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Where should investments be included on the balance sheet?

Accounting requirements

There is no accounting standard in the UK covering investments. FRS 15 covering tangible fixed assets does not cover investments, as they are not within the definition of a tangible fixed asset. SSAP 19 covers investment properties only, not other types of investments.

Should investment be included as fixed or current?

Investments should be classified according to intentions, or by nature of investment. Fixed implies no intention or requirement to sell in the year following acquisition. It could also be implied for unlisted investments in that they do not have an active market and therefore are likely to be held for the long term.

Current would apply to those where there was an intention or requirement to sell.

An investment classified as a current asset could be reclassified as a fixed asset in the future if there was a change in the entity's intentions.

How should investments be classified?

The answer to this question depends on control and influence. Companies Act 2006 and Accounting Standards recognise the following types of investments:

- Subsidiary undertaking
- Joint venture
- Associate
- Participating interest
- Other

Subsidiary undertakings

Definition of subsidiary undertaking

FRS 2 Paragraph 14 (based on the definitions in CA 2006 S. 1162 and Sch. 7)

An undertaking is the parent undertaking of another undertaking (a subsidiary undertaking) if any of the following apply.

(a) It holds a majority of the voting rights in the undertaking.

(b) It is a member of the undertaking and has the right to appoint or remove directors holding a majority of the voting rights at meetings of the board on all, or substantially all, matters.

(c) It has the right to exercise a dominant influence over the undertaking:

(i) by virtue of provisions contained in the undertaking's memorandum or articles; or
(ii) by virtue of a control contract. The control contract must be in writing and be of a kind authorised by the memorandum or articles of the controlled undertaking. It must also be permitted by the law under which that undertaking is established.

(d) It is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking.

(e)(i) it has the power to exercise, or actually exercises, dominant influence or control over the undertaking; or

(ii) it and the undertaking are managed on a unified basis.

(f) A parent undertaking is also treated as the parent undertaking of the subsidiary undertakings of its subsidiary undertakings.

For the purpose of section 1161 [parent and subsidiary undertakings] an undertaking shall be treated as a member of another undertaking:

(i) if any of its subsidiary undertakings is a member of that undertaking; or

(ii) if any shares in that other undertaking are held by a person acting on behalf of the parent undertaking or any of its subsidiary undertakings.

Any shares held, or powers exercisable, by a subsidiary undertaking should be treated as held or exercisable by its parent undertaking.

FRS 2 Paragraph 7

> Dominant influence:- Influence that can be exercised to achieve the operating and financial policies desired by the holder of the influence, notwithstanding the rights or influence of any other party.
>
> (a) In the context of paragraph 14(c) (shown above) and section 1161(2)(c) the right to exercise a dominant influence means that the holder has a right to give directions with respect to the operating and financial policies of another undertaking with which its directors are obliged to comply, whether or not they are for the benefit of that undertaking.
>
> (b) The actual exercise of dominant influence is the exercise of an influence that achieves the result that the operating and financial policies of the undertaking influenced are set in accordance with the wishes of the holder of the influence and for the holder's benefit whether or not those wishes are explicit. The actual exercise of dominant influence is identified by its effect in practice rather than by the way in which it is exercised.
>
> (c) The power to exercise dominant influence is a power that, if exercised, would give rise to the actual exercise of dominant influence as defined in paragraph 7b.

Note that in FRS 2 Paragraph 14(e), there is no longer a need for the parent to hold a participating interest in the subsidiary.

Accounting for subsidiaries in group accounts

Where an entity has subsidiary undertakings then consolidated/group accounts must be prepared unless the parent company can obtain exemption. Exemption is available under S 398 (parent company subject to the small companies regime), S400/401 (vertical groups) and S 402 (company where none of the subsidiaries are required to be included in the consolidation).

All subsidiary undertakings are required to be included in the consolidated/group accounts unless they can be omitted under CA 2006 – See FRS 2 Paragraph 25:

> 25 The exclusions required by this paragraph are based on the exclusions permitted by section 405(3). A subsidiary undertaking should be excluded from consolidation where:
>
> (a) severe long-term restrictions substantially hinder the exercise of the rights of the parent undertaking over the assets or management of the subsidiary undertaking. The rights referred to are those by reason of which the parent undertaking is defined as such under section 1161 and in the absence of which it would not be the parent undertaking; or [FRS requires exclusion permitted by s405(3)(a)]
>
> (b) the interest in the subsidiary undertaking is held exclusively with a view to subsequent resale (as defined in paragraph 11) and the subsidiary undertaking has not previously been consolidated in group accounts prepared by the parent undertaking. [FRS restricts exclusion permitted by s405(3)(c)]

Notice that difference of activities is no longer an acceptable reason for exclusion of a subsidiary from consolidation.

Accounting for subsidiaries in individual accounts

In the parent company's individual balance sheet the investment in the subsidiary is accounted for as for any other investment, see below.

Associated undertakings

Definition of associate

FRS 9 paragraph 4

An associate is an entity (other than a subsidiary) in which another entity (the investor) has a participating interest and over whose operating and financial policies the investor exercises a significant influence.

Participating interest

An interest held in the shares of another entity on a long-term basis for the purpose of securing a contribution to the investor's activities by the exercise of control or influence arising from or related to that interest. The investor's interest must, therefore, be a beneficial one and the benefits expected to arise must be linked to the exercise of its significant influence over the investee's operating and financial policies. An interest in the shares of another entity includes an interest convertible into an interest in shares or an option to acquire shares.

Companies legislation provides that a holding of 20 per cent or more of the shares of an entity is to be presumed to be a participating interest unless the contrary is shown. The presumption is rebutted if the interest is either not long-term or not beneficial.

Exercise of significant influence

The investor is actively involved and is influential in the direction of its investee through its participation in policy decisions covering aspects of policy relevant to the investor, including decisions on strategic issues such as:

(a) the expansion or contraction of the business, participation in other entities or changes in products, markets and activities of its investee; and

(b) determining the balance between dividend and reinvestment.

Companies legislation provides that an entity holding 20 per cent or more of the voting rights in another entity should be presumed to exercise a significant influence over that other entity unless the contrary is shown. For the purpose of applying this presumption, the shares held by the parent and its subsidiaries in that entity should be aggregated. The presumption is rebutted if the investor does not fulfil the criteria for the exercise of significant influence set out above.

Accounting for associates in group accounts

Associates should be accounted for using the equity method of accounting if group accounts are prepared.

The equity method is defined in FRS 9 as a method of accounting that brings an investment into its investor's financial statements initially at its cost, identifying any goodwill arising. The carrying amount of the investment is adjusted in each period by the investor's share of the results of its investee less any amortisation or write-off for goodwill, the investor's share of any relevant gains or losses, and any other changes in the investee's net assets including distributions to its owners, for example by dividend. The investor's share of its investee's results is recognised in its profit and loss account. The investor's cash flow statement includes the cash flows between the investor and its investee, for example relating to dividends and loans.

Further information about the equity method is provided in Paragraphs 27 to 30 of FRS 9.

27 In the investor's consolidated profit and loss account the investor's share of its associates' operating results should be included immediately after group operating result (but after the investor's share of the results of its joint ventures, if any). Any amortisation or write-down of goodwill arising on acquiring the associates should be charged at this point and disclosed. The investor's share of any exceptional items included after operating profit (paragraph 20 of FRS 3) or of interest should be shown separately from the amounts for the group. At and below the level of profit before tax, the investor's share of the relevant amounts for associates should be included within the amounts for the group, although for items below this level, such as taxation, the amounts relating to associates should be disclosed. Where it is helpful to give an indication of the size of the business as a whole, a total combining the investor's share of its associates' turnover with group turnover may be shown as a memorandum item in the profit and loss account but the investor's share of its associates' turnover should be clearly distinguished from group turnover. Similarly, the segmental analysis of turnover and operating profit (if given) should clearly distinguish between that of the group and that of associates.

28 In the consolidated statement of total recognised gains and losses the investor's share of the total recognised gains and losses of its associates should be included, shown separately under each heading, if the amounts included are material, either in the statement or in a note that is referred to in the statement.

29 The investor's consolidated balance sheet should include as a fixed asset investment the investor's share of the net assets of its associates shown as a separate item. Goodwill arising on the investor's acquisition of its associates, less any amortisation or write-down, should be included in the carrying amount for the associates but should be disclosed separately.

30 The investor's consolidated cash flow statement should include dividends received from associates as a separate item between operating activities and returns on investments and servicing of finance. Any other cash flows between the investor and its associates should be included under the appropriate cash flow heading for the activity giving rise to the cash flow. None of the other cash flows of the associates should be included.

Accounting for associates in individual accounts

In the company's individual balance sheet the investment in the associate is accounted for as for any other investment, see below.

Joint ventures

Definition of joint venture

FRS 9 paragraph 4

A joint venture is an entity in which the reporting entity holds an interest on a long-term basis and is jointly controlled by the reporting entity and one or more other venturers under a contractual arrangement.

Joint control

A reporting entity jointly controls a venture with one or more other entities if none of the entities alone can control that entity but all together can do so and decisions on financial and operating policy essential to the activities, economic performance and financial position of that venture require each venturer's consent.

Accounting for joint ventures in group accounts

Joint ventures should be accounted for using the gross equity method of accounting. This is the same as the method used for associates except that:

- in the consolidated profit and loss account the investor's share of its joint ventures' turnover should also be shown - but not as part of group turnover. In the segmental analysis too, the investor's share of its joint ventures' turnover should be clearly distinguished from the turnover for the group itself.

- in the consolidated balance sheet the investor's share of the gross assets and liabilities underlying the net equity amount included for joint ventures should be shown in amplification of that net amount.

Note that CA 2006 allows proportional consolidation where the joint venture is neither a subsidiary nor a body corporate. This is not allowed by FRS 9.

Accounting for joint ventures in individual accounts

In the company's individual balance sheet the investment in the joint venture is accounted for as for any other investment, see below.

Joint arrangement that is not an entity (JANE)

Definition of JANE

FRS 9 Paragraph 4

Joint arrangement that is not an entity is a contractual arrangement under which the participants engage in joint activities that do not create an entity because it would not be carrying on a trade or business of its own. A contractual arrangement where all significant matters of operating and financial policy are predetermined does not create an entity because the policies are those of its participants, not of a separate entity.

Paragraphs 8 and 9 give further explanation as follows:

8 A reporting entity may enter a variety of commercial arrangements but not all of these result in the creation of entities. Even if the participants have a long-term interest and have joint control within an arrangement, that arrangement is not a joint venture as defined in the FRS unless it constitutes an entity. For a joint arrangement to amount to an entity, it must carry on a trade or business, meaning a trade or business of its own and not just part of its participants' trades or businesses. In its activities the joint arrangement must therefore have some independence (within the objectives set by the agreement governing the joint arrangement) to pursue its own commercial strategy in its buying and selling; it must either have access to the market in its own right for its main inputs and outputs or, at least, be able to obtain them from the participants or sell them to the participants on generally the same terms as are available in the market. The following indicate that the joint activities undertaken in a joint arrangement do not amount to its carrying on a trade or business of its own and therefore that the joint arrangement is not an entity:

(a) the participants derive their benefit from products or services taken in kind rather than by receiving a share in the results of trading; or

(b) each participant's share of the output or result of the joint activity is determined by its supply of key inputs to the process producing that output or result.

9 In practice, a joint arrangement will not be an entity if, rather than its activities amounting to its carrying on a trade or business of its own, it is no more than a cost- or risk-sharing means of carrying out a process in the participants' trades or businesses for example a joint marketing or distribution network or a shared production facility. Carrying on a trade or business normally denotes a continuing activity with repetition of the buying and selling activities and, therefore, a joint arrangement carrying out a single project (as, for example, occurs in the construction industry) is unlikely to be carrying on a trade or business of its own, being instead a facility or agent in its participants' trades or businesses. The nature of a joint arrangement may change over time for example, a pipeline operated as a joint arrangement that initially provided a service only directly to the participants may develop into a pipeline business providing services to others, where access to the pipeline is sold in the market. Changes in the nature of a joint arrangement should be reflected in its accounting treatment.

Accounting for JANE

Participants in a joint arrangement that is not an entity should account for their own assets, liabilities and cash flows, measured according to the terms of the agreement governing the arrangement.

Accounting for investments in the investor's balance sheet

The measurement rules come from the Accounts Regulations to CA 2006. In this respect, the regulations for small companies are the same as for large and medium companies.

Fixed asset investment

Either: Historical cost accounting rules (Paragraphs 17 to 20)

Purchase price subject to diminution in value.

Where a fixed asset investment has diminished in value, provisions for diminution in value *may* be made in respect of it and the amount to be included in respect of it *may* be reduced accordingly.

Provisions for diminution in value *must* be made in respect of any fixed asset which has diminished in value if the reduction in its value is expected to be permanent (whether its useful economic life is limited or not), and the amount to be included in respect of it must be reduced accordingly.

Permanent diminution should be charged to the profit and loss account, temporary diminution can be charged to the profit and loss account. If the provision for diminution in value is not shown in the profit and loss account then it must be disclosed (either separately or in aggregate) in a note to the accounts.

Where the reasons for which any provision for diminution in value was made have ceased to apply to any extent, that provision must be written back to the extent that it is no longer necessary.

Any amounts written back which are not shown in the profit and loss account must be disclosed (either separately or in aggregate) in a note to the accounts.

Or: Alternative accounting rules (Paragraph 32(3))

[Fixed asset] investments may be included either

(a) at a market value determined as at the date of their last valuation, or

(b) at a value determined on any basis which appears to the directors to be appropriate in the circumstances of the company.

But in the latter case particulars of the method of valuation adopted and of the reasons for adopting it must be disclosed in a note to the accounts.

In case of departure from the historical cost accounting rules, additional information must be provided as follows (Paragraph 34):

1. The items affected and the basis of valuation adopted in determining the amounts of the assets in question in the case of each such item must be disclosed in a note to the accounts.

2. In the case of each balance sheet item affected (except stocks) either

    a. the comparable amounts determined according to the historical cost accounting rules, or

    b. the differences between those amounts and the corresponding amounts actually shown in the balance sheet in respect of that item,

    must be shown separately in the balance sheet or in a note to the accounts.

Current asset investment

Either: Historical cost accounting rules (Paragraphs 23 to 24)

Purchase price or, if lower, net realisable value.

Where the reasons for which any provision for diminution in value was made have ceased to apply to any extent, that provision must be written back to the extent that it is no longer necessary.

Or: Alternative accounting rules (Paragraph 32(4))

[Current asset] investments may be included at their current cost.

In case of departure from the historical cost accounting rules, additional information must be provided as shown above for fixed asset investments.

Diminution in value or impairment?

Diminution in value is a term used by the Companies Act. It can apply to fixed assets or current assets. The equivalent term in accounting standards is impairment – although this term is only applied to fixed assets. Fixed asset investments are within the scope of FRS 11.

FRS 11 – Paragraph 2

Impairment:- A reduction in the recoverable amount of a fixed asset or goodwill below its carrying amount.

Recoverable amount: The higher of net realisable value and value in use.

Net realisable value: The amount at which an asset could be disposed of, less any direct selling costs.

Value in use: The present value of the future cash flows obtainable as a result of an asset's continued use, including those resulting from its ultimate disposal.

We have considered indications of impairment and impairment tests in a recent set of Update Notes and so these topics are not repeated here.

Where should impairment be recognised?

In accordance with FRS 11, impairments should usually be recognised in the profit and loss account, within operating profit. An impairment could be exceptional but is still included in the appropriate statutory heading above the operating profit line.

The exception to the above requirement concerns an impairment which arises on a previously revalued fixed asset. This should be recognised in the profit and loss account if it is caused by a clear consumption of economic benefits. Other impairments of revalued fixed assets should be recognised in the statement of total recognised gains and losses until the carrying amount of the asset reaches its depreciated historical cost and thereafter in the profit and loss account.

What is the impact of FRS 11?

The notes to FRS 11 indicate that impairment is similar to diminution in value.

If there is a permanent diminution in value then this is similar to impairment and the amount should be charged to the profit and loss account as it represents a consumption of economic benefits. Therefore where assets are held at historic cost then a reduction in the recoverable amount below the carrying value should be provided for.

However, the rules for temporary diminutions in value are different. FRS 11 does not distinguish between temporary and permanent diminutions. Since the Companies Act permits temporary diminutions to be charged in the P&L account then, as a result of FRS 11, temporary diminutions will also be charged against profit. This comment is of course subject to the exception where the asset has previously been revalued.

FRS 11 only allows write backs of impairment where there is a change in the economic conditions.

Reversal of past impairments

Tangible fixed assets and investments in subsidiaries, associates and joint ventures

56 If, after an impairment loss has been recognised, the recoverable amount of a tangible fixed asset or investment increases because of a change in economic conditions or in the expected use of the asset, the resulting reversal of the impairment loss should be recognised in the current period to the extent that it increases the carrying amount of the fixed asset up to the amount that it would have been had the original impairment not occurred. The reversal of the impairment loss should be recognised in the profit and loss account unless it arises on a previously revalued fixed asset, in which case it should be recognised as required by paragraph 66.

66 A reversal of an impairment loss should be recognised in the profit and loss account to the extent that the original impairment loss (adjusted for subsequent depreciation) was recognised in the profit and loss account. Any remaining balance of the reversal of an impairment should be recognised in the statement of total recognised gains and losses.

57 Events and circumstances that are the reverse of those set out in paragraph 10 as triggers for an impairment review may indicate that the recoverable amount of a fixed asset has increased. The increase in the recoverable amount must arise from a change in economic conditions or in the expected use of the asset. This would include situations where the recoverable amount increases as a result of further capital investment or a reorganisation, the benefits of which had been excluded from the original measurement of value in use.

58 Increases in value in use may arise simply because of.

(a) the passage of time: as future cash inflows become closer, their discounted value increases. (Where value in use has been calculated using cash flows based on

current prices and a real discount rate, value in use may also increase because of the effect of general inflation on current prices.)

(b) the occurrence of forecast cash outflows: once the cash outflows are past, they are no longer part of the value in use calculation and value in use therefore increases.

Such increases in value may not be recognised as reversals of an impairment loss.

59 The recognition of an increase in the recoverable amount of a tangible fixed asset above the amount that its carrying amount would have been had the original impairment not occurred is a revaluation, not a reversal of an impairment.

Investment properties

Definition of investment property

SSAP 19 Paragraphs 7 and 8

7 Subject to the exceptions in paragraph 8 below, an investment property is an interest in land and/or buildings:

(a) in respect of which construction work and development have been completed; and

(b) which is held for its investment potential, any rental income being negotiated at arm's length.

8 The following are exceptions from the definition:

(a) A property which is owned and occupied by a company for its own purposes is not an investment property.

(b) A property let to and occupied by another group company is not an investment property for the purposes of its own accounts or the group accounts.

Accounting for investment property

Investment properties should not be subject to periodic charges for depreciation except for properties held on lease which should be depreciated at least over the period when the unexpired term is 20 years or less.

Investment properties should be included in the balance sheet at their open market value.

SSAP 19 Paragraph 6 (part of the explanatory note)

This statement requires investment properties to be included in the balance sheet at open market value. The statement does not require the valuation to be made by qualified or independent valuers; but calls for disclosure of the names or qualifications of the valuers, the bases used by them and whether the person making

the valuation is an employee or officer of the company. However, where investment properties represent a substantial proportion of the total assets of a major enterprise (e.g., a listed company) the valuation thereof would normally be carried out:

(a) annually by persons holding a recognised professional qualification and having recent post-qualification experience in the location and category of the properties concerned; and

(b) at least every five years by an external valuer.

SSAP 19 Paragraphs 11 to 13

Investment properties should be included in the balance sheet at their open market value.

The names of the persons making the valuation, or particulars of their qualifications, should be disclosed together with the bases of valuation used by them. If a person making a valuation is an employee or officer of the company or group which owns the property this fact should be disclosed.

Changes in the market value of investment properties should not be taken to the profit and loss account but should be taken to the statement of total recognised gains and losses (being a movement on an investment revaluation reserve), unless a deficit (or its reversal) on an individual investment property is expected to be permanent, in which case it should be charged (or credited) in the profit and loss account of the period.

The carrying value of investment properties and the investment revaluation reserve should be displayed prominently in the financial statements.

SSAP 19 Paragraph 17 (part of the legal requirements section)

The application of this standard will usually be a departure, for the overriding purpose of giving a true and fair view, from the otherwise specific requirement of the law to provide depreciation on any fixed asset which has a limited useful economic life. In this circumstance there will need to be given in the notes to the accounts ‘particulars of that departure, the reasons for it, and its effect’. Paragraphs 62-65 of FRS 18 "Accounting Policies" specify disclosures that should be made in connection with this statutory requirement.

FREQUENTLY ASKED QUESTIONS ON INVESTMENTS

Q1 Investments in the shares of a listed company

Q. A company has an investment in the shares of a listed company. These are included in fixed assets because the company has an intention to hold the shares for

the long term. Last year market value was above cost; this year it is lower. Is it acceptable to carry the investments at cost in both periods?

A. In principal, yes. Fixed asset investments can be carried at cost. Impairment needs to be considered but, since the intention is to hold shares for the long term, then "value in use" may well exceed cost. Certainly, the fact that the value of the shares is currently depressed does not necessarily mean that their value has been impaired.

Paragraph 32 of Schedule 1 of "The large and medium-sized companies and groups (accounts and reports) regulations 2008" permits the company to carry fixed asset investments at market value under the alternative accounting rules. If this route is followed, additional disclosure is required as set out in paragraph 33.

Since the investment is in a listed company, paragraph 54 of the Regulations requires disclosure of the amount included in investments which is ascribable to listed investments. There must also be stated

a) the aggregate market value of those investments where it differs from the amount so stated, and

b) both the market value and the stock exchange value of any investments of which the former value is, for the purposes of the accounts, taken as being higher than the latter.

Q2 Investment which has become worthless since the balance sheet date

Q. I am preparing a set of accounts for A Ltd. Turnover for the year ended 31 December 2009 was £2m. A Ltd hold a fixed asset investment in another company called X Ltd. This is included in the balance sheet at 31 December 2009 at £400k which is the original cost.

On 8 April 2010, X Ltd was put into liquidation and the investment is now worthless.

How should this impairment be disclosed?

Should the £400k impairment be shown on the face of the Profit & Loss account?

Is it an exceptional item?

What disclosure notes do I need to include?

A. An impairment provision at the balance sheet date should be considered but it is by no means certain that it is necessary. The directors of A Ltd need to consider what the position was at 31 December 2009. If, at that date, there was evidence that

the investment had been permanently impaired then it would be necessary to write down the investment to its recoverable amount.

If your conclusion is that an impairment provision needs to be made then it will need to be recorded in the P&L. Depending on the materiality of the write-down, it may need to be disclosed as an exceptional item. Since this is an impairment and not a disposal, it cannot be shown below operating profit. Further information will be provided in the notes to the accounts.

Q3 Accounting for intergroup balances and investments

Q. A group has a number of subsidiaries (and sub-subsidiaries) which trade with each other. This means that in some companies there will be intercompany receivables and investment in subsidiaries. Some of the companies who have the payable do not currently have the funds to repay and some subsidaries have net assets less than the parent's cost of investment. Can all of the potential issues that this raises be ignored on the grounds that all companies in the group are 100% subsidiaries and therefore everything will fall out on consolidation? The group as a whole is profitable with a positive consolidated balance sheet.

A. You should look at each company that has an intergroup receivable or investment in subsidiary and consider recoverability of debt and carrying value of subsidiary. This will necessitate looking at the current trading and future prospects of the other group company. As long as that company is still trading then, in the absence of evidence to the contrary, it may be that no provision against debt or investment is required. Where a provision re debt might be required you could discuss with the ultimate parent whether they might wish to provide appropriate guarantees. Your files should document the thought process and conclusions; it is unlikely to trigger any specific accounts disclosure. A debt provision by the company owed money would not trigger a corresponding credit in the payable company unless part of the debt is actually waived (beware tax risk of the credit being taxable and the debit not being allowable).

Q4 Investment in associate with net liabilities

Q. Our client (a plc) has a 22% interest in an LLP. This is classified as an associate, and the client is equity accounting. Do they need to show their share of the net liabilities of the associate on the plc's balance sheet? The client is arguing that because their liability is limited (it being an LLP), this need not be shown.

A. Paragraphs 44 and 45 of FRS 9 deal with the issue of an associate with net liabilities. The FRS requires the investor to continue to record changes in the carrying amount of an associate even if the equity method results in an interest in net liabilities rather than net assets. The only exception is where there is sufficient evidence that an event has irrevocably changed the relationship between the two parties, marking irreversible withdrawal from its investee as its associate. That is not

the case here. Where an interest in net liabilities arises, the amount recorded is shown as a provision or liability.

(Lecture A297 – 12.20 minutes)

KEY ISSUES FOR UK GAAP PREPARERS

Introduction

The Financial Reporting Faculty of the ICAEW has prepared a briefing for faculty members which highlights some of the key issues to be aware of in the current reporting season. The notes that follow are based on that briefing. The comments in italics are my own comments and are not taken from the faculty briefing.

New and amended standards

FRS 8 Related Party Disclosures has been amended to reflect law changes affecting the definition of a related party. This may result in more extensive related party disclosures.

Comment: The format has been changed from the old definition and we no longer have reference to those who are deemed to be related parties and those who are presumed to be related parties. It is being suggested by commentators that the change in definition will have little impact in practice but it is interesting to note the following example:

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

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

Q1: Will A Ltd be treated as a related party in the accounts of ABC Ltd?

A: Yes. A is a director of ABC Ltd and therefore a related party. A controls A Ltd and that makes A Ltd a related party of ABC Ltd

Q2: Will ABC Ltd be treated as a related party in the accounts of A Ltd?

A: Under the old version of FRS 8 (and the existing version of the FRSSE), ABC Ltd is not a related party of A Ltd. Now the revised FRS 8 is in force, ABC Ltd will be a related party of A Ltd under part (f) of the definition

On a related issue, it is now becoming more widely accepted that dividends paid to directors should be disclosed as related party transactions.

Comment: Presumably, these can be aggregated. Also dividends paid to other related parties (eg close members of the directors' families) should be disclosed – again on an aggregated basis.

In addition the threshold for the exemption from disclosing intra-group transactions has been raised from 90% to 100% owned subsidiaries, potentially significantly increasing disclosure requirements for groups with minority interests.

Going concern

Directors should consider their basis for concluding on going concern.

Insolvencies commonly increase in the latter stages of recession as companies begin to run short of working capital. As a result, going concern and the disclosures relating to this continue to be an area of focus for regulators. Directors should pay special attention to whether it remains appropriate to assert that the entity remains a going concern.

Comment: We have given considerable attention to this topic in recent updates.

Where there are concerns relating to any of these areas it may be that the directors conclude there is fundamental uncertainty over the entity's ability to continue as a going concern. If this is the case it must be disclosed and management's plans to mitigate the uncertainty detailed.

Comment: The term used by the Faculty (fundamental uncertainty) is not the same as the phrase used in FRS 18 (material uncertainties that cast significant doubt) . The term "fundamental uncertainty" is usually used in an auditing context and was commonly used in the old UK SASs. The term is not used in the ISAs. The other relevant comment here is that the Faculty want us to disclose "management's plans to mitigate the uncertainty". Where does that come from?

These comments might appear to be unduly pedantic but I think it's important to stress that, whilst a number of bodies seem to want to influence going concern disclosure, the rules remain as stated in FRS 18/FRSSE. These rules are as follows:

When preparing financial statements, directors should assess whether there are significant doubts about an entity's ability to continue as a going concern. (FRS 18.23)

If the directors, when making this assessment, are aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, then paragraph 61 requires them to disclose those uncertainties. (FRS 18.24)

Impairment

The current economic environment leads to an increased possibility that assets may be impaired. As a result, another continuing area of focus concerns management's consideration of impairment and the form and detail of the disclosures made detailing impairment reviews performed. Of particular interest are the discount and growth rates applied, the explanation of how forecasts exceeding five years have been put together and the sensitivity analysis provided.

Comment: File reviews indicate that this is an area which is frequently overlooked.

Financial instruments

Entities applying FRS 26 must also comply with the disclosures required by FRS 29

Regulators remain concerned that financial instruments are properly recognised, measured and disclosed. The disclosures should include a full explanation of risks, a sensitivity analysis, an aging analysis of past due financial assets that are not impaired and an analysis of those that have suffered impairment. These disclosures are only required for entities applying FRS 26.

Comment: Paragraph 1A of FRS 26 says that the standard applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) and are:

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

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

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

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

Good narrative reporting

ASB review suggests that further improvement is needed. A review in 2009 of narrative reporting by the Financial Reporting Council (FRC) suggests that few companies provide full disclosure of their business model, although most provide some description of their business.

Comment: These comments may appear to be irrelevant to the typical medium-sized client. However, medium-sized companies are required to include a business review in their directors' report. Do such reviews provide full disclosure of the matters required by CA 2006 S 417?

(Lecture A298 – 15.44 minutes)

RESIDENTS' MANAGEMENT COMPANIES – THE PROBLEM WITH SERVICE CHARGES

Background

One of the hottest and most frequently asked questions currently being put to the ICAEW Technical Enquiry Service relates to Residents' Management Companies (RMCs) and service charges. Where costs such as cleaning, maintenance or utilities in common areas are recharged to residents by an RMC there are:

- Accounting questions over the treatment of the service charge and
- Legal issues over the handling of the monies.

Legislation – the problem

The current legislation relating to service charge monies paid by lessees is primarily S.42 of the Landlord & Tenant Act 1987(the holding of funds) and S.21 of the Landlord & Tenant Act 1985 as amended by (S.41 and Schedule 2) the Landlord & Tenant Act 1987 (the provision of a summary of relevant costs of service charge expenditure).

S.42 requires that any service charge monies collected from lessees must be held 'on trust'; the law has created statutory trusts if the relevant leases do not create express ones.

New legislation, expected to be in force later in 2010, will further reinforce this requirement. This will mean that RMCs will be required to hold service charge monies in separate Client Accounts and provide members with statements of service charge expenditure.

The Accounting Issue

Many RMCs account for service charge monies collected from lessees as part of their annual accounts filed at Companies House. This practice is not correct. Service charge monies are held in trust by the Company and should not be accounted for as if they were company assets to be included in the Company's financial statements. Therefore, the income from the residents should not be included, neither should the expenditure earmarked for this income.

In practice these changes leave many RMCs dormant. Where RMCs in the past accounted for service charges in their financial statements they might have opted for a voluntary audit. Without the service charges in the accounts most of these would take the necessary steps to take advantage of audit exemption.

Annual statement of account – new requirement

In addition the Government will soon be introducing a requirement for all RMCs to also produce annual statements of account of service charges. The statement will have to contain certain prescribed contents and will not satisfy the requirements for company accounts as set out in Companies Act 2006.

These statements of service charge accounts will also have to be checked and a report made upon them by an independent accountant. This accountant's report will be in addition to any report by an accountant or auditor on the company's accounts.

Summary of ICAEW Guidance

- The Institute of Chartered Accountants in England and Wales (the Institute) has given the following guidance to its members who ask how to present service charge information in a company's annual accounts where, for example the company owns the freehold of a block of flats and is the 'landlord' for the purposes of the 1985 Landlord and Tenant Act (the 1985 Act), or the company manages the block and service charges under the terms of the lease. This scenario assumes that no tenant has asked for a summary of

relevant expenditure under section 21 of the1985 Act. It is also based on legislation current at 1 July 2008. The requirements will change when new Regulations are made later in 2008 or early 2009 *(now expected to be later in 2010)*. As soon as is practicable the Institute will issue formal guidance reflecting this summary subject to any legislative changes.

- The key point to bear in mind is that the management company does not ‘own' the transactions relating to service charge expenditure and the collection of monies from the lease holders/tenants because under S.42 of LTA 1987 service charges are regarded as trust funds. The cash at bank does not belong to the company because it is held on trust for the leaseholders. The only items/transactions that belong to the company are non service charge transactions such as ground rent if the company owns the freehold. Non service charge items such as ground rent do belong to the company (if it owns the freehold and is not collecting the rent on behalf of a superior landlord).

- Where no tenant has required a summary of costs, the management company must prepare two statements to satisfy the Companies Act accounts requirements; an income and expenditure account (if there is any non-service charge income or expenditure) and a balance sheet. In addition two additional statements are included; one to provide information to the leaseholders about service charge relevant costs, and the other to show balances such as service charges owed or paid in advance; any sinking funds, etc. and balances at bank that represent the cumulative excess of service charges paid by the leaseholders over payments on relevant expenditure. These latter two statements do not constitute a s.21 summary of costs.

- It follows from the above that, where the only transactions carried out by the management company are the receipt of service charges paid by the lease holders and payment of relevant costs, the management company is not carrying out any transactions in its own right. The company may not, therefore need to prepare a profit and loss/income and expenditure account. The balance sheet will contain only items that belong to the company such as the freehold of the block at cost or valuation, share capital (if the company is limited by shares) or any initial contributions by members of the company to working capital when the company was set up.

- When the new Landlord and Tenant legislation is implemented - expected to be effective for accounting periods beginning on or after 1 April 2009 *(now expected later in 2010)* - a separate summary of service charge expenditure and a balancing statement will be required in addition to the Companies Act accounts but in this case the latter need no longer include the service charge statements. Further formal guidance on accounts and accountants’ reports will be issued by the Institute in due course.

IAS 37: THE NEXT BIG CONTROVERSY

Extract from letter of comment sent by ASB to IASB:

"The ASB does not agree with proposals in the Exposure Draft or those in the Working Draft of IAS 37 published on the IASB's website on 19 February 2010. In its view the proposals will not lead to the production of decision useful information and consequently do not represent an improvement in financial reporting."

Extract from blog posted on Financial Reporting Faculty website on 25 January 2010 by Andy Simmonds (chair of the faculty):

"ICAEW in general, and the Faculty in particular, has supported IASB through thick and thin. That loyalty is about to be tested severely!"

What has happened to bring out such extreme views?

The answer is that the IASB are pushing ahead with their proposal to change the accounting for provisions and contingent liabilities.

Under UK GAAP (and the existing version of IAS 37), a provision is made if it is probable (ie "more likely than not") that a transfer of economic benefits will be required to settle the obligation. If this probability test is not met then no provision is made but instead a contingent liability will be disclosed except where the possibility of a transfer of benefits is remote.

So what's the change?

The IASB have proposed that liabilities should be measured at an exit value - what would I pay a third party to take this risk away. The way to obtain such a value is to calculate the 'expected value' of the payment based on an assessment of all possible outcomes, and the probability of each.

Example

Suppose that the entity is involved in a court case which will result in the need to pay £1m if the case is lost. There will be no cost if the case is won. The probability of winning the court case is estimated to be 80%.

Under current UK GAAP, there would be no provision but the contingent liability would be disclosed.

Under the proposals, a liability for £200,000 would be recognised being the weighted average of the two outcomes (£1m x 0.2 + £0 x 0.8).

So now you can see what the fuss is about. Remember that if IAS 37 is amended then FRS 12 is likely to follow suit!

(Lecture A299 – 6.59 minutes)

FREQUENTLY ASKED QUESTIONS ON ONEROUS CONTRACTS

Q1 Accounting for a contract for future capital works

Q. P Ltd has committed to major capital works. They signed the contract on 14 November 2009 and some preparatory work was performed during December. This work has been paid for by P Ltd . Should the full obligation under the contract be included as a liability in the accounts for the year ended 31 December 2009?

A. No. This is an executory contract as explained in Paragraph 6 of FRS 12. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. The contract will be accounted for as work is performed.

Q2 Accounting for a contract for future capital works where the contract has become onerous

Q. Q Ltd has committed to major capital works. They signed the contract on 14 November 2009 and some preparatory work was performed during December. The contractor ceased work on the contract on 15 December since, on that date, Q Ltd informed them that they did not have the necessary funding to complete the contract. Since the contract is now considered to be onerous, should the full obligation under the contract be included as a liability in the accounts for the year ended 31 December 2009?

A. An onerous contract is one where the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received under it. If the contract has become onerous then the company should provide in full for the unavoidable costs of complying with the contract less any economic benefits that are received under the contract.

Q3 Disclosure classification re onerous lease

Q. R Ltd is providing in full for its onerous property lease obligations.

Should the whole of this be included in provisions for liabilities and charges or should the amount that will be payable within one year be shown in creditors due in one year?

A. The only amount that should be included in creditors is any amount invoiced but not paid before the year end. This is unlikely to apply, so the whole amount will appear in provisions for liabilities and charges.

Q4 Calculation of provision for onerous lease

Q. S Ltd has an onerous property lease, with payments totalling £100,000 still to pay (that is 10 years at £10,000 per annum). They have sublet the property for 5 years at £5,000 per annum. Do you provide for the whole £100,000, or £75,000 after deducting the income from sub-letting, or indeed £50,000 assuming the sub-lease is renewed?

A. FRS12 states that the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date (Paragraph 36).

The best estimate is the amount that S Ltd would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time (Paragraph 37).

Matters to consider include:

- Would the landlord be prepared to cancel the lease? Paragraph 73 of FRS 12 indicates that the unavoidable costs of a contract reflect the least net cost of exiting from the contract. It might be cheaper for S Ltd to do a deal with the landlord than to continue with the lease.

- In considering what is unavoidable any expected economic benefits under the contract should be taken into account. In this case there is the benefit from sub-letting since there is a sub lease for 5 years out of the 10. Do the directors expect the tenant to renew for another 5 years on the same terms? If so, the expected income would be £50k. If renewal is not likely, then the

expected income is only £25k. The directors might expect to be able to find another tenant but this could be at a higher rent or a lower rent than at present. It is down to the directors to set out their expectations and make the best estimate.

- The above comment seems to run contrary to Paragraph 56 of FRS 12 which says "Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised only when it is virtually certain that the reimbursement will be received." Is income from sub-letting a reimbursement? If it is then this would imply that we would not take account of income from the potential extension of the lease in five years time.

- Since the period is ten years, discounting should be used so as to take into account the time value of money (if this is material).

Q5 Making a provision in the accounts re employees

Q. T Ltd wants to make a provision for 12 months of a director's salary on the grounds that her contract of employment requires the company to give 12 months' notice if she is fired or made redundant. Can they do this?

A. No. This would only meet the FRS 12 criteria for an obligating event if the employee had been given notice by the company before the year-end. Until that point there is no obligation and so no provision should be made.

(Lecture A300 – 9.30 minutes)

ISA (UK AND IRELAND) 500 AUDIT EVIDENCE

Objective and selected definitions

The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

For purposes of the ISAs (UK and Ireland), the following terms have the meanings attributed below:

Appropriateness (of audit evidence) - The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Sufficiency (of audit evidence) - The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Requirements

Paragraph 6 echoes the objective above in requiring the auditor to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

The Application Material tells us that audit evidence is cumulative in nature and may include information obtained from previous audits (provided the auditor has confirmed its continuing relevance). Audit evidence includes both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level is a matter of professional judgment.

Audit evidence is obtained by performing:

(a) Risk assessment procedures; and

(b) Further audit procedures, which comprise:

(i) Tests of controls, when required by the ISAs (UK and Ireland) or when the auditor has chosen to do so; and

(ii) Substantive procedures, including tests of details and substantive analytical procedures.

The audit procedures described below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor.

Inspection - examining records or documents or a physical examination of an asset. Note that inspection of a fixed asset (eg an item of plant) may provide reliable audit evidence with respect to existence, but not necessarily about the entity's rights and obligations (ownership) or the valuation of the asset.

Observation - looking at a process or procedure being performed by others. Observation only provides evidence that a procedure operated correctly on the occasion when it was observed by the auditor. Further, the individual performing the procedure may well have performed differently if not observed.

External confirmation - audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. Note the strict requirement for a written response – although the form of that response can vary. External confirmations are considered to be so important that they have their own standard - ISA (UK and Ireland) 505.

Recalculation - checking the mathematical accuracy of documents or records.

Reperformance - the independent execution by the auditor of procedures or controls that were originally performed as part of the entity's internal control.

Analytical procedures – the evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures will also involve investigation of significant fluctuations. For the first time, the clarity ISAs introduce requirements which must be complied with if the auditor decides to obtain substantive evidence from analytical procedures. See ISA (UK and Ireland) 520 for further guidance.

Inquiry - seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is perhaps the most commonly used audit procedure but, in practice, evidence recorded on file of inquiry can be weak (who said what to whom and when?). When using inquiry as an audit technique, professional scepticism should be the guiding principle – is this response inconsistent with other audit evidence or information I have been given in the past? If the auditor has received oral responses to inquiries, it may be appropriate to obtain written representations. Does your audit system have a methodology for identifying oral representations where a written confirmation is required? Note that inquiry alone does not ordinarily provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Paragraph 7 requires the auditor, when designing and performing audit procedures, to consider the relevance and reliability of the information to be used as audit evidence.

The first issue dealt with by the Application Material is the direction of testing. Audit evidence obtained in the wrong direction will not be relevant. In practice, it is very common when reviewing work performed on completeness of creditors to see tests of overstatement – for example selections of items for testing from the list of balances.

Another common weakness in practice is to assume that evidence will be relevant to all assertions. For example, considering receipts from debtors after the year-end provides evidence of valuation, but not necessarily cut-off.

In the section on reliability, the Application Material repeats information familiar to us all. Whilst generalisations are subject to important exceptions, the following generalisations about the reliability of audit evidence may be useful:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence generated internally is more reliable when the related controls imposed by the entity are effective.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference
- Audit evidence in documentary form is more reliable than evidence obtained orally.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies etc.

Paragraph 8 contains detailed requirements where information to be used as audit evidence has been prepared using the work of a management's expert.

A management's expert is defined as an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements. Note that the expert can be employed by the entity or be engaged to provide services.

Returning to paragraph 8, the auditor is required to evaluate the competence, capabilities and objectivity of the expert; obtain an understanding of the work of the expert; and evaluate the appropriateness of the expert's work as audit evidence for the relevant assertion.

The extent of the procedures required under Paragraph 8 depends on the significance of that expert's work for the auditor's purposes. Objectivity may be a particular problem area.

Paragraph 9 requires the auditor to evaluate whether information produced by the entity is sufficiently reliable for the auditor's purposes. If necessary in the circumstances, this will involve obtaining audit evidence about the accuracy and completeness of the information; and evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

Audit evidence concerning the accuracy and completeness of such information may be obtained at the same time as the audit procedure is performed. In other situations, the auditor may test controls over the preparation and maintenance of the information. If the auditor intends to use information produced by the entity for other purposes, such as analytical procedures, the auditor needs to consider whether the information is sufficiently precise or detailed.

When designing tests of controls and tests of details, Paragraph 10 requires the auditor to determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

The means available to the auditor for selecting items for testing are:

Selecting all items (100% examination) – unlikely to be appropriate for tests of controls but may be appropriate for substantive testing if there is a small number of large items or risk is significant.

Selecting specific items – usually items over a certain amount and items which are suspicious or error-prone. The use of selection is often efficient in that it can provide evidence about a large proportion of the population. The problem is that it provides no evidence about the items not selected.

Audit sampling - designed to enable conclusions to be drawn about the entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in ISA (UK and Ireland) 530.

Paragraph 11 deals with inconsistencies in, or doubts over the reliability of, audit evidence. In this situation, the auditor is required to determine what modifications or additions to audit procedures are necessary to resolve the matter, and to consider the effect of the matter, if any, on other aspects of the audit.

So what?

ISA (UK and Ireland) 500 has been clarified but not revised. Accordingly, there are no major changes although there is a new requirement dealing with the situation where information has been prepared by a management's expert.

(Lecture A301 – 21.40 minutes)

ISA (UK AND IRELAND) 501 AUDIT EVIDENCE - SPECIFIC CONSIDERATIONS

Objective

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

(a) Existence and condition of inventory;

(b) Completeness of litigation and claims involving the entity; and

(c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Requirements

Inventory

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

(a) Attendance at physical inventory counting, unless impracticable, to:

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

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts; and

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

There are no surprises in the above requirement nor in the Application Material that expands on it. The Application Material is helpful in giving an outline of the work the auditor would perform during attendance at stocktake but this information is no more detailed than would exist in the work programme provided in the typical audit system.

What is interesting about the above is what it tells us about the clarity process. Under the 2005 version of ISAs (UK and Ireland) auditors were left to their own devices in deciding what work needed to be performed in areas such as stock, debtors, cash etc. Now we have compulsory requirements covering stock-take attendance. Elsewhere in this standard we have requirements concerning certain liabilities; another standard covers external confirmations. How long will it be before auditing standards become a detailed audit programme – with the sting in the tail being that every procedure is compulsory?

Paragraph 5 deals with the situation where the stock-take is conducted at a date other than the date of the financial statements. This can occur either when the client is using continuous stock records to establish the year-end stock quantities or if the stock-take is the basis of the year-end quantities following adjustment for movements.

In either case, the expectation of ISA (UK and Ireland) 501 is that the client will perform a physical count of stock at some point and the auditor should attend. In addition to the procedures required by paragraph 4, Paragraph 5 requires the auditor to perform procedures to obtain evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Paragraph 6 says that if the auditor is unable to attend stock-take due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

There is no further explanation of this requirement but it would seem that the standard is assuming the existence of a continuous stock system. There would seem little point in counting stock otherwise – except in the circumstance where the auditor considers there is a need to examine the condition of stock.

Paragraph 7 considers the situation where attendance at stock-take is impracticable. (Impracticability does not include the excuse that it is inconvenient or costly to attend!) In such circumstances, the auditor is required to perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If this is not possible, the auditor is required to modify the opinion in the auditor's report.

> 8. If inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:
>
> (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
>
> (b) Perform inspection or other audit procedures appropriate in the circumstances.

This situation arises quite frequently in practice and the requirement above is interesting because it combines (and confuses?) two different audit concepts.

Paragraph (a) is treating the third party as an independent party from whom an external confirmation can be obtained.

Paragraph (b) (as amplified by the Application Material) is treating the third party as a service organisation. In this case, their warehouse is considered to be an extension of the client's own warehouse. Either the auditor should attend the physical stock-take as would happen for the entity itself or the auditor can seek a report from the service entity auditor confirming the adequacy of the third party's controls over stock.

Litigation and Claims

Paragraph 9 requires the auditor to design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. These procedures include inquiry of management and, where applicable, others within the entity, including in-house legal counsel; review of minutes of meetings of directors/trustees and correspondence between the entity and its external legal counsel; and review of legal expense accounts.

Notice that there is no choice about these procedures. Even if the auditor has no reason to suspect that there are claims against the entity, it is still necessary to perform these procedures.

In the past, the auditor would have been alert for possible claims against the entity whilst performing other procedures such as review of minutes. Now, the work performed concerning completeness of litigation and claims should be recorded on file.

The auditor might consider that there is a risk of material misstatement regarding litigation or claims. In addition, the work performed under Paragraph 9 may identify claims against the entity which have not been evaluated by management. In either

case, Paragraph 10 requires the auditor, in addition to any other procedures, to communicate directly with the entity's external legal counsel. This is done by means of a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

This communication may be by means of a letter of general inquiry which requests the entity's external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome, and an estimate of the financial implications, including costs involved.

In the UK, it is unlikely that the entity's external legal counsel will respond to a letter of general inquiry. In this case, the auditor may seek direct communication through a letter of specific inquiry. This would include a list of litigation and claims provided by management with management's assessment of the likely outcome. The external legal counsel is asked to provide confirmation that management's assessment is reasonable or to provide further information as appropriate.

In the event that it is not possible to communicate or meet with the entity's external legal counsel (either because management refuse permission or the external legal counsel refuses to respond or is prohibited from responding) then the auditor should seek to obtain sufficient appropriate audit evidence by performing alternative audit procedures.

If this is not possible, then Paragraph 11 requires the auditor to modify the opinion in the auditor's report.

Paragraph 12 requires the auditor to obtain a written representation from management and, where appropriate, those charged with governance, about the completeness of the disclosure in the financial statements of litigation and claims.

Segment information

Paragraph 13 requires the auditor to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information. Since this only affects a minority of companies in the UK, I have not covered this topic in detail.

So what?

Again a standard which is clarified but not revised. The procedures required for attendance at stock-take are not unusual and should not cause major problems. The requirements concerning litigation make no allowance for the client situation and this means that the subject will need to be addressed on every file.

ISA (UK AND IRELAND) 505 EXTERNAL CONFIRMATIONS

Objective and definition

The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

External confirmation is defined as audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

Requirements

Paragraph 7 requires the auditor to maintain control over all aspects of the procedures involved in obtaining evidence from external confirmation requests. This includes:

- Determining the information to be confirmed or requested;
- Selecting the appropriate confirming party;
- Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- Sending the requests, including follow-up requests when applicable, to the confirming party.

If management refuses to allow the auditor to send a confirmation request, the auditor is required by paragraph 8 to inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness. The auditor will also evaluate the implications for the assessment of risk, including the risk of fraud, and on the nature, timing and extent of other audit procedures. It is also necessary for the auditor to perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, then paragraph 9 requires the auditor to communicate with those charged with governance. The auditor shall also determine the implications for the audit and the auditor's opinion.

Results of the External Confirmation Procedures

If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Paragraph 10)

The Application Material indicates that doubts may arise particularly because the response has not been sent directly to the auditor or appears to come from a party other than the expected confirming party. Further, replies by e-mail have not necessarily been sent by the party who is the named respondent. The auditor might deal with such a situation by telephoning the confirming party to determine whether the confirming party did in fact send the response.

It is in this part of the ISA that we are told that an oral response does not meet the definition of an external confirmation and does not therefore constitute sufficient evidence on its own.

If the auditor determines that a response to a confirmation request is not reliable, then paragraph 11 requires the auditor to evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Paragraph 12)

If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. In this case, paragraph 13 requires the auditor to determine the implications for the audit and the auditor's opinion.

Paragraph 14 requires the auditor to investigate exceptions to determine whether or not they are indicative of misstatements. For example, a disagreement on a balance may be indicative of a timing difference rather than an error.

Negative Confirmations are permitted by the standard but they provide less persuasive audit evidence than positive confirmations. Accordingly, paragraph 15 sets strict conditions that must apply if the auditor, in a given situation, wishes to use negative confirmation requests as the sole substantive audit procedure.

These conditions are that risk is low; controls are operating effectively; the population subject to test comprises a large number of small, homogeneous items; a very low exception rate is expected; and the auditor is not aware of circumstances or

conditions that would cause recipients of negative confirmation requests to disregard such requests.

Finally, paragraph 16 requires the auditor to evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary.

So what?

The original version of ISA (UK and Ireland) 505 (effective 2005) did not cause particular problems for firms and the clarified version does not add any complications.

ISA (UK AND IRELAND) 520 ANALYTICAL PROCEDURES

Objectives and definition

The objectives of the auditor are:

(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

The Application Material explains that analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.

- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.

- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.

- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Requirements

Substantive Analytical Procedures

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with ISA (UK And Ireland) 330 the auditor shall:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7.

Paragraph 5 represents a significant difference from the old version of ISA (UK and Ireland) 520. Whilst that standard contained guidance on the use of analytical procedures as substantive evidence, there were no bold-print paragraphs. Now we have definite requirements to meet if analytical procedures are to be used in that way.

Notice also, in passing, that ISA (UK and Ireland) 520 no longer addresses the use of analytical procedures as risk assessment procedures.

The Application Material is very similar to the guidance in the old standard. It makes it clear that substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The use of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

This means that, generally speaking, substantive analytical procedures will be more effective when auditing the P&L account. Indeed the three examples given in the ISA of the use of analytical procedures are all P&L applications namely:

- the estimate of total payroll costs based on a known number of employees at fixed rates of pay.

- the use of widely recognised trade ratios (such as profit margins for different types of retail entities) – which the Application Material says provides evidence to support the reasonableness of recorded amounts.

- the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration.

By contrast with the prediction of rental income, the Application Material says that comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

Note that the only mention in the ISA of the use of analytical procedures in the balance sheet is in paragraph A10 where it states that particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Perhaps we should not read too much into the nuances of the Application Material but I would propose the following conclusions:

- Different analytical tests give different levels of assurance. So, the test of rental income provides “persuasive evidence and may eliminate the need for further verification by means of tests of details” whereas the comparison of gross margin percentages “may provide useful corroboration if used in combination with other audit procedures”.

- Analytical procedures alone may provide sufficient evidence for P&L assertions but this is unlikely to be the case for the Balance Sheet. Although it has to be added that this is not stated clearly in the clarity ISA.

I mention these two issues because some auditors have a tendency to over-rely on substantive analytical review when, in my opinion, the procedures performed do not merit the degree of reliance placed.

Note that, when the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details (ISA (UK and Ireland) 330 Paragraph 21).

The need to consider the reliability of data is familiar to us from the old standard but the explicit requirement to develop an expectation is new. This is an area where the monitors from the professional bodies have long been critical. In future, all analytical procedures which purport to provide substantive evidence should, as part of their design, set an expectation. This implies that the only acceptable form of analytical test is one that is framed as a “reasonableness test” or “proof in total”.

Paragraph 5(c) then requires an evaluation of whether the expectation is sufficiently precise. The Application Material lists matters relevant to this evaluation as follows:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor must also consider the reliability of the information as required by paragraph 5(b) above.

The auditor must also consider how accurate a test needs to be in order to provide the required level of assurance. In practice, a simplistic approach is often adopted – that is, as long as the difference between expected and actual is not material then the test is deemed to be a success.

The Application Material sees things in a rather more complicated way reminding us that ISA (UK and Ireland) 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

Analytical procedures that assist when forming an overall conclusion

Paragraph 6 requires the auditor to design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

This is very similar to the old bold print paragraph and should not cause any new problems. However, some auditors have always been uncertain as to what work should be recorded on file in order to satisfy this requirement.

Unfortunately, the ISA offers little help. Indeed the ISA as prepared by the IAASB contained only three short guidance paragraphs:

- The conclusions drawn from the results of final analytical procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

- The results of final analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, the auditor should revise the risk assessment and modify the planned audit procedures accordingly.

- Final analytical procedures may be similar to those that would be used as risk assessment procedures.

It is from a UK-plus (Paragraph A17-1) that we can develop the following list of questions to consider when carrying out final analytical procedures:

- Do the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of the audit?

- Do the procedures reveal any new factors which may affect the presentation of, or disclosures in, the financial statements?

- Do the final analytical procedures assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the entity's business?

- Has the presentation adopted in the financial statements been unduly influenced by the desire of those charged with governance to present matters in a favourable or unfavourable light?

- What is the potential impact of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit?

Investigating Results of Analytical Procedures

If analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, then paragraph 7 requires the auditor to investigate such differences by inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and performing other audit procedures as necessary in the circumstances.

So what?

ISA (UK and Ireland) 520 is clarified but not revised. However, the changes are dramatic in that, for the first time, we have compulsory procedures to perform if we wish to use analytical procedures as substantive procedures.

ISA (UK AND IRELAND) 530 AUDIT SAMPLING

Objective and selected definitions

The objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Audit sampling (sampling) is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The conclusion from this definition is that the audit technique where the items for testing are selected based on the judgement of the auditor (eg large items or error-prone items) is not audit sampling. Therefore the requirements of ISA (UK and Ireland) 530 do not apply to such techniques.

Most of the definitions in the ISA will be familiar to UK auditors. However, the following definitions are reproduced in order to remind users of these notes of the particular issues concerned.

Anomaly - A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Statistical sampling - An approach to sampling that has the following characteristics:

(i) Random selection of the sample items; and

(ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.

Tolerable misstatement - A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Tolerable rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Requirements

When designing an audit sample, paragraph 6 requires the auditor to consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Important aspects to consider at this stage are:

- What is the purpose of the test? From which population should the sample be selected? Is that population complete?
- What is a deviation or misstatement? Clear definition will avoid the misanalysis of results.
- For a test of a control procedure, what is the expected rate of deviation? If this is high then there is no point in testing the control and the auditor will not be able to place reliance on the control.
- Similarly, for a substantive test, what is the expected misstatement in the population? If this is high then the sample size is likely to be large. In this case, a 100% examination might be appropriate.
- The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Paragraph 7 requires the auditor to determine a sample size sufficient to reduce sampling risk to an acceptably low level.

The lower the risk the auditor is willing to accept, the greater the sample size will need to be. In practice, sample sizes may be determined by the use of a formula. Alternatively, the auditor will set sample size through the exercise of professional judgment.

Appendices 2 and 3 in ISA (UK and Ireland) 530 indicate the influences that various factors typically have on the determination of sample size. When using a formula based method for setting sample sizes, these factors are usually considered by the values allocated to the variables in the formula.

When setting sample sizes judgementally, care needs to be taken to flex sample sizes to reflect the particular influences in the specific audit situation.

Paragraph 8 requires the auditor to select items for the sample in such a way that each sampling unit in the population has a chance of selection.

There is no requirement for each item in the population to have the same chance of selection and there is no requirement for each item to have a known chance of selection. What matters is that each item in the population has some chance of selection.

If judgement is used to select a sample, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

Paragraph 9 requires the auditor to perform audit procedures, appropriate to the purpose, on each item selected.

If the audit procedure is not applicable to the selected item, paragraph 10 requires the auditor to perform the procedure on a replacement item.

Care is needed with this requirement. It is not acceptable to choose a replacement item if the original item is missing. This would normally constitute a deviation or misstatement (see paragraph 11 below) . An example given in the Application Material where it is acceptable to test a replacement is as follows. The auditor has selected a number of cheques to test that the signature on each is valid. One of the cheques turns out to be cancelled and so the test cannot be performed. In this case, a replacement item can be chosen.

If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Paragraph 11)

Paragraph 12 requires the auditor to investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

Notice that this is the correct audit response to any error identified – whether it arises from sampling or any other audit technique. This procedure requires the auditor to use experience and creativity in considering the possible implications of the results of the test. For example, does the existence of this error lead the auditor to believe that other similar or related errors may exist? Or is this sort of error indicative of the possibility of fraud?

In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, paragraph 13 requires the auditor to obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Some technical commentators do not believe in the existence of anomalies. Since a sample has been selected to be representative of the entire population then any error discovered in the sample is indicative that other similar errors may exist in that part of the population that has not been selected for testing.

Paragraph 14 contains the requirement that embodies the essential difference between sampling and selection. For tests of details, the auditor is required to project misstatements found in the sample to the population. This projected error gives a broad view of the scale of the misstatement but is not normally accurate enough to lead to a request for an amendment to the accounting records. Note that anomalous misstatements (if any) are not projected.

15. The auditor shall evaluate: (a) The results of the sample; and (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

This evaluation includes a comparison of the projected error plus any anomalous misstatements with tolerable misstatement. This is not simply a pass/fail type comparison since the auditor will be concerned if the amount of projected errors plus anomalous misstatements is close to tolerable misstatement. Also, if projected error exceeds the expected error used in the design of the test then the audit test may not be well designed.

So what?

There are no new issues here. However, sampling is often a weak area in practice where auditors set judgemental sample sizes which some might consider to be inadequate.

ISA (UK AND IRELAND) 580 WRITTEN REPRESENTATIONS

Objectives

The objectives of the auditor are:

(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other ISAs (UK and Ireland); and

(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Definitions

For purposes of this ISA (UK and Ireland), references to "management" should be read as "management and, where appropriate, those charged with governance".

Requirements

Required representations

Paragraph 9 requires the auditor to request written representations from those responsible for the preparation of the financial statements. In the requirement itself, the term management is used but a UK plus in the Application Material points out that, in the UK and Ireland, those charged with governance are responsible for the preparation of the financial statements. Paragraph 9 goes on to refer to the need for those who provide representations to have knowledge of the matters concerned. Again this would imply that management are the correct providers of representations but, again, the UK Plus says that, if written representations are critical to obtaining sufficient appropriate audit evidence then, in view of their importance, these representations should be provided by those charged with governance rather than management

The problem of potential lack of knowledge is addressed in Paragraph A6 of the Application Material which says that the auditor may request that management include in the written representations confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations.

Paragraphs 10 and 11 make it compulsory to obtain written representations that:

- Those charged with governance have fulfilled their responsibility for the preparation of the financial statements as set out in the terms of the audit engagement.

- Those charged with governance have provided the auditor with all relevant information and access as agreed in the terms of the audit engagement.

- All transactions have been recorded and are reflected in the financial statements.

A UK Plus (Paragraph 11-1) points out that qualifying language may be included to the effect that the representations are made to the best of management's knowledge and belief. Such qualifying language does not cause paragraph 20 to apply if, during the audit, the auditor found no evidence that the representations are incorrect.

Paragraph 12 requires that the responsibilities of those charged with governance should be described in the written representations in the same way that the responsibilities are described in the terms of the audit engagement.

Paragraph 13 identifies two other types of written representation:

- Representations required by other ISAs (UK and Ireland). For convenience, Appendix 1 of ISA (UK and Ireland) 580 contains a list of such representations.

- Representations which the auditor determines are necessary to support other audit evidence. For example, these may include representations concerning the entity's plans or the existence of contingent liabilities.

In accordance with the requirement in Paragraph 14, the date of the written representations must be as near as practicable to, but not after, the date of the auditor's report on the financial statements. In a new requirement, Paragraph 14 goes on to say that the written representations must be for all financial statements and period(s) referred to in the auditor's report.

Paragraph 15 requires the written representations to be in the form of a representation letter addressed to the auditor. Appendix 2 to ISA (UK and Ireland) 580 contains an example of such a letter. This does include the requirements of other ISAs but it has not been adapted by the APB into a form suitable for use in the UK and Ireland. Therefore, auditors are likely to find it easier to base their own letters on examples provided by those who provide UK audit manuals.

Paragraph 15 also refers to the situation where law or regulation requires management or those charged with governance to make written public statements about their responsibilities. If the auditor determines that such statements provide some or all of the representations required by paragraphs 10 or 11, then the relevant matters covered by such statements need not be included in the representation letter.

Potential problem areas

Paragraphs 16 to 19 deal with problems that may arise in connection with written representations:

- Concerns about the competence, integrity, ethical values or diligence of those who provide the representations.

- Inconsistency with other audit evidence.

- Unreliability of the representations.

- Failure by the entity to provide one or more of the requested written representations.

Users of these notes should refer to ISA (UK and Ireland) 580 for the correct response to these problems. Ultimately, Paragraph 20 requires the auditor to disclaim an opinion if the auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 10 and 11 are not reliable; or if management does not provide the written representations required by paragraphs 10 and 11.

So what?

According to the APB, the main reason for the revision of ISA 580 was to respond to concerns that auditors may be over relying on written representations. To address this concern, it is made clearer in the clarified ISA 580 that, although written representations provide necessary audit evidence, they support other audit evidence obtained and do not on their own provide sufficient appropriate audit evidence about any of the matters with which they deal.

Other changes include:

- Previously, the requirement was to obtain evidence that those charged with governance acknowledge their responsibility for the financial statements. Now there is a requirement for auditors to obtain written representations about management's responsibilities as shown in Paragraphs 10 and 11. Despite this change in the requirement, it is already common practice to include such matters in the letter of representation. However, there may well be minor changes to the wording of pro-forma letters so the key thing in practice is to make sure that the firm’s own standard letters are updated.

- If management does not provide the written representations acknowledging its responsibilities the auditor is required to disclaim an opinion on the financial statements.

(Lecture A302 – 6.28 minutes)

ISA (UK AND IRELAND) 600: SPECIAL CONSIDERATIONS - AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

Introduction

ISA (UK and Ireland) is the most changed of all the Auditing Standards. In the APB research, it was considered that this standard alone would add 3% to the cost of the audit of large and listed entities. From this it might be interpreted that there is no great impact on the auditors of smaller entities. However, many audit firms of all sizes have UK clients with subsidiaries abroad and, in this case, there will be some significant changes in how they conduct their work.

Objectives and definitions

The objectives of the auditor are:

a. To determine whether to act as the auditor of the group financial statements; and

b. If acting as the auditor of the group financial statements:

   (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and

   (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

A “component” is defined as an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Component materiality is the materiality for a component determined by the group engagement team.

Other definitions are self-explanatory or dealt with in the text below.

Overall responsibility of the group auditor

The new Clarity ISA 600 is based on the key requirement that the group auditor has overall responsibility for the group audit engagement. This means that the group engagement partner is responsible for the direction, supervision and performance of the group audit engagement and for the appropriateness of the group audit opinion (ISA 600.11).

Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatements. In a group audit, this includes the risk that the component auditor may not detect a misstatement in the financial information of the component that could cause a material misstatement of the group financial statements, and the risk that the group engagement team may not detect this misstatement.

The new Standard sets out what the group auditor considers when determining the nature, timing and extent of its involvement in the risk assessment procedures and further audit procedures performed by component auditors (ISA 600.6).

Core concepts

The following sum up the core concepts that need to be understood and applied by the group auditor:

- Scoping decisions
- Materiality considerations
- Understanding the component auditor
- Involvement in the component auditor's work

Scoping decisions

The first thing that the group auditor has to do is identify the entities that form "components" of the group. The group auditor is then required to classify the components in order to determine what audit procedures should be planned.

A significant component is a component identified by the group engagement team that is either of individual financial significance to the group, or that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

A financially significant component can be identified using benchmarks like group assets, group liabilities, cash flows, profit and turnover.

Whilst the standard does not specify a percentage that indicates an individually financially significant component a common interpretation is:

20% or greater	Probably financially significant
15% to 20%	May be financially significant
15% or smaller	Probably not financially significant

The standard includes a section entitled "Determining the type of work to be performed on the financial information of components". This is summarised in the table below.

Individually financially significant components	**Components which are significant because they are likely to include significant risks**	**Non-significant components**
Audit of financial statements	Audit of financial statements or Audit of one or more account balances or disclosures relating to the significant risks or Specified audit procedures relating to the significant risks (ISA 600.27)	Perform analytical procedures at group level (ISA 600.28) If sufficient evidence not obtained for group opinion, then additional work will be performed on non-significant components as follows: Audit of financial statements or audit of one or more account balances or disclosures or review or specified audit procedures (ISA 600.29)

Materiality considerations

The group auditor will determine materiality for the group financial statements as a whole. As usual, this may involve setting lower materiality levels for particular classes of transactions, account balances or disclosures.

In addition to determining group materiality, the group auditor is also required to determine component materiality for those components where component auditors will perform an audit or review for purposes of the group audit. Component materiality has to be smaller than group level materiality.

The group auditor will also set the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

The component auditors will set performance materiality at the component level but the group auditor must evaluate whether the level set is appropriate.

If a component is subject to audit in its own right, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether materiality for the component financial statements as a whole; and performance materiality at the component level meet the requirements of the ISA.

Understanding the component auditor

Where the group auditor is also the component auditor this is relatively straightforward, especially if the same engagement team is performing both audits under the same quality control procedures.

The group auditor is required to understand the following in relation to the component auditor:

- Compliance with relevant ethical requirements including independence,
- Professional competence and
- Regulatory environment

The group auditor must also be satisfied that the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.

The practical implications of this are:

- ISA 600 induces a strong link between the understanding of a component auditor and the extent of the involvement in the component auditor's work.
- A lower level of understanding of a component auditor has direct repercussions on the nature, timing and extent of audit procedures to be performed by the group engagement team on the financial information of the component and on the work performed by the component auditor.
- ISA 600 induces a strong incentive to try to obtain a good understanding of all component auditors relevant for a group audit.

Alternatively, it is being suggested by some commentators that it might be more cost-effective for the group auditors to audit significant components themselves (using group materiality) rather than seek to rely on component auditors.

Involvement in the work performed by component auditors

For significant components

Group auditors shall be involved in the component auditor's risk assessment. This involves at a minimum:

- Discussing business activities of significance to the group
- Discussing component's risks of material misstatements due to fraud or error and
- Reviewing the component auditor's documentation of identified significant risks of the group financial statements

The nature, timing and extent of this involvement are affected by the understanding of the component auditor.

For significant risks the group auditor shall evaluate the appropriateness of the further audit procedures to be performed to respond to those risks. In addition to this, based on the understanding of the component auditor, the group auditor shall determine whether it is necessary to be involved in the further audit procedures.

So what?

The new Clarity ISA 600 introduces a number of new group audit requirements in the following areas:

- Performing a risk assessment and planning discussion
- Establishing a group audit strategy and a group audit plan
- Testing of group wide controls, including those on consolidation if the work to be performed on components is based on an expectation that those controls are operating effectively or if substantive procedures alone cannot provide sufficient appropriate audit evidence
- Extent of the communication between a group and a component auditor and the need for "two way communication"
- Determination of the nature, timing and extent of the involvement in the work of component auditors on non-significant components

- Performance of explicitly mentioned further audit procedures on the consolidation process

- Identification of subsequent events

- Evaluation of sufficiency and appropriateness of audit evidence obtained

- Documentation of:

    - An analysis of components, indicating those that are significant and the type of work performed on those
    - The nature, timing and extent of the involvement in the component auditor's work on significant components, including, where applicable, work paper reviews and conclusions and
    - Written communications with the component auditor on audit requirements.

FAQs on group audits

This question is taken from the ICAEW Audit & Assurance Faculty's newsletter Audit & Beyond.

Q1. My firm audits a group with a UK holding company. A substantial component of the group is an Australian trading company. A local audit firm performs an audit of that component. Currently as part of the group audit we communicate on a number of issues with the audit firm in Australia at the planning and completion stages of the audit. I understand that the new Clarity Standard on groups is more onerous than the present ISAs, what additional work might we need to do?

Because of the numerous issues raised by the Clarity Standard in this area, space in Audit & Beyond does not permit a full reply to this question but I will do my best!

The Clarity standards, which are mandatory for periods ending on or after 15 December 2010, do demand considerably more of the auditors of groups. Indeed there is as much change in this one Standard as the rest of the Clarity Standards put together.

Under Clarity ISA 600 Special considerations – audit of group financial statements your firm will be required to do more at the risk assessment stage of the audit. In particular you must assess whether the Australian component of the audit is a "significant component". This may be because of its individual financial significance to the group or because of its specific nature or circumstances which might indicate significant risks of material misstatement of the group financial statements.

If it is a significant component then there are a number of obligations imposed on the group auditor, such as:

- establishing an understanding of the component auditor, including factors affecting their independence and competence,
- assessing component materiality to be used during the audit of the component,
- if the component is significant due to its individual financial significance then the component must be audited (under the Clarity Standards) using component materiality,
- communicating with the component auditor at various stages of the audit,
- being involved in the risk assessment process,
- reviewing the component auditor's documentation identifying significant risks of material misstatement of the group financial statements, and
- assessing whether sufficient appropriate audit evidence has been obtained on the component.

This is by no means an exhaustive list of your obligations. In practice it is often difficult to satisfy the requirements of the new Clarity Standards without visiting the component auditor of a significant component and reviewing the audit documentation. More rarely, the group auditor might reach the view that they will need to obtain audit evidence directly rather than relying upon the component auditor. Either way, the group auditor, if based in the UK, may incur additional review and travel costs.

Even if the component is not a "significant component" as defined by the Standard then there may still be other onerous obligations placed upon the holding company auditor.

I hope that this answer points you in the right direction but more than ever it is important to read the Standard yourself. Also, there is Faculty guidance in this area (see below).

Q2. I audit a predominantly UK based group with a subsidiary in Italy. The Italian company is eligible for audit exemption and is not subject to audit. Nevertheless the Italian subsidiary is a significant part of the group. As the group auditor we sign the group audit report but we have been asked by the Directors to ignore the Italian component of the group because it is audit exempt. What should our approach be?

Just because the Italian subsidiary is audit exempt in Italy does not mean that it can be ignored for group purposes. If it is, as you say, a significant component of the

group then it has to be subject to audit for group purposes. The answers to the previous question highlight the numerous issues that need to be addressed in the new Clarity Standards.

You either have to insist on a local Italian auditor being appointed to audit the subsidiary or you are required to conduct audit work yourself on this component for the purposes of the group audit.

If the Directors refuse to allow you to undertake the audit work as you see fit then this is an enforced limitation of scope. As such you should consider withdrawing from the engagement.

(Lecture A303 – 18.20 minutes)

THE AUDIT OF GROUPS – ICAEW GUIDANCE

The Audit and Assurance Faculty produced practical guidance which addresses the complex and topical issues surrounding the audit of groups. This was published in November 2008.

The Faculty sought the views of practitioners on how group audits are carried out in practice.

The publication that results from the findings of that research focuses on an eight point plan. It deals with the challenges of project management, communication between auditors and dealing with the sometimes tricky technical issues that arise. It also provides auditors with an introduction to the further measures that will come into effect with the introduction in the UK of the International Standard on Auditing 600 (revised).

The eight point plan

The following eight point plan highlights areas which, based on the research, results in a firm achieving best practice in group audits.

1. Get organised

- Start early and establish clear milestones.
- Provide very clear instructions and requirements for deliverables to other auditors.
- Get audit committee and management buy-in to the audit process and ensure they understand their responsibilities.

- Consider asking for information on planning and risk assessment, including fraud risk, prior to the year end.

- Keep in regular contact with the key group parties.

- Use more telephone and conference calls, rather than relying solely on letters and email.

- Where appropriate visit other auditors and subsidiary management.

2. Analyse the group structure

- Focus attention on the more unusual corporate structures.

- If there are doubts about the group structure, verify it against publicly available information.

- Consider whether to accept an engagement where the group auditor is only directly responsible for a minority of the total group.

- Understand the accounting framework applicable to each component and any local statutory reporting requirements.

3. Focus on the quality of other auditors

- Consider the qualifications, independence and competence of other auditors up front, along with their quality control procedures.

- For related auditors (those who have common quality control policies and procedures) group auditors may be able to rely on those common policies and procedures, particularly where they also adopt the same audit methodology.

- For unrelated auditors, or related auditors where the group auditor is unable to rely on common policies and procedures, consider:
    - visiting the other auditor;
    - requesting that the other auditor completes a questionnaire or representation;
    - obtaining confirmation from a relevant regulatory body; and/or

  - discussing the other auditor with colleagues from their own firm.

- For other auditors based overseas, consider whether they have enough knowledge and experience of ISAs (UK and Ireland).

4. Focus the group audit on high risk areas

- Group auditors need to ask for enough information from other auditors to form their own conclusion on significant risks arising in components that affect the group financial statements. Focus attention on the five warning signs identified by respondents to the research:

  - recently acquired components;
  - jurisdictions with under-developed financial reporting regimes;
  - components which are just ‘below the radar’;
  - components that have a history of reporting late; and
  - components that have had big swings in their profits.

- Consider the risks arising from the consolidation process itself, including the use of journals and incomplete information relating to adjustments between accounting frameworks or to align accounting policies.

- Discuss fraud risks with other auditors as appropriate.

5. Understand internal controls across the group

- Request details of material weaknesses in internal control identified by other auditors.

- Communicate material weaknesses in group-wide controls and significant weaknesses in internal controls of components to group management and those charged with governance of the group.

6. Ensure staff understand the technical complexities of group audits and know when to bring in specialist help

- Consider areas of particular concern, where it is important that practitioners are aware of the main issues and bring in expertise where it is needed:

  - Differing accounting frameworks and policies
  - Intra group transactions and balances

  - Fair values on acquisitions
  - Capturing post-balance sheet events
  - Intangibles
  - The basis and calculation of share options, bonuses
  - Deferred tax

- Plan early any specialist involvement, for example the use of a tax expert to deal with international tax issues or a valuation expert for share options.

7. Review other auditors' working papers

- Group and other auditors should co-operate as regards sharing of information unless prohibited by law. Appropriate use of hold harmless letters may be used to manage risk.

- Get group management to obtain the consent of subsidiary management to communicate with the group auditor to deal with concerns about client confidentiality and sensitivity.

- Consider whether holding discussions with or visiting other auditors could deal with secrecy and data-protection issues.

8. Review and update procedures, training and tools

- Provide formal training on group audits to supplement on-the-job-experience.

- Review standard questionnaires, if any, for effectiveness.

- Make sure that training materials and manuals are updated to reflect the new ISA (UK and Ireland) 600.

REPORT OF THE AUDIT INSPECTION UNIT

Introduction

I have prepared extracts from two sections of the Audit Inspection Unit (AIU) report published in December 2009. Firstly, we have the comments on the inspections at those audit firms that conduct up to ten listed or major audits in the AIU's scope. The information from the summary report is helpful since many of the problems it

identifies are common to firms of all sizes. I have omitted the comments made on independence and communicating with audit committees since these are only of interest to auditors of listed companies. Secondly, the AIU have published a list of challenges facing auditors in the 2009/10 reporting season and we can use this list as a reminder of the key issues to concentrate on in the coming months.

Extracts from findings from inspections

Audit evidence and related judgments

Audit work was inadequate in the following areas:

- Balances subject to uncertainty such as insurance recoveries or earn-outs
- Insufficient confirmations from banks and investment custodians
- Deficiencies in the audit of inventory balances

Group audits

- Failure to consider properly whether the firm's participation in the audit of the group was sufficient for it to act as principal auditor

Using the work of an expert engaged by the client

- It was not clear how the auditors were able to assess robustly the reasonableness of the assumptions used by the experts
- It is insufficient for the auditor merely to discuss the work of the expert with them particularly in the case of property valuations where the expert is in fact the directors

Audit risks

- Lack of evidence that audit risks including fraud risks had been appropriately assessed and responded to
- Lack of clarity over the identification of significant risks
- Insufficient consideration of fraud risks

- Failure to evaluate the design and implementation of controls over significant risks

Going concern

- The quality and extent of evidence on file to support the assessment of going concern required improvement

- Firms need to be more robust in their assessment of going concern. Directors should be asked to prepare formal documentation to support the going concern assumption, including forecasts. Audit files should evidence that assumptions underlying directors' forecasts have been subject to appropriate scrutiny

- Inadequate consideration of the ability of a foreign parent company to continue to support the UK subsidiary. The context of this comment was that the foreign parent was a bank which had completed its accounts nine months before the accounts of the UK subsidiary were approved. There had been significant deterioration in the credit markets during that nine month period.

Challenges facing auditors

1. Economic climate: This puts pressure on fees and margins and may lead firms to compromise on audit quality.

2. Changes to auditing standards: There is a need to maintain a significant level of investment in this area if improvements in audit systems are to be achieved.

3. Fraud risks: There is an increased risk of significant fraud in the current economic climate. Firms are urged to consider the adequacy of their fraud risk assessment procedures. Is the risk associated with revenue recognition policies being properly assessed by audit teams?

4. Going concern: Beware threats to independence where the firm is asked to provide assistance to clients in connection with refinancing.

5. Impairment of goodwill and other intangibles: This is more likely in an economic downturn. Consider the quality of audit evidence obtained concerning impairment tests.

6. Valuation of assets held at fair value (including investment properties): As with goodwill, this is likely to be a problem area in an economic downturn. Consider the quality of audit evidence obtained concerning valuations and the basis for reliance on the work of experts.

7. Determination of materiality: How should losses and one-off costs be dealt with? Firms should ensure that the rationale for the chosen level of materiality is clearly articulated on audit files.

8. Group audit arrangements: Ensure that you have sufficient involvement in the audit to act as group auditor. Ensure that the file contains sufficient evidence to support the group audit opinion.

(Lecture A304 – 9.57 minutes)

AUDIT REPORTS: ANOTHER CHANGE IN THE WORDING

This change takes effect immediately.

In 2003 the Audit & Assurance Faculty of the ICAEW issued technical release Audit 1/03, the Audit Report and Auditors' Duty of Care to Third Parties. This included an example audit report which included what has become known as the Bannerman paragraph; this clarifies that the audit is performed for the benefit of the company's members as a body, in accordance with the Companies Act and case law.

In 2008 the wording was changed to refer to specific sections of the Companies Act 2006. Following legal advice the Faculty has changed the wording again so that it now refers to Chapter 3 of Part 16 of the Companies Act 2006 rather than to specific section numbers.

If firms decide to use this paragraph in their audit report, the new wording can be used from its date of issue in January 2010. The Faculty points out that it remains for each firm to decide its own individual approach to the management of audit risk and whether or not to include this paragraph.

The new paragraph for Companies Act audit reports is as follows:

"This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are

required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed."

This paragraph can also be used in audit reports on LLPs, subject to changing company to LLP and company's members to LLP's members.

Leading Counsel has endorsed the formulation of the new language above without the need for any tailoring by practitioners. The statutory reference (to Chapter 3 of Part 16 of the Act) includes all relevant Sections (and should capture any subsequent amendments to this Chapter that might be made). The Chapter is self-contained and comparatively brief and this reference provides a reader with an informative message.

The purpose of the guidance contained in Audit 1/03 The Audit Report and Auditors' Duty of Care to Third Parties is to provide firms with a thought process to develop appropriate language for a particular case rather than simply trying to fit different situations into the example language. It is not possible to provide standard words for other public reports to cover all circumstances which firms might encounter - each situation is different for different types of reports.

It should be emphasised that the advice the ICAEW received from Leading Counsel on the revision to the clarification wording is specifically for Companies Act 2006 reports and whilst it is likely that similar legal considerations will apply for other public reports, members are reminded that they may need to take specific legal and professional advice on their particular reporting engagements.

SUMMARY OF DEVELOPMENTS

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

Accounting Standards Board (ASB)

Urgent Issues Task Force (UITF)

Financial Reporting Review Panel (FRRP)

Auditing Practices Board (APB)

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

Policy proposal: The future of UK GAAP

The Accounting Standards Board (ASB) of the FRC has received in excess of 150 high quality responses to its policy proposal: 'The Future of UK GAAP.' The responses have been posted on its website.

The proposal was issued in August 2009 and sets out recommendations for the future reporting requirements for UK and Irish entities, with an emphasis on moving UK GAAP towards an international framework.

The responses demonstrate a divergence of views on many important issues and the ASB will have a challenging task in analysing them and in coming to firm recommendations.

The ASB plans, later in the year, to host an event or events to share with UK and Irish constituents its initial analysis of the responses and how the process might be taken forward. More discussion and comment will be encouraged at that stage. After such further public consultation, it is the ASB's intention to publish an exposure draft outlining the Board's recommendations for the Future of UK GAAP. The Board will work closely with the UK Department for Business, Innovation and Skills (BIS) in exploring the most appropriate mechanism to implement the new UK GAAP.

The ASB Chairman Ian Mackintosh said:

"The responses are thoughtful and expound different points of view on major topics. This will be an excellent basis for redeliberating the original proposal. The ASB will now be busy carefully considering all the points of view and coming up with the best way forward for UK GAAP."

16 February 2010

European Parliament backs exemption for micro-entities

The European Parliament has adopted a report supporting the proposal to permit EU Member States to exempt micro-entities from the requirements of the Fourth Directive, provided that they keep adequate records to reflect their business transactions and position. This is a crucial step towards final adoption of the exemption but it is now up to national governments at the Council to seal the

approval. The final outcome is not certain as not all countries seem to support the proposal.

An entity is a micro-entity if it satisfies 2 out of the following 3 conditions: Turnover less than €1m; Total assets less than €0.5m; Fewer than 10 employees.

The lifting of the EU obligations, in particular the requirement for companies to prepare true and fair view accounts, could open up a number of possibilities in the UK. What would the new “simple” regime look like? Is there a case for pursuing a ‘tax GAAP’ to achieve the fullest possible simplification for micros? Should the FRSSE be retained for the minority of small companies that would not qualify as micros or should they move towards the IFRS for SMEs?

Adapted from blog posted on Financial Reporting Faculty website on 10 March 2010

Exposure draft of revisions to Practice Note 12

The Auditing Practices Board (APB) today issued an exposure draft of an update to Practice Note 12 (Revised), ‘Money Laundering – Guidance for auditors in the United Kingdom’. This draft guidance has been approved under the Proceeds of Crime Act 2002 by HM Treasury and has been updated for the new ISAs (UK and Ireland). The APB is issuing this guidance as an exposure draft to meet its due process. APB does not believe that there are any substantial changes made as a result of the update for ISAs (UK and Ireland) and therefore HM Treasury will not be asked to reapprove the document following the exposure period, assuming there are no substantial changes made as a result of this consultation.

Richard Fleck, Chairman of APB commented:

“This Practice Note, which has now been approved by HM Treasury, provides guidance to auditors in a complex area by assisting them in meeting their anti-money laundering responsibilities when carrying out audit work. We anticipate issuing the guidance in final form soon after the end of the exposure period.”

26 March 2010

CCAB publishes new accounting rules for LLPs

The Consultative Committee of Accountancy Bodies (CCAB) has today (31 March 2010) published a revised Statement of Recommended Practice (SORP) on Accounting by Limited Liability Partnerships (LLPs). The SORP applies UK

Generally Accepted Accounting Practice (GAAP) to LLPs incorporated in Great Britain.

The SORP was last revised in 2006. Since then, FRS 25 (IAS 32) Financial Instruments: Presentation has been amended to require certain amounts that would otherwise have been presented as liabilities to be reclassified, in limited circumstances, as equity. Proposed revisions to the SORP examining these new requirements and providing guidance on how they may affect LLPs was published in July 2009, for comment by 3 November 2009.

The amendments to FRS 25 affect the treatment of 'puttable instruments' and obligations arising on liquidation. Broadly, their purpose is to identify, for an entity that would otherwise have no equity, whether the most residual interests in that entity are sufficiently 'like equity' to be reclassified from liabilities to equity. The impact of these complex requirements on LLP financial reporting requires detailed analysis, and the CCAB spent considerable time debating the issues and considering the comments received on the draft.

The outcome is that it is likely that many - perhaps most - LLPs, especially where members provide services to the LLP, will continue to present their capital as a liability and may as a result have no 'equity' financial instruments. However, it is possible that some LLPs, including perhaps certain investment vehicle entities, will reclassify elements of capital or members' interests from a liability to equity.

The CCAB also took the opportunity to update the SORP to reflect the impact of the Companies Act 2006 and related regulations.

Andrew Vials, Chairman of the CCAB Steering Committee that oversaw the revision of the SORP, said: "The 'puttables amendment' to FRS 25 involves new accounting requirements that are complex and detailed, and determining their impact on LLPs has been challenging. The revised SORP has been updated to explain the potential effect of the new rules, using illustrative examples and guidance on the circumstances in which the various criteria for reclassification will or will not be met. In practice, fewer LLPs are likely to need to change their accounting than may have been expected at the exposure draft stage".

The CCAB notes that the IASB is shortly expecting to release an exposure draft on the topic of debt: equity classification and that it is possible that further changes may eventually arise in this area.

The revised SORP is applicable for accounting periods commencing on or after 1 January 2010 and is available for download from the CCAB website.

31 March 2010

Scope of the Audit Inspection Unit's work for 2010/11

The Professional Oversight Board ("the Oversight Board"), part of the Financial Reporting Council, today publishes a description of those entities whose audits will be deemed to be "major audits" for the purposes of audit inspections in the year from 1 April 2010 to 31 March 2011 ("2010/11"). Such audits come within the scope of the work of its independent Audit Inspection Unit ("the AIU") in 2010/11.

The Board has chosen to simplify the definition of UK unquoted companies, limited liability partnerships and industrial and provident societies to include all such entities having either a Group turnover greater than £500m or having a Group turnover in excess of £100million and external long term debt in excess of £250million. The Board has also chosen to include all banks incorporated in the UK as a separate category. No other significant changes have been made to the AIU's scope of inspection.

The Board has agreed that the AIU should have particular regard during its inspection work in 2010/11 to audit issues relating to segmental reporting, revenue recognition and fraud and continue to focus on going concern, fair value accounting estimates, asset impairments and compliance with ethical standards.

The Oversight Board welcomes comments on the scope of independent inspection by the AIU. Any such comments received during the year will be taken into account when the scope is next reviewed in March 2011.

Dame Barbara Mills, Chair of the Oversight Board, said:

"The Board continues to have regard to the level of public interest involved and has determined that the level of current public interest in banks means that these should be included as a separate category.

The challenges of the recession still present heightened audit risks in a number of areas and the AIU will continue to have particular regard during 2010/11 to those risks."

12 April 2010

The ASB issues draft UITF Abstract 'Extinguishing Financial Liabilities with Equity Instruments'

This Information Sheet sets out for comment a draft UITF Abstract ‘Extinguishing Financial Liabilities with Equity Instruments’. The draft Abstract, when issued in final form, will be applicable to entities preparing their financial statements in accordance with UK accounting standards and applying FRS 26 (IAS 39) ‘Financial Instruments: Recognition and Measurement’.

The draft Abstract addresses the recognition of an entity’s own equity instruments where these are issued to extinguish all or part of a financial liability. The consensus reached is that the equity instruments issued should be measured at the fair value of the equity, unless that fair value cannot be reliably measured.

The draft Abstract is based on Interpretation 19 issued by the IASB’s International Financial Reporting Interpretations Committee (IFRIC). The draft Abstract sets out the full text of IFRIC 19, including IFRIC’s Basis for Conclusions. IFRIC 19 affects the application of IAS 39 Financial Instruments: Recognition and Measurement. As FRS 26 Financial Instruments: Recognition and Measurement is converged with IAS 39, the UITF is proposing to issue this Abstract to maintain convergence between UK and International Financial Reporting Standards.

The UITF invites comments on any aspect of the draft Abstract but, in particular, would welcome comments on its application in the UK and Republic of Ireland.

23 April 2010

Time to review whether the value of the audit can be enhanced

Stephen Haddrill, Chief Executive of the Financial Reporting Council, spoke at the ICAS Aileen Beattie Memorial Event at Stationer’s Hall yesterday. In light of the longer term lessons of the financial crisis, he said that the FRC believes it is time to review the value of the audit and whether it can be enhanced. He announced that the FRC would be publishing its thinking on this later in the year.

He argued that:

“Audit is a key part of high quality governance. The auditor sees the company’s approach to risk. The auditor challenges management’s judgement on the financials. The auditor reports to shareholders on whether the company is providing a true and fair view of the business. The investor only sees the tip of the iceberg of work. But nevertheless investors are relying on that work being done.”

Whilst not wanting to pre-empt the debate, he said that some of the key issues that need to be addressed are:

- How do we achieve a strong alignment between the auditor and the interests of the shareholder?
- Do we need to change the form of the audit report to make it more useful?
- Do we need to see more said in the front of the report about risk and the business model and should the auditor provide greater assurance about such matters?
- Can auditors give more help to regulators and avoid conflicts of interest in doing so?

29 April 2010

(Lecture A305 – 10.26 minutes)