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SSAP 20: FOREIGN CURRENCY TRANSLATION

(Lecture A289 – 17.52 minutes)

Introduction

In a period of volatility in the foreign exchange markets, file reviews are showing up some weaknesses in understanding of the requirements of SSAP 20. The purpose of these notes is to consider the basic requirements of SSAP 20 and to look at problem areas by way of examples.

Before starting on this topic, remember that FRS 23 "The effects of changes in foreign exchange rates" is one of that set of standards whose application depends on the entity's adoption of FRS 26. FRS 26 - and therefore the entire package of standards including FRS 23 - applies to all listed entities preparing their financial statements in accordance with UK requirements - including listed parent undertakings preparing individual financial statements in accordance with those requirements. Other entities are permitted to apply the entire package of standards from that date, although entities are not permitted to apply some of the standards in the package but not others.

Therefore, the typical unlisted entity will continue to apply SSAP 20.

SSAP 20 explains that a company may engage in foreign currency operations in two main ways:

(a) Firstly, it may enter directly into business transactions which are denominated in foreign currencies; the results of these transactions will need to be translated into the currency in which the company reports.

(b) Secondly, foreign operations may be conducted through a foreign enterprise which maintains its accounting records in a currency other than that of the investing company; in order to prepare consolidated financial statements it will be necessary to translate the complete financial statements of the foreign enterprise into the currency used for reporting purposes by the investing company.

In these notes we are only concerned with the first of these.

Foreign currency translation and the individual company

Initial recording

The result of each transaction should normally be translated into the company's local currency using the exchange rate in operation on the date on which the transaction occurred; however, if the rates do not fluctuate significantly, an average rate for a period may be used as an approximation. Where the transaction is to be settled at a contracted rate, that rate should be used; where a trading transaction is covered by a related or matching forward contract, the rate of exchange specified in that contract may be used.

A company's local currency is the currency of the primary economic environment in which it operates and generates net cash flows (see below).

Once non-monetary assets, e.g., plant, machinery and equity investments, have been translated and recorded they should be carried in the local currency. Subject to the provisions concerning the treatment of foreign equity investments financed by foreign currency borrowings, no subsequent translations of these assets will normally need to be made.

An exchange gain or loss will result during an accounting period if a business transaction is settled at an exchange rate which differs from that used when the transaction was initially recorded, or, where appropriate, that used at the last balance sheet date.

Exchange gains or losses arising on settled transactions in the context of an individual company's operations have already been reflected in cash flows, since a change in the exchange rate increases or decreases the local currency equivalent of amounts paid or received in cash settlement. Similarly, it is reasonably certain that exchange gains or losses on unsettled short-term monetary items will soon be reflected in cash flows. Therefore, it is normally appropriate, because of the cash flow effects, to recognise such gains and losses as part of the profit or loss for the year; they should be included in profit or loss from ordinary activities.

Example 1

A Ltd raises funds in the UK in sterling and invests these funds in holiday homes and apartments in Europe. Rental income is received in either Euros or Sterling when bookings are made by clients. Clients are responsible for their own travel arrangements. Local managing agents are used who will settle all local expenses in return for a commission on the rental income. They may also organise rentals locally in consultation with the UK company.

What is the company's local currency?

A company's local currency is defined in SSAP 20 as "the currency of the primary economic environment in which it operates and generates net cash flows". There is no further guidance in the SSAP in respect of this. Some guidance may be found in FRS 23. FRS 23 uses the term functional currency which in definition is similar to local currency in SSAP 20. It explains that the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. The following indicators will help to determine functional currency:

- Sales price - whether sales prices are determined principally by local competition or by exchange rate changes. Therefore in this example how does the company determine its rental price? If it is determined in relationship to the local competition this would indicate the euro for this indicator. If the company determines the price in sterling and then translates to euros using exchange rates this would indicate sterling. Given the current economic conditions how the company has considered the fluctuating and deteriorating sterling exchange rate may provide a useful indicator. For example if the sterling price has been increased to reflect the decrease in value then this would indicate that the principal price is the euro.
- Sales market indicators – does the entity have a significant market in a particular country, or countries in which one currency would apply. In this example the market is in countries that use the euro. So under this indicator the euro would be the local currency.
- Expense indicators - the denomination of the entity's costs (production labour, materials etc). In this example there is a mixture.
- Financing indicators – in which currency is finance obtained. In this case sterling.

It is a matter of judgment and how you weight the above indicators.

If the company decides the euro is the local currency then any transactions in sterling would be translated in accordance with the standard. The company would then present its financial statements in euros. Companies House will accept accounts in other currencies provided disclosure is made of the exchange rate used.

Can you change local currency?

Yes. The change can only be made if there is a change in circumstances. There would have to be a change in the indicators above. If, in the above example, the company raised its finance in euros then this would clearly indicate that the euro is the local currency. Therefore if the company had used sterling then it could change to the euro.

How do you change local currency?

The change is made prospectively. Therefore there is no retrospective adjustment. At the date of change the balance sheet is converted at the rate ruling. Therefore there is no gain or loss.

Example 2

Company year end 30/9/09, uses US$ as local currency. On 1/10/04 company purchases an excavator for £100,000 with a useful life of 10 years. Exchange rate was £1 = US$2.00. US dollar equivalent cost was $200,000. On 30/9/09 the net book value is US$100,000. The historic sterling book value is £50,000. On 1/10/09 company changes to sterling as the local currency. Exchange rate US$1.6/£1. The new carrying value is £62,500 (US$100,000 @1.6). This is the new carrying value rather than £50,000.

What is the date of the transaction?

Why might this be important? As indicated above, excluding those situations where there is a hedge, the initial recording is at the rate of exchange on the date of the transaction. There is no subsequent retranslation unless the transaction is unsettled at the balance sheet date.

Example 3

Company contracts to purchase goods from France, value €500,000. the spot rate when the goods are delivered is €1.10/£1. The goods are paid for one month later when the exchange rate is €1.03/£1

Initial recording			
	€	**Rate**	**£**
Purchases	500,000	1.10	454,545
Creditor	500,000	1.10	454,545
Settlement			
Payment	500,000	1.03	485,437
Exchange loss			30,891

The exchange loss would be taken to the profit and loss account. Therefore, as long as settlement takes place before the balance sheet date, the profit for the year takes into account the final settlement price and therefore, as regards overall profit, the rate for the initial translation is irrelevant. There may be an effect on the gross profit depending on where the exchange gains and losses are included in the profit and loss account. The standard offers no guidance on this aspect.

The above transaction is a trading transaction. What would happen if it was a fixed asset? In this instance the exchange loss would be taken to the profit and loss account and the asset would be recorded at initial recording with no subsequent adjustment. The asset would be depreciated over its useful life. In this situation, the rate for the original translation does have an impact on the reported profit and loss figures for the entire period of ownership of the asset.

If the exchange movements are not material over the period of the transaction the difference is not likely to be material. However, recent history has shown some very volatile markets with significant exchange rate movements over a short period of time.

Example 4

Company is to purchase a new printing press from Germany. The cost will be €1m. The terms are as follows:

Deposit on signing contract – 25%

Delivery – 8 weeks after signing contract – further payment 25%

Installation and testing – 4 weeks

Final payment – 8 weeks after installation

In this situation the exchange rate could vary considerably over the period. Therefore the date of the transaction could have a significant impact on the recording of the transaction and gains or losses arising. If a forward contract has been taken out to hedge the transaction the effect will be minimal, if not it could be significant. It is likely that companies involved in these transactions would hedge their exposure to movements on the currency market.

SSAP 20 contains no specific guidance on the transaction date. It could be:

- the date on which the contract for the purchase or sale was signed
- the date of delivery

- the date when the invoice is received
- the date of payment

It seems reasonable to assume that the date on which a transaction is recorded under normal accounting rules should be taken as the transaction date.

What happens if the company has hedged the transaction?

Extract from SSAP 20

> Where the transaction is to be settled at a contracted rate, that rate should be used. Where a trading transaction is covered by a related or matching forward contract, the rate of exchange specified in that contract may be used

Example 5a

Company contracts to purchase goods from France, value €500,000. The spot rate when the goods are delivered is €1.10/£1. The goods are paid for one month later when the exchange rate is €1.03/£1.

If the contract includes a contracted rate of €1.08/£ the accounting would be:

Initial recording			
	€	**Rate**	**£**
Purchases	500,000	1.08	462,963
Creditor	500,000	1.08	462,963
Settlement			
Payment	500,000	1.08	462,963
Exchange gain/loss			-

Notice that in this case, the spot rate is not relevant and so the calculations above would apply to the purchase of goods or of fixed assets.

Example 5b

Company contracts to purchase goods from France, value €500,000. The spot rate when the goods are delivered is €1.10/£1. The goods are paid for one month later when the exchange rate is €1.03/£1.

The only difference from example 5a is that this time the company purchase a forward contract at a rate of €1.05/£

The company has two alternatives:

Initial recording

	€	Rate	£
Purchases	500,000	1.10	454,545
Creditor	500,000	1.10	454,545
Settlement			
Payment	500,000	1.05	476,190
Exchange loss			21,645

Initial recording

	€	Rate	£
Purchases	500,000	1.05	476,190
Creditor	500,000	1.05	476,190
Settlement			
Payment	500,000	1.05	476,190
Exchange loss			-

Since the transaction involves a trading transaction there is no effect on the profit or loss for the period. There is no provision in SSAP 20 to use this method for the purchase of a fixed asset.

At the balance sheet date

At the balance sheet date monetary assets and liabilities denominated in a foreign currency, e.g., cash and bank balances, loans and amounts receivable and payable, should be translated by using the rate of exchange ruling at that date, or, where appropriate, the rates of exchange fixed under the terms of the relevant transactions. Where there are related or matching forward contracts in respect of trading transactions, the rates of exchange specified in those contracts may be used.

An exchange gain or loss will arise on unsettled transactions if the rate of exchange used at the balance sheet date differs from that used previously.

Example 6

A company purchases goods from the US, value US$500,000. The spot rate at the date of the transaction is US$1.65/£. At the balance sheet date the transaction has not been settled, the spot rate is US$1.6/£. The transaction is settled at US$1.55/£.

Initial recording

	US$	Rate	£
Purchases	500,000	1.65	303,030
Creditor	500,000	1.65	303,030

Balance sheet date

		Rate	£
Creditor	500,000	1.60	312,500
Exchange loss			9,470

Settlement

Payment	500,000	1.55	322,581
Exchange loss			10,081

If the company has a forward currency contract then the translation is made at that rate. As before the company may have an option as to which approach to adopt.

Example 7

Company makes extensive purchases from the US. All transactions are denominated in US$. To settle these transactions the company operates a US$ bank account which has an overdraft facility. Creditors are settled from the US$ account when due. The company has entered into numerous forward currency contracts which are used to top up the US$ account. At the balance sheet date there are sufficient forward currency contracts to cover the overdraft on the US$ bank account. Should the company use the spot rate at the balance sheet date, or that contained in the forward contracts? Is the US$ bank account a trading transaction?

On 30/6/09 a company purchases stock for $300,000, year end is 30/9/09, payment will be made on 31/12/09. It also takes out a matching forward contract to purchase $300,000 on 31/12/09 at a rate of US$1.7/£. The exchange rate at 30/6/09 is 1.6, and at 30/09/09 it is 1.8.

Any of the following methods is acceptable:

Rates	
Transaction date	1.60
Balance sheet date	1.80
Contract rate	1.70

Option 1

Initial recording	**US$**	**Rate**	**£**
Stock	300,000	1.60	187,500
Creditor	300,000	1.60	187,500
Balance sheet date			
Creditor	300,000	1.80	166,667
Exchange (gain)/loss		-	20,833
Settlement			
Payment	300,000	1.70	176,471
Exchange (gain)/loss			9,804

Option 2

Initial recording	**US$**	**Rate**	**£**
Stock	300,000	1.60	187,500
Creditor	300,000	1.60	187,500
Balance sheet date			
Creditor	300,000	1.70	176,471
Exchange (gain)/loss		-	11,029
Settlement			
Payment	300,000	1.70	176,471
Exchange (gain)/loss			-

Option 3

Initial recording	**US$**	**Rate**	**£**
Stock	300,000	1.70	176,471
Creditor	300,000	1.70	176,471
Balance sheet date			
Creditor	300,000	1.80	166,667
Exchange (gain)/loss		-	9,804
Settlement			
Payment	300,000	1.70	176,471
Exchange (gain)/loss			9,804

Option 4

Initial recording	**US$**	**Rate**	**£**
Stock	300,000	1.70	176,471
Creditor	300,000	1.70	176,471
Balance sheet date			
Creditor	300,000	1.70	176,471
Exchange (gain)/loss			-
Settlement			
Payment	300,000	1.70	176,471
Exchange (gain)/loss			-

These could be classified as:

1. Recorded throughout at actual
2. Initially recorded at actual, retranslated at contract rate
3. Initially recorded at contract rate, retranslated at actual
4. Recorded throughout at contract rate.

The calculation, and recording, of profits and losses on exchange on short-term monetary items is not usually contentious. The closing rate is assumed to be a reasonable estimate of the amount to be paid or received, and treated accordingly.

Currency options

SSAP 20 does not include any reference to currency options. A currency option is the right (but not the obligation) to sell or acquire a specified amount of currency at a given rate at a given time or during a given period. An amount referred to as the premium is paid up-front. This is not refundable.

As with the situation of a forward contract, there is a choice for the accounting treatment. **Either** the impact of the option on the underlying contract is ignored and the premium is treated as an asset in its own right, **or** the option rate can be used as the rate at which the transaction will be settled. The former method could also be used if the company purchased the option on a speculative basis.

If it is used as the settlement rate then the premium would be taken into the gain or loss on the contract. If the option was unlikely to be exercised then the premium would be written off and the translation would be performed using the spot rate at the balance sheet date.

What is a monetary asset or liability?

Unless the item is an equity investment financed by foreign earnings, non monetary assets or liabilities are not re-translated at the balance sheet date.

Monetary items are money held and amounts to be received or paid in money and, where a company is not an exempt company, should be categorised as either short-term or long-term. Short-term monetary items are those which fall due within one year of the balance sheet date.

In most instances it is obvious as to whether the item is monetary or not. However, the following have been raised as questions in the past.

A company has purchased gold in US$ as an investment. The transactions were settled in sterling at the rate ruling when the transaction took place. The directors consider this to be a monetary asset, are they correct?

A company has purchased redeemable cumulative preference shares in a company in the United States. Should these be considered as monetary or non monetary? If the shares were not redeemable nor cumulative would this make any difference?

Long term monetary items

When dealing with long-term monetary items, additional considerations apply. Although it is not easy to predict what the exchange rate will be when a long-term liability or asset matures, it is necessary, when stating the liability or the asset in terms of the reporting currency, to make the best estimate possible in the light of the information available at the time; generally speaking translation at the year-end rate will provide the best estimate, particularly when the currency concerned is freely dealt in on the spot and forward exchange markets.

The special case of equity investments financed by foreign borrowings

Under the procedures set out in this statement, exchange gains or losses on foreign currency borrowings taken up by an investing company or foreign enterprise would normally be reported as part of that company's profit or loss from ordinary activities and would flow through into the consolidated profit and loss account.

Where an individual company has used borrowings in currencies other than its own to finance foreign equity investments, or where the purpose of such borrowings is to provide a hedge against the exchange risk associated with existing equity investments, the company may be covered in economic terms against any movement in exchange rates. It would be inappropriate in such cases to record an accounting profit or loss when exchange rates change.

Therefore, provided the conditions apply, the company may denominate its foreign equity investments in the appropriate foreign currencies and translate the carrying amounts at the end of each accounting period at the closing rates of exchange. Where investments are treated in this way, any resulting exchange differences should be taken direct to reserves and the exchange gains or losses on the borrowings should then be offset, as a reserve movement, against these exchange differences. The conditions which must apply are as follows:

(a) In any accounting period, exchange gains or losses arising on the borrowings may be offset only to the extent of exchange differences arising on the equity investments;

(b) the foreign currency borrowings, whose exchange gains or losses are used in the offset process, should not exceed, in the aggregate, the total amount of cash that the investments are expected to be able to generate, whether from profits or otherwise; and

(c) The accounting treatment adopted should be applied consistently from period to period

ISSUES ARISING IN GROUP ACCOUNTS

(Lecture A290 – 27.50 minutes)

Introduction

As a result of Companies Act 2006, parent companies of medium-sized groups are no longer exempt from the requirement to prepare consolidated accounts. This may be the first time that the directors of such companies have had to prepare group accounts. Even some accountants may well be rusty on the issues involved. Therefore, we have decided to include in these update notes a section covering some of the problem areas which arise concerning group accounts.

We start by looking at extracts from the standards FRS 7 and FRS 10 and then move on to look at practical problem areas.

Extracts from FRS 7: Definition and measurement of goodwill

Definition of goodwill

Goodwill is defined by FRS 10 as the difference between the cost of a business as a whole and the aggregate of the fair values of its identifiable assets and liabilities.
FRS 7, fair values in acquisition accounting, refers to positive or negative goodwill as the difference between:

- the cost of acquisition
- fair values of identifiable assets and liabilities acquired

Cost of acquisition

The cost of acquisition should consist of:

(a) Amount of cash paid

(b) The fair value of other purchase consideration

(c) Expenses of acquisition

If the consideration includes an element which is contingent on one or more future events, such as profit performance the cost of acquisition should include the fair value of amounts expected to be payable in the future. Cost of acquisition may therefore be subject to subsequent revision.

Determining the cost of acquisition

> 26 The cost of acquisition is the amount of cash paid and the fair value of other purchase consideration given by the acquirer, together with the expenses of the acquisition as described in paragraph 28. Where a subsidiary undertaking is acquired in stages, the cost of acquisition is the total of the costs of the interests acquired, determined as at the date of each transaction.
>
> 27 Where the amount of purchase consideration is contingent on one or more future events, the cost of acquisition should include a reasonable estimate of the fair value of amounts expected to be payable in the future. The cost of acquisition should be adjusted when revised estimates are made, with consequential corresponding adjustments continuing to be made to goodwill until the ultimate amount is known.
>
> 28 Fees and similar incremental costs incurred directly in making an acquisition should, except for the issue costs of shares or other securities that are required by FRS 25 'Financial Instruments: Disclosure and Presentation' to be accounted for as a reduction in the proceeds of a capital instrument, be included in the cost of acquisition. Internal costs, and other expenses that cannot be directly attributed to the acquisition, should be charged to the profit and loss account.

Extracts from FRS 10 – Recognition of goodwill and intangible assets

Internally Generated Goodwill

Internally generated goodwill should not be capitalised. This is consistent with the Companies Act 2006 which states that 'Amounts representing goodwill shall only be included to the extent that the goodwill was acquired for valuable consideration'.

Purchased Goodwill

FRS 10 requires positive purchased goodwill to be capitalised, and included on the balance sheet under intangible fixed assets. Negative goodwill, referred to below, must also be included in the fixed asset section of the balance sheet.

Intangible Assets

FRS 10 applies to all intangible assets, except for:

- oil and gas exploration and development costs
- research and development costs
- any other intangible assets that are specifically addressed by another accounting standard.

Where an intangible asset is purchased separately from a business, it should be capitalised at cost.

An intangible acquired as part of a business acquisition should be capitalised separately from goodwill provided its value can be measured reliably on initial recognition.

Initially, it should be recorded at fair value. Except where an asset has a readily ascertainable market value (as defined in FRS 10), the fair value figure is limited. The cap on fair value is that it is restricted to an amount that does not create or increase any negative goodwill arising on the acquisition.

If its value cannot be measured reliably, the intangible should be included within the part of the purchase price allocated to purchased goodwill.

An internally developed intangible may be capitalised only if it has a readily ascertainable market value.

Extracts from FRS 10 – Amortisation

The key point is whether or not positive goodwill and intangibles are regarded as having limited useful economic lives:

(a) if they are, they should be amortised on a systematic basis over those lives

(b) if, however, they are regarded as having indefinite useful economic lives, they should not be amortised.

Where purchased goodwill is capitalised, the Companies Act requires systematic amortisation over a finite period. Should a company adopt (b) and depart from the statutory requirement, it will be necessary to invoke the true and fair over-ride and provide the disclosures required by CA 2006 and UITF 7/FRS 18.

Determining useful economic lives

The general presumption, capable of being rebutted, is that useful lives should be limited to 20 years or less. Some companies may wish to rebut this presumption and argue that:

(a) useful economic life exceeds 20 years – for example, 40 years, or

(b) useful economic life is indefinite.

To overturn the general presumption of a maximum write-off period of 20 years, a company must satisfy two conditions:

Condition 1 - the durability of the acquired business or intangible asset can be demonstrated and justifies estimating the useful economic life to exceed 20 years

Condition 2 - the goodwill or intangible asset is capable of continued measurement (so that annual impairment reviews will be feasible).

Determining useful lives - further comments

A `standard write-off period of 20 years cannot be adopted simply on the grounds that the useful economic life of purchased goodwill or an intangible is uncertain. If the useful life is expected to be less than 20 years, an estimate should be made. Uncertainty does not justify choosing an unrealistically short life. Some companies may initially be attracted by the possibility of a write-off period in excess of 20 years (for example, 40 years) or even an indefinite period, resulting in nil amortisation. Condition 2 above refers to '……..capable of continued measurement...'

However, paragraph 23 of the Standard states that goodwill and intangible assets will not be capable of continued measurement if the cost of such measurement is viewed as being unjustifiably high, and gives the following as examples where this may be so:

- where acquired businesses are merged with existing businesses to such an extent that the goodwill associated with the acquired businesses cannot readily be tracked thereafter
- where the management information systems used by the entity cannot identify and allocate cash flows at a detailed income-generating unit level
- where the amounts involved are not sufficiently material to justify undertaking the detailed procedures of annual impairment reviews.

The expectation is that very few companies will be able to justify amortisation periods in excess of 20 years. Most companies are likely to amortise over periods not exceeding 20 years.

Review of useful lives

Useful economic lives should be reviewed at the end of each period. Where revision is considered necessary, carrying value should be amortised over the revised remaining useful economic life. Stringent requirements must be satisfied wherever the effect of the revision is to increase the life to more than 20 years from the date of the acquisition.

Residual value

A residual value may be assigned to an intangible only if such residual value can be measured reliably. Note that no residual value may be assigned to purchased goodwill.

Amortisation method

The amortisation method should be chosen so as to reflect the expected pattern of depletion of the goodwill or the intangible asset. The straight line method should usually be chosen. An exception might be an intangible in the form of a license which entitles the holder to produce a finite quantity of a product where the amortisation could follow the pattern of production.

Impairment Reviews

Goodwill and intangible assets amortised over a period of 20 years or less

Goodwill and intangible assets that are amortised over a finite period not exceeding 20 years should be reviewed for impairment:

(a) at the end of the first full financial year following the acquisition - (referred to as `the first year review') and, where applicable,

(b) in other periods, if events or changes in circumstances indicate that the carrying values may not be recoverable.

The first year review

Where a first year review identifies an impairment, this could be due to:

- an overpayment
- an event that occurred between the acquisition and the first year review
- depletion between the acquisition date and the date of the first year review (where the amount exceeds the amortisation charge).

The Standard indicates that the impairment loss should be justified by reference to expected future cash flows. The Standard does not permit write-off of the entire goodwill balance at the time of the first year review simply because the company believes that the value of goodwill will not be capable of continued measurement in the future. FRS 10 states that `...it should be possible to perform the first year impairment review by updating investment appraisal calculations'.

The first year review may be performed in two stages:

(a) in all cases, identify any possible impairment by comparing post-acquisition performance in the first year with pre-acquisition forecasts used to support the purchase price

(b) in specified cases only, it will also be necessary to carry out a full impairment review in accordance with the requirements of the FRS on impairment of fixed assets and goodwill.

The cases specified in para 40(b) of FRS 10 are:

- where the initial review indicates that the post acquisition performance has failed to meet pre- acquisition expectations
- where any other previously unforeseen events/changes in circumstance indicate the carrying values may not be recoverable.

If the first year review does indicate the need for a write-down of the balance, the remaining carrying value should be amortised over a period not exceeding 20 years.

Goodwill and intangible assets amortised over a period exceeding 20 years or not amortised

Goodwill and intangibles that are amortised over a period exceeding 20 years from the date of acquisition or are not amortised should be reviewed for impairment at the end of each reporting period. Impairment reviews should be performed in accordance with the requirements of the FRS on impairment of fixed assets and goodwill.

FRS 10 offers the following guidance:

- after the first period, the reviews need only be updated
- updating procedures should be quick to perform provided expectations of future cash flows and discount rates have not changed significantly
- in some cases it may be possible to decide immediately that an income-generating unit is not impaired: the Standard refers to situations where there have been no adverse changes in the key assumptions or where previously there was substantial leeway between carrying value and value in use.

If an impairment loss is recognised, the revised carrying value (if being amortised), should be amortised over the current estimate of the remaining useful economic life.

Impairment of investment in parent company's accounts

If goodwill on consolidation is found to be impaired, it will be necessary to review for impairment the carrying amount of the investment in the parent company's accounts.

Negative Goodwill

Review of fair values

In all cases where an acquisition appears to give rise to negative goodwill:

- fair values of acquired assets should be tested for impairment
- fair values of acquired liabilities should be checked carefully for omission or understatement.

Disclosure on the balance sheet

Negative goodwill should be recognised on the balance sheet and separately disclosed. The required positioning is somewhat unusual - the negative goodwill should be disclosed in the asset section of the balance sheet, immediately below the goodwill heading. It should also be followed by a subtotal showing the net amount of the positive and negative goodwill.

Accounting treatment

Negative goodwill, of an amount not exceeding the fair values of the non-monetary assets acquired, should be recognised in the profit and loss accounts of the periods in which the non-monetary assets are recovered, whether through depreciation, or sale.

Any negative goodwill in excess of the fair values of the non-monetary assets acquired, should be recognised in the profit and loss accounts of the periods expected to benefit. This situation might arise, for example, where a small price is paid for a business in a net liability position.

The fair value exercise

Extracts from FRS 7

The identifiable assets and liabilities to be recognised should be those of the acquired entity that existed at the date of the acquisition. (Paragraph 5)

The recognised assets and liabilities should be measured at fair values that reflect the conditions at the date of the acquisition. (Paragraph 6)

Fair value is defined as the amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale.

Specific guidance provided in FRS 7

Tangible fixed assets

The fair value of a tangible fixed asset should be based on:

(a) market value, if assets similar in type and condition are bought and sold on an open market; or

(b) depreciated replacement cost, reflecting the acquired business's normal buying process and the sources of supply and prices available to it.

The fair value should not exceed the recoverable amount of the asset which is the greater of the net realisable value of an asset and, where appropriate, the value in use.

Paragraph 46 in the explanation section of FRS 7 adds the following advice:

"Both net realisable value and value in use at the time of the acquisition are unaffected by the acquirer's intentions for the future use of the asset. Net realisable value represents the amount for which the business would be able to sell the asset, whether or not such sale is intended. Similarly, the value in use of a fixed asset at the time of the acquisition depends, not on the intended use, but on the most profitable possible use of the asset."

Intangible assets

Where an intangible asset is recognised, its fair value should be based on its replacement cost, which is normally its estimated market value.

Stocks and work-in-progress

Stocks, including commodity stocks, that the acquired entity trades on a market in which it participates as both a buyer and a seller should be valued at current market prices.

Other stocks, and work-in-progress, should be valued at the lower of replacement cost and net realisable value. Replacement cost is for this purpose the cost at which the stocks would have been replaced by the acquired entity, reflecting its normal buying process and the sources of supply and prices available to it - that is, the current cost of bringing the stocks to their present location and condition.

Quoted investments

Quoted investments should be valued at market price, adjusted if necessary for unusual price fluctuations or for the size of the holding.

Monetary assets and liabilities

The fair value of monetary assets and liabilities, including accruals and provisions, should take into account the amounts expected to be received or paid and their timing. Fair value should be determined by reference to market prices, where available, by reference to the current price at which the business could acquire similar assets or enter into similar obligations, or by discounting to present value.

Contingencies

Contingent assets and liabilities should be measured at fair values where these can be determined. For this purpose reasonable estimates of the expected outcome may be used.

Business sold or held exclusively with a view to subsequent resale

Where an interest in a separate business of the acquired entity is sold as a single unit within approximately one year of the date of acquisition, the investment in that business should be treated as a single asset for the purposes of determining fair values. Its fair value should be based on the net proceeds of the sale, adjusted for the fair value of any assets or liabilities transferred into or out of the business, unless such adjusted net proceeds are demonstrably different from the fair value at the date of acquisition as a result of a post-acquisition event. This treatment should be applied to any business operation, whether a separate subsidiary undertaking or not, provided that its assets, liabilities, results of operations and activities are clearly distinguishable, physically, operationally and for financial reporting purposes, from the other assets, liabilities, results of operations and activities of the acquired entity.

Where the business has not been sold by the time of approval of the first financial statements after the date of acquisition, the fair value of the interest in the business should be based on the estimated net proceeds of the sale, provided:

(a) a purchaser has been identified or is being sought; and

(b) the disposal is reasonably expected to occur within approximately one year of the date of the acquisition.

The interest in the business or, if it is not a separate subsidiary undertaking, in the assets of the business, should be shown within current assets. When the sale price is subsequently determined, the original estimate of fair value should be adjusted to reflect the actual sale proceeds.

If the subsidiary undertaking or business operation is not, in fact, sold within approximately one year of the acquisition, it should be consolidated normally with fair values attributed to the individual assets and liabilities as at the date of acquisition, and corresponding adjustments to goodwill.

Pensions and other post-retirement benefits

The fair value of a deficiency or, to the extent that it can be recovered through reduced contributions or through refunds from the scheme, a surplus in a funded pension or other post-retirement benefits scheme, or accrued obligations in an unfunded scheme, should be recognised as a liability or an asset of the acquiring group. Changes in pension or other post-retirement arrangements following an acquisition should be accounted for as post-acquisition items and should be dealt with in accordance with the requirements of the standard concerned with pension costs.

Deferred taxation

Deferred tax on adjustments to record assets and liabilities at their fair values should be recognised in accordance with the requirements of FRS 19 Deferred Tax. Deferred tax assets that were not regarded as recoverable and hence were not recognised before the acquisition may, as a consequence of the acquisition, satisfy the recognition criteria of FRS 19. Assets of the acquired entity should be recognised in the fair value exercise. Those of the acquirer or other entities within the acquiring group should be recognised as a credit to the tax charge in the post-acquisition period.

Examples

Consider the following proposed fair value adjustments. As auditor, what would be your initial thoughts?

Example 1

Information with respect to acquired plant and machinery is as follows:

Net book value	£72,000
Depreciated replacement cost	£90,000
Net realisable value	£23,000

Client intends to dispose of the plant and machinery rather than to use it.

PROPOSAL: Fair value is £23,000

Example 2

Information with respect to an acquired loan is as follows:

Capital outstanding	£60,000
Unexpired term	3 years
Interest rate	14% (£8,400) per annum, annually in arrears.
Current interest rate	9% per annum, annually in arrears.

PROPOSAL: Fair value is $8{,}400/1.09 + 8{,}400/1.09^2 + 68{,}400/1.09^3$ = £67,594

Example 3

Information with respect to an acquired debtor is as follows:

Outstanding debtor	£40,000
Falling due	2 years time
Interest rate	Nil
Current interest rate	9% per annum, annually in arrears.

PROPOSAL: Fair value is £$40{,}000/1.09^2$ = £33,667

Example 4

Information with respect to an acquired contingent liability is as follows:

Contingent liability	£55,000
Contingency	Claim by ex-employee for wrongful dismissal
Current book value	Nil

Most likely outcome	Claim may be successful – possible not probable

PROPOSAL: Fair value is £55,000 (subject to the need for discounting)

Example 5

Information with respect to an acquired contingent asset is as follows:

Contingent asset	£125,000
Contingency	Claim against supplier for faulty goods
Current book value	Nil
Most likely outcome	Claim will be successful

PROPOSAL: Fair value is £125,000 (subject to the need for discounting)

Example 6

Information with respect to leasehold property is as follows:

a) The acquired company has a vacant leasehold property which it has been unable to sub-let. The company is committed to minimum lease payments of £30,000 per annum for five years from the date of the acquisition. No provision has currently been made.

PROPOSAL: Provide for the present value of the minimum lease payments

$30{,}000/1.09 + 30{,}000/1.09^2 + 30{,}000/1.09^3 + 30{,}000/1.09^4 + 30{,}000/1.09^5 =$ £116,690

b) The acquired company has an occupied leasehold property on which it is committed to minimum lease payments of £30,000 per annum for five years from the date of the acquisition. A current market rental is considered to be £25,000 per annum.

PROPOSAL: Provide for the present value of the minimum lease payments above the current market rental

$5{,}000/1.09 + 5{,}000/1.09^2 + 5{,}000/1.09^3 + 5{,}000/1.09^4 + 5{,}000/1.09^5 = £19{,}449$

Comments on examples

Example 1: Acquired plant and machinery

FRS 7 (paragraph 46) states:

Both net realisable value and value in use at the time of the acquisition are unaffected by the acquirer's intentions for the future use of the asset. Net realisable value represents the amount for which the business would be able to sell the asset, whether or not such sale is intended. Similarly, the value in use of a fixed asset at the time of the acquisition depends, not on the intended use, but on the most profitable possible use of the asset.

FRS 7 states that the fair value of a tangible fixed asset should be based on:

(a) market value, if assets similar in type and condition are bought and sold on an open market; or

(b) depreciated replacement cost, reflecting the acquired business's normal buying process and the sources of supply and prices available to it.

The fair value should not exceed the recoverable amount of the asset.

Therefore:

- If value in use is at least £90,000 then the fair value is £90,000.
- If value in use is between £23,000 and £90,000 then the fair value is equal to the value in use.
- If the value in use is £23,000 or less then the fair value is £23,000

Example 2: Acquired loan

CORRECT!

Subsequent accounting would be:

Year	B/F	Interest @ 9%	Cash	C/F
1	67,594	6,083	(8,400)	65,277
2	65,277	5,875	(8,400)	62,752
3	62,752	5,648	(68,400)	-

Example 3: Acquired debtor

CORRECT!

Subsequent accounting would be:

Year	B/F	Interest @ 9%	Cash	C/F
1	33,667	3,030	-	36,697
2	36,697	3,303	(40,000)	-

Example 4: Acquired contingent liability

INCORRECT!

FRS 12 applies – no provision is appropriate since it could result in post acquisition profit if the contingency fails to crystallise. If no provision is made it could result in a post acquisition loss but only because circumstances have changed in the post acquisition period.

Example 5: Acquired contingent asset:

CORRECT!

FRS 7 states:

The usual accounting practice, for example, of deferring recognition of contingent assets, does not apply, because the recognition of an acquired asset represents the expectation that the amounts expended on its acquisition will be recovered; it does not anticipate a future gain.

Example 6: Acquired leasehold property

a) PROBABLY CORRECT!

FRS 7 states:

Identifiable liabilities include items such as onerous contracts and commitments that existed at the time of acquisition, whether or not the corresponding obligations were recognised as liabilities in the financial statements of the acquired entity.

b) PROBABLY CORRECT!

However if liabilities are set up for operating leases at above market rental, then assets should be set up for any leases at below market rental.

Note that FRS 7 states:

The identifiable assets and liabilities may include items that were not previously recognised in the financial statements of the acquired entity. These include assets and liabilities that are not normally recognised in accounts where no acquisition is involved, because other accounting standards preclude their immediate recognition.

Hindsight provision

The standard also includes a `hindsight provision. Normally, the recognition and measurement of assets and liabilities acquired should be completed by the date of approval of the first set of accounts for the period after acquisition.

However, if it is not possible to complete the investigation for determining fair values, provisional valuations should be made. Any necessary adjustments will then be reflected in the set of accounts for the first full financial year following the acquisition.

Investigation period and goodwill adjustments

23 The recognition and measurement of assets and liabilities acquired should be completed, if possible, by the date on which the first post-acquisition financial statements of the acquirer are approved by the directors.

24 If it has not been possible to complete the investigation for determining fair values by the date on which the first post-acquisition financial statements are approved, provisional valuations should be made; these should be amended, if necessary, in the next financial statements with a corresponding adjustment to goodwill.

25 Any necessary adjustments to those provisional fair values and the corresponding adjustment to purchased goodwill should be incorporated in the financial statements for the first full financial year following the acquisition. Thereafter, any adjustments, except for the correction of fundamental errors, which should be accounted for as prior period adjustments, should be recognised as profits or losses when they are identified.

ISA (UK AND IRELAND) 200 OVERALL OBJECTIVES AND CONDUCT OF AN AUDIT

(Lecture A291 – 12.19 minutes)

Overall objectives of the auditor and definitions

In conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the ISAs (UK and Ireland), in accordance with the auditor's findings.

You will see reference above to the applicable financial reporting framework. The need to prepare auditing standards which can be used throughout the world leads to this rather inelegant form of words and you will see throughout the ISAs (UK and Ireland) references to "fair presentation" frameworks and "compliance" frameworks. This does not in any way change or diminish the requirement in UK GAAP for the financial statements to give a true and fair view and for the auditor to report on that basis.

The only definition which may be unusual to UK readers is the definition of "premise". This is the presumption that management and, where appropriate, those charged with governance, have acknowledged and understand their responsibilities that are fundamental to the conduct of an audit. That is, responsibility:

- For preparation of the financial statements
- For such internal control as they consider to be necessary;
- To provide the auditor with access to all information that is relevant to the preparation of the financial statements, any additional information that the auditor may request for the purpose of the audit, and unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

So important is the premise that the auditor is required by ISA (UK and Ireland) 210 to obtain the agreement of management and, where appropriate, those charged with governance that they acknowledge and understand that they have the responsibilities set out above as a precondition for accepting the audit engagement.

Requirements

Professional requirements

Paragraph 14 requires the auditor to comply with relevant ethical requirements. The Application Material in ISA (UK and Ireland) 200 requires compliance with the IFAC code. Auditors in the UK and Ireland are subject to ethical requirements from two sources: the APB Ethical Standards for Auditors concerning the integrity, objectivity and independence of the auditor, and the ethical pronouncements established by the auditor's relevant professional body. Compliance with the APB Ethical Standards for Auditors should automatically achieve compliance with the IFAC code since the ethical standards are amended regularly to reflect any new requirements introduced internationally.

Paragraphs 15 and 16 require the auditor in planning and performing an audit to exercise:

- Professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated; and
- Professional judgment.

Professional scepticism includes being alert to contradictory audit evidence; the possibility that documents may be unreliable; and conditions that may indicate possible fraud. Professional scepticism protects against the risk that the auditor might make inappropriate assumptions or overlook unusual circumstances.

The Application Material tells us that the auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. However, the auditor is required to consider the reliability of information to be used as audit evidence and to consider the need for additional procedures if there is a doubt about the reliability of information or indications of possible fraud.

The Application Material goes on to acknowledge the auditor can take into account past experience of the honesty and integrity of the client but this does not relieve the auditor of the need to maintain professional scepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. This will be achieved by compliance with the requirement in ISA (UK and Ireland) 230 to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

Obtaining reasonable assurance

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

It is in Paragraph 17 above that we get the simplest statement of what an audit involves. The Application Material in Paragraphs A 28 to A 52 give a fuller explanation of the basics of auditing including a discussion of the following matters:

- Sufficiency and appropriateness of audit evidence - whether sufficient appropriate audit evidence has been obtained is a matter of professional judgment.
- Audit risk - is a function of the risks of material misstatement and detection risk. Audit risk is defined as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Therefore the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not is not considered.
- Risks of material misstatement may exist at the overall financial statement level and the assertion level. Risks of material misstatement at the overall financial statement level may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud. They may derive in particular from a deficient control environment. For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
- The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.
- The auditor must assess risks of material misstatement at the assertion level. The auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.
- For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. The greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted

and, accordingly, the more persuasive the audit evidence required by the auditor.

- There are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. Therefore, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISAs (UK and Ireland). Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with ISAs (UK and Ireland).

These themes are developed in other ISAs including ISA (UK and Ireland) 300 which covers planning, ISA (UK and Ireland) 315 which deals with identifying and assessing risks of material misstatement and ISA (UK and Ireland) 330 which is called the auditor’s responses to assessed risks. These ISAs will be the subject of future courses.

Conduct of an audit in accordance with ISAs

Paragraph 18 is the most frequently quoted paragraph from the standard.

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

Close relative to this Paragraph is Paragraph 22.

22. Subject to paragraph 23, the auditor shall comply with each requirement of an ISA (UK and Ireland) unless, in the circumstances of the audit:

(a) The entire ISA (UK and Ireland) is not relevant; or

(b) The requirement is not relevant because it is conditional and the condition does not exist.

(Paragraph 23 permits the auditor, in exceptional circumstances, to depart from a relevant requirement in an ISA (UK and Ireland). In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. This situation is only expected to arise where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement.)

There are 474 requirement paragraphs in ISAs (UK and Ireland). This has led some to suggest that compliance with the clarity ISAs will require the completion of voluminous checklists. The IAASB and the APB are keen to play down such suggestions. The Application Material in ISA (UK and Ireland) 200 ends with the comment:

> “While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's

evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor."

I think it is reasonable to assume that this comment applies to requirements in the same way as it applies to objectives.

Paragraph 19 requires the auditor to have an understanding of the entire text of an ISA (UK and Ireland), including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

This paragraph places considerable training requirements on firms and individuals. Partners and staff involved in audit work should supplement their attendance at courses dealing with ISAs by private reading of the entire text of the documents.

The auditor's report should only state that the auditor complies with ISAs (UK and Ireland) if the auditor has complied with the requirements of all ISAs (UK and Ireland) relevant to the audit.

Whilst paragraph 22 above requires compliance with all of the requirements of ISAs (UK and Ireland), Paragraph 21 goes even further in requiring the auditor to use the objectives stated in relevant ISAs (UK and Ireland) to determine whether any additional audit procedures are necessary in order to achieve the objectives stated in the ISAs (UK and Ireland); and to evaluate whether sufficient appropriate audit evidence has been obtained.

Failure to achieve an objective in a relevant ISA (UK and Ireland), leads the auditor to evaluate whether the overall objectives can be achieved and whether there is a need to modify the auditor's opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with ISA (UK and Ireland) 230. (Paragraph 24)

Audit documentation that meets the requirements of ISA (UK and Ireland) 230 and the specific documentation requirements of other relevant ISAs (UK and Ireland) provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor.

So what?

In my opinion, the two biggest problems are the requirement in Paragraph 22 to comply with every requirement in ISAs (UK and Ireland) and the demand in Paragraph 19 for the auditor to have an understanding of the entire text of all ISAs (UK and Ireland) relevant to the audit.

Since ticking 474 boxes is not required, the only answer to both problems is to ensure that partners and staff are trained to a very high level of competence.

In their staff paper which summarises the main changes introduced by the clarity ISAs, the APB identify Paragraph 21 as being of great importance.

If you recall, this requires the auditor to use the objectives stated in relevant ISAs (UK and Ireland) to determine whether any additional audit procedures are necessary in order to achieve the objectives stated in the ISAs (UK and Ireland); and to evaluate whether sufficient appropriate audit evidence has been obtained.

Many audit systems are based heavily on lists of required procedures. It will be interesting to see how such systems are amended to reflect this new way of thinking. The response from the monitors from the professional bodies will also be eagerly anticipated.

ISA (UK AND IRELAND) 260 COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

(Lecture A292 – 13.51 minutes)

Introduction

This ISA (UK and Ireland) provides a framework for the two-way communication between auditors and those charged with governance. It also identifies some specific matters to be communicated to those charged with governance.

Additional matters to be communicated are identified in other ISAs (UK and Ireland). In addition, ISA (UK and Ireland) 265 establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to both management and those charged with governance.

Objectives and definitions

The objectives of the auditor are:

(a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;

(b) To obtain from those charged with governance information relevant to the audit;

(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and

(d) To promote effective two-way communication between the auditor and those charged with governance.

Those charged with governance - defined as the person(s) or organisation(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In the UK and Ireland, those charged with governance include the directors (executive and non-executive) of a company and the members of an audit committee where one exists. For other types of entity it usually includes equivalent persons such as the partners, proprietors, committee of management or trustees.

Management – defined as the person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. In the UK and Ireland, management will not normally include non-executive directors.

Requirements

Those charged with governance

Paragraph 11 requires the auditor to determine the appropriate person(s) within the entity's governance structure with whom to communicate.

If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, Paragraph 12 requires the auditor to determine whether it is necessary to communicate with the governing body.

If all of those charged with governance are involved in managing the entity, then if the matters noted in paragraph 16(c) below have been communicated to person(s) with management responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Paragraph 13)

Matters to be communicated

Paragraphs 14 to 17 require the auditor to communicate the following matters to those charged with governance

- The responsibilities of the auditor in relation to the financial statement audit – this includes that the auditor is responsible for forming and expressing an opinion on the financial statements and that the audit of the financial statements does not relieve management or those charged with governance of their responsibilities (Paragraph 14).

- An overview of the planned scope and timing of the audit (Paragraph 15).
- Significant findings from the audit (Paragraph 16) including

  (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

  (b) Significant difficulties, if any, encountered during the audit;

  (c) Unless all of those charged with governance are involved in managing the entity:

    (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

    (ii) Written representations the auditor is requesting; and

  (d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

- In the case of listed entities, statements concerning compliance with relevant ethical requirements. This includes fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. It also includes the safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level (Paragraph 17).

The requirements to communicate above are usually achieved as follows:

Paragraph 14 – by an engagement letter.

Paragraphs 15 and 17 – by an audit arrangements (planning) letter. It is not necessary to repeat matters included in the engagement letter and it is not necessary to repeat matters which are unchanged from previous periods – in this case the auditor would inform those charged with governance that there are no new matters to communicate. The audit arrangements letter may cover matters such as the application of materiality and the auditor’s approach to significant risks and internal controls. Care should be taken not to compromise the effectiveness of the audit by giving detailed information about the nature and timing of audit procedures.

Paragraph 16 – over the last few years, we have complied with this requirement by means of a letter of comment. This requirement arose as a result of a UK Plus – Paragraph 16-1 of ISA (UK and Ireland) 260 said that the auditor should communicate in writing the significant findings from the audit. It is acceptable under the clarity ISA to make the report orally – although the auditor would need to document that oral communication had taken place. See Paragraph 19 below.

The communication process

Paragraph 18 requires the auditor to communicate with those charged with governance the form, timing and expected general content of communications.

This would normally be done in the engagement letter or the audit arrangements letter.

Paragraphs 19 and 20 require written communication in two circumstances:

1. Regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Note that written communications need not include all matters that arose during the course of the audit.

2. Regarding auditor independence when required by paragraph 17.

There are some interesting UK Pluses in the Application Material.

- Firstly, there is the present tense statement that the auditor discusses issues clearly and unequivocally with those charged with governance so that the implications of those issues are likely to be fully comprehended by them.
- Secondly, the judgment of whether to communicate significant matters orally or in writing may be affected by the evaluation, required by paragraph 22 shown below, of whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit.
- Finally, the auditor may judge that, in order to achieve effective communication, a written communication should be issued even if its content is limited to explaining that there is nothing the auditor wishes to draw to the attention of those charged with governance.

Paragraph 21 requires the auditor to communicate on a timely basis.

The application Material is not specific on this subject containing comments like "The appropriate timing for communications will vary with the circumstances of the engagement" and "Communications regarding planning matters may often be made early in the audit engagement..."

More helpful is the suggestion that it may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly helpful is the advice to consider prompt oral communication of significant deficiencies in internal control that the auditor has identified prior to communicating these in writing as required by ISA (UK and Ireland) 265.

Paragraph 22 requires the auditor to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor is required to evaluate the effect, if any, on their assessment of risks and ability to obtain sufficient appropriate evidence.

This requirement existed as a bold print paragraph in the previous version of ISA (UK and Ireland) 260. It was in fact a UK Plus (Paragraph 17-2). Despite this, many firms have made no conspicuous attempt to comply. Reassuringly, the Application Material says that the auditor need not design specific procedures to support the evaluation of the two-way communication; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes.

In my view, auditors should address this requirement by a specific statement

Documentation

Finally, there is a clear requirement for documentation.

> 23. Where matters required by this ISA (UK and Ireland) to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

In addition, there are many other ISAs (UK and Ireland) that require communications with those charged with governance. The full list can be found in Appendix 1 to ISA (UK and Ireland) 260.

So what?

Compliance with ISA (UK and Ireland) 260 is a matter of setting up a robust methodology for dealing with audit assignments. We have had plenty of experience of the need to send a letter of comment since it was first introduced in SAS 610 in June 2001. Despite this, many firms are still weak at ensuring that the letter of comment is sent at the right time (or at all). On a different matter, I have never seen a confirmation on file that the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit.

In their staff paper which summarises the main changes introduced by the clarity ISAs, the APB says that the amendments bring ISA 260 closer to the previous ISA (UK and Ireland) effective 2005. This is because the international board have drawn on the pluses included in that document. However, despite this comment, the APB still draw out some important changes. The following matters were covered in substance in the guidance text in the old ISA (UK and Ireland) 260 but are now explicit requirements:

- The requirement, when applicable, for the auditor to explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
- Documenting matters communicated orally

And the following are new requirements:

- Communication of significant difficulties, if any, encountered during the audit;
- Communication of significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management (unless all of those charged with governance are involved in managing the entity).

ISA (UK AND IRELAND) 265 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

(Lecture A293 – 12.30 minutes)

Introduction

The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. ISA (UK and Ireland) 265 specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

Objective and Selected definitions

The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

A significant deficiency in internal control is defined as a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Issues that are likely to be particularly important in deciding whether deficiencies are significant are materiality and the risk of fraud.

Requirements

Paragraph 7 requires the auditor to determine whether deficiencies in internal control have been identified and Paragraph 8 requires the auditor to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

Significant deficiencies must be communicated in writing to those charged with governance on a timely basis. (Paragraph 9)

Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimise the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this ISA (UK and Ireland) requires.

The requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

There is now in Paragraph 10 a requirement to communicate to management at an appropriate level of responsibility on a timely basis. The auditor will report significant deficiencies in writing - unless it would be inappropriate to communicate directly to management in the circumstances. This report can anticipate the report to those charged with governance or it can follow it.

The auditor will also report other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. These deficiencies can be reported orally or in writing. In contrast with the guidance above, If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period.

Paragraph 11 tells us what should be included in the written communication of significant deficiencies in internal control:

(a) A description of the deficiencies and an explanation of their potential effects; and

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:

(i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

(ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Such a requirement is very reminiscent of the old-style “Management letter”!

So what?

ISA (UK and Ireland) 265 is a new standard and therefore it might be thought that all of the requirements are entirely new. However, Paragraph 11 of the 2005 version of ISA (UK and Ireland) 260 did contain a general catch-all requirement to communicate matters to those charged with governance and this included material weaknesses in internal control.

What we now have is a clear definition of “significant deficiencies” and requirements to report all significant deficiencies in writing to both those charged with governance and to management. In addition, there is the requirement to report other deficiencies to management – either orally or in writing.

Auditors of small companies should not be confused. Here, the directors will usually be involved in day-to-day management of the company and therefore all deficiencies (if worthy of mention) will be reported to the directors. In the charity, there is a clear demarcation between communication with the trustees and communication with management.

ISA (UK and Ireland) 265 is simply an extension of ISA (UK and Ireland) 260 and therefore the solution is to set up a robust methodology for reporting.

ISA (UK AND IRELAND) 540 AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES

(Lecture A294 – 14.32 minutes)

Introduction

Some financial statement items cannot be measured precisely, but can only be estimated. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias.

It might be thought that accounting estimates are only a problem for larger entities but this is not the case. Situations where accounting estimates may be required for entities of all sizes include:

- Provision for doubtful debts.
- Stock write-downs.
- Warranty obligations.
- Depreciation.
- Amounts recoverable on contracts.

A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Objective

ISA (UK and Ireland) 540 tells us that the objective of the auditor is to obtain sufficient appropriate audit evidence about whether:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate,

in the context of the applicable financial reporting framework.

Definitions

(a) Accounting estimate - An approximation of a monetary amount in the absence of a precise means of measurement.

(b) Auditor's point estimate or auditor's range - The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

(c) Estimation uncertainty - The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

(d) Management bias - A lack of neutrality by management in the preparation of information.

(e) Management's point estimate - The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

(f) Outcome of an accounting estimate - The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Requirements

Risk assessment

Paragraph 8 is concerned with the auditor’s knowledge of the business. This is required to include an understanding of the following:

1. The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Note that, in UK GAAP, FRS 18 requires estimation techniques to be selected so as to give a true and fair view and be consistent with accounting standards, UITF

abstracts and companies legislation. Disclosure is required of estimation techniques that are significant. In this context, significant means that the range of reasonable monetary estimates is so large that the use of a different amount within that range could materially affect the view shown by the financial statements. The description of a significant estimation technique will include details of those underlying assumptions to which the monetary amount is particularly sensitive.)

2. How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

3. How management makes the accounting estimates, and an understanding of the data on which they are based, including:

- The method, including where applicable the model, used in making the accounting estimate;
- Relevant controls;
- Whether management has used an expert;
- The assumptions underlying the accounting estimates;
- Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
- Whether and, if so, how management has assessed the effect of estimation uncertainty.

Paragraph 9 requires the auditor to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time.

It is to be expected that the outcome of accounting estimates will differ from the original estimates. This does not necessarily mean that the financial statements were misstated. The review will, however, provide information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process. It will also provide the auditor with information about estimation uncertainty and possible management bias.

ISA (UK and Ireland) 240 also requires a retrospective review of management judgments and assumptions related to significant accounting estimates. That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls.

The Application Material tells us that the auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

Paragraph 10 requires the auditor to evaluate the degree of estimation uncertainty associated with an accounting estimate. This will assist the auditor in identifying and assessing the risks of material misstatement.

The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as the extent to which judgement is required; the sensitivity of the estimate to changes in assumptions; the existence of recognised measurement techniques; and the availability of reliable data from external sources.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

Matters relevant to the assessment of the risks of material misstatement may also include the amount of the estimate; the difference between management's point estimate and the auditor’s estimate; whether management has used an expert in making the accounting estimate; and the outcome of the review of prior period accounting estimates.

Paragraph 11 requires the auditor to determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

This is likely to be the case if accounting estimates:

- are highly dependent upon judgment,
- are not calculated using recognised measurement techniques.
- performed in the past show a substantial difference between the original estimate and the actual outcome.

Note that the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty. In other words, an apparently immaterial estimate can contain a material misstatement.

Recall that, in the situation where the auditor assesses a risk to be significant, Paragraph 29 of ISA (UK and Ireland) 315 requires the auditor to obtain an understanding of the entity's controls, including control activities.

Response to risk

Bearing in mind the assessment of risk, the auditor is required by paragraph 12 to determine whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate. In addition, the auditor should determine whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

Paragraph 13 contains detailed requirements for audit procedures based on the risk assessment. The auditor is required to undertake one or more of the following, as appropriate in the circumstances:

- Determine whether events after the balance sheet date (and up to the date of the auditor's report) provide audit evidence regarding the accounting estimate. This method may be appropriate for matters such as the estimate of a provision for doubtful debts.
- Test the method used by management and the reliability of the data on which it is based. In doing so, the auditor must evaluate whether the method is appropriate in the circumstances and the assumptions are reasonable. This method may be appropriate if the method has been used consistently in the past and has been found to give a reasonable estimate of actual outcomes.
- Test the operating effectiveness of the controls together with appropriate substantive procedures. This method is likely to be effective if the accounting estimates are made frequently (eg for management accounting purposes) and therefore the estimate is derived from the routine processing of data by the entity's accounting system. Further, because of the repetitive nature of such estimates, there is a process to ensure management approval of the models used.
- Develop a point estimate or a range to evaluate management's point estimate. This method is likely to be used when an accounting estimate is not derived from the routine processing of data by the accounting system and the auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective. It may be that the auditor’s knowledge of the industry suggests the use of a model which has been used at other entities.

  When developing a point or range estimate, the auditor must obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. Further, if the auditor concludes that it is appropriate to use a range, the auditor must narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

Following on from the requirements in Paragraphs 12 and 13 above, Paragraph 14 requires the auditor to consider whether specialised skills or knowledge are required in order to obtain sufficient appropriate audit evidence concerning accounting estimates.

Response to significant risks

For accounting estimates that give rise to significant risks, Paragraph 15 requires the auditor to perform additional procedures by evaluating the following:

- How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

  The Application Material suggests that sensitivity analysis might be an appropriate technique for this purpose. This does not mean that such a technique is compulsory and the auditors of small entities may well be able to assist management by discussing estimation uncertainty with them`
- Whether the significant assumptions used by management are reasonable.

  An assumption is deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.
- Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

If, as a result of the evaluation described above concerning significant risks, the auditor concludes that management has not adequately addressed the effects of estimation uncertainty, Paragraph 16 requires the auditor to consider whether it is necessary to develop a range with which to evaluate the reasonableness of the accounting estimate.

Paragraph 17 requires the auditor to consider the applicable financial reporting framework and obtain sufficient appropriate evidence about whether accounting estimates (where risk is significant) have been properly recognised (or not) in the financial statements and whether they have been measured using an appropriate basis. For these same accounting estimates, Paragraph 20 requires the auditor to evaluate the adequacy of the disclosure of estimation uncertainty in the notes to the accounts

Conclusions and disclosures

The auditor must state a conclusion as to whether the accounting estimates in the financial statements are either reasonable or are misstated. (Paragraph 18)

A misstatement should be dealt with in accordance with ISA (UK and Ireland) 450 but the Application Material in ISA (UK and Ireland) 540 adds some helpful comments.

Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has used a range then the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A change in the method of making an accounting estimate may be seen as an indicator of possible management bias – see Paragraph 21 below.

Paragraph 19 deals with disclosures of accounting estimates in the accounts and requires the auditor to obtain sufficient appropriate audit evidence about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

Paragraph 21 requires the auditor to consider whether there are indicators of possible management bias. Such indicators do not necessarily mean that individual accounting estimates are misstated.

Management bias might be indicated if:

- Methods for making accounting estimates have changed.
- The assumptions used in making estimates are inconsistent with observable marketplace assumptions.
- Assumptions are being selected which give estimates favourable for management objectives.
- The auditor’s opinion of misstatements in estimates show a pattern of over- or under-optimism.

On a practical level, this suggests that the auditor might find it helpful to prepare a schedule which summarises all accounting estimates along with the auditor’s conclusion as to their reasonableness – both individually and in aggregate.

Paragraph 22 requires the auditor to obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Paragraphs A126 and A127 in ISA (UK and Ireland) 540 provide examples of the contents of representation letters.

There is a specific documentation requirement in Paragraph 23 which is reproduced in full below.

> 23. The auditor shall include in the audit documentation:
>
> (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
>
> (b) Indicators of possible management bias, if any.

Recall that, the absence of other specific requirements for documentation does not mean that there are no other documentation requirements. The auditor will, for example, need to evidence audit work performed on all material accounting estimates not just those that are significant.

So what?

In their research into the cost of adopting the new clarity ISAs, the APB stated that the two standards which would cause most extra expense were ISA (UK and Ireland) 540 and ISA (UK and Ireland) 550.

The list of changes in ISA (UK and Ireland) 540 provided in the APB’s staff paper repeats a large part of the standard covered above.

In my view, we need to address the following:

1. Notes in the permanent file (or section of the current file which deals with knowledge of the business) probably need to be expanded to meet the requirements of Paragraph 8. This will include the process used by management to identify the need for accounting estimates and the methods used to calculate estimates. The permanent file may also be a good place to record estimation uncertainty (Paragraph 10) and the existence of significant risks (Paragraph 11). The vital thing is that any risks identified are picked up when the audit is planned.

2. The need to address the outcome of prior-year estimates could again be dealt with in the permanent file – indeed this may be an appropriate place to record the history of such estimates (their amounts and outcome). However, it is probably more reliable to include the response to this requirement (Paragraph

9) in the current file. The auditor needs to be aware that it is necessary to consider these issues when auditing any accounting estimate.

3. Auditors have a choice of procedures (Paragraph 13). It is true to say that many firms do not give accounting estimates the attention they deserve. Staff are too willing to accept consistency with the prior year as an acceptable explanation.

4. It has been well-documented that some auditors are weak at identifying significant risks. Many accounting estimates will give rise to significant risks and this means that we need to obtain an understanding of the entity's controls, including control activities, over the accounting estimates. (Paragraphs 15 to 17)

5. As mentioned earlier, I think the auditor should prepare a schedule which lists all accounting estimates so that management bias can be considered both individually and in aggregate. (Paragraph 21)

ISA (UK AND IRELAND) 550 RELATED PARTIES

(Lecture A295 – 13.56 minutes)

Introduction

The nature of related party relationships and transactions may give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. This might be because of complexity, lack of information in the accounting system or because related party transactions may not be conducted at arm’s length.

The auditor will be concerned with the impact of related party relationships in two ways:

- Are disclosures in accordance with FRS 8 (IAS 21)?
- Are there any fraud risk indicators since fraud may be more easily committed through related parties?

The auditor needs to be alert for previously undisclosed related party relationships and to exercise professional scepticism throughout the audit.

Objectives

ISA (UK and Ireland) 550 tells us that the objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

(ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

a. Achieve fair presentation (for fair presentation frameworks); or

b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

Requirements

Paragraphs 12 to 17 require the auditor to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. This is seen as part of the risk assessment procedures and related activities required by ISA (UK and Ireland) 315 and ISA (UK and Ireland) 240.

Paragraph 12 requires the engagement team discussion to include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. The guidance material gives some assistance in this area.

It says that matters that may be addressed in the discussion among the engagement team include:

- The nature and extent of the entity's relationships and transactions with related parties.
- An emphasis on the importance of maintaining professional scepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor.
- The records or documents that may indicate the existence of related party relationships or transactions.
- The attitude of management and those charged with governance to the accounting for, and disclosure of related party relationships and transactions and the related risk of management override of relevant controls.

In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud.

Paragraph 13 requires the auditor to make inquiries of management concerning the identity of the entity's related parties; the nature of the relationships; and whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

There is a specific documentation requirement in Paragraph 28 for the auditor to include in the audit documentation the names of the identified related parties and the nature of the related party relationships. Recall that, the absence of other specific requirements for documentation does not mean that there are no other documentation requirements. The auditor will, for example, need to evidence that the discussion among the engagement team took place and dealt with the issues in Paragraph 12.

Paragraph 14 requires the auditor to obtain an understanding of the controls, if any, established by management in respect of related party relationships and transactions and their authorisation and approval including significant transactions and arrangements outside the normal course of business. A consideration of the control environment may be relevant in mitigating risks arising from related party relationships.

The Application Material points out that controls over related party relationships and transactions within some entities may be deficient or non-existent. In this case, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions.

Specific guidance is given for the audit of smaller entities where control activities are likely to be less formal. The regular involvement of an owner-manager may mitigate or increase risks arising from related party relationships. The auditor’s understanding of related party relationships and transactions, and any relevant controls will come from inquiry of management combined with other procedures, such as observation and inspection.

Paragraph 15 contains the requirement for the auditor to be alert!

It does however provide some assistance in this requirement by specifying when this state of alertness is required. Paragraph 15 is reproduced in full below.

> 15. During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.
>
> In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:
>
> (a) Bank and legal confirmations obtained as part of the auditor's procedures;
>
> (b) Minutes of meetings of shareholders and of those charged with governance; and
>
> (c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Where the auditor identifies significant transactions outside the entity's normal course of business, Paragraph 16 requires the auditor to inquire of management about the nature of these transactions; and whether related parties could be involved.

Paragraph 17 requires the auditor to share relevant information obtained about the entity's related parties with the other members of the engagement team.

Paragraph 18 includes the requirement that the auditor identifies and assesses the risks of material misstatement associated with related party relationships and transactions and determines whether any of those risks are significant risks. A significant related party transactions outside the entity's normal course of business is automatically treated as a significant risk.

Recall that Paragraph 29 of ISA (UK and Ireland) 315 contains the particular requirement when the auditor is faced with a significant risk that the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Fraud risk factors identified by the auditor when performing procedures in connection with related parties should be considered when identifying and assessing the risks of material misstatement due to fraud. (Paragraph 19)

When responding to risks associated with related party relationships and transactions, Paragraph 20 requires that the auditor's procedures include:

- Confirmation that previously unidentified related party relationships actually exist (Paragraph 21).
- Prompt communication of the relevant information to the other members of the engagement team.
- A request of management to identify all transactions with the newly identified related parties for the auditor's further evaluation.
- Inquiry of management as to why the entity's controls failed to identify or disclose the related party relationships or transactions.
- Performance of appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions.
- Reconsideration of the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and the performance of additional audit procedures as necessary.
- Evaluation of the implications for the audit if the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud) (Paragraph 22)

Paragraph 23 requires that the auditor's response to significant related party transactions outside the entity's normal course of business should include inspection of underlying contracts or agreements to evaluate whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. Further, are terms of the transactions consistent with management's explanations and are they appropriately accounted for and disclosed? The auditor should also obtain audit evidence that the transactions have been appropriately authorised and approved.

In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider matters such as the complexity of the transaction; whether the terms of trade are unusual; lack of logic; the involvement of previously unidentified related parties; unusual processing; or emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.

International Accounting Standards make the assumption that related party transactions are not usually at arm's length. Therefore, if appropriate, the accounts will contain explicit disclosure of management's assertion that a related party transaction was conducted on arm's length terms. In this case Paragraph 24 requires the auditor to obtain sufficient appropriate audit evidence about the assertion.

It might be thought that the above is irrelevant for the audit of those entities preparing their accounts using UK GAAP but this is not the case. FRS 8 requires additional disclosure where a related party transaction is **not** conducted on an arm's length basis. In these circumstances, failure to provide additional disclosure may be an implicit assertion that the transaction was conducted on arm's length terms.

Paragraph 25 requires the auditor to evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed.

Paragraph 26 requires the auditor to obtain written representations from management and, where appropriate, those charged with governance that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and that they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

An entity may require its management and those charged with governance to sign individual declarations in relation to related party matters. In other cases, the auditor may wish to obtain written representations directly from each of those charged with governance and from members of management.

Unless all of those charged with governance are involved in managing the entity, Paragraph 27 requires the auditor to communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

So what?

This is the other new clarity ISA where the APB expects the auditor's costs to increase considerably. The revised ISA is written on the risk based approach and, again, there are many new requirements.

To provide a quick checklist of the major issues might not be appropriate since the auditor must have an understanding of the entire text of the ISA (UK and Ireland). However, I see the following as the practical impacts:

1. The auditor needs to document an improved knowledge of the business identifying the names of the related parties and the nature of the relationship. (Paragraph 28) This must extend to an understanding of internal controls. (Paragraph 14)

2. The file needs to document that related parties were included in the engagement team discussion at the planning stage. (Paragraph 12)

3. Significant risks arising from related party relationships need to be considered and a response to risk documented. (Paragraph 18). This will include the response to the identification of related parties or significant related party transactions not previously disclosed to the auditor. (Paragraph 22). Similarly, the auditor needs to respond appropriately if significant related party transactions are identified which are outside the normal course of business. (Paragraph 23)

IT'S A RISKY BUSINESS

A QAD inspector made an interesting comment to me the other day. He said that, in his view, the risk over income in the majority of audit files should be recorded as 'high' risk. There are very few rebuttal arguments for income that do not involve systems and controls, he said, and hence for most audits the risk over income should be recorded as high. This made me think a little more deeply about risk and the approach that I see taken to risk on the majority of the audit files I review.

What do we mean by risk?

Auditing is about risk and response. The risk that is being assessed is the risk that the accounts will not give a true and fair view due to a material misstatement in the accounts caused by fraud or error that the auditor has failed to spot. While it is possible to have a generic assessment of risk it should be remembered that the risk being assessed is the risk for each client relative to that client's background and circumstances. This is not an external assessment of risk but an internal assessment of risk considering the internal factors that impact on the client's accounts.

For example cash income may be higher risk than credit/cheque income as a general risk assessment. However, for a specific client, the relative attractiveness of income, even if this income is credit/cheque based may be quite high when compared to the relative attractiveness of say expenditure for that client. In other words regardless of the type or format of the income it is likely to be at a higher risk of being manipulated when compared to expenditure. A fact that HMRC are well aware of in their approach to investigations!

The concept of risk and response has an impact on both cost and quality of an audit file. If the risk is assessed as high then I would expect the quality of the audit evidence to be very good and in general terms I would expect the audit team to spend more time on high risk areas. For a low risk area I would expect to see 'quick and dirty' audit evidence of a lower quality and generally I would expect the audit team to spend less time getting this evidence or to allocate the work to a lower grade member of staff. However a large number of audit files do not demonstrate this variation of work and so I often see files that have too much audit work on the low risk issues and not enough audit work on the high risk issues. This gives the worst of both worlds i.e. you have a file that is poor in quality and over budget!

On a lot of audit files the risk assessment has not been considered in sufficient detail and all the areas are recorded as low risk. There seems to be a perception amongst the audit teams that low risk is good and high risk is bad.

Income and Risk

So coming back to my QAD inspector does he have a point that the risk assessment for income should be high for most audit clients? The technical requirements for risk assessment and fraud are set out in ISA (UK and Ireland) 240 and I have used the paragraphs from the clarified version of this ISA.

Paragraph 26 from the requirements section of ISA (UK and Ireland) 240 says:

> When identifying and assessing the risk of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give risk to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.

Paragraph 47 referred to above says:

> If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall include in the audit documentation the reasons for that conclusion.

In other words you must put forward your rebuttal argument as part of the assessment of risk. It should be noted that comments such as 'The income is easy to record' is not a rebuttal argument to the presumption of risk. If you say that the systems are good this may change the risk assessment for the area overall but generates a requirement for you to carry out compliance testing to support this statement. Reliance on systems can be a response to an assessment of high inherent risk.

What paragraph 26 tells us is that we have an assumption of a risk of material misstatement and unless we have a rebuttal argument this risk should be assessed as high for all clients. There is another comment about risk that is relevant to the smaller audit. Paragraph 31 of ISA (UK and Ireland) 240 deals with audit procedures in a situation where the client's management can override the controls. The last sentence of this paragraph says ‘Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk’. This adds weight to the argument that for small audits the risk of fraud in revenue recognition should be shown as ‘High’ and should be identified as a significant risk at the planning stage.

Setting risk at the planning stage

The auditing standards require us to plan an audit so as to reduce audit risk to an acceptably low level. Audit risk is defined as:

Audit risk	⇨	The risk of a material misstatement due to fraud or error	X	The risk that we will not detect this risk with our audit testing

If we have a high risk of material misstatement then we must have appropriate audit testing to ensure that we stand a good chance of detecting the misstatement. In other words, this is the assessment of risk and the response to risk. The above equation mathematically would have High Risk X Low Risk giving us an acceptable estimate of audit risk overall.

The risk of a material misstatement is further defined as follows:

The risk of a material misstatement due to fraud and error	⇨	Inherent risk of misstatement in the area or assertion concerned	X	Control risk i.e. the risk that the client’s systems will not detect the misstatement or prevent any fraud

Thus when considering audit risk we need to consider the inherent risk of the area or assertion and the control risk. If the inherent risk is high but the control risk is low the overall risk may still be low but we would need to have some compliance testing on the audit file to justify the assessment that the systems are good and are effective (i.e. low risk). For small audits we often make the assumption that we are not going to rely on the systems and hence the level of risk of a misstatement is governed by the inherent risk assessment alone. This assessment must be made ignoring any systems or controls the client may have in place. On this basis for many clients we can conclude that income has a high inherent risk when compared to other areas within the accounts.

In the guidance section of ISA 240 (UK and Ireland) paragraph A30 has the following advice:

> The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

In other words the income can be reconciled to information outside of the accounting system. This would make the income less attractive for fraud as the correct level of income is easily identifiable and hence its inherent risk is low.

It is important that we understand the concept of inherent risk being assessed with no reference to controls. Consider the following analogy:

Question: I have an old rusty fridge that I put on the pavement outside my house. What is the risk that it will get stolen?

Answer: It is a low risk because the fridge is not attractive to the passing public

Question: I have a pile of £10 notes on the pavement outside my house. What is the risk that they will get stolen?

Answer: This is high risk because the £10 notes are attractive to the passing public.

Question: I now have a big security guard outside my house guarding the pile of £10 notes. What is the risk that those £10 notes will get stolen?

Answer: This is a low risk because the control risk is low (my security guard) the inherent risk is still high but the multiple of high x low gives an overall risk assessment of low. However I am now relying on the systems and hence from an audit viewpoint I would need to have some compliance testing to justify this reliance.

If we view income in this way then for most businesses the inherent risk associated with income is high and unless we are prepared to do the compliance testing we should recognise the fact that we have a high risk area and match this with appropriate audit work.

Is a high risk always bad for the audit budget?

The impact of setting a high risk level for any area of the audit is the requirement to produce good quality audit evidence. In practical terms this often means increasing the sample sizes as a response to the high risk.

However this is not an automatic response, we may consider that we can get suitable, good quality, audit evidence from other substantive work. For example we may be able to agree income on a detailed analytical review basis and it may be our opinion that the quality of this information is sufficient to justify the risk allocated to it.

Conclusion

We started this debate with the argument that the risk over revenue recognition is always high unless we have a rebuttal argument to the contrary. For many small audit clients we will not be able to put forward a suitable rebuttal argument and hence we should consider that the risk, or at least the inherent risk, is high. If we are prepared to rely on the systems and carry out some compliance testing then the risk of material misstatement may be low. However, many firms are not prepared to do this or the client's controls are not that good and reliance on them is not a feasible option.

The practical advice is as follows:

- Look at the risk assessment for income very carefully. If the risk is low does the file need a rebuttal argument or have you planned to carry out compliance testing to justify your reliance on the controls.
- Check that if you have a rebuttal argument it is not a response to the risk rather than an assessment of the inherent risk.
- Consider if other audit evidence such as good analytical review will give you the quality of audit evidence that is required.
- If the only audit evidence available is going to be substantive tests of detail then you have to accept that increased sample sizes may be the only adequate response.

SUMMARY OF DEVELOPMENTS

Lecture A288 (14.20 Minutes)

This section of the notes is mainly 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.

FRC advises caution on internal/external audit boundary

In the context of the consultation on non-audit services currently being undertaken by the Auditing Practices Board ('APB') and recent public comment concerning the additional services, described as internal audit services or extended assurance services, that some auditors provide in conjunction with an audit, the FRC has written to the larger audit firms to advise them of steps it intends to take to review current market practice.

Paul Boyle, Chief Executive of the FRC commented:

"The FRC believes it is important that audit firms and their clients should be aware of the steps being taken and may want to be cautious before entering into arrangements which stretch the internal/external audit boundary, not least because it could prove to be inconvenient and/or costly to change such arrangements should the outcome of the FRC's work be that the Ethical Standards are changed in a way that affects the provision of such services."

The FRC and APB intend to take the following steps:

I. The APB and the Audit Inspection Unit of the Professional Oversight Board ('POB') will work with the profession to understand the precise scope of those engagements that involve the provision of additional services in conjunction with an audit, including those described as extended assurance services;

II. Over the next three months, the APB will seek the views of stakeholders on the implications of auditors providing such services to their audit clients so that those views are available to it when considering the responses it gets to its Consultation Paper on non-audit services generally;

III. With the benefit of the information obtained the APB and the POB will determine whether such engagements, or similarly constructed packages of services, comply with the principles underlying the APB's current Ethical Standards; and

IV. In the light of the information obtained and the conclusions reached, the APB will consider whether the principles on which its Ethical Standards relating to such matters require reinforcement and, if so, in what way the provisions of its Ethical Standards need to be amended.

04 November 2009

FRC highlights current challenges for audit committees and users of actuarial information

The Financial Reporting Council (FRC), the United Kingdom's independent regulator responsible for promoting confidence in corporate reporting and governance, has published two documents highlighting the challenges being faced by audit committees and users of actuarial information arising from the difficult economic conditions.

The current economic outlook appears to be less depressed than this time last year. However, significant economic risks remain and will present challenges for many during the 2009/10 reporting season.

Past experience shows that insolvencies have increased after the technical end of recessions as companies run out of working capital. Such conditions mean that the next twelve months are likely to be particularly difficult for directors, trustees and management and increase the risk that annual reports and accounts misreport facts and circumstances and contain unidentified errors and omissions.

The current year questions for audit committees focus upon the risks that arise as companies change their business models to help manage through the effects of a significant recession. Such changes often involve modifying the terms of trade including arrangements with pension funds. The existence of such changes may call into question whether accounting policies remain appropriate, whether internal control systems capture all of the relevant data in a reliable way and whether assumptions used in models for accounting and actuarial purposes are appropriate in the circumstances.

The current year questions for users of actuarial information are particularly relevant to the governing bodies of insurers and pension schemes, but may also be useful for scheme sponsors, auditors and audit committees. The questions focus on the risks surrounding the business model, how those risks are managed, on understanding the key assumptions and cash flows underlying discounted values and on the quality controls on actuarial work.

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

“Many companies and pension schemes did sterling work last year to make sure that all material issues were captured properly and reported in an appropriate way in their financial reports. Whilst there are some positive economic signs we must be even more alert to the risk of error and omission at this time given the risk of a rise in insolvencies over the next few months”.

Louise Pryor, Director, Actuarial Standards of the FRC said:

“The last year has demonstrated how critical it is to understand risk and uncertainty when making significant and complex financial decisions. Trustees, directors and others who base their decisions on actuarial information need to be sure that they and their actuaries have a shared understanding of the relevant risks”.

14 November 2009

The Financial Reporting of Pensions: ASB issues Feedback and Redeliberations Report on Future Directions

The Accounting Standards Board (ASB) has today issued a report 'The Financial Reporting of Pensions: Feedback and Redeliberations'. The objective is to provide the International Accounting Standards Board (IASB) with recommendations on matters it might consider in developing a future financial reporting standard on pensions.

The report is a follow-up to the January 2008 Discussion Paper (DP) 'The Financial Reporting of Pensions'. It sets out the ASB's redeliberations and recommendations following the comments received during the consultation process. A total of 103 responses were received to the DP and the ASB has spent considerable time in reviewing the issues raised.

The report is being published under the Pro-active Accounting Activities in Europe (PAAinE) initiative by the ASB, the European Financial Reporting Advisory Group (EFRAG), the Accounting Standards Committee of Germany (ASCG) and the French Conseil National de la Comptabilité (CNC). The recommendations are, however, only those of the ASB. The other bodies consider the report a useful contribution to the debate on the financial reporting of pensions but do not express a view as to the recommendations.

The report has, in the main, affirmed the views set out in the DP, acknowledging that a number of them cover difficult issues and are controversial. In particular, on the measurement of liabilities, it has affirmed the view that the discount rate used should reflect the time value of money, and therefore should be a risk-free rate. The ASB has reiterated that it is not possible to make a reliable estimate of the risk arising from the size and variability of the liability to pay pension benefits. In its view users of financial statements are better served by disclosures regarding the risk rather than through adjustment of the underlying liability.

In addition there is an attempt to clarify the cash flows that should be used in measuring the liability to pay pensions.

The ASB has, however, decided not to affirm its view that the actual return on assets held to fund pension liabilities should be presented separately as financing income in the statement of comprehensive income. Whilst acknowledging the conceptual merits of this approach, it took into consideration the views of some respondents, including users of financial statements, who did not consider the approach useful. The ASB considers that further research is required in this area.

The report is being sent to the IASB today. Commenting on its publication, Ian Mackintosh, ASB chairman, said:

"When embarking on this project in October 2005 the aim of our research was to stimulate debate and assist in the further development of international financial reporting standards for pensions.

The quality and number of responses received to the discussion paper provide evidence that the discussion paper achieved its objective of stimulating debate on the financial reporting of pensions.

This report sets out the ASB's views following redeliberations and I believe provides the IASB with valuable material for consideration in its current short-term project and for the longer term fundamental review of the financial reporting of pensions."

20 November 2009

Completion of AIU Reporting Cycle and Publication of Overview Report

Public reports on individual firms

The Professional Oversight Board, part of the Financial Reporting Council, has today published reports on the Audit Inspection Unit's (AIU) inspections for 2008/9 of four audit firms:

Baker Tilly UK Audit LLP

BDO Stoy Hayward LLP

Deloitte LLP

Ernst & Young LLP

These reports, together with reports on the AIU's 2008/9 inspections of four other major firms published on 5 November 2009, are available on the Professional Oversight Board website at http://www.frc.org.uk/pob/audit/firmreports0809.cfm

The reports cover reviews of firm-wide procedures and individual audits conducted by the AIU from April 2008 to March 2009. The individual audits reviewed related primarily to financial years ending in December 2007 and March 2008.

Overview public report

The reports on individual audit firms should be read in conjunction with "2008/9 Audit Quality Inspections: An Overview", also published today. This report contains an overview of the findings from the AIU's inspection work in 2008/9 at the eight major firms subject to full-scope inspections and specific commentary on the findings of the AIU's inspection work in 2008/9 at ten other firms. In addition, it sets out the AIU's views on some of the key challenges facing auditors in the current economic environment. This report is also available on the website at http://www.frc.org.uk/pob/audit/reports.cfm

Commenting on the reports, Dame Barbara Mills, Chair of the Oversight Board said:

"The AIU's findings support the view that the overall quality of auditing of major public companies in the UK remains fundamentally sound. I am pleased to note in particular that individual audit teams have generally responded positively to the AIU's findings by taking appropriate action to address them in the next year's audit. However, we did find some areas for further improvement and I wish to emphasise the importance we attach to firms demonstrating a continued commitment to audit quality in the current economic environment, notwithstanding the increased commercial pressures they face."

The public reports identify a number of important issues in certain areas in relation to which further improvements need to be made by the audit firms. These include behaviour regarding non-audit services, the identification of significant risks and the assessment of going concern judgments. The firms' acceptance of the need to address appropriately the AIU's findings is key to the continued effectiveness of its work in safeguarding and enhancing audit quality in the UK. Firms need to analyse the underlying causes of weaknesses identified by the AIU to enable them to take action which is likely to result in the behavioural changes needed on the part of their audit partners and staff.

This is the second year that AIU reports on the findings of inspections of individual audit firms have been made publicly available. In addition, reports on individual audits reviewed by the AIU have been issued to each audit firm inspected which they are expected to make available to the directors of the audit clients concerned. These various reports resulting from the AIU's inspections form part of our programme to support the continuous improvement of audit quality in the UK.

07 December 2009

The Financial Reporting Review Panel announces priority sectors for 2010/11

The Financial Reporting Review Panel today announced that its review activity in 2010/11 will focus on the following sectors:

- Commercial property
- Advertising
- Recruitment
- Media
- Information technology

Banking, house-builders and travel and leisure have featured as priority sectors for the last two years. As companies enter the next stage of the recession where the outlook for corporate spending is uncertain, the Panel is turning its attention to sectors that rely heavily on discretionary spend and which might be stretched in the short term.

Advertising, media, recruitment and technology all featured in the Panel's priority list last year as deserving attention but this year they take centre stage.

Annual reports and accounts will continue to be selected from across the full range of companies within the Panel's remit and will also be selected for review on the basis of company specific factors and complaints.

Recent economic pressures on companies have led some to make changes to the way in which they do business, particularly where this helps them to manage their cash flow. These companies may need to take a fresh look at their accounting policies that impact on the measurement of earnings, such as revenue recognition and the expensing of costs, to ensure that they remain appropriate. The reporting and accounting impact of changes to business models is likely to be a focus of the Panel's work for 2010/11.

Commenting on areas of reporting where this might be reflected, Bill Knight, Chairman of the Panel said:

"Companies who are seeing their business models develop to meet the challenges of the recession will need to reconsider their revenue recognition policies to ensure that they still reflect their business activities. The Panel will pay particular attention to the accounts of those companies which appear to apply aggressive policies compared with their peers."

09 December 2009

The APB issues new guidance to auditors in assessing companies' Corporate Governance and Going Concern Statements

The Auditing Practices Board (APB) of the FRC has today produced new guidance for auditors on their responsibilities in reviewing a listed company's statement as to whether the business is a going concern and in reviewing Corporate Governance Statements required by the FSA under its Disclosure and Transparency Rules.

Richard Fleck, Chairman of the APB and a director of the FRC said,

"The FRC issued new fuller guidance for directors on going concern earlier this year in response to the credit crisis. This new guidance for auditors clarifies their responsibilities in reviewing whether the directors' statements on going concern in their Annual Reports are consistent with the FRC guidance for directors."

The guidance is set out in Bulletin 2009/4

14 December 2009

The APB revised guidance on smaller entity audit documentation

The Auditing Practices Board (APB) of the FRC has today updated Practice Note 26 which provides guidance and illustrative examples on how the documentation requirements contained within ISAs (UK and Ireland) can be applied to smaller entity audits.

Richard Fleck, Chairman of APB commented:

"The APB received strong support from practitioners, training providers and standard setters in other countries for Practice Note 26 when it was first issued in 2007. This has now been updated to reflect the new ISAs (UK and Ireland) that apply to audits of accounting periods ending on or after 15 December 2010. I hope that the timely publication of this update will assist firms with their implementation of the new standards in 2010."

Practice Note 26 (Revised) may be downloaded from the Publications (Practice Notes) section of this website.

15 December 2009

FRC says improvements are needed in M&A accounting

Merger and Acquisition (M&A) activity is likely to grow as economic conditions improve. Companies have told the Financial Reporting Council (FRC) that M&A accounting is costly and difficult, yet investors say that the resulting information is not useful.

This FRC study of the quality of accounting and reporting on acquisitions suggests a possible reason for this is that the International Financial Reporting Standard (IFRS) on business combinations has been poorly applied by companies due to unfamiliarity with its requirements and the complexity of valuing intangible assets such as brands and customer relationships.

The study found that companies had provided insufficient or inconsistent information about material acquisitions in their audited accounts when compared to the rationale for these acquisitions and supporting explanations given in their business reviews.

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

“A step change is needed in the quality of the information about M&A transactions given in annual reports and accounts. Improvements should result, in part, from new fair value guidance and more practical experience of estimating fair values for intangible assets.

In addition, recent amendments to IFRS 3 ‘Business combinations’ mean that, in future, more intangibles will be recognised for accounting purposes. This may help ensure a greater degree of consistency between what is disclosed about acquisitions in the accounts and the rationale for acquisitions set out in business reviews.”

The FRC intends to conduct further interviews with investors and other stakeholders in 18 months time to assess whether the information about acquisitions in annual reports and accounts has improved in quality and proved to be useful. In addition, the FRC will work with companies to better understand whether the costs of compliance and the complexity of performing the asset valuations are increasing or reducing.

The FRC will publish the results of this work and will provide feedback to the International Accounting Standards Board as part of its planned post implementation review of IFRS 3 (revised).

07 January 2010

ASB issues Amendment to FRS 25 - Classification of Rights Issues

The Accounting Standards Board (ASB) has today issued an amendment to FRS 25 (IAS 32) Financial Instruments: Presentation 'Classification of Rights Issues'. The amendment requires a rights issue involving the exchange of a fixed number of an entity's own equity instruments for a fixed amount of cash denominated in a foreign currency to be classified as an equity instrument.

The amendment follows the issue of 'Classification of Rights Issues – Amendment to IAS 32' published by the International Accounting Standards Board (IASB) in October 2009.

The ASB published a Financial Reporting Exposure Draft (FRED) in November 2009 proposing parallel amendments to FRS 25. Respondents to the FRED were supportive of the ASB's proposals on the basis that the amendment ensures consistency with IAS 32 *Financial Instruments: Presentation*.

Entities are required to apply the amendment for annual periods beginning on or after 1 February 2010.

25 January 2010

The APB issues Guidance for Auditors on XBRL Tagging of Information in Audited Financial Statements

The Auditing Practices Board (APB) of the FRC has today issued guidance for auditors where financial statements have been tagged for XBRL purposes.

Richard Fleck, Chairman of the APB and a director of the FRC said,

> "XBRL tagging of UK statutory financial statements is required for tax purposes in 2011. This guidance provides background information on that requirement and on the application of APB's Ethical Standards for Auditors to non-audit services relating to XBRL tagging. Currently XBRL tagging is not within the scope of an audit performed under ISAs (UK and Ireland)."

The guidance is set out in Bulletin 2010/1 which may be downloaded free of charge from the Publications (Bulletins) section of this website.

01 February 2010

ISQC1 : Practical guidance for small and medium sized audit firms

The ACCA's practice monitoring staff have developed a useful new guide, "ISQC1: Practical guidance for small and medium sized audit firms" to help ACCA firms implement the requirements of ISQC1.

All firms are required to establish a system of quality controls designed to provide reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner(s) are appropriate in the circumstances.

ISQC1 requires that a firm's quality control systems should include policies and procedures addressing each of the following points:

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

The guidance includes the following features:

- Detailed supporting guidance for each of the above elements
- Example policies and procedures which the firms can tailor according to their needs
- Example forms and checklists, including:
    - Cold file review checklist (including practical tips for cold file reviews)
    - Independence and confidentiality statements
    - Acceptance and continuance forms
    - Registers of audit staff and audit clients

The guidance is specially written for small firms (and sole practitioners). Small firms often find ISQC1 difficult to document and implement and therefore should find the guidance particularly helpful.

It is free for all ACCA members. Simply log onto the ACCA's website, click on "My ACCA" and scroll down to the "downloads" section on the screen.