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LLP SORP

Lecture A306 (6.07 Minutes)

Introduction

The new SORP was issued on 31 March 2010 and is effective for accounting periods commencing on or after 1 January 2010.

The amendments are in respect of the following:

- The treatment of puttable financial instruments
- Updating of the SORP for the requirements of the Companies Act 2006

The transition from the Companies Act 1985 to 2006 has only involved changing the references in the SORP to reflect the new Regulations under that Act. There are minimal changes to the formatting and reporting requirements in the financial statements.

Puttable instruments

These were included in FRS 25 by an amendment which was effective for accounting periods commencing on or after 1 January 2010.

The amendment changed the classification from liabilities to equity of certain financial instruments. The amendment related to the liability-equity classification requirements of FRS 25 for puttable financial instruments. The amendments required equity classification for certain puttable financial instruments and for certain financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

FRSSE

The FRSSE was not amended to reflect these instruments. Therefore a LLP which has adopted the FRSSE is not required to apply the requirements. They will continue to classify equity and liabilities in accordance with the guidance contained in the SORP.

The FRSSE does indicate that when an issue is not covered by the standard but requirements are included in other standards then consideration should be given to those requirements, not on a mandatory basis, but in order to establish the true and fair view. The SORP comments as follows (paragraph 45):

> Accordingly, the requirements described in Appendix 3 do not apply to LLPs that have adopted the FRSSE. Such LLPs should continue to comply with the requirements of the FRSSE in respect of liabilities and equity, which are essentially consistent with those of FRS 25 before it was amended in August 2008.

What are puttable instruments?

By definition:

> A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Further information is contained in FRS 25 – BC7:

> Such financial instruments are commonly issued by mutual funds, unit trusts, co-operative and similar entities, often with the redemption amount being equal to a proportionate share in the net assets of the entity. Although the legal form of such financial instruments often includes a right to the residual interest in the assets of an entity available to holders of such instruments, the inclusion of an option for the holder to put the instrument back to the entity for cash or another financial asset means that the instrument meets the definition of a financial liability. The classification as a financial liability is independent of considerations such as when the right is exercisable, how the amount payable or receivable upon exercise of the right is determined, and whether the puttable instrument has a fixed maturity.

Consider the following example in the context of a LLP. A member is required to pay “capital” into the LLP but should they leave they have the right to the return of the capital. Under the previous SORP this would have been classified as a liability because the entity has no discretion should the member leave. By nature this is a puttable instrument.

The amendment to FRS 25 permitted some puttable instruments that had been classified as a liability to be reclassified as equity.

Therefore in application to LLPs this will not have any impact if the members “capital” has been classified as equity.

Which instruments are affected?

A member in an LLP may hold a number of instruments. The change only has an impact on the most subordinate. If for example the member has “capital” and a loan with the LLP the amendment will only apply to the “capital”. As discussed above it is not possible under the amendment to reclassify equity as liability, only liability as equity.

When will reclassification apply?

Reclassification will apply where members receive an “equity like” return in respect of their rights. The SORP notes that where the members provide services to the LLP it is unlikely that the amendment will have any effect.

The SORP provides a flowchart to illustrate the application of the puttables amendment.

Fast questions

The following questions may provide a quick method of assessing whether the changes will have an impact.

Does the LLP use the FRSSE?

Which instruments may be affected by this?

Which will be affected by amendment?

Do the members provide services to the LLP?

Example (from the SORP)

An LLP has been set up as an investment vehicle, and has ten members. Members do not provide services to the LLP. The LLP’s investments are managed by a third party who is not a member. Under the terms of the members’ agreement, each member subscribes £1,000,000. The agreement specifies certain dates on which a member can require the LLP to repurchase his or her interest. On repurchase, the member will receive the £1,000,000 originally subscribed, adjusted for the member’s share of any losses or any profits not yet divided. Any decision to divide profits must be approved by a majority of the members. On such a division, the profits are divided equally between all ten members.

The LLP has no discretion over cash outflows in respect of the repurchase of members' interests. However, it considers the tests included in the puttables amendment, and concludes that they are met in relation to the members' initial capital. Accordingly:

- The capital subscribed of £10,000,000 is presented within equity, and

- Any divisions of profit are reported as equity appropriations when they occur (whether during or after the end of the period).

Prior to the puttables amendment, the capital in this example would have been presented as a liability, because the LLP has an obligation to repurchase members' interests. However, the LLP now concludes that all the tests for equity treatment in the puttables amendment are met – for example the total cash flows attributable to the capital over its life are based substantially on the LLP's profit or loss (paragraph 16A (e) of FRS 25).

SERVICE CHARGE ACCOUNTING

Lecture A307 (4.48 Minutes)

There has been an increasing interest in this topic over the last few months. The publication by the ICAEW of information on the accounting treatment for service charge funds has required a number of RMCs to reconsider the accounting treatment adopted in the financial statements.

The document from the ICAEW indicated that a change in the legal requirements was likely in the very near future which would clarify the position and also put in place some additional procedures. It is possible that some companies were awaiting this change before making any changes to their own financial statements.

The ICAEW guidance was linked to the guidance issued by ARMA (LAN 08).

ARMA have stated the following in a recent announcement.

> "Under the provisions of the Commonhold and Leasehold Reform Act 2002 lessees' money was to be held in separate designated bank accounts and lessees would have the right to automatically receive a full set of annual service charge accounts along with an accountant's report.

At the end of June the Communities and Local Government department informed us that, after eight years since the Act was passed and three years of intensive work to produce the regulations, matters were not going to be progressed.

The end result is we are back to self-regulation and ARMA will play its part in filling the dreadful void in lessee protection. Not least we will be looking to produce detailed guidance on good accounting practice to supplement the existing Codes."

It should be noted that LAN 08 has been withdrawn by ARMA. New guidance is being developed between ARMA and the ICAEW and should be available later this year.

SECTION 413 DISCLOSURES

Lecture A308 (7.39 Minutes)

There has been a lot of debate over the disclosure requirements of s413.

What are the requirements?

413 Information about directors' benefits: advances, credit and guarantees

(1) In the case of a company that does not prepare group accounts, details of-

(a) advances and credits granted by the company to its directors, and

(b) guarantees of any kind entered into by the company on behalf of its directors,

must be shown in the notes to its individual accounts.

(2) In the case of a parent company that prepares group accounts, details of-

(a) advances and credits granted to the directors of the parent company, by that company or by any of its subsidiary undertakings, and

(b) guarantees of any kind entered into on behalf of the directors of the parent company, by that company or by any of its subsidiary undertakings,

must be shown in the notes to the group accounts.

(3) The details required of an advance or credit are-

(a) its amount,

(b) an indication of the interest rate,

(c) its main conditions, and

(d) any amounts repaid.

(4) The details required of a guarantee are-

(a) its main terms,

(b) the amount of the maximum liability that may be incurred by the company (or its subsidiary), and

(c) any amount paid and any liability incurred by the company (or its subsidiary) for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

(5) There must also be stated in the notes to the accounts the totals-

(a) of amounts stated under subsection (3)(a),

(b) of amounts stated under subsection (3)(d),

(c) of amounts stated under subsection (4)(b), and

(d) of amounts stated under subsection (4)(c).

(6) References in this section to the directors of a company are to the persons who were a director at any time in the financial year to which the accounts relate.

(7) The requirements of this section apply in relation to every advance, credit or guarantee subsisting at any time in the financial year to which the accounts relate-

(a) whenever it was entered into,

(b) whether or not the person concerned was a director of the company in question at the time it was entered into, and

(c) in the case of an advance, credit or guarantee involving a subsidiary undertaking of that company, whether or not that undertaking was such a subsidiary undertaking at the time it was entered into.

(8) Banking companies and the holding companies of credit institutions need only state the details required by subsections (3)(a) and (4)(b).

What are the issues arising?

The following issues have been identified:

Advances and credits

The term ‘advances and credits’ is not defined in the Act. This leads to difficulties in deciding exactly what transactions are included and what needs to be disclosed, e.g. does it cover only loans or should other advances such as quasi loans and expense advances be included?

Level of disclosure

The section is worded in a way that appears to require separate disclosure of each individual advance made to a director. For OMBs with frequent transactions this could result in an extensive note. There has been debate as to what the accounts should show and a feeling that common-sense should be applied.

The ICAEW has stated the following in its Technical Enquires Service FAQ April 2009

> **It appears from the legislation that every single loan transaction with a director has to be disclosed, this would be impractical where there are numerous transactions with a director during the year in the form of a director's current account.**
>
> Agreed, the legislation (s413 Companies Act 2006) does seem to make this a requirement, there is no further guidance on this subject at present except to suggest that the disclosures do have to be made for each loan payment to a director.

Application

The statutory disclosure applies to advances granted to directors. It does not include connected persons or any other parties.

Where a director's current or loan account remains in credit it is likely that the company is not making advances; the director is merely drawing against what the company owes him or her.

The disclosure requirements of the Act become significant when a director has an 'overdrawn' current account.

There is a formal approval requirement for loans and, for plcs and members of plc groups, this also extends to quasi loans and credit transactions. A company can make a loan to a director provided the members give their approval before the transaction takes place. The approval is required to include the matters contained in section 197. No approval is required if the company is a wholly owned subsidiary of another body corporate. No approval is required if the value of the transaction does not exceed £10,000. The £10,000 includes any other relevant transactions. This would include any previous loans or quasi loans.

A company may provide a director with funds to meet expenditure for the purposes of the company or to enable him to carry out his duties. Advances of expenses do not need the same approval as other transactions in this section of the Act. However, they are limited to a maximum of £50,000 in aggregate.

The section concerning quasi loans applies only to public companies and those companies associated with public companies. Transactions with directors are covered under section 198, and those with connected persons under s200. In respect of directors, quasi loans (and guarantees in respect of such loans) are permitted provided the company has given approval prior to the transaction taking place. Such transactions are permitted with connected persons provided they are approved by the members. In all cases (i.e. director and connected persons), if the value of the quasi loan is less than £10,000 (taking into account any other loans to the same person) then no approval is required.

The section concerning credit transactions applies only to public companies and those companies associated with public companies. Transactions are covered under section 201. Such transactions are permitted provided the company has given approval in general meeting. This applies to both directors and connected persons. Transactions below £15,000 in aggregate per person do not require approval.

Auditors should satisfy themselves that the disclosures are in accordance with the Act.

What is happening in practice?

Audit and Beyond May 2010 indicated the following:

"To date, a wide range of disclosures have been made in published accounts from details of every single advance or credit and every repayment set against them (plus mandatory information on interest rates/conditions etc), through summaries by category, to opening and closing balances and maximum amount during the year (ie, no perceptible change from the CA 1985).

One of the big firms published an analysis of section 413, with the comment: 'a common sense interpretation of the requirement is that it will be adequate to give summarised details such as the total amounts drawn down and repaid during the period, together with the balance at the year end and the maximum outstanding during the period'. The firm noted that the original EU Directive from which section 413 is derived does not require every individual movement on a loan account to be disclosed."

The authors of the article indicated that they think that this analysis has considerable merit although they recognise that it is not completely consistent with the exact wording in section 413. The article continued:

"There are risks with summarising directors' advances in this way. For example, if only aggregate amounts advanced and repaid are shown it may not be apparent that a director's loans exceeded £10,000 in aggregate and so shareholder approval should have been sought.

It might also conceal amounts paid as 'dividends' when the company did not have the realised profit to support them. Such issues could cause problems if a company gets into financial difficulty.

The directors must bear in mind the need to give a true and fair view. There is no stated materiality to the disclosures, so any measure of materiality applied in practice is likely to be much lower than for other items in the accounts, simply because of the directors' involvement."

Abbreviated accounts

Are the disclosures required in abbreviated accounts?

The ICAEW has stated the following in its Technical Enquires Service FAQ April 2009

Should the disclosures required by section 413 Companies Act 2006 (Information about directors' benefits: advances, credit and guarantees) be included in small company abbreviated accounts?

It appears the legislation could be open to interpretation. S444 of the CA 2006 and Reg 6 of SI 2008/409 indicate a requirement only to deliver a balance sheet and notes and the balance sheet and notes delivered can comply with Sch 4 of SI 2008/409. Therefore, by implication, there is no need for the s413 directors' loans disclosures.

However, as far as we are aware, there was no intention to change the law in this respect through Companies Act 2006. S444(3) says that the copy filed with the Registrar needs to be the same as the full accounts, except that the balance sheet can be prepared in accordance with regulations (which is Sch 4 to the small co regs), and s444(1) exempts you from filing the P&L and directors' report (or rather, makes filing optional).

In conclusion it is not clear that disclosure of directors' loan and other related transactions have to be made in small company abbreviated accounts, but as there was no known intention of changing this requirement, our recommendation would be to continue to make disclosure.

A possible approach

Audit and Beyond May 2010 indicated the following:

1. Create a chronological record of transactions between the company and the director to establish whether there were any 'advances' (ie was the account overdrawn at any time).

2. Identify opening and closing debit balances and the maximum amounts outstanding (the account may be overdrawn on more than one occasion and be rectified in between times).

3. Identify individually material advances to the director in the overdrawn period(s) and list them separately. Remember that loans exceeding £10,000 in aggregate require prior approval by the members.

4. Identify any other individually material advances, for example where the director used company money for personal purposes (quasi loans in a plc), and consider whether these need reporting separately.

5. Aggregate the remaining advances.

6. Identify amounts repaid by the director, listing material amounts individually and separately.

7. Compile the note, adding details of interest, security etc.

Future consultation

In August 2009 BIS consulted on amendments to s413(8). This section only applies to banks. The proposal was to allow banks to aggregate disclosures of advances to directors.

It also asked for views on extending such aggregation to all companies. The government response to the consultation was published in November 2009. The government decided at that time only to allow the aggregation by banks but stated that any additional changes would be subject to further consultation.

DIRECTOR LOAN OR CURRENT ACCOUNTS AND DIVIDENDS

Lecture A309 (11.23 Minutes)

A characteristic of OMBs is the existence of director loan or current accounts. Transactions which are often credited to these accounts are dividends and bonuses. These credits may be set off against debits which have arisen during the period (probably as a result of the company settling liabilities on behalf of the director) or may be left as creditors at the balance sheet date.

There are legal and recognition issues associated with these transactions. In addition it has been noted that in some cases the dividend has been drawn on a regular basis over a period of time. The financial position of the company may have changed over that period to the extent that the dividend is being paid out of capital.

Useful sources of information

Companies Act 2006 – Part 23 (specific sections covered below)

ICAEW TES Helpsheet March 2009

ICAEW Financial reporting Faculty Factsheet April 2010

ICAEW Tech 01/09 Guidance on realised profits

Companies Act 2006

Before any dividends can be declared by the directors there have to be sufficient distributable reserves. This provision is contained in s830; “A company may only make a distribution out of profits available for the purpose”. The section also indicates that the profits available for distribution are “accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made”.

There is an additional requirement for plcs in s831. The distribution can only be made to the extent that the net assets exceed the aggregate of the called up share capital and undistributable reserves. The undistributable reserves could include share premium account, capital redemption reserve, revaluation reserve, etc.

An example of this is shown below:

Net assets	90
Share capital	20
Share premium	80
Unrealised revaluation deficit on property	(20)
Accumulated realised profits	10
	90

In this example a private company could make a distribution from the realised profits of 10. A plc could not as the share capital and undistributable reserves amount to 100 which are in excess of its net assets.

Whether reserves are available for this purpose is covered by s836 which requires the distribution to be justified by reference to relevant accounts. Excluding the aspect of a company's first year, the relevant accounts will either be the last annual accounts prepared by the company or interim accounts. A failure to comply with this requirement would indicate the distribution is unlawful.

If the last annual accounts are used then the distributable reserves are assessed in accordance with them. If the audit report was qualified, the auditor is required to provide a statement to indicate whether the qualification is material in assessing the value of the distributable reserves. This report can either be provided at the same time as their report or on a subsequent date.

Where a number of distributions are made by reference to the same set of relevant accounts each distribution has to be deducted to assess whether there are sufficient distributable reserves (s840).

The alternative to the last annual accounts is interim accounts (s838). There are no specific requirements for the interim accounts for a private company except that they must enable a reasonable judgement to be made as to whether sufficient reserves exist under s836. For plcs the interim accounts must be properly prepared. Properly prepared means in accordance with s395 to s397, i.e. the requirements for individual (annual) accounts.

The consequences of an unlawful distribution are covered in s847.

(2) If at the time of the distribution the member knows or has reasonable grounds for believing that it is so made, he is liable-

(a) to repay it (or that part of it, as the case may be) to the company, or

(b) in the case of a distribution made otherwise than in cash, to pay the company a sum equal to the value of the distribution (or part) at that time.

Therefore a director who is aware that the requirements of the Act have not been followed would be liable to repay the sums to the company. However, a member who is not a director and may not have been aware that the distribution is unlawful, would not be required to repay.

The consequences of unlawful distributions were established in the following case.

Bairstow v Queens Moat Houses plc

- In order to pay a dividend the company must have distributable profits.
- Distributable profits are determined from the company's accounts.
- The accounts must be properly prepared to give a true and fair view of the state of affairs and profit or loss.

The result of the above case is that if these requirements are not complied with then the distribution is unlawful.

The effect on the directors of the above company was that they were liable for the repayment of £26.7m of dividends together with costs.

Any dividend paid on the basis of accounts which are known not to be properly prepared constitutes an unlawful payment. Whether the company has distributable profits or not is not relevant. In general this will affect directors who authorise the payment of a dividend on the basis of accounts they know have not been properly prepared. It could also make shareholders liable if they were aware of the circumstances.

This supports the decision in Allied Carpets Group plc v Nethercott. In this case it was contended that the overstated profits had no effect on the dividend and the level of distributable profits. The courts decided that this is irrelevant. If the accounts are not properly prepared then any dividend paid is unlawful and the directors will be liable.

Other director responsibilities

ICAEW Tech 01/09 makes the following comment in Section 2.2:

Under common law, a company cannot lawfully make a distribution out of capital. Thus, the directors must consider, both at the time of proposing the distribution and at the time it is made, whether the company, subsequent to the balance sheet date to which the 'relevant accounts' were prepared, has incurred losses that have eroded its profits available for distribution (the 'capital maintenance rule').

The group situation

Distributions are made by companies not by groups. Therefore the directors must establish that the requirements are met by the company making the distribution. Attention is drawn to ICAEW Tech 01/09 which discusses whether profits arising in group situations are realised or not.

The process for paying dividends

The process of paying a dividend is not included within the Act. This is referred to in Table A. This has not changed as a result of the new Table A under the 2006 Act.

> 102 Subject to the provisions of the Act, the company may by ordinary resolution declare dividends in accordance with the respective rights of the members, but no dividend shall exceed the amount recommended by the directors.
>
> 103 Subject to the provisions of the Act, the directors may pay interim dividends if it appears to them that they are justified by the profits of the company available for distribution.

ICAEW Tech 01/09

When dividends become a liability of the company is discussed as follows:

> 2.10 A distribution is made when it becomes a legally binding liability of the company, regardless of the date on which it is to be settled. In the case of a final dividend, this will be when it is declared by the company in general meeting or, for private companies, by the members passing a written resolution. In the case of an interim dividend authorised under common articles of association (e.g. 1985 Act Table A), normally no legally binding liability is established prior to payment being made of the dividend. In such a case, a distribution is made only when the dividend is paid. However, in the case of an interim dividend, steps may be taken to establish a legally binding liability at an earlier date. See 9.5 to 9.18 below concerning how such a liability may be established. That guidance is written in the context of intra-group transactions. However, the guidance may also be relevant in other cases.
>
> 2.10A Distributable profits are consumed when a distribution is made in accordance with the previous paragraph. After that time, a shareholder’s right to any unpaid dividend is as a creditor of the company rather than as a shareholder.

When is a dividend paid?

This is discussed in the context of inter group dividends but not in the context of director current accounts. However, in nature the parent company's current account in a subsidiary's books is similar in nature to a director's current account. Both are asset/liability accounts. Therefore the observations made by the ICAEW could be equally applied to directors' current accounts.

9.11 This therefore raises the question as to what constitutes payment of an interim dividend and what steps may be taken to establish a legally binding liability. This will affect the timing of its recognition as a distribution by the paying company and as a profit by the recipient company. The question of whether a profit recorded by the recipient company is a realised profit falls to be determined under the general principles in this guidance, for example, whether it is qualifying consideration.

9.12 Where there is a transfer of cash the answer will be clear as payment has been received. This conclusion would not be affected by the cash being immediately or closely afterwards reinvested in the paying company either by way of loan or by way of capital investment, although the fact of such reinvestment will require consideration of the guidance at 9.19 below as to whether the profit is realised or unrealised in the parent company's hands.

9.13 Where the dividend is recorded on inter-company account and the effect of such an entry reduces the amount recorded as receivable from the parent to the dividend paying subsidiary, this would constitute settlement by way of set-off and would be equivalent to a payment in cash taking place at the date that the book entries were made by both companies (or later if these should be different) to the extent that this does not reduce the amount recorded as receivable from the parent to the dividend paying subsidiary below nil.

9.14 Where the dividend is recorded on inter-company account and the book entry creates or increases a liability of the paying subsidiary, the question arises as to whether the dividend falls to be treated as paid and received, or a legally binding liability is otherwise established.

9.15 Effecting the dividend via a group treasury function (see 9.4 above) where the subsidiary company instructs the group treasury function to debit the subsidiary's account and credit the parent's account, would constitute payment.

9.16 In other circumstances, more than just entries into the accounting records of the paying and receiving company are likely to be required. If there were no doubt as to the paying subsidiary's ability to pay the dividend, a legally binding liability in respect of an individual dividend could be established by the execution, as a Deed, of an acknowledgment of liability to pay the amount entered in the accounting records as a payable by the subsidiary and a receivable by the parent company or the constitution of such liability pursuant to an enforceable contract under Scots Law.

9.17 Any doubts about whether an interim dividend recorded by book entry is a legally binding liability can be removed by the conversion of the interim dividend into a final dividend before the year end. Under common form articles of association, this will require a recommendation by the directors and the declaration of the dividend either by approval by the members in a general meeting or, for private companies, by the members passing a written resolution.

Disclosures in the financial statements

The ICAEW issued a help sheet in March 2009.

Section 277 CA 1985 and s847 CA 2006 says that where shareholders have received a dividend from the company knowing at the time that there were insufficient reserves available for the purpose, then they are liable to repay the illegal portion. When profitability deteriorates later in the year after directors have paid interim dividends, the year-end financial statements may show a cumulative loss on reserves. Provided the directors had previously substantiated the interim dividend, the liability to repay would not normally arise.

If, however, the dividend was not, say, supported by relevant accounts and the reserves are now in deficit, directors should make full disclosure in the notes to the accounts. For example, a disclosure that the dividend was not supported by relevant accounts but was received by shareholders unknowingly. The directors should also state that they undertake to make no further distributions until such time as there are reserves available for the purpose. Until this time, a request to repay the dividend would be likely in the case of insolvency.

If full disclosure is made in the notes to explain the situation then it is possible, in fact probable, that the auditors will not need to qualify their audit report. The deficiency of reserves may, however, cause the auditors to qualify their report on the basis of doubts over the going concern of the company.

Dividends paid to related parties

Disclosure requirements of FRSSE and FRS 8

The disclosure should include:

(a) the names of the transacting related parties;

(b) a description of the relationship between the parties;

(c) a description of the transactions;

(d) the amounts involved;

(e) any other elements of the transactions necessary for an understanding of the financial statements;

(f) the amounts due to or from related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(g) amounts written off in the period in respect of debts due to or from related parties.

Transactions with related parties may be disclosed on an aggregated basis (aggregation of similar transactions by type of related party) unless disclosure of an individual transaction, or connected transactions, is necessary for an understanding of the impact of the transactions on the financial statements of the reporting entity or is required by law.

Disclosure of dividends paid to directors

The ICAEW and ACCA have stated that dividends paid to directors should be disclosed as related party transactions. Questions have arisen as to the nature of the disclosures.

Should you name the directors in the notes to the financial statements for the purposes of (a)?

With OMBs the directors are often named in the disclosures concerning control and therefore it could be argued that the requirement has been met. Where this is not the situation reliance could be placed on the disclosures made in the directors' report. There is a technical issue as to whether such disclosures are made in the "true and fair" element as the directors' report does not form part of the financial statements.

Do you need a separate note in the financial statements?

Again this needs to be considered in the context of other disclosures which are included. For example if there is one director and shareholder who is named in the control note, it could be argued that any dividends paid must have been to that individual.

Do you need to name each director and the amount of dividend they received?

Standards allow aggregation of similar transactions with similar related parties.

Do dividends need to be specifically disclosed in the notes?

Regulations state

> There must be stated -
>
> (a) any amount set aside or proposed to be set aside to, or withdrawn or proposed to be withdrawn from, reserves,
>
> (b) the aggregate amount of dividends paid in the financial year (other than those for which a liability existed at the immediately preceding balance sheet date),
>
> (c) the aggregate amount of dividends that the company is liable to pay at the balance sheet date, and
>
> (d) the aggregate amount of dividends that are proposed before the date of approval of the accounts, and not otherwise disclosed under paragraph (b) or (c).

Disclosure of dividends paid to other related parties

Other related parties include:

> Extracts from FRS 8
>
> 2.5 Related parties:-
>
> A party is related to an entity if:
>
> (a) directly, or indirectly through one or more intermediaries, the party:
>
> (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
>
> (ii) has an interest in the entity that gives it significant influence over the entity; or

(iii) has joint control over the entity;

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

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

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

Extract from FRSSE

Two or more parties are related parties when at any time during the financial period:

(a) one party has direct or indirect control of the other party; or

(b) the parties are subject to common control from the same source; or

(c) one party has significant influence over the financial and operating policies of the other party. Significant influence would occur if that other party is inhibited from pursuing its own separate interests.

For the avoidance of doubt, related parties of the reporting entity include the following:

(i) parent undertakings, subsidiary and fellow subsidiary undertakings;

(ii) associates and joint ventures;

(iii) investors with significant influence and their close families; and

(iv) directors of the reporting entity and of its parent undertakings and their close families.

What disclosures are required if the company is a family business in which some members of the family are directors and shareholders and others are not?

FRS8 and FRSSE both require disclosure of material transactions with related parties. The members of the close family of directors are related parties. Therefore disclosure of dividends paid is required if material. The payments made to members of the family who are not directors can be disclosed on an aggregated basis although the names of the individuals concerned would also need to be disclosed along with an indication of the relationship which makes them related parties.

What disclosures are required if an individual controls 20% or more of the voting rights but is not a director of the company?

This would depend on whether the individual is a related party through part a(ii) of the definition in FRS 8 or part (c) of the definition in FRSSE – that is does the individual have significant influence over the entity?

Aggregation

How do you establish similar related parties?

Extract from FRS 8 explanatory material:

21 Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, similar transactions may be aggregated by type of related party. For example, in the individual accounts of a group company, purchases or sales with other group companies can be aggregated and described as such. However, this should not be done in such a way as to obscure the importance of significant transactions. Hence purchases or sales of goods should not be aggregated with purchases or sales of fixed assets. Nor should a material related party transaction with an individual be concealed in an aggregated disclosure.

FREQUENTLY ASKED QUESTIONS - WEBSITE COSTS

Lecture A310 (7.29 Minutes)

Q1: Capitalisation of development costs

Q. The client capitalised website development costs last year, and has further costs incurred this year that they wish to capitalise. Can they do this?

A. In terms of the website costs, UITF 29 is the relevant standard. Website costs should be capitalised only if they meet the criteria in paragraph 12, otherwise they should be expensed to the P&L.

The requirement is that they lead to the creation of an enduring asset delivering benefits at least as great as the amount capitalised. This will be the case only to the extent that:

a) the expenditure is separately identifiable;

b) the technical feasibility and commercial viability of the Website have been assessed with reasonable certainty in the light of factors such as likely market conditions (including competing products), public opinion, and possible legislation;

c) the Website will generate sales or other revenues directly and the expenditure makes an enduring contribution to the development of the revenue-generating capabilities of the Website;

d) there is a reasonable expectation that the present value of the future cash flows (ie future revenues less attributable costs) to be generated by the Website will be no less than the amounts capitalised in respect of that revenue-generating activity; and adequate resources exist, or are reasonably expected to be available, to enable the Website project to be completed and to meet any consequential need for increased working capital.

Q2: Websites containing technical data

Q. A company has developed its website to contain a good deal of technical data which customers can access to back up its sales. Can the website costs be capitalised?

A. No. this does not meet the requirements of UITF 29. See particularly Section c) above.

Q3: Website costs and the FRSSE

Q. A company using the FRSSE has incurred costs on its website. What should the accounting be?

A. Entities that apply the FRSSE are exempt from the requirements of UITF 29. The directors of the company using the FRSSE may refer to the principles in UITF 29 for guidance but they are not required to follow them.

In particular, the starting point is to look at the FRSSE itself to see whether the principles laid down in the FRSSE can apply to website development costs. Whilst the term “development” is usually applied to development of products, the definition of development includes the following:

“Use of .... technical knowledge in order to .... install new processes or systems before the commencement of .... commercial applications....”

Therefore, the best approach for FRSSE entities is to deal with website costs under the more general heading of development costs. This means following paragraphs 6.5 to 6.10. of the FRSSE which set out the usual five conditions for capitalisation, namely:

a) there is a clearly defined project; and

b) the related expenditure is separately identifiable; and

c) the outcome of such a project has been assessed with reasonable certainty as to:

    I. its technical feasibility; and

    II. its ultimate commercial viability considered in the light of factors such as likely market conditions (including competing products), public opinion, consumer and environmental legislation; and

d) the aggregate of the deferred development costs, any further development costs, and related production, selling and administration costs is reasonably expected to be exceeded by related future sales or other revenues; and

e) adequate resources exist, or are reasonably expected to be available, to enable the project to be completed and to provide any consequential increases in working capital.

Failure to meet these conditions means that the development expenditure is expensed.

These conditions are, of course, very similar to those in UITF Abstract 29 but not identical. In particular, the requirement in UITF 29 is that the website should generate revenues "directly" whereas in FRSSE the reference is to "related future sales".

TOP TEN ISSUES THAT QAD FIND DURING PRACTICE ASSURANCE VISITS

Lecture A311 (10.21 Minutes)

The Institute has just published the 2009 Practice Assurance Report. By the end of the year QAD had visited about 8,500 firms since the start of Practice Assurance, leaving about 3,000 firms to visit in the final year of the six-year cycle.

In 2009 there was a focus on reviewing accounts filed at Companies House, which resulted in an increase in the number of firms referred to the Practice Assurance Committee to 5.1% of firms visited, compared with 2.7% in 2008. Of these firms 44% were referred to the Professional Conduct Department (37% in 2008).

So, with more than 2,000 visits during the year, what were the top ten problems that they came across?

1. Failure to have adequate PI in place, often forgetting cover for connected entities (such as payroll companies).

2. Non-compliance with the Money Laundering Regulations, particularly inadequate customer due diligence, and lack of awareness and training on how to report suspicious transactions.

3. Making loans to clients. This is prohibited for non-audit clients as well as audit clients.

4. Poor accounts disclosure, which was a particular focus for 2009 (and will continue to be in 2010)

5. Failure to comply with the Clients' Money Regulations, including failing to have a trust letter in place with the bank, reconciliations not being in the prescribed manner, client money being incorrectly offset against fees and a lack of compliance review.

6. No or poor letters of engagement, particularly not communicating in writing the basis of charging fees and the right to complain to the Institute.

7. Using the incorrect ICAEW logo. Whilst this may seem trivial the Institute has invested a lot of effort in developing the brand, which is now a top 200 global super-brand. If members wish to use the logo it is important to use the correct version.

8. Failure to register under the Data Protection Act, which affected 15% of the firms visited.

9. Whilst most record CPD, 72% of firms did not use the 'reflect, act, impact' model required by the Institute.

10. 55% of firms did not carry out an annual compliance review. Although the regulations do not require an annual Practice Assurance compliance review, the QAD generally finds fewer reportable issues where firms do undertake a regular review.

This report is taken from the SWAT UK website. The full report is available on the ICAEW web site.

ISA (UK AND IRELAND) 250 SECTION A - CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

Lecture A312 (14.28 Minutes)

Introduction

Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

The requirements in this ISA (UK and Ireland) are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs (UK and Ireland). In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity, that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.

- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

This ISA (UK and Ireland) distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

6(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations (see paragraph 13); and

6(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating licence, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14).

In this ISA (UK and Ireland), differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

The auditor is required by this ISA (UK and Ireland) to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional scepticism throughout the audit, as required by ISA (UK and Ireland) 200, is important in this context, given the extent of laws and regulations that affect the entity.

Objectives

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Requirements

The auditor's consideration of compliance with laws and regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with ISA (UK and Ireland) 315, the auditor shall obtain a general understanding of:

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework.

The Application Material tells us that, to obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

The question arises as to what documentation is required to evidence compliance with Paragraph 12 above. In the absence of any guidance within the standard, I would suggest we have to apply the general principle laid down in Paragraph 18 of Practice Note 26:

"...it is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor has based the assessment of the risks of material misstatement in the financial statements."

Paragraph 13 requires the auditor to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

The Application Material explains that such laws and regulations could relate to, for example, the form and content of financial statements, industry-specific financial reporting issues, or accounting for specific transactions. In the UK and Ireland, these laws and regulations include those which determine the circumstances under which a company is prohibited from making a distribution except out of profits available for the purpose and those laws which require auditors expressly to report non-compliance, such as the requirements relating to the maintenance of adequate accounting records or the disclosure of particulars of directors' remuneration in a company's financial statements.

The aim of the requirement in paragraph 13 is for the auditor to obtain sufficient appropriate audit evidence regarding the determination of amounts and disclosures in the financial statements in compliance with the relevant provisions of those laws and regulations.

Non-compliance with other provisions of such laws and regulations and other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

A UK Plus in the Application Material points out that the auditor's responsibility to express an opinion on an entity's financial statements does not extend to determining whether the entity has complied in every respect with applicable tax legislation. The auditor needs to obtain sufficient appropriate evidence to give reasonable assurance that the amounts included in the financial statements in respect of taxation are not materially misstated. This will usually include making appropriate enquiries of those advising the entity on taxation matters (whether within the audit firm or elsewhere). If the auditor becomes aware that the entity has failed to comply with the requirements of tax legislation, the auditor considers whether to report the matter to parties outside the entity.

14. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's licence or other entitlement to perform its operations could have such an impact. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

The Application Material tells us that, in general, a small company which does not operate in a regulated area will require few specific procedures compared with a large multinational corporation carrying on complex, regulated business.

Paragraph 15 contains the requirement for the auditor to remain alert during the audit to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

Procedures that may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention may include reading minutes, inquiries concerning litigation, claims etc and the performance of substantive tests.

A UK plus in the Application Material draws particular attention to the auditor’s duty to report suspected money laundering activity.

Paragraph 16 requires the auditor to request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

In the absence of identified or suspected non-compliance, Paragraph 17 tells us that the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 12-16.

This reflects a guidance paragraph in the old version of ISA 250 but it is interesting that it is now placed within the section of the ISA dealing with requirements when it is, in fact, a clear statement of what is not required.

There has always been confusion amongst auditors as to what is required in this area of laws and regulations. The confusion was not helped in 2005 when ISAs were adopted and a lot of UK Pluses were added to ISA 250. In particular readers of these notes should observe that the old reference to laws and regulations “central to the business” has now disappeared.

Audit procedures when non-compliance is identified or suspected

The ISA (UK and Ireland) goes on to deal with procedures when non-compliance is identified or suspected. If this is relevant in a particular situation then users of these notes are referred to the full standard which covers the following issues:

- The need to obtain an understanding and further information so as to evaluate the possible effect on the financial statements. (Ref: Paragraph 18)

- The need to discuss the matter with management and/or those charged with governance and the possible need to obtain legal advice. (Ref: Paragraph 19)

- The potential effect of the lack of sufficient appropriate audit evidence on the auditor's opinion. (Ref: Paragraph 20)

- The impact on other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. (Ref: Paragraph 21)

- Reporting non-compliance to those charged with governance. (Ref: Paragraphs 22 to 24)

- Reporting non-compliance in the auditor's report on the financial statements. (Ref: Paragraphs 25 to 27)

- Reporting non-compliance to regulatory and enforcement authorities. (Ref: Paragraph 28) See also the Application Material paragraph A19ff for UK pluses dealing with reporting suspicions of money laundering and also reporting in the public interest.

Documentation

29. The auditor shall include in the audit documentation identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

So what?

This standard is clarified not revised but in fact there are significant changes made to it. For me, the most important thing is that there is a clearer analysis of the types of law and regulation affecting the business and clear instructions as to the auditor's responsibilities. In particular, the removal of the UK pluses from the requirements section of the standard is a great step forward in simplifying matters.

ISA (UK AND IRELAND) 402 AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION

Lecture A313 (7.36 Minutes)

Introduction

This standard deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies ISA (UK and Ireland) 315 and ISA (UK and Ireland) 330 to the situation of a service organisation.

Outsourcing is common and many of the services provided by service organisations are integral to the entity's business operations; however, not all those services are relevant to the audit. Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets.

Objectives and definitions

The objectives of the user auditor, when the user entity uses the services of a service organisation, are:

(a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and

(b) To design and perform audit procedures responsive to those risks.

Definitions are provided in the text of the standard but most are fairly obvious in their meaning. The definitions concerning the assurance report on the controls of a service organisation that may be obtained from the auditor of the service organisation are contained in the relevant part of the notes below.

Requirements

Obtaining an understanding

Paragraph 9 of the standard requires the auditor to obtain an understanding of how the user entity uses the services of a service organisation in the user entity's operations. This will include

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

A UK plus in the Application Material refers specifically to the importance of the situation where the activities undertaken by the service organisation are in an area in which the user entity is required to comply with the requirements of law and regulations. See also the notes on ISA (UK and Ireland) 250A.

(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

(c) The degree of interaction between the activities of the service organisation and those of the user entity;

The Application Material draws particular attention to the situation where the service organisation initiates or initially records, processes, and does the accounting for the user entity's transactions. In these circumstances the user entity may not implement their own controls over transactions relying instead on the controls at the service organisation.

(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

(e) If the service organisation maintains all or part of a user entity's accounting records, whether those arrangements impact the work the auditor performs to fulfil reporting responsibilities in relation to accounting records that are established in law or regulation.

This requirement (in paragraph (e) is a UK plus. It continues the theme mentioned above concerning the requirements of laws and regulations. In particular, the Application Material refers to the prescriptive nature of the wording of UK company law which appears to require the company itself to keep accounting records. Consequently, whether a company 'keeps' records (as opposed to 'causes records to be kept') will depend upon the particular terms of the outsourcing arrangements and, in particular, the extent to which the company retains ownership of, has access to, or holds copies of, those records.

In line with the requirements of ISA (UK and Ireland) 315, Paragraph 10 requires the user auditor to evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation.

The aim here is that the auditor of the user entity may be able to test the user entity's controls and conclude that they are operating effectively for some or all of the related assertions, regardless of the controls in place at the service organisation.

Paragraph 11 requires the user auditor to determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

If this is not the case, then Paragraph 12 requires the user auditor to obtain that understanding from one or more of the following procedures:

(a) Obtaining a type 1 or type 2 report, if available (see below);

(b) Contacting the service organisation, through the user entity, to obtain specific information;

(c) Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or

(d) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

With reference to sub-paragraph (a) above, a type 1 report on the description and design of controls at a service organisation comprises:

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

A type 2 report on the description, design, and operating effectiveness of controls at a service organisation comprises:

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:

a. The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and

b. A description of the service auditor's tests of the controls and the results thereof.

In determining the sufficiency and appropriateness of the audit evidence provided by a type 1 or type 2 report, Paragraph 13 requires the user auditor to be satisfied as to the service auditor's professional competence and independence from the service organisation and the adequacy of the standards under which the type 1 or type 2 report was issued.

If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, paragraph 14 requires the user auditor to:

(a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and

(c) Determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Responding to the Assessed Risks of Material Misstatement

15. In responding to assessed risks in accordance with ISA (UK and Ireland) 330, the user auditor shall:

(a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,

(b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

When the service organisation maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor to obtain sufficient appropriate audit evidence relating to the operation of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service organisation's premises or interrogation of records maintained electronically from the user entity or another location, or both.

In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organisation on behalf of the user entity, the user auditor may obtain evidence by inspecting records and documents held by the user entity. Alternatively, the user auditor may obtain access to the records of the service organisation.

Another possibility is that the user auditor could obtain confirmations of balances and transactions from the service organisation. However, this approach is only effective if the user entity maintains independent records of balances and transactions. If the user entity does not maintain independent records, information obtained in confirmations from the service organisation is merely a statement of what is reflected in the records maintained by the service organisation. Therefore, such confirmations do not, taken alone, constitute reliable audit evidence. It is a common error in practice that auditors rely on information provided by a service organisation without corroboration.

Finally, the user auditor could perform analytical procedures on the records maintained by the user entity or on the reports received from the service organisation: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available.

If a user entity outsources some or all of its finance function to a service organisation, the user auditor may face a situation where a significant portion of the audit evidence resides at the service organisation. This will then result in a need to perform substantive procedures at the service organisation.

Paragraph 16 states that when the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls. This can be achieved by obtaining a type 2 report (see paragraph 17 below). If such a report is not available, then the user auditor will need to perform tests of controls at the service organisation or request another auditor to perform such tests on behalf of the user auditor.

In the situation where the user auditor plans to use a type 2 report as audit evidence that controls are operating effectively, Paragraph 17 lays down detailed requirements: the report must cover an appropriate period; the auditor must test the operating effectiveness of any complementary controls in the user entity which are controls that the service organisation assumes, in the design of its service, will be implemented by user entities; the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls must be adequate; and the user auditor must evaluate whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

The reason for the existence of the requirements in Paragraph 17 is that the report may have been prepared with the needs of many different users in mind. Now the user auditor has to decide whether the report meets the specific needs of this audit. For example, it is essential that at least some of the tests of control performed by the service auditor are for a period which coincides with the period being audited by the user auditor.

The situation might arise where the user auditor plans to use a type 1 or a type 2 report that excludes the services provided by a subservice organisation. If these services are relevant to the audit of the user entity's financial statements, Paragraph 18 requires the user auditor to apply the requirements of this ISA (UK and Ireland) to the services provided by the subservice organisation.

19 The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

Reporting by the User Auditor

Paragraphs 20 to 22 deal with the auditor’s report:

- Paragraph 20 requires the user auditor to modify the opinion in the user auditor's report if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

- If the user auditor’s report is unmodified then it should not refer to the work of a service auditor except where required by law or regulation to do so.

- Conversely, if the user auditor's report is modified and contains a reference to the work of a service auditor then paragraph 22 requires the user auditor's report to indicate that such reference does not diminish the user auditor's responsibility for that opinion.

So what?

ISA 402 has been revised as well as clarified therefore the APB has addressed the changes in its staff paper. Their comments are summarised below.

The revision was intended to respond to relevant developments, including the increasing use of service organisations by entities and increasing complexity of such relationships and the need to align the standard with the risk assessment standards.

The revised ISA 402 is also intended to enhance the consistency of auditor performance in an audit of financial statements through more specific requirements and expanded guidance.

In addition to aligning the standard with the risk assessment standards, the revision increases the focus on, and expands the requirements and guidance, when the auditor intends to use a service auditor's report as audit evidence (in particular 'Type 2' reports, which cover the operating effectiveness of controls at a service organisation).

The APB's summary states that the requirements of ISA (UK and Ireland) 402 include:

- Specifying matters included in the understanding of how the user entity uses the services of a service organisation. (Paragraph 9)
- When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, specifying procedures the user auditor performs to obtain audit evidence about the operating effectiveness of those controls, including: (paragraph 16)
    - Obtaining a Type 2 report, if available;
    - Performing appropriate tests of controls at the service organisation; or
    - Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.
- Specifying procedures to be performed if the user auditor plans to use a report from a service auditor as audit evidence, including:
    - being satisfied as to the service auditor's professional competence and independence from the service organisation, and the adequacy of the standards under which the report was issued; (paragraph 13) and

- o in relation to Type 2 reports, procedures to determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment. (Paragraph 17)

ISA (UK AND IRELAND) 510 INITIAL AUDIT ENGAGEMENTS - OPENING BALANCES

Lecture A314 (8.38 Minutes)

Objective and definitions

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

An initial audit engagement is defined as an engagement in which either the financial statements for the prior period were not audited; or the financial statements for the prior period were audited by a predecessor auditor.

Opening balances are defined to include also matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Requirements

Audit Procedures

Paragraph 5 requires the auditor to read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

6. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

(i) Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

There is relatively little guidance provided in the Application Material. However, one useful comment is that the nature and extent of audit procedures will depend on (inter alia) the risks of material misstatement in the current period's financial statements and the significance of the opening balances relative to the current period's financial statements.

The Application Material also acknowledges that the work performed during the audit of the current period will provide evidence concerning some assertions in some audit areas (eg the valuation of opening debtors). The most difficult area to deal with in this way is inventory where, in most circumstances, work performed on closing balances will provide little or no evidence about opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, then Paragraph 7 requires the auditor to perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor communicates the misstatements to management and those charged with governance.

Paragraph 8 requires the auditor to obtain sufficient appropriate audit evidence about the consistency of accounting policies. The auditor will also obtain evidence that any changes in accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Paragraph 9 requires the auditor to consider the impact of a modified audit report in the prior period when assessing the risks of material misstatement in the current period.

Audit Conclusions and Reporting

Modifications to the auditor's report will be necessary if:

- the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances: qualified opinion or disclaimer (Paragraph 10)

- the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed: qualified opinion or adverse opinion (Paragraph 11)

- the auditor concludes that accounting policies are not consistently applied or a change in accounting policies is not appropriately accounted for or not adequately presented or disclosed: qualified opinion or adverse opinion (Paragraph 12)

- the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements: modified report (Paragraph 13)

The Appendix to ISA (UK and Ireland) 510 includes illustrative auditors' reports but these have not been adapted for use in the UK and Ireland. Readers should refer instead to APB Bulletins .

So what?

The previous version of this ISA contained a UK Plus requiring the auditor to obtain sufficient appropriate audit evidence concerning opening balances for continuing audit engagements. This plus is now included in ISA (UK and Ireland) 710. Otherwise, there are no changes of principle from the approach adopted in the old standard.

ISA (UK AND IRELAND) 560 SUBSEQUENT EVENTS

Lecture A315 (6.14 Minutes)

Objectives

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework; and

(b) To respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Requirements

Events occurring between the date of the financial statements and the date of the auditor's report

Paragraph 6 contains a general requirement for the auditor to obtain sufficient appropriate audit evidence that subsequent events have been dealt with properly in the accounts.

Paragraph 7 goes on to require specific procedures. These procedures should cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The nature and extent of such procedures depends on the auditor’s risk assessment.

The procedures mandated are

- Obtaining an understanding of any procedures established by management to ensure that subsequent events are identified.
- Making inquiries of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- Reading minutes, if any, of meetings held after the year-end and inquiring about matters discussed at such meetings for which minutes are not yet available.
- Reading the entity's latest subsequent interim financial statements. If there are no interim financial statements then it may be appropriate to inspect the available books and records, including bank statements. In addition, the auditor may consider it necessary and appropriate to read the latest

available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

The auditor might make specific inquiries about the following matters:

- Up-to-date information concerning accounting estimates and contingencies.
- New commitments or borrowings.
- Major changes in fixed assets or investments.
- Increases in share capital or debt.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether the accounting policies remain appropriate and the validity of the going concern assumption.

As a result of the procedures performed, the auditor may identify events that require adjustment of, or disclosure in, the financial statements. In this case, Paragraph 8 requires the auditor to determine whether each such event is appropriately reflected in those financial statements.

Paragraph 9 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 subsequent events.

Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

The auditor has no obligation to perform any audit procedures after the date of the audit report.

However, on occasions, a fact becomes known to the auditor after the date of the audit report but before the date the financial statements are issued that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report.

Paragraphs 10 to 13 cover the procedures required in this situation and users of these notes should refer to them in the event that the situation arises.

Facts which become known to the auditor after the financial statements have been issued

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements.

However, on occasions, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report.

Paragraphs 14 to 17 cover the procedures required in this situation and users of these notes should refer to them in the event that the situation arises.

So what?

This is another example of a standard that has been clarified but not revised. Again we see the mandating of procedures – but again they are procedures which many auditors would already be performing.

ISA (UK AND IRELAND) 570 GOING CONCERN

Lecture A316 (14.03 Minutes)

Objectives

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To determine the implications for the auditor's report.

Note that the ISA uses the term “Management” throughout but in the UK, it is those charged with governance who are responsible for the preparation of the financial statements and the assessment of the entity's ability to continue as a going concern.

Requirements

Risk assessment procedures and related activities

When performing risk assessment procedures as required by ISA (UK and Ireland) 315, paragraph 10 requires the auditor to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

This consideration is necessary whether or not management has already performed a preliminary assessment of the entity's ability to continue as a going concern. If they have performed such an assessment and identified significant doubts then the auditors will discuss with management their plans to address such doubts.

It is, of course, a requirement of both FRS 18 and FRSSE that the directors perform such an assessment but that does not mean that this will occur prior to the auditor commencing work. Accordingly Paragraph 10b goes on to say that, if no such assessment has been performed, the auditor is required to discuss with management the basis for the intended use of the going concern assumption, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

The Application Material provides a list of events or conditions that may cast significant doubt about the going concern assumption. Such a list is familiar to all auditors and does not present any new problems.

The Application Material goes on to explain that the purpose of the risk assessment procedures required by paragraph 10 is to help the auditor to determine whether management's use of the going concern assumption is likely to be an important issue and its impact on planning the audit.

11. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

The point being, of course, that this will lead to a revised risk assessment and, possibly, a modification of the auditor’s plan.

Evaluating Management's Assessment

Paragraph 12 requires the auditor to evaluate management's assessment of the entity's ability to continue as a going concern.

It is not the auditor's responsibility to rectify the lack of analysis by management but there may be circumstances where detailed analysis is not required. For example, when there is a history of profitable operations and ready access to financial resources, it may be acceptable to the auditor for management to make its assessment without detailed analysis.

Paragraph 13 requires the auditor's evaluation to cover the same period as that used by management. Under UK GAAP, this period will usually be 12 months from the date of approval of the financial statements. If the period is not adequate then the auditor is required to request management to extend its assessment period.

UK Pluses in ISA (UK and Ireland) 570 consider this issue in more detail as it affects UK entities. We also have the following guidance from the APB in Paragraph A10-4:

"The extent of the auditor's procedures is influenced primarily by the excess of the financial resources available to the entity over the financial resources that it requires. The entity's procedures (and the auditor's procedures) need not always be elaborate in order to provide sufficient appropriate audit evidence. A determination of the sufficiency of the evidence supplied to the auditor by those charged with governance will depend on the particular circumstances. For example, to be sufficient the evidence may not require formal cash flow forecasts and budgets to have been prepared for the period ending one year from the date of approval of the financial statements. Although such forecasts and budgets are likely to provide the most persuasive evidence, alternative sources of evidence may also be acceptable. This is particularly likely to be the case in respect of entities with uncomplicated circumstances. Many smaller companies fall into this category."

This is similar to the guidance from the APB in the old SAS 130 and the 2005 version of ISA (UK and Ireland) 570. The guidance is designed to allay the fears of those who were concerned that the work required would be onerous for small entities. Now, of course, there is more concern about the impact of the current economic environment hence the additional guidance in Bulletin 2008/10 and various FRC documents.

Paragraphs 14 and 15 require the auditor:

- to consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

- to inquire of management as to its knowledge of events or conditions beyond the period of their assessment that may cast significant doubt on the entity's ability to continue as a going concern.

The Application Material makes it clear that the auditor does not have a responsibility to perform any other audit procedures (ie other than enquiry) to identify events or conditions that may cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management.

Additional audit procedures when events or conditions are identified

Paragraph 16 covers the additional audit procedures which are necessary when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern. The auditor must determine whether or not a material uncertainty exists through performing additional audit procedures and a consideration of mitigating factors.

The term “material uncertainty” is not defined as such but Paragraph 17 includes the explanation that a material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for the financial statements to show a true and fair view.

We have discussed in previous update notes that that there are slight differences in terminology and approach between the auditing standards and the accounting standards. However, it is probably easiest to assume that the material uncertainties mentioned here in Paragraph 16 of ISA (UK and Ireland) 570 are exactly the same material uncertainties mentioned in paragraph 24 of FRS 18 which says:

“If the directors ..... 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, paragraph 61 requires them to disclose those uncertainties.”

The additional procedures required by Paragraph 16 must include:

- Requesting management to make its assessment of the entity's ability to continue as a going concern (where this has not already occurred).

- Evaluating management's plans to consider whether they are likely to improve the situation and whether they are feasible in the circumstances.

- If a cash flow forecast has been prepared and is significant in the evaluation of management's plans, evaluating the reliability of the underlying data generated to prepare the forecast; and determining whether there is adequate support for the assumptions underlying the forecast.

- Considering whether any additional facts or information have become available since the date on which management made its assessment.

- Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

Audit conclusions and reporting

Based on the audit evidence obtained, Paragraph 17 requires the auditor to conclude whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, Paragraph 18 requires the auditor to determine whether the financial statements:

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

Notice once again the inconsistency between this requirement and Paragraph 61(a) of FRS18 which requires disclosure of "any material uncertainties, of which the directors are aware in making their assessment, related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern". There is no reference in FRS 18 to disclosing plans or the possible inability to realise assets and discharge liabilities.

The examples in the FRC guidance (which we have looked at previously in these update notes) do include reference to the possible inability to realise assets and discharge liabilities.

Paragraph 17-1 contains a UK Plus which says that, if the period to which those charged with governance have paid particular attention in assessing going concern is less than one year from the date of approval of the financial statements, and those charged with governance have not disclosed that fact, then the auditor must do so within the auditor's report

Paragraphs 19 to 22 deal with the auditor’s report:

- If adequate disclosure is made in the financial statements, an unmodified opinion with an Emphasis of Matter paragraph to highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to draw attention to the note in the financial statements that discloses the matters set out in paragraph 18.

- If adequate disclosure is not made in the financial statements, a qualified opinion or adverse opinion, as appropriate,

- If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, an adverse opinion.

- If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report.

Unless all those charged with governance are involved in managing the entity, Paragraph 23 requires the auditor to communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. A list of the required contents of the communication is provided in the ISA (UK and Ireland).

If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, Paragraph 24 requires the auditor to inquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform the additional audit procedures described in paragraph 16. The auditor must also consider the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 17.

So what?

We have considered going concern in detail in recent months and this clarified ISA does not present us with any new problems.

ISA (UK AND IRELAND) 620 USING THE WORK OF AN AUDITOR'S EXPERT

Lecture A317 (5.32 Minutes)

Introduction

Previously, ISA 620 dealt with the auditor’s use of an expert engaged by management as well as an expert engaged by the auditor. The requirements concerning the use of a management’s expert have now been included in ISA 500.

Paragraph 8 of ISA (UK and Ireland) 500 requires the auditor 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 this paragraph depends on the significance of that expert's work for the auditor's purposes. The Application Material makes the point that objectivity could be a particular problem area.

An auditor'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 auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this ISA (UK and Ireland), concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

Objectives

The objectives of the auditor are:

(a) To determine whether to use the work of an auditor's expert; and

(b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

Requirements

Audit procedures

If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, Paragraph 7 requires the auditor to determine whether to use the work of an auditor's expert.

If the auditor is using an auditor's expert, then the requirements laid down by ISA (UK and Ireland) 620 can be summarised as follows:

- Evaluation of the expert's competence, capabilities and objectivity including threats to the expert's objectivity. (Paragraph 9)
- Understanding of the field of expertise of the auditor's expert sufficient to enable the auditor to determine the nature, scope and objectives of the expert's work for the auditor's purposes and to evaluate the adequacy of that work for the auditor's purposes. (Paragraph 10)
- Written agreement between the auditor and the expert. (Paragraph 11)
- Evaluation of the adequacy of the auditor's expert's work for the auditor's purposes (Paragraph 12) and an appropriate response if that work is not adequate. (Paragraph 13)

Paragraph 8 sets out the matters to consider in determining the nature, timing and extent of the procedures required in Paragraphs 9 to 13. These include

- The nature of the matter to which the expert's work relates and the risk of material misstatement
- The significance of the expert's work in the context of the audit;
- The auditor's knowledge of and experience with previous work performed by the expert; and
- Whether the expert is subject to the auditor's firm's quality control policies and procedures.

Reporting

Generally it is inappropriate to refer to the work of an expert in the auditor's report since the auditor has sole responsibility for the opinion and any reference to an expert may confuse the user of the report. There are two circumstances where it is acceptable to refer to the expert:

- Where required by law or regulation. (Paragraph 14)

- Where such reference is relevant to an understanding of a modification to the auditor's opinion. (Paragraph 15)

In either case the auditor is required to indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

So what?

ISA (UK and Ireland) is revised and clarified. Therefore the APB have addressed the changes in their staff paper.

They say that the IAASB revised ISA 620 in response to developments including:

(a) A concern that the extant ISA 620 mainly focuses on the use of experts with respect to substantive procedures regarding the measurement of account balances, whereas experts may be used for other purposes during the audit, for example, to assist in identifying and assessing the risks of material misstatement; and

(b) The possibility that the wider use of fair value accounting may require more frequent use of experts by the auditor.

During the project, the IAASB considered matters, including whether the auditor's report should refer to the expert, and how the nature, timing and extent of audit procedures varies depending on such matters as: the nature of, and risks of material misstatement in, the matter to which the expert's work relates; the significance of the expert's work in the context of the audit; the auditor's knowledge of and experience with previous work performed by the expert; and whether the expert is subject to the auditor's firm's quality control policies and procedures.

The scope of the revised standard is restricted to consideration of the auditor's use of the work of an expert, employed or engaged by the auditor, possessing expertise in a field other than accounting or auditing. Conforming amendments have been made to paragraph 8 of ISA 500, “Audit Evidence,” so that it addresses use of management’s experts. Considerations where a member of the engagement team with expertise in a specialised area of accounting or auditing is used are addressed in paragraph A20 of ISA 220, “Quality Control for an Audit of Financial Statements.”

Compared to the extant ISA there is more specification of audit procedures, in particular regarding the agreement of work to be performed (paragraph 11) and evaluating the reasonableness of the expert’s findings (paragraphs 12 and 13).

ISA (UK AND IRELAND) 710 COMPARATIVE INFORMATION - CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS

Lecture A318 (5.13 Minutes)

Introduction

The auditor's responsibilities concerning comparative information depend on whether the accounting framework requires corresponding figures or comparative financial statements. The essential audit reporting differences between the approaches are that, for corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas, for comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

In the UK and Ireland the corresponding figures method of presentation is usually required. Whilst the ISA (UK and Ireland) addresses both approaches, these notes only deal with the corresponding figures method.

Objectives and definitions

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and

(b) To report in accordance with the auditor's reporting responsibilities.

Corresponding figures - Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Comparative financial statements - Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

For purposes of this ISA (UK and Ireland), references to "prior period" should be read as "prior periods" when the comparative information includes amounts and disclosures for more than one period.

Requirements

Audit Procedures

7. The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, has been restated; and

(b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

A UK Plus in the Application Material indicates that when meeting the requirement of paragraph 7(a) above, the auditor's procedures should include checking whether the related opening balances in the accounting records were appropriately brought forward.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, Paragraph 8 requires the auditor to perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of ISA (UK and Ireland) 560 (paragraphs 14 to 17). If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.

Paragraph 9 requires the auditor to request written representations for all periods referred to in the auditor's opinion. In the UK this will normally mean the current period only. It is necessary to obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.

Audit Reporting

Corresponding Figures

Paragraph 10 states that the auditor's opinion should not refer to the corresponding figures except in the following circumstances:

- If the auditor's report on the prior period, as previously issued, included a modified opinion and the matter which gave rise to the modification is unresolved (paragraph 11);

- If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made (paragraph 12);

- If the prior period financial statements were not audited (paragraph 14).

If the financial statements of the prior period were audited by a predecessor auditor, Paragraph 13 requires the auditor to include certain information in an Other Matter paragraph in the auditor's report. However this requirement is subject to the exception that local rules may forbid such a reference and the position in the UK and Ireland is that the incoming auditor does not refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period.

A UK Plus in the Application Material goes on to point out that the incoming auditor assumes audit responsibility for the corresponding figures only in the context of the financial statements as a whole. The incoming auditor reads the preceding period's financial statements and, using the knowledge gained during the current audit, considers whether they have been properly reflected as corresponding figures in the current period's financial statements.

Comparative Financial Statements

Paragraphs 15 to 19 deal with comparative financial statements and are not dealt with in these notes.

So what?

No new problems are presented by this clarified ISA.

SUMMARY OF DEVELOPMENTS

Lecture A319 (6.57 Minutes)

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

Accounting Standards Board (ASB)

Urgent Issues Task Force (UITF)

Financial Reporting Review Panel (FRRP)

Auditing Practices Board (APB)

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

APB issues draft revised guidance on the audit of insurers

The Auditing Practices Board (APB) of the FRC has today published a consultation draft of a revision of Practice Note (PN) 20: 'The Audit of Insurers in the United Kingdom (Revised)'. The consultation period ends on 16 August 2010.

When finalised the guidance proposed in the consultation draft will apply to the audits of insurers for periods ending on or after 15 December 2010. The consultation draft updates the current guidance, which was issued in January 2007, to reflect:

- the issuance of the new ISAs (UK and Ireland) (which apply to audits of financial statements of insurers for periods ending on or after 15 December 2010); and

- changes in the legislative and regulatory framework.

The new ISAs (UK and Ireland) primarily improve the overall readability and understandability of the ISAs (UK and Ireland). The core guidance contained in the consultation draft is largely unchanged from the current guidance. However, new, enhanced or revised guidance has been included with respect to:

- Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures.
- Evaluation of Misstatements Identified During The Audit.
- The Auditor's Report (including the reporting of equalisation provisions).
- The illustrative examples of various regulatory auditor's reports.

Richard Fleck, APB Chairman, said:

"The APB regards this Practice Note as providing important guidance for auditors of insurers. The issuance of the clarified ISAs has significantly improved the quality of auditing standards and those improvements are now reflected in the proposed revision to the Practice Note. The APB is grateful for the work of the Institute of Chartered Accountants in England & Wales in assisting with the development of this document."

11 May 2010

Professional Oversight Board publishes its review of transparency reporting by auditors of public interest entities

The Professional Oversight Board has today published its review of the first set of mandatory Transparency Reports produced by auditors of public interest entities.

Under the Statutory Audit Directive and the subsequent Statutory Auditors (Transparency) Instrument 2008, auditors of UK companies with securities traded on a UK regulated market are required to produce a Transparency Report in respect of each financial year starting on or after 6 April 2008.

The Statutory Instrument sets out certain mandatory information for inclusion in each report and this was supplemented in 2009 by recommendations from the Oversight Board on appropriate disclosures.

The review of the first set of mandatory Transparency Reports includes a detailed commentary on common themes across the reports, an update on the extent to which issues identified in last year's review of voluntary reports have been addressed by the firms and an analysis of disclosures under each of the statutory requirements.

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

"Overall, we believe that the quality of this year's reports is higher than that of the previous voluntary reports. However, the majority of firms could improve the quality of their disclosures in certain areas, particularly independence policies, financial information and international network arrangements. We remain of the view that firms could make more use of their transparency reports to distinguish between themselves and to compete on audit quality.

We will be pursuing the small number of firms who have failed to produce a transparency report by the statutory deadline to rectify the situation."

13 May 2010

Professional Oversight Board publishes its report on the monitoring arrangements of the UK professional accountancy bodies

The Professional Oversight Board has today published its review of the UK professional accountancy bodies' monitoring of their members who provide non-regulated accountancy services (such as accounts preparation, payroll, tax and bookkeeping but not audit and insolvency work).

The Oversight Board considers improvements are necessary in order to enhance the effectiveness of the arrangements and public confidence in the profession. These include more detailed reviews of compliance with the Code of Ethics, better examination of complaints received and more comprehensive follow up work to ensure that concerns raised during the monitoring visit are adequately addressed.

During the review the Oversight Board undertook a survey in conjunction with the UK professional accountancy bodies to understand what external users want from providers of non regulated accountancy services. The survey shows the importance that they place on the competence, reputation and qualifications of their accountant.

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

"Given the importance that users place on the competence of the UK professional accountancy bodies it is imperative that the professional bodies respond to the issues we have raised and publish information on how they have done so. In particular it is vital that publicly available information on the monitoring arrangements accurately reflects the work undertaken by the professional body and is of a high standard."

We have asked the UK professional bodies to provide responses to our recommendations by no later than 1 September 2010.

20 May 2010

The Financial Reporting Council issues new governance standards for listed companies

The Financial Reporting Council (FRC) has today introduced changes to the UK Corporate Governance Code – formerly known as the Combined Code – to help company boards become more effective and more accountable to their shareholders.

Changes include a clearer statement of the board's responsibilities relating to risk, a greater emphasis on the importance of getting the right mix of skills and experience on the board, and a recommendation that all directors of FTSE 350 companies be put up for re-election every year.

Introducing the new Code Baroness Hogg, the FRC Chairman, said:

"Under my predecessor's wise leadership, the FRC responded to the financial crisis by examining the questions it raised about corporate governance and thoroughly reviewing the Code. We have now reconfirmed its core principles and the flexibility provided by the 'comply or explain' approach."

"The changes we have made are designed to reinforce board quality, focus on risk and accountability to shareholders. In return, we look to see a step up in responsible engagement by shareholders under the Stewardship Code, on which we have consulted and aim to publish by the end of June."

Changes to the Code include:

- To improve risk management, the company's business model should be explained and the board should be responsible for determining the nature and extent of the significant risks it is willing to take.
- Performance-related pay should be aligned to the long-term interests of the company and its risk policy and systems.
- To increase accountability, all directors of FTSE 350 companies should be put forward for re-election every year.
- To promote proper debate in the boardroom, there are new principles on the leadership of the chairman, the responsibility of the non-executive directors to provide constructive challenge, and the time commitment expected of all directors.
- To encourage boards to be well balanced and avoid "group think" there are new principles on the composition and selection of the board, including the need to appoint members on merit, against objective criteria, and with due regard for the benefits of diversity, including gender diversity.
- To help enhance the board's performance and awareness of its strengths and weaknesses, the chairman should hold regular development reviews with each director and FTSE 350 companies should have externally facilitated board effectiveness reviews at least every three years.

The UK Corporate Governance Code, formerly known as the Combined Code, sets out standards of governance for listed companies. Companies are required either to follow the Code or explain how else they are acting to promote good governance.

The new edition of the Code will apply to financial years beginning on or after 29 June 2010.

28 May 2010

ASB proposes amendments to SSAP 25, FRS 8 and FRS 29 - improvements to financial reporting standards 2010

The Accounting Standards Board (ASB) has today published a Financial Reporting Exposure Draft (FRED) proposing amendments to SSAP 25 'Segmental Reporting', to FRS 8 'Related Party Disclosures' and to FRS 29 (IFRS 7) 'Financial Instruments: Disclosures'.

The amendments are the result of the ASB's annual review of Financial Reporting Standards for the UK and Republic of Ireland (FRS). The annual review is driven principally from the amendments made by the International Accounting Standards Board (IASB) in its International Financial Reporting Standard (IFRS) 'Improvements to IFRSs' published in May 2010. In addition, consideration is given by the ASB to other changes made by the IASB to IFRSs and to other financial reporting matters raised by constituents. The ASB has sought to make minimal amendments to FRS, given its current proposals on the Future of UK Generally Accepted Accounting Practice.

The proposed amendments to FRS identify the date from which it is proposed each amendment will become effective.

The comment period for the FRED closes on 30 August 2010.

8 June 2010

IASB and FASB propose a new joint standard for revenue recognition

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) today published for public comment a draft standard to improve and align the financial reporting of revenue from contracts with customers and related costs.

If adopted, the proposal would create a single revenue recognition standard for International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) that would be applied across various industries and capital markets. The publication of this joint proposal represents a significant step forward toward global convergence in one of the most important and pervasive areas in financial reporting. The proposed standard would replace IAS 18 Revenue, IAS 11 Construction Contracts and related interpretations. In US GAAP, it would supersede most of the guidance on revenue recognition in Topic 605 of the FASB Accounting Standards Codification.

The core principle of the draft standard is that an entity should recognise revenue from contracts with customers when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer. The proposed standard would improve both IFRSs and US GAAP by:

- removing inconsistencies in existing requirements;
- providing a more robust framework for addressing revenue recognition issues;
- improving comparability across companies, industries and capital markets;
- requiring enhanced disclosure; and
- clarifying the accounting for contract costs.

In developing the proposals, the boards considered more than 220 comment letters received on their discussion paper, Preliminary Views on Revenue Recognition in Contracts with Customers, in addition to feedback received from interested parties through an extensive outreach programme, including workshops with preparers. The boards will undertake further outreach activities during the exposure draft's comment period to ensure that the views of all interested parties are taken into consideration when finalising the standard.

Commenting on the exposure draft, Sir David Tweedie, chairman of the IASB, said:

The proposal by the two boards is the result of our intensified joint efforts. It is an important step towards a single global principle-based standard that would make it absolutely clear when revenue is recognised—and why. We shall want to hear the views of all those affected by the proposals.

Robert Herz, chairman of the FASB, said:

This proposal marks a key milestone in our joint efforts to improve and converge our standards in one of the most important and pervasive areas in accounting. The unanimous agreement of the boards on this proposal is the culmination of an intensive process of working together jointly. The proposed new standard not only seeks to reduce complexity by streamlining the way revenue recognition principles are applied across various industries and transactions, but it also aims at eliminating inconsistencies in existing revenue recognition standards and practices.

The exposure draft Revenue from Contracts with Customers is open for comment until 22 October 2010 and can be accessed via the 'Comment on a Proposal' section of www.iasb.org or on www.fasb.org. A live webcast introducing the proposals is planned for early July - details will be available on the FASB and IASB websites soon. An IASB 'Snapshot' and an 'FASB In Focus', high level summaries of the proposals, will be available in due course to download free of charge from the IASB and FASB websites: http://go.iasb.org/revenue+recognition and http://www.fasb.org.

24 June 2010

FSA and FRC look to enhance auditors' contribution to prudential regulation

The Financial Services Authority (FSA) and the Financial Reporting Council (FRC) have today issued a discussion paper which considers ways of enhancing auditors' contribution to regulation.

High quality corporate reporting, audit and assurance support effective governance and underpin market confidence and market discipline. Together with effective communication between the FSA, regulated firms and their auditors, they are critical to achieving the FSA's objectives relating to market confidence, financial stability and consumer protection. They are also central to the FRC's complementary objectives in promoting high quality corporate governance and reporting to foster investment.

The purpose of the paper is to stimulate debate on the role of auditors following the financial crisis. The paper therefore explores how the FSA, the FRC and auditors can work together more effectively to enhance auditors' contribution to prudential regulation.

The paper:

- Questions aspects of the quality of audit work relevant to prudential regulation – in particular, whether the auditor has always been sufficiently sceptical and has paid sufficient attention to indicators of management bias when examining key areas of financial accounting and disclosure which depend critically on management judgement;

- Outlines the FSA's concerns about auditors' work on client assets and how auditors fulfil their legal obligation to report to the FSA;

- Explores a variety of ways in which changes are being made and further changes could be made by the FSA, the FRC and auditors to increase the effectiveness with which auditors undertake their work; and

- Examines the regulatory environment in which auditors operate more widely and suggests measures to enhance how auditors contribute to prudential supervision.

Paul Sharma, FSA director of prudential policy, said:

"Our experience has indicated that, at times, auditors have focused too much on gathering and accepting evidence to support firms' assertions rather than exercising sufficient professional scepticism in their approach - this falls far short of what the FSA - and society at large - expects from auditors.

"We have learnt the lessons of the financial crisis and continue to enhance all aspects of our approach to prudential regulation of firms. It is time for the auditing profession to demonstrate that they have also learnt from the crisis. This paper is an important step in the debate that needs to be had around the role of auditors."

Stephen Haddrill, chief executive of the FRC, said:

"Raising the bar for auditors on the application of professional scepticism has been high on our agenda for some time. Investors have a right to expect a more robust approach from auditors in challenging management's judgements and related disclosures. The auditor's ability to carry through their challenge is also important and proposals in this paper for improved engagement and information sharing between auditors and the FSA will facilitate appropriate improvements.

"We see significant improvements in disclosures about credit exposures, risks and uncertainties provided by banks in their most recent financial statements. Much of this follows from guidance issued by various bodies in the regulatory community. These improvements should have been achieved earlier and with less intervention. This is a key lesson we believe auditors can help firms respond to as disclosures required in relation to critical risks and judgements evolve."

The deadline for responses to the discussion paper is 29 September 2010.

29 June 2010

Findings of the Financial Reporting Review Panel in respect of the accounts of designcapital plc for the year ended 31 December 2008

The Financial Reporting Review Panel ("the Panel") has had under review the report and accounts of designcapital plc ("the company") for the year ended 31 December 2008.

The Panel's principal concern related to the company's treatment of foreign exchange differences arising on the retranslation of foreign operations in its consolidated cash flow statement.

In the Final results for the year to 31 December 2009, released on 30 June, the directors have corrected errors reported in the 2008 consolidated cash flow statement through a restatement of the comparative figures. The principal correction related to the presentation of the effect of changes in exchange rates. As a consequence of this correction and other more minor corrections, cash outflow from operating activities originally reported as £19,712 was understated by £805,126 and should, therefore, have been reported as £824,838 in the 2008 accounts. There is no effect on the opening and closing cash position as previously reported.

The company has also taken the opportunity to correct its accounting treatment of a subsidiary acquired during the year that had a different reporting date to the parent company. The effect of these adjustments is that cash outflow from operating activities has been revised to £719,212 and cash and cash equivalents at the end of the year revised to £1,056,514.

The Panel welcomes the corrective action taken by the directors and regards its enquiries into the company's accounts for the year under review, initiated on 5 November 2009, as concluded.

The press release contained a number of other helpful notes including the following:

1. IAS 7 'Cash Flow Statements' states that unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end of period exchange rates.

2. The method of translation for foreign operations under IAS 21, 'The Effects of Changes in Foreign Exchange Rates', requires monetary and non-monetary assets and liabilities to be translated at the closing rate and income and expense items to be translated at the rate ruling at the date of the transaction or an average rate that approximates to the actual exchange rates, for example, an average rate for the period. All exchange differences are taken to a separate component of equity, until disposal of the foreign operation when they are recycled to the income statement.

3. All exchange differences relating to the retranslation of a foreign operation's opening net assets to the closing rate will have been taken directly to reserves. As such exchange differences have no cash flow effect; they will not be included in the consolidated cash flow statement. However, where the opening net assets include foreign currency cash and cash equivalents, then, to that extent, the exchange difference arising on their retranslation at the closing rate for the current period will have been reflected in the closing balances. Such translation differences should be reported in the cash flow statement to determine the total movement in cash and cash equivalents in the period.

4. IAS 27, 'Consolidated and Separate Financial Statements', states that the financial statements of the parent and its subsidiaries used in the preparation of consolidated financial statements should be prepared as of the same reporting date. When the reporting dates of a parent and its subsidiary are different, the subsidiary should prepare, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent unless it is impracticable to do so.

5. Where, in accordance with IAS 27, the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a reporting date different from that of a parent, adjustments should be made for the effects of significant transactions or events that occur between that date and the date of the parent's financial statements.

1 July 2010

Financial Reporting Council publishes first UK Stewardship Code

The Financial Reporting Council (FRC) today publishes the first Stewardship Code for institutional investors following the publication in May of the updated UK Corporate Governance Code for listed companies.

The Code includes principles on:-

- The monitoring of investee companies;
- The escalation of activities taken to protect or enhance shareholder value;
- Collective engagement;

- Voting policy;
- Managing conflicts of interest; and
- Public reporting and reporting to clients.

The purpose of the Code is to improve the quality of corporate governance through promoting better dialogue between shareholders and company boards, and more transparency about the way in which investors oversee the companies they own.

Introducing the new Code Baroness Hogg, FRC Chairman, said:

> “We hope this new Code will be a catalyst for better engagement between shareholders and companies and create a stronger link between governance and the investment process.”
>
> “Disclosures made by institutions under the Code should assist companies to understand the approach and expectations of their major shareholders. They should also assist those issuing mandates to fund managers. Pension funds and other owners may not wish to become directly involved in engagement but they can make a significant contribution by, for example, mandating their fund managers to do so on their behalf.”
>
> “I am grateful to the Institutional Shareholders’ Committee for their substantial contribution to this work. The FRC has adopted the majority of the ISC Code as we believe it is important to maintain momentum. But I would expect the Code to evolve over time as we learn from experience.”

The FRC is encouraging all institutional investors to report publicly on the extent to which they follow the Code. From the end of September 2010 the FRC will maintain on its website a list of all those who have done so.

2 July 2010

The APB issues draft revised guidance on attendance at stocktaking

The Auditing Practices Board (APB) of the FRC has today issued for comment a consultation draft of a revision of Practice Note 25 “Attendance at stocktaking.” The consultation period ends on 5 October 2010.

The consultation draft updates the current guidance to reflect the issuance of the new ISAs (UK and Ireland) which apply to audits of financial statements for periods ending on or after 15 December 2010.

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

> “Following the publication of the clarified ISAs (UK and Ireland) in October 2009, there is a need to update the APB’s related Practice Notes currently in issue. Although most of the changes in this consultation draft of Practice Note 25 have been made to conform the Practice Note with the new ISAs (UK and Ireland), the APB invites comments on any aspect of the guidance.”

5 July 2010

Abstract 47 (IFRIC Interpretation 19) Extinguishing financial liabilities with equity instruments

Urgent Issues Task Force (UITF) Abstract 47 implements the requirements of IFRIC Interpretation 19 'Extinguishing Financial Liabilities with Equity Instruments'. The Abstract is applicable to entities preparing their financial statements in accordance with UK GAAP and applying FRS 26 (IAS 39) 'Financial Instruments: Recognition and Measurement'.

The 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.

9 July 2010

Publication of AIU 2009/10 Annual Report

The Professional Oversight Board, part of the Financial Reporting Council, has today published the Audit Inspection Unit's (AIU) Annual Report for 2009/10.

The report provides an overview of the activities and findings of AIU. The report is also available on the website at http://www.frc.org.uk/pob/audit/reports.cfm.

The Report emphasises:

- How firms have responded positively to the challenges arising from the economic downturn particularly in relation to the audit of going concern.
- The rigorous nature of the AIU's inspections and their impact on audit quality.
- That firms have policies and procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base.
- Despite the quality of firms' policies and procedures, the number of audits assessed by the AIU as requiring significant improvements remains too high.
- The findings suggest that firms are not always applying:
    - their procedures consistently on all aspects of individual audits; or
    - sufficient professional scepticism in relation to key audit judgments.

- Firms must embrace the principles underlying the Ethical Standards and accept that they should not provide non-audit services to audit clients where appropriate safeguards do not exist.

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

> "The AIU's inspection activities continue to result in improvements to firms' policies and procedures which are now generally good. While the number of good quality audits we have seen has increased, I am disappointed that the number of audits assessed as requiring significant improvement remains too high. Firms must make more effort to ensure that the improvements in their procedures are reflected in individual audit engagements. We expect firms to place greater emphasis on achieving behavioural change to ensure this is the case and we will increase our efforts to see that this occurs."

Individual reports on the findings from the AIU's inspections at Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers will be published in September.

The Future of UK GAAP: Latest News

The ASB has tentatively decided to propose a reduced disclosure framework for subsidiaries. The reduced disclosure framework is available to any subsidiary that does not have public accountability; and whose parent prepares consolidated financial statements in which that subsidiary is included and those financial statements are publicly available.

The ASB has tentatively decided to replace existing FRS and UITF Abstracts with the IFRS for SMEs; making only the following amendments to the IFRS for SMEs:

- areas of incompatibility of the IFRS for SMEs with the Accounting Directives.
- areas where the IFRS for SMEs permitted options that were not compatible with the Directives.
- replacing chapter 29 of the IFRS for SMEs with IAS 12 'Income Taxes'.

The major differences from the policy proposal and the Board's new tentative proposals include:

- introducing the reduced disclosure framework for subsidiaries which gives relief for subsidiaries of both tier 1 and tier 2 entities;
- permitting small publicly accountable entities that meet all three of the qualifying conditions of the small companies' regime but are excluded from the regime to apply the IFRS for SMEs;
- amending IFRS for SMEs which includes replacing section 29 of the IFRS for SMEs with IAS 12 'Income Taxes';

- providing application guidance on the definition of entities which have public accountability; and
- providing transitional relief for dormant companies.

The ASB's next steps include developing and drafting a FRED for consultation.

Taken from Inside Track July 2010

APB issues a feedback and consultation paper on the provision of non-audit services by auditors and FRC consults on related new guidance on audit committees

The Auditing Practices Board (APB) today publishes stakeholder feedback following its consultation in October last year on whether there should be a prohibition on auditors providing non-audit services to the entities that they audit. In parallel the FRC is publishing for consultation updated guidance to audit committees on determining whether a company's auditor should be permitted to provide particular non-audit services.

The APB's October consultation followed a report last year by the House of Commons Treasury Committee which proposed a ban on the auditor providing non-audit services. The consultation generated a substantial number of responses from all APB's stakeholder groups, in particular, including the views of a range of investors.

The overwhelming view of respondents (irrespective of the constituency involved) is that there should be no outright prohibition on non-audit services.

There is agreement, however, that auditor objectivity and independence is perceived to be adversely affected by the provision of non-audit services and that improved transparency and governance would address these concerns.

The APB is therefore proposing changes to the APB Ethical Standards for Auditors and amendments to the FRC's Guidance on Audit Committees, both of which are being published today.

As part of the consultation APB asked commentators whether there were any other views that they would like to be taken into account and has also held discussions with the FRC's Audit Inspection Unit on their findings from audit inspections. As a result, APB is now consulting on three particular issues relating to the provision of non-audit services by auditors (restructuring services, contingent fees and conflicts of interest).

Richard Fleck, Chairman of APB commented:

"The consultation process was extremely worthwhile as it increased the general understanding of the reasons why there are concerns about auditors providing non-audit services to the entities they audit and the impact this has on the perception of auditor independence. We welcome the fact that a common view emerged from all constituencies as to how to address these concerns, namely through improved transparency and governance.

APB remains conscious of the effect that the provision of non-audit services by auditors has on confidence in auditor objectivity and independence and we will monitor the effectiveness of our proposals and continue to respond to other issues that may arise.

We are also consulting on whether to prohibit auditors from providing restructuring services to listed companies in distress, to prohibit auditors from providing any non-audit services on a contingent fee basis and to extend the threats and safeguards approach to non-audit services provided to an audited entity's connected parties."

Baroness Hogg, FRC Chairman, said:

"There remains concern that substantial provision by audit firms of other services to the companies they audit may pose a threat to their independence. We believe that audit committees can help by having a clear framework for assessing when it would be appropriate for the auditor to provide other services, and are consulting about how to make this more transparent."

23 July 2010

APB issues draft revised guidance on the audit of occupational pension schemes

The Auditing Practices Board (APB) of the FRC has today published an exposure draft of a revision of Practice Note (PN) 15: 'The Audit of Occupational Pension Schemes in the United Kingdom (Revised)'. The consultation period ends on 29 October 2010.

When finalised, the guidance proposed in the exposure draft will apply to the audits of occupational pension schemes for periods ending on or after 15 December 2010. The exposure draft updates the current guidance, which was issued in March 2007, to reflect:

- the issuance of the new ISAs (UK and Ireland) (which apply to audits of financial statements of occupational pension schemes for periods ending on or after 15 December 2010); and
- changes in the legislative and regulatory framework.

The new ISAs (UK and Ireland) primarily improve the overall readability and understandability of the ISAs (UK and Ireland). The core guidance contained in the exposure draft is largely unchanged from the current guidance. However, new, enhanced or revised guidance has been included with respect to:

- Communicating Deficiencies in Internal Control to Those Charged with Governance and Management.
- Audit Considerations Relating to an Entity Using a Service Organisation.

- Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures.
- Going Concern.
- The illustrative examples of various auditor's reports.

Richard Fleck, APB Chairman, said:

> "This Practice Note is important guidance for auditors of occupational pension schemes and it is used extensively by the auditing profession. The issuance of the clarified ISAs has significantly improved the quality of auditing standards and those improvements are now reflected in the proposed revision to the Practice Note."

29 July 2010

The APB issues draft updated guidance on bank reports for audit purposes

The Auditing Practices Board (APB) of the FRC has today issued for comment a consultation draft of a revision of Practice Note 16 "Bank reports for audit purposes." The consultation period ends on 29 October 2010.

The consultation draft updates the current guidance to reflect the issuance of the new ISAs (UK and Ireland) which apply to audits of financial statements for periods ending on or after 15 December 2010. No changes are proposed to the process that was agreed in 2007 between the UK auditing profession and the British Bankers Association (BBA) regarding the procedures auditors use when requesting confirmation of balances, transactions or arrangements from the bankers of an entity being audited.

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

> "Most of the changes in this consultation draft of Practice Note 16 have been made as part of our programme to conform the Practice Note with the clarified ISAs (UK and Ireland) published in October 2009. However, the APB invites comments on any aspect of the guidance."

The consultation draft of Practice Note 16 (Revised) may be downloaded, free of charge, from the Publications (Exposure Drafts) section of this website.

30 July 2010

The APB issues draft revised guidance for the audit of banks and building societies in the United Kingdom

The Auditing Practices Board (APB) of the FRC has today issued for comment a consultation draft of a revision of Practice Note 19 "The audit of banks and building societies in the United Kingdom." The consultation period ends on 29 October 2010.

The consultation draft updates the current guidance to reflect the issuance of the new ISAs (UK and Ireland) which apply to audits of financial statements for periods ending on or after 15 December 2010 and for changes in legislation. In addition the APB has also revised and enhanced the guidance in a number of areas, including in relation to the audit of accounting estimates and impairment provisions and related disclosures. The APB has also added guidance on bilateral and other periodic meetings between auditors and the FSA.

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

> “Following the publication of the clarified ISAs (UK and Ireland) in October 2009, there is a need to update the APB’s related Practice Notes currently in issue. The APB also considers this an opportune time to enhance the guidance in relation to areas that were identified as being of particular interest in the credit crisis. The APB invites comments on any aspect of the draft guidance. The APB will also have regard to responses to the FSA and FRC joint Discussion Paper on ‘Enhancing the auditor’s contribution to prudential regulation’ when finalising the guidance.”

The consultation draft of Practice Note 19 (Revised) may be downloaded, free of charge, from the Publications (Exposure Drafts) section of this website.

30 July 2010

FRC announces project on lessons from credit crisis and formation of advisory group

The Financial Reporting Council (FRC) has launched a project to examine the lessons to be learned from the credit crisis and other market developments as they impact corporate reporting, accounting and auditing of non-financial services companies. The FRC expects to publish a discussion document in the Autumn.

To assist the FRC in identifying and evaluating appropriate issues, it has established a senior business and accountancy profession advisory group.

The new group will advise the FRC on issues such as narrative reporting and the role of the auditor.

30 July 2010

APB emphasises the importance of scepticism for audit quality

The Auditing Practices Board (APB) of the FRC today issues for comment a Discussion Paper entitled ‘Auditor scepticism: Raising the bar’. This has been developed in close co-operation with the Professional Oversight Board (POB) and its Audit Inspection Unit (AIU), which monitors the conduct of audits of larger entities. Comments on the Discussion Paper are invited by 31 October 2010.

Professional scepticism is a crucial component of a high quality audit that pervades every aspect of the auditor’s judgement. The Discussion Paper emphasises the importance of scepticism to audit quality and draws on recent research to stimulate debate about what actions may be needed to ensure that the appropriate degree of scepticism is applied by auditors in practice.

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

> “We believe that the time is right for an informed discussion about the ‘right’ level of scepticism to be applied by auditors and the conditions that foster appropriate sceptical behaviour. The Audit Inspection Unit emphasised that close attention must be applied to scepticism in its recent annual report. We hope this paper will lead to a full discussion within the profession about what audit firms need to do to ensure that auditors are appropriately sceptical in practice and how companies and others can facilitate this in the interests of investors and other company stakeholders.”

05 August 2010