors.

Guarantees between a company and its directors

FRS 8 and FRSSE require that guarantees and the provision of security should be disclosed where they are provided by or to related parties. The Companies Act requires disclosure of guarantees or security provided by the company in relation to borrowing obtained by a director. It also requires the accounts to disclose where the company's assets have been used to secure the liabilities of any other person.

In the current economic climate particular attention should be paid to the following.

- It is more likely that banks will require directors to give personal guarantees to secure funding, especially where the company has relatively few assets that can be used as security. FRSSE explicitly requires guarantees provided by directors to be disclosed in the accounts.

- If a director is in personal financial difficulty he might use company assets to secure personal borrowings or seek to obtain a guarantee of personal borrowings from the company. Company law requires that details of the guarantee or security should be disclosed.

Bank loan security and repayment terms

Company law requires the accounts to disclose details of security provided by the company for company borrowing. Many smaller companies rely primarily on a bank overdraft facility for their funding and historically may not necessarily have had an overdraft at the balance sheet date.

Disclosure is only necessary where a liability exists at the balance sheet date and in the past some companies have overlooked the disclosure requirement because the bank balance has swung between credit and overdraft year on year. In the current economic climate overdrafts may become more common and so preparers should ensure the accounts disclose if the overdraft is secured on company assets.

Operating lease commitments

SSAP 21 and FRSSE both require disclosure of operating lease commitments for the forthcoming year, analysed between land and buildings and other leases. The annual commitment is further analysed based on when the lease commitments expire. While finance lease or hire purchase obligations are usually readily identifiable from the trial balance, operating lease commitments are not, with the result that details of commitments are sometimes omitted from the accounts.

There are two ways to double-check whether operating lease commitments require disclosure. One is to consider whether operating lease rentals are disclosed in relation to the profit for the period. The other is to consider the company's business premises and other significant business assets. Are they shown as assets on the balance sheet? If not, there should be an operating lease commitment note and/or, very possibly, a related party disclosure because the premises are rented from a director, shareholder or the company pension fund.

GOING CONCERN & LIQUIDITY RISK: GUIDANCE FOR DIRECTORS OF UK COMPANIES 2009

Lecture A281 (25.21 Minutes)

This guidance was issued by the FRC in October 2009. As the title suggests the document gives guidance for directors of all UK companies and brings together the original guidance that was set out in the earlier FRC documents for Directors of Listed Companies and Directors of Companies that are applying the FRSSE. This section of the notes focuses on the areas of the document that are relevant to companies applying the FRSSE.

The guidance applies to accounting periods ending on or after 31 December 2009. However, as the guidance covers existing requirements set out in the FRS and the FRSSE, earlier accounting periods would still be expected to comply with the advice given. A link to the guidance from the FRC can be found at:
http://www.frc.org.uk/press/pub2141.html

Going Concern

It is a fundamental accounting concept that accounts are prepared using the going concern assumption. That is an assumption that the company will continue in operation and that there is neither the intention nor the need either to liquidate it or to cease trading.

Procedures

Directors of small companies are not relieved from the obligation to assess going concern when they prepare annual financial statements. The extent of the procedures necessary to make an assessment for a small company will generally be less than would be appropriate for much larger or more complex businesses.

It should be remembered that all company accounts are required to give a 'true and fair' view and, as such, the directors of a small company not having an audit should consider taking advice to ensure that the disclosures and accounting treatment adopted meet the requirements of the FRSSE.

Clear guidance is given that directors of all companies should prepare thoroughly for their assessment of going concern and make appropriate disclosures in the accounts. This preparation should decide on the information, analyses and supporting documentation that the directors may need to assess going concern. The information should be considered at an early stage so that there are no surprises when it comes to finalising the accounts.

The planning should consider what evidence is available and should include an assessment of potential remedial actions that may be needed to address the issues identified. Having a good 'plan B' may mitigate some of the risks that are faced by the business and may have an impact on the disclosure in the accounts.

Three possible conclusions

As a result of their assessment, the directors can reach three possible conclusions:

1. There are no material uncertainties that may cast significant doubt about the company's ability to continue as a going concern.

2. There are material uncertainties related to events or conditions that may cast significant doubt about the company's ability to continue as a going concern but the going concern basis remains appropriate.

3. The use of the going concern basis is not appropriate i.e. the company has no realistic alternative but to cease trading or go into liquidation or the directors intend to cease trading or place the company into liquidation.

The directors should consider the relevant facts and circumstances and make a balanced assessment of the possible outcomes for the business. This should then be related to the three possible conclusions above.

Bank facilities

The document makes the point that the absence of confirmation from lenders does not of itself necessarily cast significant doubt upon the ability of the company to continue as a going concern.

Disclosure

The directors should make a rigorous assessment that is documented and the FRC guidance states that the accounts should have a balanced, proportionate and clear disclosure of going concern uncertainties and liquidity risk necessary to give a true and fair view.

The three principles

The document sets out 3 principles that directors of all companies should consider.

Principle one – assessing going concern

Directors should make and document a rigorous assessment of whether the company is a going concern when preparing annual financial statements. The process carried out by the directors should be proportionate in nature and depth depending upon the size, level of financial risk and complexity of the company and its operations.

Comments on Principle One

FRS 18/FRSSE make it clear that if the directors intend to cease trading, or go into liquidation or they have no realistic alternative but to do so, the use of the going concern basis of accounting ceases to be appropriate and this is likely to lead to significant differences in the carrying amounts of assets and liabilities recognised in the financial statements.

As part of their assessment of going concern, directors of smaller companies should, at least, consider the following:

- Their plan to manage the company's borrowing requirements including any covenant compliance issues.
- The timing of cash flows.
- The company's exposure to contingent liabilities.
- Budgets and forecasts for a relevant period together with an appropriate sensitivity analysis.
- Any plans to mitigate problems faced by the business.

Principle two – the review period

Directors should consider all available information about the future when concluding whether the company is a going concern at the date they approve the financial statements. Their review should usually cover a period of at least 12 months from the date of approval of annual financial statements.

Principle three – disclosures

Directors should make balanced, proportionate and clear disclosures about going concern for the financial statements to give a true and fair view. Directors should disclose if the period that they have reviewed is less than twelve months from the date of approval of the annual financial statements and explain their justification for limiting their review period.

Comments on principle 3

Circumstances	**Impact on the disclosure in the accounts**
No material uncertainties regarding going concern	The accounts should use the going concern principle and make the necessary disclosures, including those about liquidity risk, necessary to give a true and fair view
Material uncertainties but the use of going concern is considered appropriate	The accounts should use the going concern principle.

	The accounts should disclose the material uncertainties that may give rise to significant doubt about the going concern principle. This disclosure should be made in the accounting policy section so that it shows through in to the abbreviated accounts.
Going concern is not appropriate	Detailed disclosure of the accounting basis adopted

Example disclosures

Appendix I to the document gives the following examples of going concern disclosure for small companies.

In the first example, no material uncertainties that may cast significant doubt about the company's ability to continue as a going concern have been identified by the directors. The company is a small company that has adopted the FRSSE and anticipates reduced sales next year.

'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 might be withdrawn. As a result they have adopted the going concern basis of accounting.'

In the second example, material uncertainties related to events or conditions that cast significant doubt about the company's ability to continue as a going concern have been identified by the directors. The company is a small company that has adopted the FRSSE and has experienced difficulties in securing future work

'The company has orders for work for the next two months. However, despite significant efforts, it has so far proved impossible to obtain additional sales orders. If new orders are not forthcoming, the directors will need to close the factory and make the employees redundant.

The directors have concluded that a material uncertainty exists that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realise its assets and discharge its liabilities in the

normal course of business. However, given the continuing efforts to secure new orders, the directors continue to adopt the going concern basis of accounting.'

LIQUIDITY RISK DISCLOSURES

Lecture A282 (15.22 Minutes)

We turn our attention now to how the "Guidance for Directors of UK companies 2009" affects large and medium-sized companies. The FRC have provided examples of going concern disclosure in Appendix II of the document.

Example 1(a) is a company with a significant positive bank balance, uncomplicated circumstances and little or no exposure to economic difficulties that may impact the going concern assumption. The example is shown in the box below.

The company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the company, its cash flows, liquidity position and borrowing facilities are described in the Finance Director's Review on pages P to Q. In addition, notes A-D to the financial statements include the company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The company has considerable financial resources together with long-term contracts with a number of customers and suppliers across different geographic areas and industries. As a consequence, the directors believe that the company is well placed to manage its business risks successfully despite the current uncertain economic outlook.

The directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

You will see that the example is in three sections:

1. An introductory section which brings together (by cross-reference) the key disclosures in the Directors' report and elsewhere in the financial statements.

2. The second element is the material relating to the uncertainties (if any) which may affect the assessment of going concern. The FRC describe this section as containing the particular factors which the directors have considered in reaching a conclusion on going concern. They add that clutter caused by excessive disclosure of irrelevant or immaterial data has the capacity to detract from the ability of users of financial statements to identify the relative significance of issues facing a company and could undermine the ability of financial statements to provide a true and fair view.

3. Finally, we end with a standard paragraph expressing the directors conclusion that it is appropriate to adopt the going concern basis of accounting.

The fact that Appendix 2 is considered to be appropriate for all companies other than small companies has led some accountants to question whether there is a requirement for their large and medium-sized clients to produce the liquidity risk and other information referred to in the first paragraph of the example report.

The answer is provided by paragraphs 59 to 83 of the FRC guidance.

Paragraph 59 tells us that Directors of all companies need to reach a conclusion about the ability of the company to continue as a going concern. We considered this earlier in the notes as it applies to FRSSE companies but now we need to consider the three outcomes in more detail.

Outcome 1

The use of the going concern basis of accounting is appropriate because there are no material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern. The directors should use the going concern basis of accounting in preparing the financial statements and make the necessary disclosures, including those about liquidity risk, necessary to give a true and fair view.

Outcome 2

The use of the going concern basis is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt about the

ability of the company to continue as a going concern. The directors should use the going concern basis of accounting in preparing the financial statements, disclose the material uncertainties that may give rise to significant doubt and make the disclosures, including those about liquidity risk, necessary to give a true and fair view.

Outcome 3

The going concern basis is not appropriate. Such a conclusion will result in abandoning the going concern basis of accounting in preparing the financial statements and making detailed disclosures about the basis of accounting that has been used.

Notice the similarity between Outcomes 1 and 2:

"The directors should .... make the necessary disclosures, including those about liquidity risk, necessary to give a true and fair view."

And note the difference, which is the extra comment in Outcome 2:

"The directors should .... disclose the material uncertainties that may give rise to significant doubt and ...."

Note also at this point that example 1a above is an illustration of Outcome 1

Paragraph 61 tells us that both FRSSE and UK GAAP require disclosure where directors identify a material uncertainty that may lead to significant doubt about going concern. The disclosure should set out the facts and circumstances in a manner that is proportionate to the nature of the company.

The Business Review is required by CA 2006 to be included in directors' reports of medium and large companies. The Business Review must include a description of the principal risks and uncertainties facing the company. This should include any particular economic conditions and financial difficulties that the company is experiencing.

The FRC guidance tells us that the issues which may require disclosure depend upon individual facts and circumstances but may include:

- uncertainties about current financing arrangements (whether committed or uncommitted);

- potential changes in financing arrangements such as critical covenants and any need to increase borrowing levels;

- counterparty risks arising from current credit arrangements (including the availability of insurance where relevant) with either customers or suppliers;

- a dependency on key suppliers and/or customers; and

- uncertainties posed by the potential impact of the economic outlook on business activities.

Disclosures required for all companies

The FRSSE, FRS 18 "Accounting policies" and IAS 1 all require directors to disclose the existence and nature of the uncertainties where they have concluded that there are "material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern".

Although it is not necessary to use the precise phrase "material uncertainties that may cast significant doubt...." Paragraph 66 of the guidance tells us that, when preparing their financial statements directors will wish to bear in mind the need for the disclosures to be clear about them having identified a material uncertainty that has led to significant doubt about going concern. Auditors will also look for this clear statement in deciding whether the disclosures are adequate and whether to modify their report.

FRSSE and UK GAAP also require explicit disclosure if the period of the review for going concern has not extended to twelve months from the date of approval of the financial statements. Such disclosures should explain the directors' justification for their decision.

Disclosures required for large and medium-sized companies

In addition, for medium and large companies (and small companies that do not apply the FRSSE) a number of UK GAAP and IFRS standards require specific disclosures to be made about liquidity risk and other risks that may have a bearing on a going concern assessment. The FRC provide the following table:

Disclosure	IFRS (2009)	UK GAAP (2009/10)
Disclosures relating to risks arising from financial instruments, including liquidity risk where it is material.	IFRS 7 paragraphs 31 to 42	FRS 29 paragraphs 31 to 42 (where adopted)
Disclosure is encouraged of undrawn borrowing facilities and any restrictions on the use of those facilities such as covenant requirements, where relevant.	IAS 7 paragraph 50 (a)	For certain companies that have not adopted FRS 26, FRS 13 paragraph 40 requires disclosure of the maturities of material undrawn committed borrowing facilities
Disclosure of defaults and covenant breaches.	IFRS 7 paragraphs 18 and 19	FRS 29 paragraphs 18 and 19 (where adopted)
Disclosure of sources of estimation uncertainty about the carrying amounts of assets and liabilities.	IAS 1 paragraphs 125 to 133	FRS 18 paragraphs 50 to 55 and 57

We are now ready to answer the question posed earlier in the notes – is there a requirement for large and medium-sized companies to produce the liquidity risk and other information referred to in the first paragraph of the example report?

The answer is provided in the right-hand column. Liquidity risk disclosures are required by FRS 29. According to the table, a company must comply with FRS 29 when it has been adopted.

Paragraph 2C in the scope section of FRS 29 says that “entities that are not applying FRS 26 are exempt from this Standard”.

So which entities need to apply FRS 26? Paragraph 1A of that standard says that it applies to all financial statements that are intended to give a true and fair view of a

reporting entity's financial position and profit or loss (or income and expenditure) and are:

a) for an entity that is a listed entity, or

b) prepared in accordance with the fair value accounting rules set out in the Companies Act 1985

except that reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt.

Therefore, as long as your client is not listed and you can keep them away from the fair value rules of the Companies Act then you don't need to worry about the disclosures in FRS 29.

But the table also refers to disclosures under FRS 13. Which companies are required to follow FRS 13? Part A of FRS 13 applies to a reporting entity that has any of its capital instruments listed or publicly traded on a stock exchange or market. It does not apply to a financial institution because disclosures for such companies and groups are dealt with in Part C of SSAP 13. Also it does not apply to an insurance company or group.

So once again, the typical private company does not need to give such disclosures.

Finally, we come to the last row of the table and the reference to FRS 18. The issue here is the use of estimation techniques when these need to be used to enable the accounting policies adopted to be applied.

Paragraphs 51 to 54 deal with:

- The choice between estimation techniques
- The reliability of estimation techniques
- The extent to which each technique may be understood by users, and the extent to which each will facilitate comparisons with other entities.
- How a change in an estimation technique should be dealt with

The disclosure requirements referred to by the above table are set out in Paragraphs 55 and 57.

Paragraph 55 is mainly concerned with disclosure of accounting policies and changes in those policies or estimation techniques.

Paragraph 55(b) requires a description of those estimation techniques adopted that are significant, as explained in paragraph 57.

Paragraph 57 is as follows:

57. Estimation techniques are used where there is uncertainty over the monetary amount at which an item is to be measured. The amount that is determined will depend both on the estimation technique selected and on any assumptions (such as interest rates and useful lives) used in applying that technique. Although many estimation techniques are used in preparing financial statements, most do not require disclosure because, in most instances, the monetary amounts that might reasonably be ascribed to an item will fall within a relatively narrow range. An estimation technique is significant for the purposes of paragraph 55(b) only if the range of reasonable monetary amounts is so large that the use of a different amount from within that range could materially affect the view shown by the entity's financial statements. To judge whether disclosures are required in respect of a particular estimation technique, an entity will consider the impact of varying the assumptions underlying that technique. The description of a significant estimation technique will include details of those underlying assumptions to which the monetary amount is particularly sensitive.

Liquidity risk

For the sake of completeness let’s briefly consider the requirements of FRS 29.

Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities. FRS 29 "Financial Instruments: Disclosures" requires a company to make both qualitative and quantitative disclosures concerning liquidity risk, where it is a material financial risk.

Where liquidity risk is material, FRS 29 requires:

- disclosure of information that enables users to evaluate the nature and extent of the entity's exposure to liquidity risk;

- narrative disclosures explaining how liquidity risk arises in the business and how it is managed in practice;

- summary numerical data about liquidity risk based on the information that is provided to key management personnel, often the Board of Directors; and

- certain mandatory disclosures such as a maturity analysis of financial liabilities.

Conclusion

We can now reach the conclusion that the first paragraph of Example 1a above will not be relevant to a typical private company. In fact, the FRC recognise this themselves. Consider example 1b which is a subsidiary company which is financed by its parent company and participates in group banking arrangements

> The company's business activities, together with the factors likely to affect its future development and position, are set out in the Business Review section of the Directors' Report on pages X to Y.
>
> The company is expected to continue to generate positive cash flows on its own account for the foreseeable future. The company participates in the group's centralised treasury arrangements and so shares banking arrangements with its parent and fellow subsidiaries.
>
> The directors, having assessed the responses of the directors of the company's parent ABC Limited to their enquiries have no reason to believe that a material uncertainty exists that may cast significant doubt about the ability of the ABC group to continue as a going concern or its ability to continue with the current banking arrangements.
>
> On the basis of their assessment of the company's financial position and of the enquiries made of the directors of ABC Limited, the company's directors have a reasonable expectation that the company will be able to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

A subsidiary company is subject to the same requirements as any other company but now the introductory paragraph refers only to the Business review in the Directors’ report.

MATERIALITY – ACCOUNTING CONSIDERATIONS

Lecture A286 (20.07 Minutes)

Later on in these notes, we are considering the new clarity ISA 320 which covers materiality in planning and performing the audit. A necessary precursor for studying ISA 320 is an understanding of the relevant financial reporting framework.

The following material consists mainly of extracts from Tech 03/08 "Guidance on materiality in financial reporting by UK entities" published by ICAEW. Reproduction of this document in whole or in part is permitted as long as the copyright of the Institute of Chartered Accountants in England and Wales is acknowledged.

The technical release can be found at
http://www.icaew.com/index.cfm/route/158691/icaew_ga/Faculties/Financial_Reporting/UK_regulation/Technical_releases/Tech_03_08_Guidance_on_Materiality_in_Financial_Reporting/pdf

Definition of materiality

The concept of materiality is fundamental to the reporting of information. The ASB's Statement of Principles defines and explains it as follows:

Materiality is the final test of what information should be given in a particular set of financial statements. While the paragraphs above [dealing with relevance, reliability, comparability and understandability] describe the characteristics that, if present, will mean that the usefulness of the financial information has been maximised, the materiality test asks whether the resulting information content is of such significance as to require its inclusion in the financial statements. (Paragraph 3.28)

Materiality is therefore a threshold quality that is demanded of all information given in the financial statements. Furthermore, when immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided. In such circumstances, the immaterial information will need to be excluded. (Paragraph 3.29)

An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessments of management's stewardship. (Paragraph 3.30)

Whether information is material will depend on the size and nature of the item in question judged in the particular circumstances of the case. The principal factors to

be taken into account are set out below. It will usually be a combination of these factors, rather than any one in particular, that will determine materiality.

a) The item's size is judged in the context both of the financial statements as a whole and of the other information available to users that would affect their evaluation of the financial statements. This includes, for example, considering how the item affects the evaluation of trends and similar considerations.

b) Consideration is given to the item's nature in relation to:

   I. the transactions or other events giving rise to it;

   II. the legality, sensitivity, normality and potential consequences of the event or transaction;

   III. the identity of the parties involved; and

   IV. the particular headings and disclosures that are affected.

If there are two or more similar items, the materiality of the items in aggregate as well as of the items individually needs to be considered.

General considerations

Materiality depends on an item's size, nature and circumstances. Dependence on size means that materiality is quantifiable in financial terms. However, the nature and circumstances of an item are qualitative matters and so materiality is not capable of general mathematical definition. Because judgement is required to determine materiality, different people may have different views about whether an item is material. Materiality will often be indicated by a range of potential values with the eventual treatment of a particular item depending upon a full consideration of the information involved and how it will be used.

Judgements about materiality ultimately depend on how information could influence the economic decisions of users of financial statements or other information ('users'). According to Chapter One of the Statement of Principles:

“The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.”

There is a role for guidelines in reaching consistent and properly considered conclusions. Nevertheless, if preparers are to be responsive to users, they should not substitute the mechanical application of rules and formulae for careful consideration of how information could influence or enhance users' economic decisions, such as whether to hold or sell investments or whether to reappoint or replace management. Preparers should also appreciate that information often has economic effects without changing economic decisions. For example, in preparing financial statements to be used to value a business for an acquisition, a relatively minor adjustment may alter the purchase price without changing the decision to proceed with the acquisition.

Applications of materiality

In financial reporting, the concept of materiality is applied to, inter alia, tolerances, uncertainties, differences and errors, in relation to:

a) classes of transaction;

b) account balances;

c) disclosures; and

d) the financial statements as a whole.

In maintaining accounting records relating to individual transactions with other parties, accuracy and precision are essential and therefore the concept of materiality does not apply. Other items are recorded in accounting records based on best estimates of the outcomes of future events, fair values and the appropriate allocation of costs and revenues to different activities and periods. Such estimates are subjective and the concept of materiality is applied in determining appropriate precision tolerances that reflect the nature of the items involved.

The application of materiality thresholds and tolerances is fundamental to the internal and external reporting that underpins corporate governance, the management of commercial risk and business decision-making. Managements require internal reports which highlight relevant matters and omit irrelevant detail and they supplement basic accounting records with management systems and controls which, amongst other things:

a) summarise information from the accounting records which might be material in aggregate; and

b) prevent and detect material misstatement of that information.

For internal and external financial reporting purposes it is conventional to apply low thresholds for accumulating information so that similar items can be considered in aggregate against a chosen level of materiality as the time for reporting approaches. The use of lower thresholds helps ensure that cumulative omissions (including those accumulating over more than one year) and other errors do not lead to an overall material misstatement. It is also conventional to select a monetary unit, such as a pound or a thousand pounds, and to round to the nearest unit. The chosen unit is set sufficiently low to ensure that the resulting loss of precision and detail is clearly immaterial, trivial or inconsequential.

In assessing the materiality of errors, account should be taken of the effect on both the balance sheet and the profit and loss account, including the effect of uncorrected errors in past years and the effect on trends.

In the context of external reporting, legislation and regulations for different types of organisation contain requirements to report particular accounting and other information. Legislation and regulations usually specifically describe such requirements as applying only when a materiality condition is satisfied: for example, the need to include a line item shown in the accounts formats in companies legislation.

Application of the concept of materiality is also explicitly permitted under financial reporting standards of the ASB and the IASB and their respective interpretations ('financial reporting standards') and companies legislation in a variety of circumstances.

Many materiality decisions are called for in the application of financial reporting standards. Even where preparers decide to apply an individual provision of a standard - eg, in relation to measurement - they are not necessarily committed to apply all the other provisions of the standard: eg, to make specified disclosures which are immaterial. The importance of such decisions is clear from paragraph 20 of the ASB's Foreword to Accounting Standards which states that the Financial Reporting Review Panel (FRRP) is concerned with material departures from financial reporting standards or the accounting provisions of companies legislation where such a departure results in the financial statements in question not giving a true and fair view. (The FRRP considers financial statements prepared both under UK GAAP and IFRS.)

In respect of other disclosures required by legislation rather than by standards (for example, directors' emoluments, auditor remuneration, staff costs), application of the concept of materiality is neither specifically permitted nor forbidden by the relevant legislation. These disclosures are required principally for accountability purposes and materiality should be assessed in that light (see below).

Users

The primary focus of the Statement of Principles is on those financial statements that are intended to give a true and fair view of the reporting entity's financial performance and financial position. For most entities, those statements will be their full annual financial statements to be laid before the members as a body.

The Statement of Principles regards financial statements as providing information that is useful to a wide range of external users. It notes a rebuttable presumption that '...financial statements that focus on the interest that investors have in the reporting entity's financial performance and financial position will, in effect, also be focusing on the common interest that all users have in that entity's financial performance and financial position.' Such users include actual and potential investors, employees, lenders, suppliers and other trade creditors, governments and their agencies, and members of the public with access to financial statements. In making judgements on materiality, preparers should therefore be concerned with identifying relevant users. Identifying groups of users for the purpose of making reporting decisions does not itself involve acknowledging a legal duty of care to such groups.

The expectation that preparers will address the needs of a wide range of users is mitigated by the Boards' assertions in the Statement of Principles and the Framework that:

a) not all the information needs of all users can be met by financial statements (Statement of Principles paragraph 1.8 and Framework paragraph 10);

b) financial statements that focus on the interest that investors have in the reporting entity's financial performance and financial position will, in effect, be focusing on the interest that all users have (Statement of Principles paragraph 1.11 and, in different terms, Framework paragraph 10);

c) users can be assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study information with reasonable diligence (Statement of Principles paragraph 3.27(c) and Framework paragraph 25).

It is therefore envisaged that judgements about materiality can generally be made on the basis of the needs of classes of knowledgeable and diligent users who are reasonable in their use of and reliance on financial statements and other information. Such users recognise the inherent limitations of financial statements and other information requiring the use of estimates and the consideration of future events. It is also important when there are large numbers of users in a group to consider representative users. Preparers should not seek to address a single hypothetical

user, especially one on the brink of making a decision to buy or sell, whose decision might be changed by even a small change in a reported number or disclosure.

The ASB (and IASB) identify providers of risk capital as the primary users of financial statements. Consequently, in considering materiality, preparers are expected to focus on the relevance of information to the assessment of financial performance, position and adaptability and management's discharge of its stewardship responsibilities (referred to generally in this guidance as 'accountability'). In entities where the provision of risk capital is of reduced importance (eg, charities, pension schemes and government bodies), the same broad financial and accountability issues are still likely to be of most interest to the relevant primary user groups.

Determinants of materiality

The determinants of the materiality of an item are its size and nature as judged in the 'particular circumstances of the case' (see the Statement of Principles) or 'surrounding circumstances' (see paragraph 11 of IAS 1). The tests are both quantitative and qualitative, and where the nature and circumstances are of sufficient importance it is these qualitative aspects, rather than considerations of the relative size of an item alone, that determines whether an item falls to be separately disclosed. Judgements are applied consistently within the period and from one period to the next.

It may be that an item should be brought to the attention of users due to its nature or the circumstances of its arising, notwithstanding that the amount might not otherwise be regarded as material. Criteria that might apply when deciding whether separate disclosure of an item is needed include the assessment of an item's nature in relation to the matters set out below.

Examples of such items include unlawful transactions, fines, penalties and illegal dividends. Further examples of qualitative items would include the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose a breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

Size

The size of an item recognised in primary financial statements can only be expressed in terms of monetary value. In considering the materiality of uncertainties and contingencies, preparers therefore have to make best estimates of the potential monetary amounts involved, taking into account the likelihood of crystallisation. In considering the materiality of related party transactions for which no price is charged, preparers should have regard to the potential monetary amounts involved.

Whilst the quantification of materiality is fundamental and unavoidable, materiality can never be judged purely on the basis of absolute size.

- £1 million is a large amount but in relation to a potential misstatement of sales by a large multinational, it is likely to be immaterial.

- Conversely, in some cases the nature and circumstances of an item can be of such importance to users that a size threshold is of little practical significance in determining materiality. For example, £10,000 is a comparatively small amount but it might be seen as material, even for a large multinational, if it relates to a benefit-in-kind which has been wrongly omitted from the disclosure of directors' remuneration.

The latter point may be particularly relevant where management accountability or corporate governance are at issue or in the context of disclosures in financial statements required by legislation (see above).

Nature

The nature of an item is characterised by:

a) the transactions or other events giving rise to it;

b) the legality, sensitivity, normality and potential consequences of the event or transaction;

c) the identity of the parties involved; and

d) the account captions and disclosure notes affected.

Particular care should be taken not to offset items which are different in nature when they might be material if considered separately; eg, an unrecorded sale and the related cost of sale, or an item and its tax effect. Conversely, the materiality of items of a similar nature should be considered in aggregate; eg, if a number of sales have not been recorded, their materiality should be considered in aggregate.

The Statement of Principles states that, 'In requiring information provided by financial statements to represent faithfully what it purports to represent and to be neutral, there is an implication that the information is complete and free from error - at least within the bounds of materiality. Information that contains a material error *or has been omitted for reasons other than materiality* can cause the financial statements to be false or misleading and thus unreliable and deficient in terms of their relevance'

(paragraph 3.16, emphasis in italics added). Creating immaterial errors deliberately or selectively correcting immaterial errors in order to influence a trend is not in accordance with UK GAAP.

See also paragraph 41 of IAS 8, which makes it clear that 'financial statements do not comply with IFRSs if they contain ... immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.'

This is also an issue that has been highlighted in other relevant literature. For example, the APB's Aggressive Earnings Management states that 'as a matter of principle the APB believes that directors and management should correct all misstatements identified by the auditors' (paragraph 35); and 'auditors consider whether judgements and decisions made by the directors and management... could be part of a pattern of bias, even though individually they may appear reasonable, to avoid the financial statements reflecting the underlying reality' (paragraph 47).

Circumstances

The materiality of information can only be judged in relation to its ultimate impact, or potential impact, on users. Consequently, the materiality of a given item of a given size will depend on the context of the accounting and other information available to users.

The immediate context of an item is the entity's financial statements. Some financial reporting standards and related guidance contain explicit references to the appropriate context in which to judge materiality and look beyond the immediate disclosures and captions affected by an item. It might be appropriate to focus on one or more of the following:

a) individual disclosures;

b) primary statement captions and subtotals;

c) the relevant primary financial statement as a whole;

d) the financial statements as a whole; and

e) the entity's financial position or the scale of its operations as indicated by the financial statements.

Paragraph 20 of the Explanation of FRS 8 Related Party Disclosures provides additional guidance. It indicates that the materiality of related party transactions is to be judged not only in the broader context of the reporting entity but also in relation to an individual related party; eg, where that party is a director, key manager or some other accountable person. (This does not apply in the FRSSE, which is silent on the issue.) If the disclosure of a related party transaction is considered to be sensitive (eg, for tax reasons or the nature of the transaction) this is likely to affect consideration of the transaction's materiality if disclosure might be expected to influence the users of the financial statements.

The financial statements of a single period for a single entity are of limited value and users generally consider such information in a wider context. It will therefore often be appropriate for preparers to modify their views on the materiality of an item in the light of:

a) comparative figures and trend information;

b) expectations including, where relevant, projections and forecasts;

c) the financial statements of comparable entities; and

d) economic and industry background information.

Half-yearly statements

The ASB Statement Half-Yearly Financial Reports (July 2007) states that 'materiality should be assessed by reference to the results and financial position for the half-yearly period rather than in relation to expected results and financial position for the full year' (paragraph 28). Interim measurements of financial data may rely on estimates to a greater extent than annual measurements and this may be relevant when making assessments of materiality at half-yearly or other interim dates.

Making decisions about materiality

Prescriptive rules which seek to reflect how users make decisions cannot address all situations and relieve preparers of the need to apply judgement. Preparers may wish to develop and maintain guidelines for their own organisation which reflect their consideration of users and the size, nature and circumstances of individual items within the financial statements. Such guidelines provide relatively objective rebuttable presumptions against which subsequent judgements about particular situations can be gauged. Preparers may have regard to the increasing precision with which materiality can be expressed during the course of preparation of financial statements. An important overall test of the appropriateness of decisions about

materiality is to consider whether the resulting financial statements give a true and fair view as required by companies legislation and the regulations for many different types of entity.

Materiality guidelines can be derived from answering the following questions:

a) who are the relevant users?

b) what are their decision-making needs?

c) what types of financial information are likely to influence the decisions of the users? (For example, users of financial statements of a non-profit organisation and users of financial statements of a commercial trading entity may focus on different information.)

d) for a given item, what is the appropriate context for assessing its materiality?

e) in what range of values do items become critical in terms of materiality?

f) how should particular items in these critical ranges be decided and reported?

Preparers' perceptions of users' needs can be based on:

a) general discussions with users and other information relating to users' expectations gathered as a result of a company's corporate governance procedures;

b) observing users' responses to information, eg, press or analyst comment on particular disclosures, numbers, ratios or trends and the effects on decisions to hold or sell investments or to reappoint or replace management;

c) the impact on market prices of specific items of news; and

d) their own reactions and attitudes as users of financial information in similar situations.

In some cases the approach will be relatively straightforward. Where a company's bank facility is dependent on compliance with covenants based upon financial statements, the users of those statements include investors, bankers and creditors with an interest in knowing whether the covenants are violated. Their decision-

making needs will at least cover the figures that are used in the covenant calculations. An item will be judged material if it will make a difference in triggering non-compliance with a covenant or in ensuring that a covenant is satisfied.

At certain critical thresholds, an assessment of users' needs will indicate a requirement for very low levels of materiality and potentially unrealistic demands for accuracy; eg, where trends reverse, profits become losses, technical insolvency occurs, or compliance with debt covenants is in doubt. In these circumstances, preparers should:

a) adopt an even-handed approach in areas where the required degree of accuracy is difficult to achieve so that there is perceived to be an equal chance of mistakenly falling on either side of a critical divide;

b) be particularly sensitive to the potentially misleading cumulative effect of individually immaterial items or errors; and

c) consider whether the reliability of the information in relation to its potential use is such that the information should be accompanied by a clear statement of the circumstances of its preparation and its inherent limitations.

On the basis of experience, a preparer might reasonably decide to attach particular importance to the materiality of items in a company's financial statements in the context of the trend of earnings and the margins of other companies in the same sector. Such considerations might be particularly appropriate in situations of marginal or break-even profitability.

Evidencing decisions

It may be appropriate for those preparing financial statements, whether as individuals or, collectively, as a body charged with governance, formally to document, for their own purposes, and commensurate with the size and complexity of the entity in the prevailing circumstances, their principles, policies and guidelines with regard to materiality and the main decisions they have taken. Such steps may be useful in appropriate circumstances in dealings with Regulators such as the FRRP.

PLANNING OPPORTUNITY FOR PRIVATE COMPANIES UNDER THE CA 2006 RULES?

Lecture A283 (6.54 Minutes)

The following example is similar to one shown in a recent set of update notes. It dealt with the accounting treatment for redemption of own shares out of capital.

Extracts from the balance sheet of Y Ltd show the following:

Ordinary £1 shares	£60,000
Redeemable preference £1 shares	£20,000
Share premium account	£8,000
Total capital and undistributable reserves	£88,000
Profit and loss account	£12,000

The directors wish to redeem all of the preference shares at par. Since the distributable profits of the company are insufficient to achieve this, the directors will need to follow the requirements of the Act for purchase of own shares out of capital.

Having fulfilled the necessary steps, the required journal entries are as follows:

Dr Redeemable preference shares	£20,000	
Cr Cash		£20,000

Being the purchase of the shares.

Dr Profit and loss account	£12,000	
Cr Capital redemption reserve		£12,000

Being the transfer to make good the capital as far as it can be achieved from distributable profits.

Extracts from the balance sheet of Y Ltd at this stage:

Ordinary £1 shares	£60,000
Redeemable preference £1 shares	-
Share premium account	£8,000
Capital redemption reserve	£12,000
Total capital and undistributable reserves	£80,000
Profit and loss account	-

So what's the planning opportunity?

There are no distributable profits in the company but the shareholder directors need to get some money out of the business.

For private companies the 2006 Act introduces a streamlined method of reducing their share capital. This is referred to as a “Self help” reduction procedure. The process has three key stages:

1) Each director of the company makes a solvency statement to the effect that he/she has formed the opinion that the company is solvent and will continue to be so after the capital reduction for at least one year after the date of the statement.

2) The shareholders must pass a special resolution within 15 days of the date of the solvency statement; and

3) The solvency statement, the special resolution and a statement of capital must be filed with the Registrar of Companies.

The company therefore has the opportunity to create share capital and then reduce it. The company can capitalise the share premium account and the capital redemption reserve by an issue of fully paid bonus shares (provided that the articles do not forbid this). The increased share capital can then be reduced using the procedure above hence turning the non-distributable reserves into cash in the hands of the shareholders.

Let’s complete the journal entries for the above example:

Dr Share premium account	£8,000	
Dr Capital redemption reserve	£12,000	
Cr Share capital		£20,000

Being the transfer required to reflect the issue of fully-paid bonus shares to all shareholders on the basis of 1 new share for every 3 shares previously held.

Dr Share capital	£20,000	
Cr Cash		£20,000

Being the reduction of share capital.

Extracts from the final balance sheet of Y Ltd:

Ordinary £1 shares	£60,000
Redeemable preference £1 shares	-
Share premium account	-
Capital redemption reserve	-
Total capital and undistributable reserves	£60,000

Profit and loss account -

It is being suggested by some that this same idea could be applied to the revaluation reserve. A company could revalue fixed assets creating a revaluation reserve; issue bonus shares from that reserve; and then reduce the share capital by the same amount.

Is this a good idea? Well it depends on the directors being prepared to make a solvency statement and if that statement is appropriate then, presumably, no harm is done. It rather concerns me that the whole point of non-distributable reserves is being undermined and therefore I would recommend extreme caution before recommending this route to a client.

COMPANIES ACT 2006 - NEW REGULATIONS FOR OVERSEAS COMPANIES

One of the most welcome measures to come into force on 1 October 2009 is the simplification of the regime for registering an overseas company in the UK. The procedure under CA 1985 imposed different registration, reporting and disclosure requirements depending on whether the company established a “branch” or a “place of business” here. From 1 October 2009 these complicated provisions were replaced with a single registration regime that applies to any overseas company that opens an “establishment” in the UK.

From 1 October 2009, registration of overseas companies and their ongoing statutory obligations are governed by:

a) Part 34 of the Companies Act 2006

b) The Overseas Companies Regulations 2009 and

c) The Overseas Companies (Company Contracts and Registration of Charges) Regulations 2009.

Generally speaking, the new provisions adopt the existing branch registration rules. Consequently companies that would have registered a place of business under the old regime may find the new requirements slightly more onerous than was previously the case.

Initial registration

Under the new regime any overseas company (i.e. any company incorporated outside the UK) must register with Companies House within one month after opening an “establishment” in the UK. An “establishment” includes a branch (within the meaning of the Eleventh Company Law directive) or a place of business (meaning, under current law, some more or less permanent location, not necessarily owned or leased by the company, but at least associated with it and from which habitually or with some degree of regularity the business of the company is conducted). Merely doing business in the UK without a physical presence, or with just a temporary or

fleeting presence, is not sufficient to justify registration under Part 34.

Particulars to be delivered to the Registrar of Companies on application for registration are broadly the same as under the existing branch regime. The main difference is that directors of the overseas company must give a service address and home address in the same way as a director of a UK company. The home address is protected information and only disclosed to certain public authorities and credit reference agencies. A director can apply to the Registrar to prevent disclosure of his or her home address to credit reference agencies if he or she or someone living at the same address is at serious risk of violence or intimidation because of the activities of the overseas company.

As before, the application for registration of the UK establishment must be accompanied by a certified copy of the company's constitution and a copy of its latest annual accounts (if any) together with the appropriate fee, currently £20 for a standard registration or £50 for a same day registration.

Change of particulars

Once the overseas company is registered, any alteration of the particulars held at Companies House and any changes to its name, constitution or accounting requirements must be notified to the Registrar on the prescribed form within 21 days of the change.

If an overseas company closes its UK establishment it must notify Companies House forthwith. Once such notification has been given, all filing requirements under the UK legislation cease.

Annual reporting

Financial reporting requirements also follow the current branch regime in most respects.

If its parent law requires the company to prepare, have audited and disclose annual accounts, the company must deliver a copy of these, with a statement identifying the law, accounting principles and auditing standards under which they have been prepared, to Companies House within 3 months after they are disclosed in the country of incorporation under the parent law.

If its parent law does not require the company to disclose annual accounts, it must prepare and file accounts complying with a modified version of the Companies Act 2006 requirements or International Accounting Standards or under its parent law (which need not necessarily be audited but must meet the requirements set out in the Overseas Companies Regulations 2009). The time limit for filing such accounts is 13 months from the end of the accounting period to which the accounts relate or, if the accounting period is the company's first and exceeds 12 months, 13 months after the anniversary of the date that the company opened its UK establishment.

A filing fee (currently £30) must be sent with each set of accounts filed and failure to

file accounts in accordance with these requirements constitutes a criminal offence by each person who is a director of the company.

Disclosure requirements

The trading disclosure requirements apply to all overseas companies carrying on business in the UK, not just those that have registered an establishment in the UK. The company's name and country of incorporation must be displayed at the service address of every person resident in the UK authorised to accept service of documents on the company's behalf and at every location in the UK where the company carries on business. The company's name must also be displayed on its communications such as business letters, order forms, notices and other official publications and on its website.

Companies incorporated outside an EU member state must also display their country of incorporation, registered number, legal form, head office and certain other details on business letters, notices and other official publications.

Registration of charges

Under The Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009 (currently in draft), only overseas companies that have registered an establishment in the UK will be required to register mortgages and charges. The unofficial "Slavenburg" Register will no longer be maintained.

The draft regulations provide that a mortgage or charge will be registrable if:

- it is of a type that requires registration (as specified in the regulations) and
- on the date it is created, the property subject to the charge or mortgage is situated in the UK.

Registration must be effected within 21 days of a registrable charge being created over the company's assets. The draft regulations provide that failure to register a registrable charge or mortgage will render it void against a liquidator of the company, an administrator of the company and any creditor of the company but there will be no criminal sanction.

Rights of inspection of records will apply to the inspection of an overseas company's register of charges and copies of instruments creating charges in a similar way as they apply to UK private companies.

FREQUENTLY ASKED QUESTIONS

Lecture A284 (12.28 Minutes)

Signature on the audit report on filed accounts

Q. I went on a course recently and was told that there is no longer any need to sign the audit report on the copy filed at Companies House. However, one of my firm's high profile clients has had their accounts rejected by Companies House when the accounts were filed without a signed report.

A. It seems that not everyone at Companies House understands the Companies Act 2006. For periods commencing on or after 6 April 2008 the requirement for a signature on the audit report is removed for the filed copy of the financial statements, on or after 1 October 2009.

However, in these first few days of the new regime mistakes are being made. Some of these mistakes have been with high profile clients causing much embarrassment for auditors and strained relationships with clients. Companies House is working hard to get up to speed.

Meanwhile a number of firms have established internal policies requiring partners to continue to sign the audit report on the filed copy. For instance Deloitte is requiring partners to sign in their own name. Other firms are suggesting that the partner signs in the firm's name. Both of these approaches are acceptable

This does not affect the requirement for the auditor to sign the member's copy of the audit report. This signature must be that of the Senior Statutory Auditor rather than the firm for periods commencing 6 April 2008.

Company number

Q. Companies House has recently rejected a client's financial statements because the company number was incorrectly stated. What has changed?

A. Previously most companies have stated the company number on the cover page of the financial statements. From 1 October 2009 the company number must be stated either on the balance sheet, auditors' report, directors' report or directors' remuneration report. Typically companies might make the disclosure on the balance sheet as this is the only statement that will appear in the small company abbreviated financial statements.

There have been instances of accounts being rejected by Companies House for omitting the leading zeros on shorter company numbers! At the moment it is unclear whether there is any good basis for this.

Signing in black ink

Q. My firm has been filing sets of accounts, with the Registrar of Companies, on behalf of our clients for years without ever paying much attention to whether the directors have signed the accounts with blue or black ink. I understand that the Companies Act 2006 requires only black ink to be used. To my knowledge accounts are not being rejected if blue ink is used. What is the position?

A. You are correct in thinking that black ink has to be used for the signatures. Companies House have intimated that they might not reject improperly delivered documents where there is a minor breach of the delivery requirements as it may be in the public interest to register such documents.

This means Companies House may accept accounts even though they include a blue signature, or the accounts contain the company name and/or registered number somewhere but not in the required place, eg it is included in a cover sheet (but this would not include an accompanying letter).

However, the fact that the registrar has accepted and registered the document does not mean that the company (or LLP) has complied with the filing requirement, and the obligation to file the document continues (and any liabilities that arise from not doing so still apply). Therefore, filing penalties may be incurred at a later date, eg as a result of a complaint brought by a third party.

"Statutory Auditors" or "Registered Auditors"

Q. The new audit report describes my firm as "Statutory Auditors" but my firm's letterhead states that we are Registered Auditors. Does the firm's letterhead need to be changed and if it does when does this need to happen?

A. Interestingly, there is no mention in the requirements of Audit Regulation for a firm's notepaper to carry a legend stating that it is a registered or statutory auditor.

If a firm wishes to use a legend, then it is suggested that the following wording is used:

'registered to carry on audit work by the [Institute name in full]'.

In addition a firm may describe itself as a firm of registered or statutory auditors. In conclusion there is no hurry to change the legend on an audit firm's letterhead.

COMPILATION REPORTS - CCAB AND ACCA GUIDANCE

Lecture A285 (????? Minutes)

Once upon a time every company required an audit and the accountant's job was straightforward. Over the past 20 years audit exemption thresholds have regularly increased which means that the majority of UK companies no longer require an audit.

The directors of these companies still have to prepare accounts for the members and for filing at Companies House. When firms of professional accountants assist in the preparation of these accounts it is called a compilation or accounts preparation assignment and there is professional guidance on the work required and the wording of the report.

The professional bodies, the regulator and politics

The main professional accountancy bodies all issue their own guidance in this area and there are some stark differences between them. The Professional Oversight Board (POB) has been applying pressure for several years for the professional bodies to issue a Cross Profession Accounts Compilation Report. In addition to this, POB has a clear idea of its own what the report should look like which is different again from all of the professional accountancy bodies!

The Consultative Committee of Accountancy Bodies (CCAB) has finally (September 2009) issued guidance on a cross profession report which will sit alongside the guidance of the professional bodies. The Association of Chartered Certified Accountants (ACCA) has responded by issuing its own new guidance which adopts the CCAB report.

The CCAB guidance can be found at:
http://www.ccab.org.uk/documents.php?subaction=showfull&id=1252423539&archive=&start_from=&ucat=2

The CCAB report is cross-referred to the professional guidance issued by each individual body and the following is a summary of the guidance currently in issue and the relevant web-addresses:

- The Institute of Chartered Accountants in England and Wales
[http://www.icaew.com/index.cfm/route/166998]
- The Institute of Chartered Accountants of Scotland
[http://www.icas.org.uk/site/cms/contentChapterView.asp?chapter=607]
- The Institute of Chartered Accountants in Ireland
[https://www.carb.ie/]

- The Association of Chartered Certified Accountants [http://rulebook.accaglobal.com/]
- The Chartered Institute of Management Accountants [http://www2.cimaglobal.com/cps/rde/xchg/SID-0A82C289-BFBB3F2D/live/root.xsl/31608_31618.htm]

Each accountancy body has produced detailed technical guidance which explains to the practitioner the work needed to produce a CCAB accounts compilation report. To see this, click on the accountancy body named in the report:

- The Institute of Chartered Accountants in England and Wales [http://www.icaew.com/index.cfm/route/117924]
- The Institute of Chartered Accountants of Scotland [http://www.icas.org.uk/site/cms/download/aa_FrameworkPrepAccounts_Apr05.pdf]
- The Institute of Chartered Accountants in Ireland [http://www.icai.ie/Global/documents/Miscellaneous%20Technical%20Statement%20M48.pdf]
- The Association of Chartered Certified Accountants [http://www.accaglobal.com/factsheet163]
- The Chartered Institute of Management Accountants [http://www2.cimaglobal.com/cps/rde/xchg/SID-0A82C289-FBFB40B7/live/root.xsl/31608_31618.htm]

CCAB – Example Report without optional risk paragraphs

Report to the Directors on the preparation of the unaudited statutory accounts of XYZ Limited [for the year [/period] ended …]

In order to assist you to fulfil your duties under the Companies Act 2006, we have prepared for your approval the accounts of XYZ Limited for the year [/period] ended [date] [as set out on pages x-x/which comprise of [insert statements]] from the Company's accounting records and from information and explanations you have given us.

As a practising member [/member firm of] of [name of accounting body], we are subject to its ethical and other professional requirements which are detailed at [web address provided by the accounting body].

Our work has been undertaken in accordance with the requirements of [name of accounting body] as detailed at [web address provided by the accounting body].

[Explanatory paragraph: e.g. departure from generally accepted accounting practice]

Signature………………………

Typed name of accountant

Chartered/Chartered Certified/Chartered Management Accountants

Address

Date ………………………….

CCAB – Example Report with optional risk paragraphs

Report to the directors on the preparation of the unaudited statutory accounts of XYZ Limited [for the year [/period] ended …]

In order to assist you to fulfil your duties under the Companies Act 2006, we have prepared for your approval the accounts of XYZ Limited for the year [/period] ended [date] [as set out on pages x-x/which comprise of [insert statements]] from the company's accounting records and from information and explanations you have given us.

As a practising member [/member firm of] of [name of accounting body], we are subject to its ethical and other professional requirements which are detailed at [website address].

[This report is made solely to the Board of Directors of XYZ Limited, as a body, in accordance with the terms of our engagement letter dated [date].] Our work has been undertaken [solely to prepare for your approval the accounts of XYZ Limited and state those matters that we have agreed to state to them/the Board of Directors of XYZ Limited, as a body, in this report] in accordance with the requirements of [name of accounting body] as detailed at [website address]. [To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than XYZ Limited and its Board of Directors as a body for our work or for this report.]

[It is your duty to ensure that XYZ Limited has kept adequate accounting records and to prepare statutory accounts that give a true and fair view of the assets, liabilities, financial position and profit[/loss] of XYZ Limited. You consider that XYZ Limited is exempt from the statutory audit requirement for the year [/period].]

[We have not been instructed to carry out an audit or a review of the accounts of XYZ Limited. For this reason, we have not verified the accuracy or completeness of the accounting records or information and explanations you have given to us and we do not, therefore, express any opinion on the statutory accounts.]

[Explanatory paragraph: e.g. departure from generally accepted accounting practice etc.]

Signature etc as before

ICAEW Guidance

The ICAEW have neither revoked nor changed their existing guidance. The CCAB guidance will sit alongside the existing guidance and the ICAEW are happy for firms to use any of the three versions (i.e. existing ICAEW report or CCAB report with or without risk paragraphs) of the compilation report.

Note that, as an alternative to the compilation report, the ICAEW continue to encourage firms to offer clients an assurance report.

The ICAEW is silent on the subject of whether the accounts filed at Companies House should include a copy of the compilation report, whichever one is used.

ACCA Guidance

The ACCA recommends that the cross-profession accounts preparation report, developed by the Consultative Committee of Accountancy Bodies (CCAB), is used. The ACCA accounts preparation report comprises core paragraphs and optional risk paragraphs. The ACCA recommends that core paragraphs should be present in all ACCA accounts preparation reports. The use of optional paragraphs is left to the practitioner's professional judgement. The ACCA accounts preparation report uses web links to enable a clear and concise report. .

ACCA also strongly recommends that a copy of the ACCA accounts preparation report be included with the financial statements filed at Companies House, in order to increase the credibility of the financial information placed on public record and to differentiate the accounts from those prepared by firms and individuals who are not members of one of the CCAB bodies. The recommendation to include a copy of the ACCA accounts preparation report is also applicable to abbreviated accounts filed at Companies House.

Where the financial statements of a company are filed electronically with Companies House, the copy of the ACCA accounts preparation report filed with such accounts will not require a physical signature from the professional accountant or from the accounting firm. In such circumstances the report will need to be suitably modified to include the typed name of the accountant or firm only.

Unincorporated entities

All of the guidance referred to above is in respect of incorporated bodies, mainly companies. For professional guidance on the compilation of unincorporated financial statements, accountants should refer to the separate guidance of their professional bodies.

RELIANCE ON THE WORK OF AN EXPERT AND USE OF SERVICE ORGANISATIONS

Audit teams sometimes get confused between reliance on the work of an expert and situations where the audit client is using a service organisation. These two audit issues are covered by the following ISAs:

- ISA 620 Using the work of an expert
- ISA 402 Audit considerations relating to entities using service organisations

ISA 620 Using the work of an expert

The ISA sets out that an expert can be contracted by the entity, contracted by the auditor or employed by the entity or employed by the auditor. The ISA says that an expert that is employed by the audit firm may be subject to the audit firm's systems and procedures for ensuring competence and the audit can place reliance on these systems.

Generally an expert is used to produce reports, opinions, valuations and statements on which the audit team will place some reliance when forming their opinions.

Para 2 ISA 620 says,

When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purpose of the audit.

The ISA requires the audit team to assess the professional qualifications, experience and resources of the expert. The audit team should also consider the objectivity of the expert and assess the risk that the objectivity is influenced by the client in situations where the expert is employed by the client. The audit team should also consider if the scope of the expert's work is adequate for the purposes of the audit.

In most cases the audit team should speak to the expert to check that the scope of the work carried out has not been restricted by the client.

ISA 402 Audit considerations relating to entities using service organisations

ISA 402 defines a service organisation as an entity that provides services to another. The definition says that service organisations provide a wide range of activities including:

- Information processing
- Maintenance of accounting records

- Facilities management
- Maintenance of safe custody assets, such as investments
- Initiation or execution of transactions on behalf of the other entity

Service organisations may undertake activities on a dedicated basis for one entity, or on a shared basis, either for members of a single group of entities or for unrelated customers.

The ISA also defines relevant activities as those that relate directly to the preparation of the entity's accounts, including the maintenance of its accounting records and activities that relate to the reporting of material assets, liabilities and transactions. It also includes activities that relate to laws and regulations that are central to the entity's ability to conduct its business.

Para 2 ISA 402 says,

The auditor should consider how an entity's use of service organisations affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures.

Paragraph 6-1 says that access to information held by the service organisation is not always necessary in order to obtain sufficient appropriate audit evidence. Sufficient evidence may be available at the client itself regarding the risk and control of the outsourced activity. If the auditor considers that access to the service organisation is needed then the client should be asked to arrange this.

The auditor may also consider asking the service organisation's auditors to provide a report on the service organisation's controls. If they decide to do this they should assess the competence and qualifications of the entity's auditors. The service organisation's auditors can be asked to provide two types of report.

Type A – Report on the design and implementation of internal controls

a) A description of the service organisation's internal control, ordinarily prepared by the management of the service organisation; and

b) An opinion by the service organisation's auditor that:

    i) The above description is accurate;

    ii) The internal control is suitably designed to achieve their stated objectives; and

    iii) The internal controls have been implemented.

Type B – Report on the design, implementation and operating effectiveness of internal control

a) A description of the service organisation's internal control, ordinarily prepared by the management of the service organisation; and

b) An opinion by the service organisation's auditor that:

i) The above description is accurate;

ii) The internal control is suitably designed to achieve their stated objectives;

iii) The internal controls have been implemented; and

iv) The internal controls are operating effectively based on the results from the tests of controls. In addition to the opinion on operating effectiveness, the service organisation auditor would identify the tests of controls performed and related results.

Some practical points

For some clients you may have both reliance on an expert and use of a service organisation being provided by the same organisation to the audit client. For example a company with a large number of investment properties may have outsourced the maintenance and collection of rent to a firm of surveyors. They may also use the same firm to provide valuations of the properties as well.

The audit team will need to identify the two activities and have different assessments of reliance and risk for each area. The maintenance and rental side may be covered by the client's own records and controls over the service organisation. The level of reliance to be placed on the valuations should be assessed against the scope of the work and professional qualifications of the service organisation and the risk considered against the background of the service organisation's relationship with the client.

ISA 320 MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

Lecture A286 (20.07 Minutes)

The previous version of ISA 320 dealt with materiality at all stages of the audit. The clarity ISA 320 deals with materiality in planning and performing the audit. The new ISA 450 explains how materiality is applied in dealing with misstatements.

Materiality in the context of an audit

The introductory section of ISA 320 refers to the impact of the financial reporting framework. We have covered that issue earlier in these notes. The financial reporting

framework provides a frame of reference for the auditor in determining materiality for the audit.

Paragraph 6 says that, in planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

(a) Determining the nature, timing and extent of risk assessment procedures;

(b) Identifying and assessing the risks of material misstatement; and

(c) Determining the nature, timing and extent of further audit procedures.

Paragraph 6 goes on to say that in some circumstances uncorrected misstatements which are (individually or in the aggregate) below materiality may still be evaluated as material by the auditor since the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence.

Objective

The ISA states that the objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

Materiality itself is not defined by the standard. Presumably, the thinking behind this is that materiality will be determined by the financial reporting framework and this may vary in different parts of the world.

There is a definition of "performance materiality" which is "the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole." The concept of performance materiality did not exist in the previous version of ISA 320. In the UK, performance materiality has traditionally been referred to as working materiality or tolerable error.

Note that there can be more than one figure for performance materiality and that the term can also refer to the amount or amounts set by the auditor at less than the

materiality level or levels for particular classes of transactions, account balances or disclosures.

Requirements

Determining materiality and performance materiality when planning

The fundamental requirement to set materiality is in Paragraph 10 of the standard:

> 10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

Similarly Paragraph 11 requires the auditor to determine performance materiality for the purposes of assessing the risks of material misstatement and also for determining the nature, timing and extent of further audit procedures.

The requirements contained in these paragraphs may lead to a change in audit documentation for some firms.

The application material considers the use of benchmarks in determining materiality for the financial statements as a whole – although Paragraph A3 starts by stressing that the determination of materiality involves the exercise of professional judgment.

Paragraph A4 gives examples of benchmarks that may be appropriate, depending on circumstances. These include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax is often used but can be volatile in which case other benchmarks may be more appropriate,

In determining the amount to use for a benchmark, financial data from prior periods and budgets may be relevant as well as the data from the current period. Amounts may need to be adjusted for significant changes in the circumstances of the entity, the industry or the economic environment.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. Different percentages will be appropriate for different benchmarks. For example, Paragraph A7 suggests that the auditor may

consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry. On the other hand, the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity.

For small entities, profit before tax might be an inappropriate benchmark if the owner takes much of the profit before tax in the form of remuneration. A benchmark such as profit before remuneration and tax may be more relevant.

The application material gives examples of situations where a misstatement below the overall materiality could reasonably be expected to influence the economic decisions of users. These include:

- Where measurement or disclosure of certain items is affected by law or regulations (for example, related party transactions or directors' remuneration).

- Key disclosures in the relevant industry (for example, research and development costs for a pharmaceutical company).

- Interest in a particular aspect of the entity's business (for example, a newly acquired subsidiary).

The views of management may be helpful in deciding whether such situations exist.

Paragraph A12 of the application material considers performance materiality. It uses what might be called a “margin of safety” argument. This recognises that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leave no margin for possible undetected misstatements.

The purpose of performance materiality is to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality. This principle applies both to the financial statements as a whole and also to any particular class of transactions, account balance or disclosure where a lower materiality level has been set.

The application material says that the determination of performance materiality is not a simple mechanical calculation but involves the exercise of professional judgment.

Revision as the audit progresses

As before the auditor must revise materiality if new information emerges as the audit progresses - for example, actual profit or turnover might be substantially different from the expectations used initially to determine materiality. If the revision to materiality results in a lower materiality than initially determined the auditor must consider whether it is necessary to revise performance materiality, and therefore whether additional audit procedures are required.

Documentation

The documentation requirements are in Paragraph 14 of the standard:

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole;

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;

(c) Performance materiality; and

(d) Any revision of (a)-(c) as the audit progressed.

MATERIALITY – GUIDANCE PROVIDED BY PRACTICE NOTE 26: GUIDANCE ON SMALLER ENTITY AUDIT DOCUMENTATION

Lecture A286 (20.07 Minutes)

The APB have released an exposure draft of an amended PN 26. This updates the example documentation to comply with the new clarity ISAs. One particular change is the introduction of an illustrative example for materiality.

As before, the APB give two examples of how audit documentation might be prepared. The first is a freeform approach. The auditor draws up a “free-form” audit strategy memorandum in which the subject of materiality is addressed.

We are not permitted to reproduce the APB examples but the following gives an indication of the free-form approach. The examples given are my own and are purely illustrative of the sort of issue that may be relevant.

Materiality

Materiality for the financial statements as a whole

Materiality for the financial statements as a whole has been set at £50,000. As in previous years this has been based on 1% of turnover. The draft accounts show turnover of £5.1m.

Lower levels of materiality for specific items

A lower level of materiality has been set for:

Related party transactions	£20,000

This is on the grounds that related party information is relevant to the minority shareholders who are not involved in management.

Directors' remuneration	£10,000

This is mainly on the grounds that this information is relevant to the minority shareholders but also considers the sensitivity of management should such information be misstated.

Performance materiality

Financial statements as a whole	£37,500
Directors' remuneration	£7,500

These are based on the firm's standard approach whereby, in the absence of indications to the contrary, performance materiality is set at 75% of materiality.

Contract work-in-progress	£25,000
Related party transactions	£10,000

A lower performance materiality is considered appropriate in these areas because of their susceptibility to error.

ISA 450 EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

The previous version of ISA 320 dealt with materiality at all stages of the audit. The clarity ISA 320 deals with materiality in planning and performing the audit. The new ISA 450 explains how materiality is applied in dealing with misstatements.

Objective

The ISA states that the objective of the auditor is to evaluate:

(a) The effect of identified misstatements on the audit; and

(b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

Misstatement is defined as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

The application material explains that misstatements may result from an inaccuracy or omission. Misstatements also arise from incorrect accounting estimates (arising from overlooking, or clear misinterpretation of, facts) and judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Examples of misstatements arising from fraud are provided in ISA 240.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Uncorrected misstatements are defined as misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of identified misstatements

The fundamental requirement to accumulate misstatements is in Paragraph 5 of the standard:

> 5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial.

"Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with ISA (UK And Ireland) 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

The application material suggests that it might be useful to distinguish between:

- Factual misstatements which are misstatements about which there is no doubt.
- Judgmental misstatements which are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements which are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

Consideration of identified misstatements as the audit progresses

Paragraph 6 is concerned with the possible need to revise the overall audit strategy and/or the audit plan in two situations. Firstly, if the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material. The second situation is if the aggregate of misstatements accumulated during the audit is approaching materiality.

Paragraph 7 then requires the auditor to perform additional audit procedures in the circumstance where, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected. These additional procedures are intended to determine whether misstatements remain.

Communication and correction of misstatements

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

There is a tendency for management to reject proposed adjustments on the grounds of immateriality. However, as the application material points out, the correction by management of all misstatements enables them to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

Management’s refusal to correct misstatements may be an indicator of possible bias in management's judgments The auditor should consider this when obtaining an understanding of management's reasons for not making the corrections.

Evaluating the effect of uncorrected misstatements

Following reassessment of the various measures of materiality, the auditor evaluates the effect of uncorrected misstatements as required by Paragraph 11.

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

(a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and

(b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

The analysis required in Paragraph 11 is performed in each audit area where uncorrected misstatements exist. Note also that the existence of a number of immaterial misstatements within an audit area may lead the auditor to reassess the risk within that area.

Assessment of uncorrected misstatements requires the exercise of judgement. For example, an immaterial error in classification may be judged to be material because of its effect on ratios or covenants. Similarly, other misstatements which are lower than materiality for the financial statements as a whole, may be judged to be material because of eg regulatory requirements, the possible material effect on the results of future periods, the involvement of related parties or the impact on bonuses paid to management.

ISA 240 explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

Communication with those charged with governance

Paragraph 12 requires the auditor, unless prohibited by law or regulation, to communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report. The auditor shall request that uncorrected misstatements be corrected.

Material uncorrected misstatements should be identified individually but where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement. The auditor is also required to communicate the effect on financial statements of the current period where there are uncorrected misstatements related to prior periods.

A “plus” in the application material points out that, in the circumstances where management have corrected material misstatements, communicating those corrections of which the auditor is aware to those charged with governance may assist them to fulfil their governance responsibilities, including reviewing the effectiveness of the system of internal control.

Written representation

Paragraph 14 deals with the letter of representation and requires management/those charged with governance to indicate whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. Paragraph 14 also requires a summary of such items to be included in or attached to the written representation.

Documentation

The requirements concerning documentation are included in Paragraph 15:

> 15. The auditor shall include in the audit documentation:
>
> (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
>
> (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and
>
> (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

The guidance notes indicate that the documentation of uncorrected misstatements may take into account:

(a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

EVALUATION OF MISSTATEMENTS – GUIDANCE PROVIDED BY PRACTICE NOTE 26: GUIDANCE ON SMALLER ENTITY AUDIT DOCUMENTATION

The APB have released an exposure draft of an amended PN 26. This updates the example documentation to comply with the new clarity ISAs. One particular change is the introduction of illustrative material for evaluation of misstatements.

We are not permitted to reproduce the APB example but the following gives an illustration of a working paper which would comply with ISA 450. I have included in my example a projected error which, interestingly, the APB did not do in their example.

Client: XYZ Ltd

Year end: 31/12/2010

Misstatements below £250 (0.5% of materiality) are considered to be clearly trivial and have not been recorded below

Adjusted errors						
Sch ref	**Detail**	**Fact or Judge**	**Balance sheet**		**P&L account**	
			Dr	Cr	Dr	Cr
x/x	Purchases test – actual error identified in sample	Fact		£278	£278	
x/x	Sales commission – cut-off error	Fact	£12,061			£12,061
	Increase in profit from adjusted errors					£11,783

Unadjusted errors						
Sch ref	**Detail**	**Fact Judge or Proj**	**Balance sheet**		**P&L account**	
			Dr	Cr	Dr	Cr
x/x	Goods received but not included in year-end creditors.	Fact		£4,185	£4,185	
x/x	Stock error due to difference between standard US$ exchange rate and actual.	Fact	£3,198			£3,198
x/x	Disputed debt not provided by client (note 1)	Judge		£4,600	£4,600	
	Totals				£8,785	£3,198
	Cumulative effect on profit of errors which client declined to correct (note 2)				£5,587	
x/x	Projected error from purchases test	Proj		£22,184	£22,184	
	Cumulative effect on profit of errors for audit consideration (note 3)				£27,771	

Comments:

Note 1: Discussed bad debt provision with John Smith on 6 April. He considers that the amount will be recovered. My view is that he is being over-optimistic.

Note 2: The uncorrected errors have been included in the letter of representation. Directors' reasons for non correction are also included.

Note 3: The net effect of the uncorrected errors is immaterial and is also offset somewhat by the effect of last year's unadjusted misstatement (payroll error £4,117) which has reversed through the profit and loss account this year.

Conclusion:

Uncorrected misstatements are not material, either individually or in aggregate.

INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD – QUESTIONS AND ANSWERS

Lecture A287 (15.16 Minutes)

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This Questions & Answers (Q&A) publication is issued by staff of the International Auditing and Assurance Standards Board (IAASB) to highlight how the design of the International Standards on Auditing (ISAs) issued by the IAASB under the Clarity Project enables them to be applied in a manner proportionate with the size and complexity of an entity. Specifically, while ISAs apply to audits of entities of all sizes and complexities, this Q&A focuses on matters that are likely to be of particular relevance to their application in the context of an audit of a small- and medium-sized entity (SME). Small and medium practices (SMPs), other auditors of SMEs, and others with responsibility for financial statement audits may find this Q&A helpful in effectively implementing the clarified ISAs.

This publication does not amend or override the ISAs, the texts of which alone are authoritative. Reading this Q&A is not a substitute for reading the ISAs. The Q&A is not meant to be exhaustive and reference to the ISAs themselves should always be made. This publication does not constitute an authoritative or official pronouncement of the IAASB.

Q1. How do the ISAs address the fact that the characteristics of an SME are significantly different from those of a larger, more complex entity?

The auditor's objectives are the same for audits of entities of different sizes and complexities. This, however, does not mean that every audit will be planned and performed in exactly the same way. The ISAs recognize that the specific audit procedures to be undertaken to achieve the auditor's objectives and to comply with the requirements of the ISAs may vary considerably depending on whether the entity being audited is large or small and whether it is complex or relatively simple. The requirements of the ISAs, therefore, focus on matters that the auditor needs to address in an audit and do not ordinarily detail the specific procedures that the auditor should perform.

The ISAs also explain that the appropriate audit approach for designing and performing further audit procedures depends on the auditor's risk assessment. For example, based on the required understanding of the entity and its environment, including its internal control and the assessed risks of material misstatement, the auditor may determine that a combined approach using both tests of controls and

substantive procedures is an effective approach in the circumstances in responding to the assessed risks. In other cases, for example, in the context of an SME audit where there are not many control activities in the SME that can be identified by the auditor, the auditor may decide that it is efficient to perform further audit procedures that are primarily substantive procedures.

It is also important to note that the ISAs acknowledge that the appropriate exercise of professional judgment is essential to the proper conduct of an audit. Professional judgment is necessary, in particular, regarding decisions about the nature, timing, and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence. However, while the auditor of an SME needs to exercise professional judgment, this does not mean that the auditor can decide not to apply a requirement of an ISA except in exceptional circumstances and provided that the auditor performs alternative audit procedures to achieve the aim of the requirement.

Q2. How might the work effort in an SME audit differ from that in a larger entity audit?

Often, SMEs engage in relatively simple business transactions, which means that their audits under the ISAs will generally be relatively straightforward.

As an illustration, consider the requirement in ISA 315 for the auditor to obtain an understanding of the entity and its environment. While the audit considerations underlying this requirement will be equally relevant for both large and small entities, the typically simpler structure and processes in an SME often mean that the auditor may obtain an understanding of the entity and its environment quite readily and document this in a straightforward manner.

Similarly, internal control in the context of an SME may be simpler. This is emphasized several times in the ISAs, for example:

“Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.”

“Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities…”

“The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary.”

Thus, while obtaining an understanding of the entity’s internal control relevant to the audit is equally important in the audit of an SME, the auditor is also likely to be able

to obtain the necessary understanding and document that understanding quite readily.

Q3. How do the ISAs help guide the auditor in their application to an SME audit?

The ISAs specifically anticipate their application to an SME audit. For example, in relation to requirements:

- They specify alternative procedures regarding understanding the entity's risk assessment process when the entity has not established such a process or it has an ad hoc process (a common occurrence in SMEs).

- They specify a choice of audit procedures based on the particular circumstances (e.g., choice of responses to assessed risks for accounting estimates under ISA 540 where the option of using evidence arising from events occurring after the date of the financial statements is often an effective response in an SME audit, when such evidence is relevant to the accounting estimate and there is a long period between the date of the statement of financial position and the date of the auditor's report).

- They indicate if a requirement is conditional where those charged with governance and management are the same (a situation often seen in SMEs).

Of particular relevance to the auditor of an SME is the fact that the ISAs also include useful guidance that assists the auditor in understanding or applying specific requirements in the ISAs in the context of an SME audit. Where appropriate, this guidance is included in sections of the application material in the ISAs under the subheading, Considerations Specific to Smaller Entities. A few examples of the type of guidance provided are noted below:

- Standard audit programs or checklists drawn up on the assumption of few relevant control activities may be used for the audit plan of an SME audit provided that they are tailored to the circumstances of the engagement.

- Because interim or monthly financial information may not be available in an SME for purposes of analytical procedures to identify and assess the risks of material misstatement, the auditor may need to plan to

perform analytical procedures when an early draft of the entity's financial statements becomes available.

- Audit evidence for elements of the control environment in SMEs may not be available in documentary form. Consequently, the attitudes, awareness, and actions of management or the owner-manager are of particular importance to the auditor's understanding of an SME's control environment.

Specific SME considerations also address how to apply the ISAs when there is only a one-person team, for example, in relation to the requirement for the engagement partner to take responsibility for the direction and supervision of an engagement team.

In addition, other guidance indicates that specific aspects of the audit will vary with the size, complexity, and nature of the entity, for example, in relation to:

- The nature and extent of the auditor's planning activities.
- The auditor's consideration of relevant fraud risk factors.
- The communication process between the auditor and those charged with governance, and the form of that communication.
- The level of detail at which to communicate significant deficiencies in internal control.
- The judgment as to whether a control is relevant to the audit.

Q4. Does the auditor have to comply with all the ISAs when performing an audit of an SME?

The basic obligations in the ISAs are as follows:

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

"The auditor shall not represent compliance with ISAs in the auditor's report unless the auditor has complied with the requirements of this ISA [ISA 200] and all other ISAs relevant to the audit."

It is important to note, however, that not all of the ISAs may be relevant in every audit—that is, the circumstances in which an ISA applies may not exist in the engagement. Indeed, for an SME audit, several of the ISAs may not be relevant for this reason. For example, some of the ISAs that would not be relevant in an SME audit include:

- ISA 402, if the SME does not use a service organization.
- ISA 510, if the SME audit is a continuing, and not an initial, engagement.
- ISA 600, if the SME audit engagement is not a group audit.
- ISA 610, if the SME has no internal audit function.
- ISAs 800, 805, and 810 if the SME audit engagement is to report on general purpose financial statements.

Further, some ISAs, such as ISA 705 dealing with modifications to the auditor's opinion, may not be relevant in the circumstances.

The auditor need not be concerned with ISAs that are not relevant to the audit. Nevertheless, it is necessary that the auditor understands the scope of each ISA to determine whether it is relevant or not in the circumstances.

Q5. Does the auditor have to comply with all the requirements of every relevant ISA when performing an SME audit?

Even if an ISA is relevant, not all of its requirements may be relevant in the particular circumstances of an audit. If a requirement is conditional and the condition does not exist, it is not necessary for the auditor to comply with the requirement. Often, it is self-evident from the circumstances of the engagement whether a condition that determines the relevance of a conditional requirement exists. A few examples of requirements that need not be applied if the relevant conditions do not exist include:

- Holding an engagement team discussion as part of the risk assessment activities if it is only a one-person team.
- Performing the specified substantive and other follow-up procedures if the auditor has not identified previously unidentified or undisclosed related parties or significant related party transactions.

- Obtaining sufficient appropriate audit evidence to determine whether a material uncertainty exists if the auditor has not identified any event or condition that casts doubt on the entity's ability to continue as a going concern.

There is a specific documentation requirement in those exceptional circumstances where the auditor judges it necessary to depart from a specific requirement. This documentation requirement applies only to a requirement that is relevant in the circumstances. The ISAs do not call for compliance with a requirement that is not relevant in the circumstances.

Q6. How does audit documentation assist the auditor in an SME audit?

At the basic level, audit documentation in an SME audit assists the auditor in planning and performing the audit. It facilitates supervision and review of the work performed by assistants, and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Also, by providing a record of matters of continuing relevance that can be simply updated, documentation provides a head start to the following year's audit.

Of particular importance, however, is that audit documentation can help to enhance the quality of the audit in terms of the quality of the auditor's judgments. The soundness of decisions is often higher when the auditor takes the time to document the facts of a significant matter and the rationale for the auditor's conclusions; the logic and clarity in thinking are generally enhanced.

Audit documentation, therefore, assists the overall audit process while also providing a record that may assist audit oversight authorities and others when reviewing audit files.

Q7. How do the ISAs help guide the auditor in applying the documentation requirements in an efficient and effective manner?

Appropriate audit documentation need not be burdensome. ISAs do much to encourage the auditor to prepare meaningful audit documentation while fostering an effective and efficient approach to it.

Firstly, the documentation requirements in the ISAs, which set out what is expected of the auditor, are designed to result in sufficient and appropriate audit documentation of the basis for the auditor's report and evidence that the audit was planned and performed in accordance with the ISAs and applicable legal and regulatory requirements.

For this purpose, ISA 230 requires the auditor to prepare audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand specific matters. This sets the benchmark in guiding the auditor in determining the content and extent of the audit documentation.

In this context, ISA 230 requires the documentation to include significant matters that arose during the audit and the significant professional judgments the auditor made in reaching conclusions on those matters. The emphasis is on the significant matters and significant professional judgments. The ISA explains that an important factor in determining the form, content, and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results.

Secondly, the ISAs also recognize that it is unrealistic to expect every aspect of an audit to be documented. Accordingly, ISA 230 makes clear the following:

"… it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. … it is [also] unnecessary for the auditor to document separately … compliance with matters for which compliance is demonstrated by documents included within the audit file…. For example, the existence of an adequately documented audit plan demonstrates that the auditor has planned the audit."

Thirdly, the ISAs explicitly encourage the auditor to exercise professional judgment in determining the form and extent of documentation. They also acknowledge how the extent of audit documentation may vary depending on the circumstances. Examples, such as the following, are included in several places in ISA 230 and other ISAs:

- The manner in which specific requirements in ISA 315 are documented is for the auditor to determine using professional judgment.

- The form, content, and extent of documentation depend on various factors, including the size and complexity of the entity, and the audit methodology and technology used in the audit.

- The documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Documentation may be simple and relatively brief.

Finally, to further assist the auditor, the ISAs provide examples of how the documentation in an SME audit can be approached in an efficient and effective manner. For example, they suggest the following:

- It may be helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate.

- The documentation of the understanding of the entity may be incorporated in the auditor's documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented as part of the auditor's documentation of further procedures.

- It is not necessary to document the entirety of the auditor's understanding of the SME and matters related to it.

- A brief memorandum may serve as the documented audit strategy. At the completion of the audit, a brief memorandum could be developed and then updated to serve as the documented audit strategy for the following year's audit engagement.

SUMMARY OF DEVELOPMENTS

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

Accounting Standards Board (ASB)

Urgent Issues Task Force (UITF)

Financial Reporting Review Panel (FRRP)

Auditing Practices Board (APB)

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 issues Amendment to FRS 20 on Group Cash-settled Share-based Payment Transactions

The Accounting Standards Board has today published an amendment to FRS 20 (IFRS 2) 'Share-Based Payment – Group Cash-settled Share-based Payment Transactions'. The amendment clarifies both the scope of the standard and the accounting for group cash-settled share-based payment transactions in the separate or individual financial statements of the entity receiving the goods or services when that entity has no obligation to settle the share-based payments transaction.

The amendment corresponds to that issued by the International Accounting Standards Board (IASB) in June 2009 and maintains the equivalence between FRS 20 and IFRS 2. In line with the IASB withdrawing IFRIC 8 'Scope of IFRS 2' and IFRIC 11 'Group and Treasury Share Transactions', the ASB will withdraw UITF 41 'Scope of FRS 20' and UITF 44 'Group and Treasury Share Transactions'.

Entities are required to apply the amendments retrospectively for annual periods beginning on or after 1 January 2010.

28 August 2009

Findings of the FRRP in respect of the accounts of Brewin Dolphin Holdings Plc for the 52 week period ended 30 September 2007

The Financial Reporting Review Panel ("the Panel") has had under review the report and accounts of Brewin Dolphin Holdings (PLC) ("the company") for the 52 week period ended 30 September 2007.

The Panel's principal concern related to the company's practice of not separately recognising customer related intangible assets in the purchase of investment management businesses. IFRS 3 (2004) 'Business Combinations' requires an acquirer to recognise intangible assets separately if they meet the definition of an intangible asset in IAS 38 'Intangible Assets' and their fair value can be measured reliably.

In its Pre Closing Trading Update published today the company has announced that it will implement a change of accounting policy in the forthcoming financial statements of the company for the period ended 27 September 2009. Intangible assets representing client relationships will now be recognised separately from goodwill.

As a result, opening reserves at 1 October 2007 will be adjusted to reflect the accumulated amortisation that would have been recognised from the date of

transition to IFRS of 25 September 2004 to 30 September 2007. Net assets at 1 October 2007 will be reduced by £2.2m to £113.1m. In the 2009 financial statements, the comparative figures for 2008 will be amended to include a total amortisation charge on intangible assets of £4.2m.

The Panel notes the actions announced by the directors today and, on the basis that the required changes are made in the company's preliminary results and full published accounts for the financial year to 27 September 2009 regards its enquiry, which commenced on the 16 July 2008, as concluded.

01 October 2009

Protection for individuals making disclosures to the FRC

With effect from 1 October 2009, the FRC and three of its Operating Bodies, the Accountancy and Actuarial Discipline Board (AADB), the Financial Reporting Review Panel (FRRP), and the Professional Oversight Board (POB), have been added to the list of bodies to which employees can responsibly disclose information under the "whistle blowing" provisions of the Employment Rights Act (1996).

The Act protects workers from any detrimental treatment from their employer if, in the public interest, they make a disclosure of wrongdoing to specified bodies.

The Public Interest Disclosure (Prescribed Persons) (Amendment) Order 2009 means that individuals will now be protected if they make a qualifying disclosure in good faith to the FRC, the AADB, the FRRP and the POB – provided that they reasonably believe that the information disclosed is substantially true and that the wrongdoing falls within the scope of the FRC's responsibilities.

FRC Chief Executive, Paul Boyle, welcomed the extension of the Act to the FRC and said:

"The FRC's effectiveness is enhanced by its ability to keep in touch with developments in the markets. We welcome this new protection for individuals who make disclosures to us within the terms of the legislation and we hope that it will encourage those who have information which may be relevant to our regulatory responsibilities to contact us. "

01 October 2009

APB finalises changes to Ethical Standards dealing with partner rotation

There has been an extended debate in recent years about the appropriate period for the rotation of the audit engagement partner on listed company audits. In March 2009 the Auditing Practices Board (APB) issued a Consultation Paper which included a proposed change to ES 3 (Revised) 'Long association with the audit engagement' to allow audit committees to decide that this rotation period could be extended from five to seven years in certain circumstances.

The APB has today issued a final version of ES 3 (Revised) that applies for periods commencing on or after 15 December 2009. In addition to revisions associated with the rotation period for audit engagement partners, changes have also been made to ES 3 (Revised) in respect of the rotation period for engagement quality control reviewers and further guidance has been included on factors affecting the significance of the threat to independence where other partners and senior staff are in senior positions for a long period of time.

Richard Fleck, Chairman of APB commented:

"In March 2009 APB consulted on whether it would be appropriate to give the audit committee of listed companies the ability to agree an extension of the partner rotation period in certain circumstances. While there was broad support for this approach, it was clear from the responses from investors that they believed that any extension from five to seven years should occur only if the audit committee was satisfied, in limited circumstances, that the extension is necessary to safeguard audit quality. While judgement will be needed in determining whether an extension is in fact necessary to safeguard audit quality, the APB decided that it should emphasise in ES 3 that the extension should only be granted if, in addition, there would be clear disclosure in annual reports of the audit committee's decision and the reasons for it. The FRC's Audit Inspection Unit will review the reasoning recorded by audit firms where the partner rotation period has been extended and the associated disclosures that are provided to shareholders."

The March 2009 consultation paper also included proposed changes to the APB Ethical Standards for Auditors (ESs) on a number of other topics including:

- remuneration and evaluation policies for key partners involved in the audit,
- the provision of non-audit services relating to securitisation and restructuring services, and
- the definition of an audited entity's 'affiliate'.

The APB has today issued a consultation paper in response to the Treasury Select Committee's recommendation that the provision of non-audit services by auditors to the entities that they audit be revisited, as set out in their report 'Banking Crisis: reforming corporate governance and pay in the City'. As a number of the topics addressed in the APB's March 2009 Consultation Paper relate to non-audit services, and to avoid those implementation problems that arise from frequent changes to the ESs, the APB has decided to defer changes to the ESs, other than to ES 3

(Revised), until it has decided how to respond to comments received on its consultation on non-audit services.

The APB concluded that it was desirable to make changes to ES 3 (Revised) at this stage as uncertainty on partner rotation periods needed to be removed so that audit firms and audit committees can take decisions on individual partner rotation questions.

06 October 2009

APB issues a Consultation Paper on audit firms providing non-audit services to listed companies that they audit

In May 2009 the Treasury Select Committee published a report entitled ‘Banking Crisis: reforming corporate governance and pay in the City'. In this report the Committee called for the appropriateness of the provision of non-audit services by auditors to the entities that they audit to be revisited, saying: "We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity".

In response to the Treasury Select Committee's recommendation, the APB has today issued a Consultation Paper providing relevant background information and inviting views on this important issue.

The consultation paper does not address issues specific to individual non-audit services. For example, in the light of recent market developments, the APB is currently reviewing its existing Ethical Standards relating to audit firms jointly providing internal and external audit services and the FRC’s Audit Inspection Unit is considering the application in its ongoing monitoring work of APB’s current standards relevant to this issue.

Richard Fleck, Chairman of APB commented:

> "The question of whether restrictions should be placed on the non-audit services that auditors can provide to the entities they audit was a key issue at the time of the Enron debacle in 2002. Since then there have been a number of developments including greater involvement by audit committees in overseeing what non-audit services are provided, greater transparency on the fees paid for non-audit services and the issuance by the APB in 2004 of Ethical Standards for Auditors which prohibit a number of non-audit services from being provided in certain circumstances. The aim of the APB Consultation Paper is to seek views, especially from investors, on whether there is support for the Treasury Select Committee’s view that investor confidence and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company.”

06 October 2009

Findings of the Financial Reporting Review Panel in respect of the accounts of Robinson Webster (Holdings) Limited for the period ended 29 September 2007

The Financial Reporting Review Panel (“the Panel”) has had under review the report and accounts of Robinson Webster (Holdings) Limited (“the company”) for the period ended 29 September 2007. The auditors’ opinion on the accounts was qualified for disagreement in relation to non-compliance with FRS 20 ‘Share-based Payment’.

The Panel concluded that the company’s failure to recognise an expense for share–based payment in the profit and loss account, in respect of a share option scheme under which shares vested during the period, was not in accordance with that standard.

The directors have accepted the Panel’s conclusions and, in the financial statements for the 52 week period ended 27 September 2008 recently filed at Companies House, have corrected the error by way of a prior period adjustment. The Panel welcomes the corrective action taken by the directors and regards its enquiries into the company’s accounts for the period under review, initiated on 14 November 2008, as concluded.

Non compliance with FRS 20 by Robinson Webster (Holdings) Limited

The company disclosed in its 2007 accounts that no provision had been made for the value of share options granted during the period in accordance with FRS 20, as the directors were of the opinion that this would give a misleading view.

The share–based payment that should have been charged in the 2007 accounts in accordance with FRS 20 was not quantified at the time the accounts were issued, but has subsequently been determined by the Directors at £1,770,000. The impact of this charge would have been to reduce consolidated profit for the financial period from £1,234,000 to a loss of £536,000. The recognition of the share-based payment charge has no effect on either cash flow for the period or net assets at 29 September 2007.

As there was no vesting period under the relevant share option scheme the whole charge under FRS 20 fell to be recognised in profit and loss for the period to 29 September 2007. The scheme, therefore, has no impact on reported financial performance for the period ended 27 September 2008.

09 October 2009

APB issues updated Interim Guidance on Auditing Complex Financial Instruments

APB today issued an update of Practice Note (PN) 23 providing interim guidance for auditors on "Auditing Complex Financial Instruments." An exposure draft of the updated PN 23 was issued for consultation in October 2008.

The previous version of PN 23 was issued in April 2002 to provide guidance on auditing derivative financial instruments. Responses to the APB's consultation supported its view that it is helpful to widen the scope of PN 23 to cover other complex financial instruments, as well as derivatives, as many of the audit considerations are the same.

The APB has decided to issue this version of PN 23 as interim guidance because:

- Relevant accounting standards are under review and future changes may have implications for auditors; and

- The guidance in the updated PN 23 has been aligned with the APB's current International Standards on Auditing (ISAs) (UK and Ireland). However, for audits of entities with accounting periods ending on or after 15 December 2010 new ISAs (UK and Ireland) will be effective that reflect the 'Clarity ISAs' issued by the IAASB. One feature of the Clarity ISAs is that ISA 545 has been subsumed into a revised ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures." Conforming changes will be needed to this Practice Note when the new ISA (UK and Ireland) 540 applies.

Richard Fleck, Chairman of the APB, commented:

"The audit of some financial instruments can be challenging, especially when market conditions make fair values difficult to estimate. The APB hopes that the updated PN 23, which contains much new guidance, will assist auditors in addressing current considerations that are relevant in the audit of financial statements of entities that use complex financial instruments."

16 October 2009

ASB publishes Review of Narrative Reporting noting continuing challenges for companies

The Accounting Standards Board (ASB) has today issued 'Rising to the challenge', the report of its review of the narrative reporting of 50 UK listed companies in 2008 and 2009.

The review focused on:

- how companies are complying with the enhanced business review content requirements from the Companies Act 2006 (CA);
- effective communication and presentation of the required content; and
- areas that are leading to clutter in narrative reporting.

The review found that the best reporters continue to evolve their narrative reporting and also did well across a number of content areas. Overall, most companies provided good content in relation to their:

- financial performance and position;
- financial key performance indicators (KPIs); and
- articulation of strategy.

Ian Wright, the FRC's Director of Corporate Reporting noted that providing the reader with a good understanding of the business is critical:

"For many companies, although we understood what they sell, where they sell it and who they sell it to, generally they fell short of describing how all the pieces fit together – that is, the business model. Many of the strongest overall reports in the sample included a business model disclosure, which lead us to conclude that good business model disclosure can drive better disclosure in other areas."

However, some companies continue to struggle to meet some of the requirements, notably the communication of principal risks and non-financial KPIs.

Ian Mackintosh, Chairman of the ASB said:

"When reporting principal risks, 66% of the sample was technically compliant but in our view needed to make improvements to meet the spirit of the requirements. A number of companies resorted to simply providing descriptions of generic risks that could be easily cut-and-pasted into many other FTSE annual reports. Thirty-two percent of the sample did not disclose any non-financial KPIs, despite the CA requirement to do so where ‘necessary’ and ‘appropriate’."

In addition, the ASB found that companies are having difficulty with some of the new enhanced business review requirements:

- only 38% of companies provided discussion of trends and factors that was relevant and forward looking

- it was unclear whether 52% of the sample specifically addressed the requirement to discuss contractual and other arrangements ... for 12% it was clear they did not.

The review found that risk reporting and CSR sections contained the most clutter, which distracted from important information in these sections.

Ian Mackintosh said:

"Listing every conceivable risk just adds to clutter, one company had 33 risks and 8 companies had 20 or more. Some companies had risk sections that were 10 pages long."

Ian Wright said:

"Another common source of clutter relates to Corporate Social Responsibility (CSR) reporting. The annual report should principally address the specific needs of shareholders and lenders, although such reports may also be useful for other stakeholders. Many shareholders and lenders are increasingly interested in environmental and other social impacts, particularly where they have an impact on the long-term sustainability of the business. Thus companies should comment on CSR matters in their annual reports to the extent that they do impact long-term sustainability of the business. Detailed explanations of sustainability issues, in our view, are best dealt with in a separate report."

Some key points to assist companies in rising to the challenge of narrative reporting have been summarised in the following list of ‘Do’s and don’ts for companies’.

Narrative Reporting: 'Do's and don'ts for companies'

1. Do provide context for principal risks and uncertainties – are they increasing or decreasing…don't simply include generic descriptions of risks that could easily be cut and pasted into another company's report.

2. Do use tables to link principal risks to related actions to manage the risks…don't shrink the risk content down to fit the table, instead expand the table to fit the content.

3. When articulating strategy, do ensure that you describe 'what' your goals are and 'how' you plan to achieve them…don't make bland statements like 'our plan is to grow' with no further explanation.

4. Do use your KPIs to demonstrate progress against stated objectives and strategies…don't just tick the box by providing a KPI table that does not link to the rest of the narrative.

5. Do explain why CSR is important to the business…don't include information on employees, environment and social and community that is not important.

6. Do include non-financial KPIs to explain how the key drivers of the business are monitored…don't include peripheral measures such as number of employees just to tick a box.

7. Do provide a comprehensive explanation of your business model - how you make money incorporating discussion of processes, distribution methods and structure…don't limit this to discussion of just products and services or resort to the use of undefined technical jargon.

8. Do support your discussion of relevant industry trends with external evidence…don't be afraid to quantify the trends instead of relying on bland statements like 'the outlook for our industry is good'.

29 October 2009