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EXTRACTS FROM FINANCIAL REPORTING FACULTY BRIEFING PAPER ON REJECTED ACCOUNTS

Lecture A320 (10.18 Minutes)

Names and signatures

For filing purposes, copies of the company's accounts must comply with the following requirements:

- The copy of the balance sheet must state the name of the director who signed it on behalf of the board.
- The copy of the balance sheet must be signed by a director.
- The copy of the directors' report must state the name of the director or company secretary who signed the report.
- If the company has to attach an auditor's report to the accounts, the copy of the auditor's report must state the auditor's name.

For an LLP, the balance sheet must be signed by a designated member and must state the name of the designated member who signed it on behalf of the LLP. As with a company, if the LLP has to attach an auditor's report, it must state the auditor's name.

Where the auditor is a firm, the auditor's report must state the name of the auditor and the name of the person who signed it as 'senior statutory auditor' on behalf of the firm.

The auditor's name or the name of the 'senior statutory auditor' may be omitted in very limited circumstances if the conditions set out under section 506 of the Companies Act 2006 are met.

Main reason accounts are rejected

Common errors

The main reasons given for rejection are:

- incorrect or missing statements, ie wrongly stating that the accounts have been prepared according to the relevant legislation;
- audit exemption statements missing or incorrect;
- duplicate made up date ie, accounts show same date as previously filed accounts;
- signatory name missing off balance sheet or balance sheet signature omitted; and

- accounting reference date/made up date absent or incorrect.

Undoubtedly some of these issues are the result of the new Companies Act coming in to force. In addition, Companies House has changed its own rules in some areas, such as where the names and signatures of directors need to appear. Therefore extra care needs to be taken.

Other tips

Generally, every paper document sent to Companies House must state in a prominent position the registered name and number of the company.

Paper documents should be on A4 size, plain white paper with a matt finish. The text should be black, clear, legible and of uniform density. Letters and numbers must be clear and legible so that Companies House can make an acceptable copy of the document. The following guidelines may help.

When you fill in a form:

- use black ink or black type – blue ink or any other colour is not acceptable
- use bold lettering (some elegant thin typefaces and pens give poor quality copies)
- don’t send a carbon copy or use a dot matrix printer
- remember – photocopies can result in a grey shade that will not scan well.

When you complete other documents, remember:

- the points already made relating to completing forms
- to use A4 size paper with a good margin
- to supply them in portrait format (that is with the shorter edge across the top)
- to include the company number and name.

What happens when accounts are rejected?

If your accounts do not meet Companies House requirements they be will returned to you for correction. It is advisable to get your accounts to Companies House well before the filing deadline as you will not be given any extra time if they are rejected.

If the accounts are submitted close to the filing deadline and subsequently rejected, an automatic late filing penalty will be issued if the accounts are not returned by the filing deadline. The grace period of 14 days for accounts that are rejected near the deadline ceased to exist on 1 October 2009.

Avoiding common errors

Incorrect or missing statements

The number one reason for rejection of accounts is that the company or LLP has included incorrect statements.

Changes were made for periods beginning on or after 6 April 2008 (or 1 October 2008 for LLPs) following the commencement of the relevant sections of the Companies Act 2006. Simply cutting and pasting from prior year accounts without making the appropriate changes will lead to your accounts being rejected.

Statements for company accounts with accounting period beginning on or after 6 April 2008

Scenario	Statement
A company submitting small company accounts must include a statement to that effect on the balance sheet.	These accounts have been prepared in accordance with the provisions applicable to companies subject to the small companies' regime.
Small companies that do not deliver abbreviated accounts may choose not to include a copy of the directors' report and/or a copy of the profit & loss. In this case, the balance sheet must also contain this statement.	These accounts have been delivered in accordance with the provisions applicable to companies subject to the small companies' regime.
A company claiming total audit exemption must show these statements on its balance sheet.	The company is exempt from the requirements relating to preparing audited accounts in accordance with section 477 of the Companies Act 2006. The members have not required the company to obtain an audit of the accounts for the year in question in accordance with section 476 of the Companies Act 2006. The directors acknowledge their responsibilities for complying with the requirements of the Companies Act 2006 with respect to accounting records and the preparation of accounts. These accounts have been prepared in accordance with the provisions applicable to companies subject to the

	small companies' regime.
A dormant company claiming total audit exemption must show these statements on its balance sheet.	The company is exempt from the requirements relating to preparing audited accounts in accordance with section 480 of the Companies Act 2006. The members have not required the company to obtain an audit of the accounts for the year in question in accordance with section 476 of the Companies Act 2006. The directors acknowledge their responsibilities for complying with the requirements of the Companies Act 2006 with respect to accounting records and the preparation of accounts.
A company submitting medium company accounts must include this statement on the balance sheet.	The accounts are prepared in accordance with the special provisions of the Companies Act relating to medium companies, as required by section 445(3) of the Companies Act 2006.

LLP accounts with accounting period beginning on or after 1 October 2008

An LLP submitting small accounts must include this statement on the balance sheet.	These accounts have been prepared in accordance with the special provisions of the Companies Act 2006 (as applied by the Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008) applicable to LLPs subject to the small LLPs regime.
Small LLPs that do not deliver abbreviated accounts may also choose not to include a copy of the profit & loss. In this case, the balance sheet must also contain this statement.	These accounts have been delivered in accordance with the special provisions of the Companies Act 2006 (as applied by the Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008) applicable to LLPs subject to the small LLPs regime.
An LLP claiming total audit exemption must show these statements on its balance sheet.	For the year ended… the Limited Liability Partnership was entitled to exemption under section 477 of the Companies Act 2006 (as applied by the

	Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008). The members acknowledge their responsibilities for complying with the requirements of the Companies Act 2006 (as applied to Limited Liability Partnerships) with respect to accounting records and the preparation of accounts.
A dormant LLP claiming total audit exemption must show these statements on its balance sheet.	For the year ended… the Limited Liability Partnership was entitled to exemption under section 480 of the Companies Act 2006 (as applied by the Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008). The members acknowledge their responsibilities for complying with the requirements of the Companies Act 2006 (as applied to Limited Liability Partnerships) with respect to accounting records and the preparation of accounts.
An LLP submitting medium company accounts must include this statement on the balance sheet.	The accounts are prepared in accordance with the provisions of the Companies Act 2006 (as applied by the Limited Liability Partnerships (Accounts and Audit) (Application of the Companies Act 2006) Regulations 2008) applicable to medium sized LLPs.

Duplicate 'made up date'

Companies House report that they receive a high number of duplicate accounts ie, accounts with the same made up date as a set of accounts that has previously been filed for that company or LLP. This can easily occur in error where last year's accounts are being used as the starting point for preparing this year's. Any duplicate accounts received by Companies House will be rejected.

Signatory name or signature missing from balance sheet

A director, or a designated member for an LLP, must sign the foot of the balance sheet. Every balance sheet and directors' report must also state the name of the

person who signed on behalf of the board. A signature without a printed name or vice versa will lead to the accounts being rejected. Both must be present.

Accounting reference date / made up date incorrect or absent

A significant number of accounts are rejected where the 'made up' date is absent or where it does not match the accounting reference date.

If you wish to prepare accounts with a made up date of more than seven days either side of your accounting reference date you must file a form AA01, or LL AA01 for LLPs, to change your accounting reference date before the last date for filing the accounts. This form cannot be used if your accounts are already overdue or to extend the accounting period beyond 18 months unless the company is in administration.

WebFiling

When submitting audit exempt or dormant company accounts, consider using Companies House's WebFiling service. WebFiling includes inbuilt checks, which eradicate most of the reject reasons listed above.

RESIDENT MANAGEMENT COMPANIES AND SERVICE CHARGES

Lecture A321 (15.24 Minutes)

ICAEW guidance:

TR 01/10 (currently in draft form) in October 2010. This provides guidance on accounting for service charges and the associated legal issues. This guidance has been issued jointly between ICAEW, RICS and ARMA.

Tech 03/07 which was issued in response to a consultation on changes to this area under the CLR 02. These changes were never brought forward and hence some elements are not applicable under current legislation.

What is a service charge?

There are obligations on landlords in respect of residential service charges but these do not extend to commercial service charges. For the later the terms of the lease will be the prime source of information on the accounting for such charges.

The distinction between the two is made in the LTA 85.

The definition of a service charge covered by the statutory provisions is contained in s18 LTA 1985.

> The amount payable by a tenant of a dwelling as part of or in addition to the rent:
>
> (a) Which is payable, directly or indirectly, for services, repairs, maintenance, improvements or insurance or the landlord's costs of management; and
>
> (b) The whole or part of which varies or may vary according to the relevant costs.

The term dwelling is defined in s38 LTA 85

> "dwelling" means a building or part of a building occupied or intended to be occupied as a separate dwelling together with any yard, garden, outhouses and appurtenances belonging to it or usually enjoyed with it;

Key points to note are the:

- use of the term dwelling. This emphasises that this does not affect commercial property. This section of the Act only applies to residential property.
- service charge can be additional to the rent or included as part of the rent.
- service charge can vary and therefore provisions would not apply to fixed service charges, whether it is included within a fixed rent or charged as a separate fixed amount.

There are no exemptions for residential properties. Therefore it makes no difference if the property is a house converted to flats, a purpose built block of flats, or a whole house. The provisions equally apply to resident landlords, landlord companies, either owned by the landlord or by the tenants. There are exemptions for Local Authorities but these are outside the scope of this course. RSLs are included within the provisions and further information is available from PN 14 but is not included as part of this presentation.

It applies to mixed properties, for example a retail outlet on the ground floor and flats above. The requirements of the LTA 85 would apply to service charges payable by the tenants of the flats but not to the service charges payable by the retail outlet. Accounting for service charges in these instances is included in the CSC and other publications from RICS. At the time of preparing these notes these are only available for download by RICS members. Otherwise they have to be purchased from RICS books.

TR 01/10

Application

The TR identifies three possible outcomes in respect of accounting for service charges:

The tenants do not require any service charge account;

The tenants require a service charge account but no tenant has exercised their right under s21 LTA 85 for a service charge statement;

A tenant or tenants have exercised their right under s21.

No requirement for service charge account

If the tenants have determined they do not require any statement then the impact on the accountant will be minimal. If the service charges are received by a company then it is important to ensure that the accounting by the company in respect of service charge monies follows the guidance. This is covered below.

Right under s21 exercised

If tenant/tenants have exercised their right under s21 then the provisions in the legislation must be complied with. The TR provides no guidance on the form of the summary but Appendix E does summarise the requirements and provides an example of a suitable report.

Provisions in S21(1)

A tenant may require the landlord in writing to supply him with a written summary of the costs incurred …. And which are relevant costs in relation to the service charge payable or demanded …. in that or any other period.

The summary is to be the service charge costs in the last completed 12 month period. If the service charges are not made up to a date then the 12 months ending with the date of the request.

The landlord must comply within one month of the request, or if made up to a period, within 6 months of the end of the period.

Key points to note:

The landlord is only required to provide a s21 statement if it is requested by a tenant. If no such request is received then there is no requirement to provide. In many cases the landlord will provide a summary under the terms of the lease and for this reason no tenant may request a s21 statement. The provision of a statement under these circumstances does not require the other requirements of s21 to apply. In the past where the tenants have used a company to provide the services the provision of the company's accounts may have satisfied the requirements of the tenants and therefore no s21 statement was provided. On this basis it may be rare for s21 statements to be provided to tenants.

Provisions in S21(5)

The summary has to state whether any costs relate to grant work

Summarise any costs in respect of which no demand has been received by the landlord within the period

Summary of any of the costs in respect of which a demand for payment was received but no payment was made in the period

A summary of any of the costs of which a demand for payment was received and payment lade by the landlord within that period

The aggregate of amounts received by the landlord in the period in respect of service charges and the amount still standing to credit of the tenants

Key points to note

There is no laid down format for the statement. Provided the information above is provided it would satisfy the requirements. If the statement provided (as above) is supplied then there are no statutory provisions and the format would be as agreed.

Provisions in S21(6)

If the service charges are payable by the tenants of more than four dwellings the summary must be certified by a qualified accountant. The certification has to be that it is a fair summary which complies with s21(5) and is sufficiently supported by accounts, receipts and other documents which were produced to the accountant.

Key points to note

A qualified accountant is one who is eligible for appointment as a company auditor under Companies Act 2006. Such an appointment is not an audit and there is no laid down work programme.

There is no indication in the Act as to whom, the report should be addressed. So it can be addressed to the landlord, or tenants, or both.

Require a service charge account but not under s21

The TR provides the following:

- An example report (Appendix C)
- An example letter of representation (Appendix B)
- An example engagement letter (Appendix A). It should be noted that this is for agreed upon procedures and would not be suitable for s21 assignments.
- Suggested procedures (Section 6). These are referred to in the engagement letter. If certain procedures are omitted or added then the engagement letter will need to be amended accordingly. The report would also have to be considered. The TR sets down a set of procedures which are referred to as such in the engagement letter and the report. Any changes would therefore have to be identified.
- Format of accounts

If an alternative method is used to provide the tenants with a summary of the service charges then whether these are examined and the work to be completed will be as agreed. In these circumstances the accountant may not have to be qualified as an auditor. The TR identifies those who should be appointed to carry out assignments under this guidance. It notes that unless a report is required under s21 then the accountant only has to be a member who is entitled to engage in public practice.

If the lease refers to the requirement for an audit then this will need to be considered in its context. Many leases were entered into before the introduction of auditing standards as they exist today. Therefore at that time the requirement for an audit may not have been seen as being onerous. Today, if the term audit is used in any report, then this would require compliance with a framework, i.e. ISAs. It is not possible for an accounting professional to sign a report which mentions the word audit without complying with such a framework. This is likely to add substantially to the costs involved. If the accountant was to agree a set of procedures which would be acceptable to all parties this would overcome such issues. However, it is suggested that such an agreement should be with both the landlord and all tenants. It may also be possible for the accountant to give a report which includes the word “audit” but where no audit has been completed. In these circumstances the context of the term would have to be included in the report, i.e. not in compliance with auditing standards. This would have to be included in the engagement letter. History has shown that if not all parties have agreed to such a process misunderstandings can arise at a later date. It is therefore important that the accountant manages the risk. If the lease refers to auditing standards then this must be complied with.

Part 11 of the RSC indicates that unless the costs of an audit cannot be recovered then an audit in compliance with APB standards should be completed. The Residential Service Code (RSC), was originally published in 1997 and revised in 2009. This code is approved by the Secretary of State (SI512/2009) under s87 of the LRHUD 93. Section 87(7) states:

> A failure on the part of any person to comply with any provision of a code of practice for the time being approved under this section shall not of itself render him liable to any proceedings; but in any proceedings before a court or tribunal—
>
> (a)any code of practice approved under this section shall be admissible in evidence; and
>
> (b)any provision of any such code which appears to the court or tribunal to be relevant to any question arising in the proceedings shall be taken into account in determining that question.

Representations have been made to have this provision removed or amended.

Section 42 LTA 87

(2)Any sums paid to the payee by the contributing tenants by way of relevant service charges, and any investments representing those sums, shall (together with any income accruing thereon) be held by the payee either as a single fund or, if he thinks fit, in two or more separate funds.

(3)The payee shall hold any trust fund—

(a)on trust to defray costs incurred in connection with the matters for which the relevant service charges were payable (whether incurred by himself or by any other person), and

(b)subject to that, on trust for the persons who are the contributing tenants for the time being.

Key points to note:

- The RSC (10.8) indicates the amounts should be identifiable and held in a separate bank account. This is not a requirement of the legislation.
- Any interest received is received on behalf of the tenants and should be included in the trust funds.
- The amount can include costs to be incurred in the future.

Application when the landlord is a company - Summary of ICAEW guidance to its members

This would apply in respect of RMCs and RTM. It will also apply in other situations where the company receives the service charges and administers them on behalf of the tenants. It would also apply to investor landlords. In the later case they should keep separate service charge accounts for each property and not to treat the trust funds as their own. This is required to comply with s42.

The key point to bear in mind when preparing the company's statutory accounts is that the landlord company (RMC or RTM or similar) does not 'own' the transactions relating to service charge expenditure or the service charge funds, even where the company is owned and operated by the leaseholders. Because a statutory trust is established by section 42 of the LTA 1987 a clear distinction is to be made between transactions and balances belonging to the company, and transactions and balances belonging to the statutory trust. For example, non service charge receipts such as ground rent (if the company owns the freehold), may be income of the company (they will not belong to the company if it does not own the freehold and is collecting the ground rent on behalf of a superior landlord). There may also be expenditure that, if not provided for by the terms of the lease, could fall on the company. Examples might be the annual Companies House filing fee or directors' and officers' insurance, although if these may be recoverable through the service charge depending on the wording of the lease e.g., if it allows 'all other costs of management'.

The balance sheet will contain only items that belong to the company, for example the freehold of the block at cost or valuation (if applicable), share capital (if the company is limited by shares) or any initial contributions by members of the company to working capital when the company was set up.

The only difference between a company limited by shares and one limited by guarantee is that there is no share capital. If the company is a company limited by guarantee and there are no items to be included on the balance sheet, then the company still has to prepare a balance sheet, without figures, but containing the statements required under s475 of the Companies Act 2006 and signed and dated as approved by the board.

The collection of service charges paid by the leaseholders and payment of relevant costs on behalf of the statutory trust by the RMC/RTM, are not transactions of the management company and may therefore not affect the management's company's statutory accounts. If so, the company may not need to prepare a profit and loss/income and expenditure account. For example, if, in accordance with best practice guidance, the company has established a separate trust account for service charge monies, that bank account will not be included on the company's balance sheet. If, however, the service charge money is held in the management company's bank account, (such arrangement is not recommended and would not meet best practice guidance) the cash and any transactions affecting the cash balance may need to be reflected in the statutory accounts of the management company.

The fact that the company does not 'own' the service charges and may not have any figures to disclose in the balance sheet or profit and loss account does not necessarily mean that it is dormant for the purposes of the Companies Act.

Consideration has to be given to the question of agency when contracts are made with third parties for the provision of goods and services to the property. For example, many companies, particularly RMCs and RTMs, contract for service charge expenditure in their own name, because the statutory trust does not exist in a form that enables it to be a party to the contract. Even where the property is managed by agents, the agents will contract for services including major works to the property, in the name of the property or the client company, so that there may be a transaction that will need to be reflected in the accounts of the management company. For example, services received that have been contracted for by the management company may give rise to a liability (amounts owed to the supplier) and a debtor (amounts by the trust), until settled. The management company may also need to disclose non-cancellable contractual commitments, if material, in the notes to its accounts.

Key points to note:

- The statutory trust is established in law and therefore cannot be overridden by any other agreement, e.g. between the company and the tenants. Even where the tenants are the shareholders of the company and some or all are directors the provisions of s42 cannot be changed. Therefore there should be a distinction between the company's transactions and the trust transactions.
- Company transactions could include the receipt of ground rent or the ownership of one or more flats that are rented out. If the later arises the ownership of this flat would probably lead to a requirement for the company to make a contribution to the service charge.
- Any expenditure which represents "costs" will be recoverable from the service charges and do not represent expenditure.
- Although the company may have no transactions to be shown in the profit and loss account it is unlikely to be dormant. The Companies Act 2006 provides:

> 1169 Dormant companies
>
> (1) For the purposes of the Companies Acts a company is "dormant" during any period in which it has no significant accounting transaction.
>
> (2) A "significant accounting transaction" means a transaction that is required by section 386 to be entered in the company's accounting records.

The company will need to prepare individual accounts as required by s396 CA 06 and would be able to take advantage of audit exemption provided the requirements of s477. However, if there were no transactions to be included in the income and expenditure account then this statement would not be prepared. The balance sheet may only include share capital (unless limited by guarantee), the property (at cost or valuation), and any initial contribution by the shareholders for working capital.

The accounting complications

The following may be topical and may or may not be addressed by future guidance.

What happens if the company has not kept the trust funds in a separate bank account?

As indicated above the RSC indicates that such monies should be kept separately. If it has then none of the transactions within this bank account would be reflected in the financial statements. If not then there may be a need to reflect the transactions in the financial statements and to include the bank balance on the balance sheet. It appears that how the bank account is "titled" may not affect this practice. Hence if the company only receives service charge monies and these are paid into its bank account there may be no requirement to reflect the transactions in the company financial statements.

In this respect consideration could be given to the requirements of FRS 5 ANG. Where an entity is acting as an agent the standard requires that any amounts due to the principal are not included in turnover. If those amounts were still due at the balance sheet date then the standard would indicate that the amount should be included in the bank balance but an amount included in creditors to represent the amount due to the principal. The position of the company could be considered as similar to that of an agent and hence a similar treatment adopted.

FRS 5 defines an asset as:

Rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.

Whether the amount in the bank account satisfies this requirement may be the subject of guidance in the future. It may be difficult to justify the exclusion of the bank account if it is under the companies control but holds only trust funds to the inclusion if it is under the company's control and contains mixed funds.

What about contracts with third parties?

It is likely the company will have to enter into agreements and contracts with third parties to provide the services. The trust does not exist in a form which would allow it be a party to a contract in its own name. The company may also employ staff such as porters, gardeners and caretakers. In this instance it will have the liability to account for PAYE and NI.

Provided the expenditure incurred is "costs" then these should be recoverable from the trust.

Relevant costs are defined in s18(2) LTA 85 as:

Relevant costs are the costs or estimated costs incurred or to be incurred by or on behalf of the landlord, or a superior landlord, in connection with the matters for which the service charge is payable.

S18(3) LTA 85 states that costs include overheads.

The term incurred or to be incurred covers relevant costs payable for an earlier period, the current period, or a future period. Therefore the establishment of a sinking fund would be permitted.

Reasonableness; S19(1) LTA 85 states:

> Relevant costs shall be taken into account in determining the amount of a service charge payable for a period:
>
> (a) Only to the extent that they are reasonably incurred, and
>
> (b) Where they are incurred in the provision of services or the carrying out of works, only if the services or works are of a reasonable standard
>
> And the amount payable shall be limited accordingly.

The costs have to be reasonably incurred it does not require that the costs must be no more than is reasonable. Therefore the test is whether the costs are reasonably incurred, thereafter of a reasonable standard.

s19(2) LTA 85 provides that where advance payments are payable

> No greater amount than is reasonable is so payable and after the relevant costs have been incurred any necessary adjustment shall be made by repayment, reduction or subsequent charges or otherwise.

It is beyond the scope of this presentation to discuss which costs could be included and those which should not. This is often a matter of disagreement between the tenants and the landlord.

- If one adopts the “agency” principal outlined above this could give rise to the following accounting treatment:

- If the transaction is entered into and settled in the period then it would not be reflected in the financial statements.
- If at the end of the accounting period there was an amount due to a third party a creditor should be included and an equivalent debtor representing the amount recoverable from the trust.
- If there was an amount due from the third party then a debtor should be included together with an equivalent creditor.

- If a contract has been entered into and this results in a prepayment at the balance sheet date, e.g. lift maintenance, then whether an asset arises or not would require careful consideration. Prepayments are included to apply the matching principle in the ASB’s Statement of Principles. There may be no “asset” as such.

The company may have entered into contracts into the future and these may need to be disclosed to comply with Accounting Standards, e.g. entering into an operational lease commitment.

What about amounts that may not be recoverable as costs?

The legislation and the RSC indicate that the cost of preparing service charge accounts is recoverable from the service charges. As noted above the only issue arising is whether the cost of an audit would also be recoverable. If a s21 statement had been prepared and was "certified" in accordance with s21 then this cost would be recoverable.

However, there may be other costs, e.g. annual return fee, late filing penalties, accountants fees for preparing the company financial statements, an audit fee for auditing those statements. Whether these are recoverable as costs will depend on the wording of the lease. On this basis some may not be recoverable directly through the service charges. In these situations the company may need to levy a management charge for managing the service charges. Such a management charge would fall to be included in income.

What about the separate accounts for the service charges?

The format of these was discussed above. These could be appended to the company's financial statements on the basis of "not for publication". They would not be filed at Companies House. By nature they would be similar to the detailed profit and loss account which is appended to financial statements.

What report should be included and how do I sign off the service charge accounts?

The 2010 guidance includes examples. A report which is not prepared under s21 is signed in the name of the reporting accountant and would be covered by the engagement letter. The s21 report is signed as a "registered auditor". However, this may change to "statutory auditor" to reflect the signing of other statutory reports

When and how should any adjustments be made to company accounts?

The when will be a matter of judgement. The guidance from the ICAEW (shown above) originated in a ARMA publication in 2008. Therefore it must be recognised that the facts above are not new and any matters arising have existed for some time. In some cases the company may have been recording service charge income as turnover for over 20 years.

There was an intention to bring forward changes to both section 21 and 42 in line with those originally proposed in the CLR 92. However, the government has indicated that there is no intention to bring these forward in the near future. On this basis any changes should probably be made as soon as is practicable.

However, a number of issues are raised above regarding how the transactions should be recorded, e.g. should the bank account be on the balance sheet or not, how do we treat contractual obligations, what costs can be charged to service charges and what will need to be recovered from a management charge. These issues may be addressed in the joint guidance issued by the ICAEW and practitioners may feel that any changes should only be made when this guidance has been finalised. Making changes now may be result in another change in the very near future.

The how is covered within FRS 3 and FRS 18. FRS 3 would indicate that any changes should be reflected retrospectively by the use of a prior period adjustment.

Prior period adjustments: Material adjustments applicable to prior periods arising from changes in accounting policies or from the correction of fundamental errors. They do not include normal recurring adjustments or corrections of accounting estimates made in prior periods.

Is it a change in accounting policy of the correction of a fundamental error?

FRS 3 explanatory section paragraph 63

In exceptional circumstances it may be found that financial statements of prior periods have been issued containing errors which are of such significance as to destroy the true and fair view and hence the validity of those financial statements.

Whether it is a change in accounting policy or the correction of a fundamental error may have some bearing on the disclosures that appear in the financial statements. Full disclosure would have to be made and the change fully reflected on a retrospective basis. Where some of the income does “belong to the company” this will need to be separated on a fully retrospective basis. This could involve some substantial costs.

REVISION OF ACCOUNTING STANDARDS

An Exposure Draft issued by ASB in June 2010 proposed changes to FRS 8 to ensure that the definition of related parties remains consistent with IFRS.

FRS 8: New definition of related party:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the ‘reporting entity’).

(a) A person or a close member of that person’s family is related to a reporting entity if that person:

(i) has control or joint control over the reporting entity;

(ii) has significant influence over the reporting entity; or

(iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:

(i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

(ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

(iii) Both entities are joint ventures of the same third party.

(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

(v) The entity is a retirement benefit scheme for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a scheme, the sponsoring employers are also related to the reporting entity.

(vi) The entity is controlled or jointly controlled by a person identified in (a).

(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

Existing wording:

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;

(b) the party is an associate (as defined in FRS 9, ‘Associates and joint ventures’) of the entity;

(c) the party is a joint venture in which the entity is a venturer (as defined in FRS 9, ‘Associates and joint ventures’);

(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); or

(g) the party is a retirement benefit scheme for the benefit of employees of the entity, or of any entity that is a related party of the entity.

STOP PRESS: Note that the final revision to FRS 8 was issued after the preparation of these notes. This incorporated the amendment referred to above but also made further changes to the existing FRS 8. The applicable date for the new standard is periods commencing on or after 1 January 2011 although earlier adoption is permitted. We will consider the revised standard fully in the next update.

FREQUENTLY ASKED QUESTIONS – REVENUE RECOGNITION

Lecture A322 (14.08 Minutes)

Q1. Accounting for sale of property with delayed completion

Q. A company owns a property which it is renovating and dividing up into individual residential units for sale.

The year end is 31 March 2010. In February 2010 it exchanged on 3 units which were complete and ready for occupation and received 10% deposit. Each of them allowed a period up to 12 months for completion (to give the purchaser time to obtain finance). The exchange was unconditional and if they did not complete within 12 months the contract would lapse and they would lose their deposit.

The accounts are now being finalised and at today's date, two of these have completed and one still has another 3 months in which to complete.

How should these be accounted for? These are the first sales and no accounting policy has yet been established.

A. Accounting for sale on exchange would be possible, but does raise the question whether it would be correct to take the profit on the third sale, especially if that profit exceeded the 10% deposit which is the minimum that could be earned. The policy could be to account for sale of property on exchange, but then make provision against the profit recognised to the extent that it is anticipated that it might not materialise; simply being uncertain would not be sufficient. See the following comments from PwC manual of accounting:

"9.101 It is appropriate to recognise the income when an unconditional and irrevocable contract has been entered into, because the equitable and the beneficial interests already vest in the purchaser, who has a legal commitment for the outstanding purchase consideration. The situation is, therefore, no different from goods sold on credit. If, however, the contract is conditional, recognition should be delayed until the last material condition is satisfied. It is only when all the material conditions have been satisfied that the gain can be considered to be earned."

The other alternative is to have an accounting policy which only recognises sale (and profit) on completion. Although this policy might not have been considered if all three had completed, the opportunity the directors have had to reflect on the correct policy might lead them to conclude that this would be a more appropriate policy (especially if there is a risk that the full sales price may be subject to renegotiation on completion). The PwC manual makes the following comment:

"9.104 Many companies do not take credit for sales, commonly of private houses, until legal completion has taken place. This policy is, therefore, more conservative than recognising revenue on the exchange of unconditional contracts. The property industry has historically taken a more prudent approach to the sale of homes to individual buyers. However, the choice of either of these methods will usually depend on the circumstances of the sale."

We have received advice that it is normal to account for sale of completed units on exchange on the grounds that it is possible to sue for the full price. Indeed, this approach is the only one that seems to be consistent with the requirements of UITF 40. This conclusion only applies, however if the sale is unconditional.

If there is a condition, eg the puchaser being able to raise the funds to enable him to complete, then the sale is not unconditional and it may not be possible to sue for the full price. Therefore, accounting for sale on conditional sales should be on completion or, if earlier, on satisfaction of the condition. You need to establish the exact terms of the exchange.

You also need to establish whether the units were complete at date of exchange. If not, then the principles of UITF 40 will need to be applied to the contract in progress.

Q2. Accounting for income recognition from admission sales

Q. A client runs a swimming pool.

They sell admissions either individually or in 10 entrances at a time. The other option is an annual pass i.e. unlimited entries for one year.

In my opinion there are no marginal costs associated with people making a visit. There are only the general overheads of rent, depreciation, wages etc on an on-going basis.

Information about how many entries have been made against the 10 ticket pass is readily available.

We are unsure if this revenue should be recognised all at the time of sale, or either usage/time apportioned in relation to the differing passes.

What is your recommended treatment? Does it differ from one pass to the other?

A. I think the different passes will have to have different treatments. Whilst I note what you say about there being no marginal costs associated with a visit, the centre itself has to be kept open in order to make the facilities available.

Single entrance fees should obviously be accounted for on the day concerned.

The blocks of 10 are more complicated. If there were a substantial number of tickets sold in a month then fees might drop the following month when they were used. However, unless the centre were to close within 10 days of selling a block of 10 there could presumably be no claim against the company for a refund as there was an opportunity to use the tickets that was not taken.

I note that information is available about the use of the tickets. Are there time or other limitations on when the credits must be used by? If there is, it would make sense to recognise income as the tickets are used and write off any balance when the tickets are no longer valid. However, if there is no expiry then you would end up with balances for unused tickets. This does not make sense when there is no liability for unused tickets and no reason not to recognise the income in the accounts when the block is sold. On balance, therefore, I think sales from the blocks of 10 should be recognised when the sale is made. If total sales of blocks of 10 are a material proportion of income then the accounting policy for revenue should specifically address how they are treated.

In some respects the argument for the annual tickets is essentially the same. But is there any entitlement to a refund if a person were to move away? If so, then the annual fees are like a membership fee and I think it makes sense to recognise the income on a monthly basis over the year. Even if there is no right to a refund the company has essentially undertaken to keep the facilities available for a year when it sells the ticket and if the facilities ceased to be available for any reason then there would be a liability in respect of the unexpired portion of the year. It cannot be right to recognise the income up front when the company has an obligation that extends for a year. The income should therefore be apportioned over the period of the obligation.

Q3. Revenue recognition from sale of lodges

Q. A company sells lodges/caravans on lodge/caravan parks. It might build one lodge as a show lodge and from this market further lodges or it might market lodges with no show lodge. If a customer orders a lodge then he is required to pay a 10% deposit; this is only refundable to the customer if the company does not build/supply the lodge. The company then has to prepare and landscape the site for the lodge; the lodges are bought in and assembled on site and prior to ordering the lodge the customer will be required to pay a further 20%. The customer will be required to pay the balance of 70% prior to completion and handing over the keys.

When the customer pays his deposit he is given an invoice for the full value of the lodge so that he can see the full value on which the deposit is calculated, the balance of 90% being payable as described.

At the balance sheet date the company had received two 10% deposits but had not commenced any work on the site; in fact it had not at that stage completed on the purchase of the land.

What should the accounting be? Since the sales invoices have been issued, should their value be accounted for as turnover and an accrual made for the estimated related costs (site preparation and lodge purchase)?

A. No. We think the deposits should be included in creditors with nothing in turnover. The deposits are returnable if the company does not build the lodge and at the balance sheet date the company had not built the lodge; they would be reclassified to turnover if the customer decided to cancel his order.

The principal accounting standard on this subject is FRS 5 Application note G on revenue recognition. This states the basic principle that 'the seller recognises revenue under an exchange transaction with a customer, when, and to the extent that, it obtains the right to consideration in exchange for its performance. At the same time, it typically recognises a new asset, usually a debtor.' Right to consideration is defined as 'A seller's right to the amount received or receivable in exchange for its performance. This right does not necessarily correspond to amounts falling due in accordance with a schedule of stage payments which may be specified in a contractual arrangement. Whilst stage payments will often be timed to coincide with performance, they may not correspond exactly. Stage payments reflect only the agreed timing of payment, whereas a right to consideration arises through the seller's performance.' Performance is defined as 'The fulfilment of the seller's contractual obligations to a customer through the supply of goods and services.'

In this situation it is not difficult to see that the seller has not performed or fulfilled any obligation because it has not even commenced work on the site. For this reason and because the deposit is repayable at the balance sheet date if the lodges are not built, then not even the 10% should be recognised as revenue.

The sale of the lodge has similarities with the sale of property and it is worth looking again at the extracts from the PwC manual of accounting included in the answer to question 1 above.

THE FUTURE OF FINANCIAL REPORTING IN THE UK AND THE REPUBLIC OF IRELAND

Lecture A323 (7.11 Minutes)

Proposals for a three-tier reporting framework and a simplified UK standard based on the IFRS for SMEs – extracts from press release

On 29 October 2010, the Accounting Standards Board published its proposals for the future of financial reporting in the UK and Republic of Ireland. The Exposure Drafts set out proposals for a three-tier reporting framework, which aims to balance the needs of preparers and users of accounts.

The document includes an explanation of the proposals, a draft Impact Assessment and two new proposed standards. The aims include:

- to explain to companies and other entities which set of accounting standards will apply to them; and
- to simplify UK standards into a concise, coherent and updated form.

The proposed three-tier approach, which has been developed and consulted on over the past six years, builds on the existing system. Quoted groups will continue to report under international financial reporting standards (IFRS), as adopted by the EU.

They would be joined in Tier 1 by other companies that are publicly accountable. This would apply if their debt is traded on public markets, or if they hold deposits or manage other people's money. (Some very small financial institutions would be exempt.)

The smallest companies will continue to use the simplified version of UK standards, known as the FRSSE.

Those in between would report under a new standard based on the IFRS for SMEs, which is considerably shorter and less complicated than current UK standards. The FRSME, as it would be called, would be modified to comply with UK and EU law and to ease tax reporting. It runs to about 400 pages.

The ASB is proposing a new standard because the current 2,000-page book, built up over decades, is an unwieldy and incoherent mixture of old UK standards and ones that have been partly converged with IFRS. Nevertheless, gaps remain, notably in the reporting of financial instruments. Without these changes, UK standards would in any case have had to be updated.

Basing reporting for all but the smallest companies on the international framework will reduce the training costs of accountants and the scope for auditing errors.

A consistent framework should also make interpretation simpler for users of accounts, and companies will find it easier to move between tiers.

An important part of the simplification process is the proposed reduced disclosure regime, which would enable most group subsidiaries to make significant savings.

In response to feedback during previous consultations, the ASB plans to develop a standard tailored to the needs of public benefit entities such as charities. It will also retain the sector-specific statements of recommended practice (SORPs) where there is a clear need.

Change always has a cost. The draft Impact Assessment estimates the costs of transition at £78.9m. While some entities will be more affected than others, overall the ASB believes this will be recouped through the simplification of reporting for many of them. There is also potential for a reduced cost of debt.

In view of the significance of the changes, the ASB is open to fundamental comments on the Draft, not just points of detail. The Board is aware that there are differing views, and one of its members has provided an alternative proposal.

It is proposed that the new framework would be effective from 1 July 2013.

Comments on the proposals

The APB has produced the following documents:

- Key facts
- Explanation including a draft impact assessment running to 75 pages and an alternative view
- Draft financial reporting standards – the first one dealing with the application of the requirements to the tiers and subsidiaries; the second gives the draft FRSME
- Appendices

There is considerable overlap between these documents and the press release above. In future updates we will cover the detail of the exposure drafts but at this stage, some of the key issues are included in the notes below.

Reduced disclosures for subsidiaries

The draft FRS sets out a reduced disclosure framework for qualifying subsidiary undertakings. A qualifying subsidiary is not publicly accountable; is included in consolidated accounts of a parent whose financial statements are publicly available; and is not subject to any objection from shareholders.

Paragraph 1.8 of FRSME states:

"In response to concerns expressed by respondents to the ASB Consultation Paper 'Policy Proposal: The Future of UK GAAP' (Policy Proposal), the draft applicable

FRS also sets out a reduced disclosure framework for qualifying subsidiary undertakings. The framework gives exemptions from certain disclosure requirements to qualifying subsidiaries that prepare financial statements either in accordance with EU-adopted IFRS or the FRSME."

Compliance with UK and European legal requirements

Whilst the draft FRSME is based on the IASB's IFRS for SMEs, it has had to be adapted to comply with UK and European legal requirements. The key facts document tells us that changes have been necessary to the treatment of negative goodwill, extraordinary items and the treatment of associates and joint ventures. Paragraph 1.10 of the explanation document adds the comment that FRSME removes certain options permitted by the IFRS for SMEs but not available in accordance with CA 2006 and inserts disclosure requirements for certain financial liabilities held at fair value.

In addition IFRS for SMEs has been amended to relax the requirement to prepare group accounts where this is permitted by CA 2006.

Other changes to IFRS for SMEs

The chapter on tax in the IFRS for SMEs was based on an assumption that an exposure draft to amend IAS 12 would be adopted by the IASB. Since this did not occur, FRSME is based on the existing version of IAS 12.

Other amendments include transitional relief for dormant companies and exemption for parents and subsidiaries from the requirement to prepare cash flow statements.

FRSSE

The ASB is not proposing to change the FRSSE except for consequential amendments to reflect the removal of the existing body of UK FRSs. The key facts document tells us that:

- Small entities may continue to use their current accounting policies.
- The ASB will consult on future options for the FRSSE at a later date.
- Future developments will be informed by the ongoing EU and FRC work on micro-entities.
- For transactions that are not covered by the FRSSE, and for which an entity does not have an accounting policy, entities will look to the FRSME.

Effective date

It is proposed that the new framework should be effective from 1 July 2013. This means periods commencing on or after 1 July 2013. If this is confirmed following the exposure period and assuming we are dealing with a full 12 month period, the earliest compulsory date of transition for any client will be 1July 2012. This is logical

since the deadline for comments on the exposure drafts is 30 April 2011 and it will probably take the ASB 12 months from then to finalise the rules.

Once the final standards are available, early adoption will be permitted!

CHARTERED ACCOUNTANTS' REPORTS ON THE COMPILATION OF FINANCIAL STATEMENTS OF INCORPORATED ENTITIES (AAF 02/10)

Lecture A324 (15.21 Minutes)

Introduction

This guidance was issued in August 2010. Professional accountants are encouraged to apply the guidance as best practice as soon as possible. The previous guidance is withdrawn as of 30 November 2010.

Guidance

Professional ethics

This refers to the Fundamental Principles of: Integrity; objectivity; professional competence and due care; confidentiality; and professional behaviour.

The guidance emphasises that members should not compile financial statements or permit their names to be associated with financial statements that they consider misleading. This would occur if the information:

- Contains a materially false or misleading statement;
- Contains statements or information furnished recklessly; or
- Omits or obscures information required to be included where such omission or obscurity would be misleading.

When a professional accountant becomes aware that their name has been associated with financial statements that are misleading then the accountant shall take steps to be disassociated from that information.

The guidance refers to ethical issues such as potential threats to objectivity, and conflicts of interest. This is a similar approach to that adopted in the APB ethical standards but note that the APB ethical standards do not apply to these assignments.

Risk areas include:

- family and other personal or business relationships
- loans
- beneficial interests in shares and other investments
- gifts and hospitality

Practice Assurance standards apply to compilation engagements.

Compilation of financial statements

The guidance is not designed and does not enable the accountants to express any assurance on the financial statements. However users derive benefit from the financial statements because Chartered Accountants are subject to various ethical requirements of ICAEW.

Terms of engagement

The guidance sets out the various matters an engagement letter would normally be expected to deal with.

The engagement letter should be addressed to the Board of Directors.

Operational issues

The guidance refers to planning, procedures, documentation and management representations. There are no explicit requirements in any of these areas other than the need to obtain a general understanding of the business and to consider whether the financial statements are consistent with their understanding of the business and whether the financial statements are misleading. The accountant will also consider methods available to check that relevant disclosures have been made on the basis of information available. See further notes below.

Approval of financial statements

Financial statements should be approved and signed by the directors before the accountants' report is signed.

Companies Act 2006 requires that the directors approve the financial statements and that the balance sheet states the name of the director who has signed the financial statements on behalf of the board.

Directors of audit exempt companies must acknowledge on the face of the balance sheet their responsibilities for keeping proper accounting records and for preparing true and fair financial statements as well as entitlement of the company to exemption from audit.

Accountants' reports

The guidance sets out basic content as well as example reports (see below).

Procedures

The following procedures are included:

Planning

- The level of planning may vary according to the complexity of the company's accounting records and the professional accountants' experience of the business.

Procedures

- Obtain a general understanding of the business and operations of the company.
- Be familiar with the accounting principles and practices of the sector in which the company operates and with the form and content of the accounting information that is appropriate in the circumstances.
- Understanding of the business is usually obtained through experience of the company or enquiry of the company's management and staff.
- Consider whether the financial statements are consistent with their understanding of the business and whether the financial statements are misleading. Make such enquiries of management and undertake such procedures as judged appropriate but there is no obligation to perform procedures that may be required for assurance engagements.
- Consider methods available, such as disclosure checklists or software packages, to check that relevant disclosures have been made based on the information available.

Documentation

- There is no requirement to document the work that has been carried out, documentation may help to demonstrate the adequacy of the work performed and that the engagement was carried out in accordance with the terms of engagement where the quality is subsequently challenged.

Management representations

- Accountants are normally reliant on representations by management, particularly in relation to estimates and the reliability, accuracy and completeness of information provided. Therefore consider obtaining written management representations.

Misleading financial statements

Paragraphs 29 to 34 are important. These paragraphs are reproduced below.

29. Financial statements prepared under the Companies Act 2006 are required to give a true and fair view. Such accounts should, amongst other things, comply with the requirements of the applicable financial reporting framework including, where necessary, any disclosures required in relation to the use of the true and fair override.

30. Without carrying out an assurance service, the professional accountants cannot form an opinion as to the truth and fairness of the view given by financial statements. During the course of the engagement, however, matters may come to light which appear to indicate that the financial statements may be misleading including the inappropriate use of the going concern basis or inadequate disclosure relating to going concern (see paragraph 22). In other situations, the professional accountant may feel that they have not been provided with all the information required in order to compile the financial statements. The directors of a company are required by law to maintain adequate accounting records, and so in such circumstances they will request the directors to provide the missing information.

31. In such cases, the professional accountants discuss the matter with the client with a view to agreeing appropriate adjustments or disclosures to be made in the financial statements or to provide the missing information. If, despite such a request, the directors refuse to permit the professional accountant to make appropriate adjustments or disclosures in the financial statements or to provide the missing information, the professional accountants may consider that the financial statements are misleading. If they do consider the financial statements to be misleading then they should withdraw from the engagement and should not permit their name to be associated with the financial statements.

32. In considering whether financial statements are misleading, the professional accountants consider whether the financial statements appear to be appropriate in form and free from material misstatements that appear obvious to them as a result of, for example:

- misclassifications in the financial statements;
- mistakes in the application of, or non-disclosure of known departures from, any relevant statutory, regulatory or other reporting requirements, including applicable financial reporting framework and non-disclosure of significant changes in accounting policies;
- other significant matters of which the professional accountants are aware.

33. When the professional accountants withdraw from an engagement, they should normally explain to their clients their reasons for withdrawing, unless this would constitute a breach of legal or other regulatory requirement (such as the 'tipping off' provisions of the money laundering legislation).

34. In rare situations, the accountant may conclude that it remains appropriate for them to be associated with the financial statements despite the fact that they depart from an applicable standard or the fact that incomplete information is available (for example, if stocktake records have been lost in a fire). In such situations, the professional accountant will check that appropriate disclosures are made in the financial statements (for example, those required by paragraphs 62–64 of FRS 18 or paragraph 2.3 of the FRRSE when the true and fair override is invoked and the accountant believes that the override is appropriate). They may further wish to highlight these disclosures in their report by way of an explanatory paragraph. For example, where the true and fair override has been used, there will already be extensive disclosure; however, if there is a lack of accounting records, there may not be. The Appendix contains an example wording for such a paragraph.

Filing the financial statements

The Professional Oversight Board's report recommends that users of financial statements are given a clear explanation of the extent and relevance of the involvement of professional accountants in the preparation of those financial statements. In the light of this, Paragraph 40 of AAF02/10 states that, provided the company is exempt from audit, the filing of the compilation report alongside the copy of the financial statements with the Registrar may help increase the credibility of the financial information placed on public record and differentiate the financial statements from those prepared by firms and individuals who are not members of one of the CCAB bodies. This does not apply when financial statements contain an audit report, or abbreviated accounts derived from audited accounts contain a special auditors' report under s449 Companies Act 2006, as inclusion of two different reports by professional accountants could be confusing.

Example report

Chartered Accountant's/Accountants' report to the board of directors on the preparation of the unaudited statutory accounts of XYZ Limited for the year [/period] ended dd/mm/20yy

In order to assist you to fulfil your duties under the Companies Act 2006, we have prepared for your approval the accounts of XYZ Limited for the year [/period] ended dd/mm/20yy [as set out on pages x–x/which comprise of [insert statements]] from the company's accounting records and from information and explanations you have given us.

As a practising member [/member firm of] of the Institute of Chartered Accountants in England and Wales (ICAEW), we are subject to its ethical and other professional requirements which are detailed at icaew.com/membershandbook.

[This report is made solely to the Board of Directors of XYZ Limited, as a body, in accordance with the terms of our engagement letter dated dd/mm/20yy.] Our work has been undertaken [solely to prepare for your approval the accounts of XYZ Limited and state those matters that we have agreed to state to them/the Board of Directors of XYZ Limited, as a body, in this report] in accordance with AAF 2/10 as detailed at icaew.com/compilation. [To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than XYZ Limited and its Board of Directors as a body for our work or for this report.]

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

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

[Explanatory paragraph: eg, departure from generally accepted accounting practice etc.]

Signature………………………

Typed name of professional accountant

Chartered Accountants

Address

Date ………………………….

Explanatory paragraph

We draw your attention to note x in the financial statements which discloses and explains the year-end stock balance is an estimate derived from management accounts. Following a fire in the warehouse, the records of the year-end stock count were not available.

Notes

The financial statements contain a reference to the fact that they are unaudited either on the front cover or on each page of the financial statements, or both.

Professional accountants use 'I' in place of 'we,' 'my' in place of 'our' etc. as appropriate.

ICAEW recommends that, in order to manage their professional liability, practices include the optional paragraphs (shown by square brackets above) in their compilation reports.

Explanatory paragraph may be positioned in other places in the report depending on the nature of the matter described.

The report is signed in the name of the professional accountant or, where appropriate, in the name of the accounting firm.

Differences for unincorporated entities (AAF 03/10)

Example wording for approval of financial information

In accordance with the engagement letter dated [date], I/we approve the financial information which comprises [state the financial information compiled]. I/we acknowledge my/our responsibility for the financial information, including the appropriateness of the applicable financial reporting framework as set out in note x, and for providing [the accountants] with all information and explanations necessary for its compilation. Signatures [XYZ and Co] Date

Example report

Chartered Accountants'/Accountants' Report to [Entity] on the Unaudited Financial Information of XYZ and Co

In accordance with the engagement letter dated [date], we have prepared for your approval the financial information of [the entity] for the year [/period] which comprises of [insert statements]] from the entity's accounting records and from information and explanations you have given us.

As a practising member [/member firm of] of the Institute of Chartered Accountants in England and Wales (ICAEW), we are subject to its ethical and other professional requirements which are detailed at icaew.com/membershandbook.

[This report is made solely to you, in accordance with the terms of our engagement letter dated dd/mm/20yy.] Our work has been undertaken [solely to prepare for your approval the financial information of [entity] and state those matters that we have agreed to state to you in this report] in accordance with the guidance of ICAEW as detailed at icaew.com/compilation. [To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than [addressee of this report] for our work or for this report.]

[You have approved the [financial information] [for the year/period] and have acknowledged your responsibility for it, for the appropriateness of the financial reporting framework adopted and for providing all information and explanations necessary for its compilation.

We have not verified the accuracy or completeness of the accounting records or information and explanations you have given to us and we do not, therefore, express any opinion on the financial information.]

Signature………………………

Typed name of professional accountant

Chartered Accountants

Address

Date ………………………….

ISA (UK AND IRELAND) 230 AUDIT DOCUMENTATION

Lecture A325 (7.38 Minutes)

Introduction

This ISA sets out the general principles concerning audit documentation. The Appendix lists other ISAs (UK and Ireland) that contain specific documentation requirements and guidance.

The introduction to ISA (UK and Ireland) 230 tells us that the specific documentation requirements of other ISAs (UK and Ireland) do not limit the application of this ISA (UK and Ireland). This means that compliance with the specific documentation requirements is necessary if an audit is to comply with ISAs but mere compliance with those specific requirements is not sufficient. Rather, the general principles laid down in this ISA will lead to a requirement for additional working papers.

A further comment made in the Application Material is that the absence of a documentation requirement in any particular ISA (UK and Ireland) is not intended to suggest that there is no documentation that will be prepared as a result of complying with that ISA (UK and Ireland).

Objective

The objective of the auditor is to prepare documentation that provides:

(a) A sufficient and appropriate record of the basis for the auditor's report; and

(b) Evidence that the audit was planned and performed in accordance with ISAs (UK and Ireland) and applicable legal and regulatory requirements.

Requirements

The auditor is required to prepare audit documentation on a timely basis. The Application Material makes the point that documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements;

(b) The results of the audit procedures performed, and the audit evidence obtained; and

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

This requirement is designed to deal with a wide variety of situations and is therefore phrased in broad terms. It might be expected that the Application Material would set out more detail of working papers required but, in fact, the guidance concentrates more on what is *not* required or *not* appropriate.

So, in Paragraph A4, we get the comment that the auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Paragraph A5 tells us that oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached. The guidance goes on to say that oral explanations may be used to explain or clarify information contained in the audit documentation. This comment is exactly the same as in the previous version of ISA (UK and Ireland) issued in 2006 but it is worthy of note that both the old SAS 230 (issued 1995 and superseded in 2005) and the original ISA (UK and Ireland) were vague when dealing with the value of oral explanations.

Continuing with the theme of telling us what is not required, Paragraph A7 tells us that it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit.

The Application Material also tells us that it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. The best example given is that the existence of an adequately documented audit plan demonstrates that the auditor has planned the audit. There is no need to complete a planning checklist as well.

Before leaving Paragraph 8, look again at part (c). This requires documentation of significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. This has been expanded slightly from the previous version of ISA (UK and Ireland) 230 by the addition of the reference to professional judgement. However, despite the clear

requirement in the previous standard for documentation of significant matters this has frequently been highlighted as a weak area when reporting the results of cold file reviews.

The Application Material suggests that the auditor may consider it helpful to prepare a summary (sometimes known as a completion memorandum or audit highlights) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information

Paragraph 9 lists requirements when documenting the nature, timing and extent of audit procedures performed. The auditor is required to record the identifying characteristics of the specific items or matters tested; who performed the audit work and the date such work was completed; and who reviewed the audit work performed and the date and extent of such review.

The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Paragraph 10 requires the auditor to document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

Again, this is a specific requirement concerning an area of general weakness. The comment so often seen on files “Discussed with client” is not adequate.

Paragraph 11 requires the working papers to document how the auditor addressed information that is inconsistent with the auditor's final conclusion regarding a significant matter.

If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in an ISA (UK and Ireland), Paragraph 12 requires the auditor to document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure.

The Application Material indicates that this would only be necessary in exceptional circumstances.

Note that a requirement is not relevant only in cases where the entire ISA (UK and Ireland) is not relevant or the requirement is conditional and the condition does not exist.

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, Paragraph 13 requires the auditor to document the circumstances encountered; the new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and when and by whom the resulting changes to audit documentation were made and reviewed.

Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report. This subject is dealt with in more detail in ISA (UK and Ireland) 560.

There may be other circumstances where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed. The example given in the Application Material is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties. In this case, regardless of the nature of the modifications or additions, Paragraph 16 requires the auditor to document the specific reasons for making the changes and when and by whom they were made and reviewed.

Paragraphs 14 and 15 deal with the assembly of the file. This should be done on a timely basis after the date of the auditor's report. ISQC 1 suggests a time limit of 60 days after the signing of the audit report. During this period changes of an administrative nature may be made to the file. However, after the assembly of the final audit file has been completed, the auditor must not delete or discard audit documentation of any nature before the end of its retention period.

ISA (UK AND IRELAND) 240 THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

Introduction

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Although fraud is a broad legal concept, for the purposes of the ISAs (UK and Ireland), the auditor is concerned with fraud that causes a material misstatement in

the financial statements. Two types of intentional misstatements are relevant to the auditor - misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention and fraud deterrence. This involves a commitment to creating a culture of honesty and ethical behaviour.

An auditor conducting an audit in accordance with ISAs (UK and Ireland) 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. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs (UK and Ireland).

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organised schemes designed to conceal it.

Further, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this ISA (UK and Ireland) are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

ISA 240 will be covered in detail in the next quarters accounting update.

ISA (UK AND IRELAND) 300 PLANNING AN AUDIT OF FINANCIAL STATEMENTS

Lecture A326 (5.52 Minutes)

Objective

The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Requirements

Paragraph 5 requires the engagement partner and other key members of the engagement team to be involved in planning the audit, including planning and participating in the discussion among engagement team members.

The following activities are compulsory at the beginning of the current audit engagement:

- Procedures required by Paragraphs 12 and 13 of ISA (UK and Ireland) 220 regarding the continuance of the client relationship and the specific audit engagement;
- Evaluating compliance with relevant ethical requirements, including independence, in accordance with Paragraphs 9 to 11 of ISA (UK and Ireland) 220; and
- Establishing an understanding of the terms of the engagement, as required by paragraphs 9 to 13 of ISA (UK and Ireland) 210.

Planning activities

Paragraph 7 requires the auditor to establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. Paragraph 8 gives more detail of what this means. The overall audit strategy includes identifying the characteristics of the engagement that define its scope; ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required; considering the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts; considering the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and ascertaining the nature, timing and extent of resources necessary to perform the engagement.

The Appendix to ISA (UK and Ireland) 300 lists examples of considerations in establishing the overall audit strategy.

The Application Material sets out considerations for smaller entities. It comments that establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 8.

Under Paragraph 9, the audit plan must include a description of:

- The nature, timing and extent of planned risk assessment procedures.
- The nature, timing and extent of planned further audit procedures at the assertion level.
- Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs (UK and Ireland).

The Application Material tells us that planning takes place over the course of the audit as the audit plan for the engagement develops. Whereas planning of the auditor's risk assessment procedures occurs early in the audit process, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. It is not necessary to complete planning in all areas before the start of detailed procedures in some areas.

Not only will the plan develop over the course of the audit, it may also be necessary to amend the strategy and audit plan during the course of the audit as required by Paragraph 10.

Under Paragraph 11, the auditor is required to plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

Documentation

12. The auditor shall include in the audit documentation:

(a) The overall audit strategy;

(b) The audit plan; and

(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

As discussed above, a brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs or checklists may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

Additional considerations in initial audit engagements

Paragraph 13 draws attention to the procedures required by Paragraphs 12 and 13 of ISA (UK and Ireland) 220 regarding the acceptance of the client relationship and the specific audit engagement.

Paragraph 13(b) makes it compulsory to communicate with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. I would interpret this to mean that communication is compulsory but that it is not necessarily compulsory to review the predecessor’s working papers.

ISA (UK AND IRELAND) 315 IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

Introduction

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

ISA 315 will be covered in detail in the next quarters accounting update.

ISA (UK AND IRELAND) 330 THE AUDITOR'S RESPONSES TO ASSESSED RISKS

Lecture A327 (3.16 Minutes)

Objective

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Requirements

Overall responses

Paragraph 5 requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.

Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasising to the audit team the need to maintain professional scepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing, or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

Responses at the assertion level

The auditor is required to design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

The nature of an audit procedure refers to both its purpose (test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). Audit procedures may involve substantive procedures only or a combined approach using both tests of control and substantive procedures. Note that, in accordance with Paragraph 18 below, some substantive procedures are always required for each material class of transactions, account balance, and disclosure.

Designing and performing further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

In designing the further audit procedures, the auditor is required by Paragraph 7(a) to consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure. This includes the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and whether the risk assessment takes account of relevant controls (that is, the control risk).

If the risk assessment takes account of control risk the auditor is required to obtain audit evidence to determine whether the controls are operating effectively.

Paragraph 7(b) requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. This may be achieved by increasing the quantity of the evidence, or by obtaining evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

Tests of controls

There are two circumstances in which the auditor is required to test the operating effectiveness of controls. This is when either:

- The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

More persuasive audit evidence is required the greater the reliance the auditor places on the effectiveness of a control.

Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent (known as preventative or detailed controls), or detect and correct (known as detective or managerial or supervisory controls), a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls.

In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test.

Nature and extent

A test of controls involves more than just inquiry. Other audit procedures must be performed in addition to inquiry in order to obtain audit evidence about the operating effectiveness of the controls. This must include how the controls were applied at relevant times during the period under audit; the consistency with which they were applied; and by whom or by what means they were applied.

Inquiry combined with inspection or reperformance will usually provide more assurance than inquiry combined with observation.

If more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. Other matters the auditor may consider in determining the extent of tests of controls include the frequency of the performance of the control and the expected rate of deviation from a control.

The auditor is also required to consider whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. The Application Material gives as an example the situation where the auditor decides to test the effectiveness of a user review of exception reports. The user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports are described as indirect controls.

Timing

Paragraph 11 requires the auditor to test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls. This is, however, subject to Paragraphs 12 and 13 to 15.

Paragraph 12 deals with interim audits and requires the auditor to obtain audit evidence about significant changes to controls subsequent to the interim period tested. The auditor must also determine the additional audit evidence to be obtained for the remaining period.

Paragraphs 13 and 14 permit the auditor to rely on tests of controls performed in previous periods. This is subject to detailed conditions of which the most notable are:

1. The need to confirm that there have been no significant changes in the controls. This evidence will usually be obtained by performing a walk-through test.
2. The need to test the controls at least once in every third audit.
3. The need to test some controls in every audit.

If the auditor plans to rely on controls over a significant risk, then Paragraph 15 requires the auditor to test those controls in the current period.

Testing some controls in each audit provides corroborating information about the continuing effectiveness of the control environment and contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the operating effectiveness of controls

Misstatements identified during substantive work may indicate that controls are not operating effectively. However, the absence of such misstatements does not provide audit evidence that controls are effective.

When performing tests of controls, deviations may be detected. The auditor is required to make specific inquiries to understand why the deviations have occurred and their potential consequences. The auditor must then consider whether the tests of controls already performed are sufficient; whether additional tests of controls are necessary; or whether the potential risks of misstatement need to be addressed using substantive procedures.

Substantive procedures

> 18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

The Application Material expands on the above and states that, depending on the circumstances, substantive analytical procedures alone may be sufficient to reduce audit risk to an acceptably low level. The example given is where the auditor's assessment of risk is supported by audit evidence from tests of controls. The Application Material adds that substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Alternatively, the auditor may perform only tests of details or may perform a combination of substantive analytical procedures and tests of details.

The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be

included in the relevant financial statement amount and investigating whether they are included.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

There is a specific requirement in Paragraph 19 for the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures.

Financial statement closing process

Paragraph 20 contains requirements for audit procedures related to the financial statement closing process. The auditor is required to agree or reconcile the financial statements with the underlying accounting records. In addition, the auditor must examine material journal entries and other adjustments made during the course of preparing the financial statements.

Response to significant risks

21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

External confirmations may well provide the auditor with the high level of assurance required when dealing with significant risks. The example given in the Application Material relates to revenue recognition. In this situation, it may be appropriate for the auditor to design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms.

Timing

Paragraphs 22 and 23 deal with substantive procedures performed at an interim date. The auditor is required to cover the remaining period by performing either substantive procedures combined with tests of controls or further substantive procedures only.

If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor is required to evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified.

Adequacy of presentation and disclosure

Paragraph 24 requires the auditor to perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework.

Evaluating the sufficiency and appropriateness of audit evidence

Following the completion of audit procedures and before the conclusion of the audit, Paragraph 25 requires the auditor to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.

The auditor is required to conclude whether sufficient appropriate audit evidence has been obtained. This consideration should take account of all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, Paragraph 27 requires the auditor to attempt to obtain further audit evidence. If this cannot be done then the auditor must express a qualified opinion or disclaim an opinion on the financial statements.

Documentation

There are a number of explicit documentation requirements:

- The overall responses to address the assessed risks; the nature, timing, and extent of the further audit procedures performed; linkage of the procedures with the assessed risks at the assertion level; and the results of the audit procedures, including the conclusions where these are not otherwise clear.
- Where appropriate, the conclusions reached about relying on the operating effectiveness of controls that were tested in a previous audit.
- Demonstration that the financial statements agree or reconcile with the underlying accounting records.

The Application Material reminds us that the form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

COLD FILE REVIEWS: SUMMARY OF FINDINGS

Lecture A328 (15.58 Minutes)

Introduction

I have performed cold file reviews for a number of firms over the last few months. The summary of the results from these reviews is included below.

As a general point, it is often the case that weaknesses are repeated from year to year. This lack of progress is particularly disappointing since the new standards will add to the difficulties faced by firms and it would be helpful if firms were starting from a stronger base position. I recommend that a selection of files should be reviewed as soon as a sufficient quantity of jobs has been completed using the new standards. Firms should not necessarily wait until a full year has elapsed since the performance of their previous reviews.

Accounts disclosure has been an area where performance has declined. The familiar list of “common errors” will be repeated in these update notes until they are eliminated from every set of accounts. A particular area requiring attention on all files is the disclosure of the accounting policy for revenue recognition.

I have also observed increased incidences of overauditing.

Accounts and the audit report

Obviously the copy of the accounts placed on file is not the copy of the accounts filed with the registrar so this comment may be unnecessary. However, some firms seem to be unaware that it is no longer acceptable for the company number to appear only on the front sheet of the filed accounts.

Coincidentally, all files reviewed this year were prepared using the small company provisions of the Companies Acts and the FRSSE. Accordingly, I cannot comment on whether there has been an improvement in the quality of business reviews in directors’ reports. My suspicion is that this is still likely to be an area of general weakness.

If charitable or political donations are made, CA 2006 has introduced additional disclosure requirements.

The situation of a client changing from being audit exempt to requiring audit is now quite common. This gives rise to issues concerning opening balances and comparatives. Even if the auditor is satisfied with opening balances and comparatives, it is still necessary to disclose in the audit report that the previous year's accounts were not audited.

There is considerable attention in the profession at the moment to the usefulness of accounting policies. The policies produced by accounting software tend to be bland and apply to a very broad range of entities. This tends to reduce their usefulness. In particular, for the clients reviewed, more detail should have been provided on revenue recognition. In one client, there should have been a policy covering research and development expenditure.

A change of depreciation rate is not a change in accounting policy. If the impact of the change in estimate is sufficiently material to require disclosure then there should also be disclosure of the impact on current period results.

Deferred tax can still be a weak area. For one client, there was no accounting policy. This could have been acceptable on the grounds of immateriality but this decision was not justified in the audit file. For another client, there was no analysis of the deferred tax balance and movements.

In some accounts, there was no disclosure of one or all of auditor's remuneration, pension costs, the number of directors who are members of pension schemes or obligations under operating leases. These are well known as common errors in disclosures and there is no excuse for these failures.

In one set of accounts, the notes for debtors and creditors referred to balances with group undertakings. In fact the balances were with related parties that were related through common ownership. You should not refer to such entities as group undertakings.

Disclosure of loans to directors was inadequate in the accounts prepared under CA 1985. This is likely to continue to be a problem area in future.

In one set of accounts, the ultimate controlling party note states "The directors control the company". I would question the appropriateness of this statement. The definition of control in FRS 8 is "The ability to direct the financial and operating policies of the entity with a view to gaining economic benefits from its activities". Paragraph 18 of FRS 8 says that disclosure of the controlling party is important because the control relationship prevents the entity from being independent. In this context, independence means the ability to pursue its activities independently of the interests of its individual owners, managers and others.

I have always taken this to mean that control is only operating if the company is being inhibited from pursuing its own objectives. To say that the directors control the company implies to me that the directors are controlling the company to their own benefit to the potential detriment of other shareholders. This would rarely be the case in practice and therefore I would suggest that in many cases where a control disclosure is provided, it is not, in fact, required. However, whatever conclusion you reach on controlling party disclosure should be justified in the audit highlights memo.

Dividends paid to related parties should be disclosed as related party transactions.

The accounts should follow FRC guidance and include a note relating to the impact of the current economic environment.

Some firms are confused in the use and disclosure of ES PASE.

Permanent file (PAF), knowledge of the business and internal control

The index page for the PAF should be initialled to indicate update and review every year.

Engagement letters must be re-issued when the client has ceased to be audit exempt. Failure to do so is a serious lapse in procedures.

Many firms produce good free-form memos for recording knowledge of the business which provide useful information in most cases. However, you should make an effort to complete all relevant sections of the form. The memo should also indicate who prepared it (and when) and who reviewed it (and when). The memo should, of course, be updated for each audit.

Remember that, under ISA 230, your working papers must be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant matters. The knowledge of the business memo should give a complete picture of the key issues of the job. It should include the different sources of revenue and indicate how revenue is recognised.

Remember that related parties are related parties even if they don’t transact with the business. Remember also that the revised FRS 8 includes key management personnel as related parties – and this will also include their close family.

Systems notes tend to be quite brief. They could be improved if they were set out in the order of the processes since this would help to ensure that all steps in the process are recorded. This would also help to identify risks.

There was little or no attention to control activities in many of the files reviewed. To confirm implementation of a control, it is necessary to perform a walk-through test and to note the details of the test on file. This is the weakest area of the files reviewed and needs urgent attention.

Some audit systems provide an outline of controls that may exist (eg schedule S4 in PCAS). Such a schedule should be used as an aide-memoire in the preparation of systems notes. It is not necessary to complete it.

If major contracts are photocopied for the PAF, then prepare also a summary of the key clauses as they affect the accounts and audit. This will make future audits more efficient.

Planning and risk assessment

Acceptance procedures should include a consideration of the integrity of the potential client.

Ensure that all threats to independence are recorded on file. This should include a list of all non-audit services provided including payroll.

Where safeguards are recorded make sure that they are applied. For example, if you say that the staff involved in preparing the accounts will not be involved in the audit then make sure that happens.

Threats to independence and safeguards applied must be reported to the client along with your assessment as to whether you can continue to act as auditor.

Your work on fraud must include a discussion with the client. It is not sufficient to make comments such as “Discussed with client”. The file should indicate who you discussed the issue with and when. The results of the discussion should be recorded on file. The comment “None” is inadequate as a record of the discussion.

You must document on file the reasons for believing inherent risk to be other than high. The reason for this is that ISA 330 states that if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to

obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.

Any risk included in the fraud heading is a significant risk. ISA 315 requires the auditor to consider the design and implementation of controls related to such risks.

Remember that ISA 240 makes a presumption that revenue recognition is always an area of significant risk. The clarity ISA 240 makes the same assumption for the risk of management override.

On one file, there was a comment that the company can dictate the timing of income because they decide when to raise an invoice. This is not true. Revenue must be recognised as it is earned irrespective of invoice date. On another file, the issue of contracts in progress and the recognition of revenue on those contracts was not dealt with in the PAF or the audit work.

Note that it is compulsory to assess the design and implementation of all controls relevant to the audit. This involves a walkthrough test. This has nothing to do with whether controls are being relied upon. As mentioned above, the operating effectiveness of controls must be tested (by a compliance test) if you assess inherent risk as low as a result of the controls.

Most audit systems contain an audit schedule which shows how risk areas are dealt with. It is unacceptable to state that the work to be performed is “substantive testing” since you would perform substantive tests even if risk was low. If you mean that extra substantive testing is required then specify exactly what this will involve.

Be on the lookout for service organisations - for example, a bonded warehouse.

When recording notes of meetings, write in complete sentences. Bullet points or brain maps are not generally understandable to anyone other than the person who produced them.

Preliminary analytical reviews could be improved.

The materiality form should be completed at the planning stage and updated at finalisation when you should consider the need for any changes to your audit plan.

Audit evidence

Most weaknesses identified in audit evidence are specific to the individual job. This course material contains issues arising from the individual files which are likely to be of general interest.

There are two situations where opening balances and comparatives require particular attention. One is where a job is taken over from another auditor. The other is where it is the first year of audit for a client which has previously been audit exempt.

In either situation, you must:

a) Issue a new engagement letter;

b) Consider whether sufficient evidence exists concerning opening balances and comparatives; and

c) Refer to the fact that the previous year's accounts were not audited. Where there is a predecessor auditor, the name of the previous auditor should not be stated.

Remember that, under ISA 230, your working papers must be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the audit approach adopted, the audit evidence obtained, and the significant matters arising during the audit and the conclusions reached thereon. In some areas, I was struggling to understand what work was performed and what conclusions were drawn. Try to improve this aspect of your work.

You should not use tippex on the audit file.

In one file, some standard programmes were not used. Instead, the work performed was written up by the partner. This can be a cost-effective way to prepare a file and should be considered for use on other jobs.

Immateriality should not be applied to sub-populations. That is, you should not dismiss eg prepayments as immaterial since they are part of a larger material population called debtors.

When auditing trade debtors, you cannot gather evidence concerning existence (cut-off) by performing a test of after date cash.

When auditing trade debtors. It is not satisfactory for you to simply accept the client's assertion that all amounts are recoverable.

When auditing liabilities, it is not appropriate to simply use a formula for sample size because you are auditing for understatement. It is usually recommended that the creditors sample should include all of the items in the purchases test and a sample taken from the trade creditor balances at the start of the year. Having selected your list of items you should then request statements or perform a direct confirmation. It is not acceptable to test just the statements offered to you by the client.

When producing a reasonableness test (proof in total), indicate the source of the input figures and the work you have performed to confirm their reliability.

Payroll testing is generally confused. Gross pay is not confirmed by reconciling the payroll figures to the nominal ledger. Confirmation of the existence of a person does not necessarily require physical verification. This means that a leaver can still be selected and tested in a payroll test. If there is a risk of fraud in the payroll area, then pay particular attention to leavers since ghosts on the payroll have a habit of leaving just before the auditors arrive!

Many firms produce analysis schedules covering various areas of P&L expenditure. These schedules have little or no value to the audit and I would ask if all of the schedules prepared are actually necessary.

Whilst on the subject of overauditing, I would make the following suggestions:

- Reconsider what work is necessary on additions to fixed assets
- Stop testing in the wrong direction – the test is pointless
- Is the test of bank receipts and payments necessary?
- Use the sample selection sheet when populations are of low value since the sample sizes obtained are likely to be smaller than any sample size set using judgement.
- If a large proportion of the tests on the standard programme are irrelevant then consider preparing your own schedule of work.
- Is the work you are planning really necessary or is it just repeating what was done last year?
- If the client prepares prepayments and accruals then consider auditing them purely by analytical review. Make sure to follow-up any significant fluctuations.
- If you are preparing prepayments and accruals, there is no need to place photocopies on file or print out schedules of nominal activity.

Finalisation

Review points should be cleared properly. Comments such as “noted for future” are unacceptable.

I recommend removing schedules of outstanding points and review notes once the issues raised have been resolved.

In many firms the audit highlights schedule (known as the audit opinion summary (B4) in PCAS) is not being completed properly. It should address the key issues of the job and give reasoning for the conclusions reached. Remember that the experienced auditor, having no previous connection with the audit, will not have your detailed knowledge of the history of the client and will therefore not know the reasoning behind the important decisions that have been made. For the audit team, matters are often seen as straightforward because they have been done a particular way for years. Try to put yourselves in the shoes of the reviewer and approach the significant issues afresh every year.

The subsequent events review should be updated to the date of the audit report. Indicate which member of the client staff you spoke to and when.

Letters of representation should include a reference to any uncorrected misstatements. A signed copy of the letter of representation should be on the audit file.

It is frequently the case that errors are made in the completion of the accounts disclosure checklist. This does not generally mean that there are errors in the accounts disclosures and therefore this comment may be thought to be unimportant. However, the careless completion of the checklist might indicate that the staff member is not giving their full attention to the task in hand.

SUMMARY OF DEVELOPMENTS

Lecture A329 (5.18 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.

The Financial Reporting Review Panel's annual report

The Financial Reporting Review Panel ('the Panel') today published its annual report based on findings from the Panel's review of accounts in the year to 31 March 2010 in which:

- 308 sets of accounts were reviewed.
- 146 companies were approached by the Panel for further information or explanation.
- 3 companies were the subject of a Panel press release having agreed to restate amounts reported in prior periods.

The Panel was pleased to note a clear improvement in the descriptions of significant accounting policies by management and the highlighting of those areas most affected by their judgement. Particularly in periods of economic uncertainty, users need to be able to understand why management choose one accounting option over another and the effect of doing so.

There is still the opportunity for a step improvement in the general quality of reporting by some smaller listed and AIM quoted companies who lack the levels of expertise of their larger peers.

Narrative reporting, specifically the business review, absorbs an increasing proportion of the Panel's energies. Letters to companies during the year often included a request for further information to help explain apparent inconsistencies between the narrative information in the front of the report and accounts and the audited accounts in the back end. This is likely to remain a key area of interest for the Panel. We will focus on opportunities for clear linkages between the narrative and accounts; principal risks and uncertainties for example, but also description of the business model which drives the policies and other solutions adopted in the financial statements.

More experience of the new standard on segmental reporting is needed, but the Panel raised a number of questions in this area following its implementation in some companies' 2009 interim accounts, where managements' decisions could be better documented and explained. This is an area the Panel will keep under review as practice develops.

Commenting on the findings and recommendations, Bill Knight, Chairman of the Panel said:

"The Panel continues to work by agreement with companies to improve standards. Our attention to narrative reporting reflects changes in the law and an increasing call for reports and accounts to tell a coherent story, with an eye to the future as well as the past."

19 August 2010

Audit inspection reports for four largest firms published

The Professional Oversight Board, part of the Financial Reporting Council, has today published reports on the findings of the Audit Inspection Unit's (AIU) inspections for 2009/10 of the four largest audit firms.

These reports are available on the FRC website. The principal findings included in these reports on individual firms were reflected in the AIU's overall 2009/10 inspection findings set out in its Annual Report published on 21 July.

The reports cover reviews of firm-wide procedures and individual audits conducted by the AIU from April 2009 to March 2010. The individual audits reviewed related primarily to financial years ending in December 2008 and March 2009. Confidential reports on the individual audits reviewed have been issued to each of the firms and they are expected to provide copies of these to the directors of the audit clients concerned.

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

> "These reports provide important information for stakeholders and, in particular, audit committees when assessing the effectiveness of their external auditors. I am therefore pleased that we have been able to publish them some two to three months earlier than in previous years.
>
> The reports continue to show that individual firms and audit teams have generally responded positively to the AIU's findings by taking actions intended to address them at a firm-wide level or on individual audits. However, they identify a number of important areas in which each firm needs to take further action to improve audit quality or safeguard auditor independence. We will review the actions taken by each firm and assess their effectiveness in future inspections."

Key overall findings of the AIU's inspections of the four largest firms

- The firms have policies and procedures in place to support audit quality that are generally appropriate to their size and the nature of their client base.
- Despite the quality of the firms' policies and procedures, the number of audits assessed by the AIU as requiring significant improvement remains too high.
- The findings suggest that the firms are not always applying:
    - Their procedures consistently on all aspects of individual audits;
    - Sufficient professional scepticism in relation to key audit judgments.
- Firms need to embrace more fully the principles underlying the Ethical Standards and, in particular, accept that non-audit services should not be provided to audit clients where appropriate safeguards do not exist.

14 September 2010

Audit inspection report on smaller firms published

The Professional Oversight Board, part of the Financial Reporting Council, has today published a report on the findings of the Audit Inspection Unit's (AIU) inspections for 2009/10 of Smaller Firms.

This report is available on the website at: http://www.frc.org.uk/pob/audit/firmreports0910.cfm and should be read in conjunction with the AIU 2009/10 Annual Report, published on 21 July and available on the website at: http://www.frc.org.uk/pob/audit/reports.cfm.

Smaller Firms are those that audit up to ten listed or other major public interest entities within the AIU's scope. A list of Smaller Firms, identifying those that had been subject to an AIU inspection by 31 March 2010, is set out in Appendix B of the Report. The AIU's inspections at Smaller Firms are generally limited to a review of

one individual audit engagement. Individual public reports are therefore not published on these firms.

The AIU's key overall findings are that:

- A high proportion of audits reviewed at Smaller Firms continue to require significant improvements, primarily regarding the audit evidence obtained in relation to material balances in the financial statements.
- While the audits of investment trusts and similar entities undertaken by Smaller Firms reviewed by the AIU were performed to a good or acceptable standard, the more complex of the other audits reviewed, in particular audits of multi-national groups, required significant improvements in most cases.

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

> "The number of Smaller Firm audits assessed by the AIU as requiring significant improvements is of concern. Smaller Firms should take more care to ensure that they undertake audits of listed and major public interest entities only if they have the level of resources and expertise appropriate to the complexity of the audit concerned.
>
> Where our findings indicated that an audit required significant improvement, action taken by the relevant Audit Registration Committee has included placing restrictions on the firm accepting further listed and AIM audit clients. To reduce further the incidence of poor quality audit work, the FRC believes that consideration should be given to establishing specific competency requirements for auditors of listed and major public interest entities."

22 September 2010

APB publishes a revision of its Practice Note on UK Anti-Money Laundering Legislation

The Auditing Practices Board (APB) today issued an update to Practice Note 12 (Revised), 'Money Laundering – Guidance for auditors in the United Kingdom' and a feedback paper on its recent consultation process. This guidance has been approved under the Proceeds of Crime Act 2002 by HM Treasury and has been updated for the new ISAs (UK and Ireland).

Richard Fleck, Chairman of APB commented:

> "This Practice Note, which has now been approved by HM Treasury, provides guidance to auditors in a complex area by assisting them in meeting their anti-money laundering responsibilities when carrying out audit work."

22 September 2010

APB publishes Exposure Draft of a revision of ISA (UK and Ireland) 700 'The Auditor's Report on Financial Statements'

The Auditing Practices Board (APB) today issued a consultation paper on a proposed revision of ISA (UK and Ireland) 700 "The Auditor's Report on Financial Statements". The consultation period ends on 26 November 2010.

A revision to ISA (UK and Ireland) 700 was issued in March 2009 with an effective date, for its application to UK companies, of periods ending on or after 5 April 2009. In meeting the requirements of ISA (UK and Ireland) 700, an auditor can choose to refer to the APB web site description of an audit in its auditor's report or incorporate verbatim the short form description, specified by ISA (UK and Ireland) 700, in its report. APB has maintained on its web site two descriptions of the scope of an audit applicable to publicly traded and non-publicly traded UK companies respectively.

Arising from the need to extend the application of ISA (UK and Ireland) 700 to all entities, the APB has decided to replace the extant company specific descriptions with a generic description that can be applied to all entities. The APB considers that publishing a separate description for each type of entity would lead to unnecessary complexity. The generic description restricts itself to addressing the auditor's responsibilities arising from the requirements of auditing standards as these are applicable to all audits. It is considered unnecessary to describe the auditor's reporting responsibilities arising from requirements other than auditing standards as they are required to be set out in either the opinion section of the auditor's report or in the section in which the auditor describes matters on which it is required to report by exception.

However, the majority of auditor's reports do not cross refer to the description on APB's web site but include the short form description specified by ISA (UK and Ireland) 700. In light of the growing importance of narrative information in annual reports the APB proposes to amend the short form description to refer to the auditor's responsibility to read such narrative information. This does not involve any change in the auditor's responsibilities or procedures.

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

> "APB proposes amending the optional short form description of an audit to refer to the important requirement of ISAs (UK and Ireland) that an auditor is required to read all of the narrative information included in the annual report in which financial statements are published, with a view to ensuring that there are no material misstatements or inconsistencies with the financial statements."

This proposed revision to ISA (UK and Ireland) 700 would apply to auditor's reports of all UK entities (including companies) for periods ending on or after 23 March 2011. Earlier adoption is encouraged.

23 September 2010

ASB issues draft UITF Abstract 'Accounting implications of the replacement of the Retail Prices Index with the Consumer Prices Index for retirement benefits'

On 8 July 2010, the Minister for Pensions announced the government's intention to move to using the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) as the inflation measure to use in determining the minimum pension increases to be applied to the statutory index-linked features of retirement benefits. The government is expected to announce the next such annual inflation measure in November 2010. The UITF received a request to provide guidance on the accounting implications of the government decision.

The draft Abstract proposes that where there is a change in the obligation to the member, there is a benefit change which is accounted for as a past service cost. Where the obligation to the member is not changed, any change in the Scheme liabilities arises from a change in assumptions applied to measure those liabilities.

The UITF noted that entities applying paragraphs 10 to 12 of International Accounting Standard 8 'Accounting Policies, Changes in Accounting Estimates and Errors' should refer to the [draft] Abstract as a source of guidance in developing an accounting policy.

13 October 2010

APB publishes Exposure Draft of a revision of Practice Note 11 - The Audit of Charities in the UK

The Auditing Practices Board (APB) today issues an exposure draft of a proposed revision of Practice Note 11 "The Audit of Charities in the UK". The consultation period ends on 21 January 2011.

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

> "This Practice Note, which was last issued in December 2008, has been updated, primarily, to reflect the introduction of the clarified ISAs (UK and Ireland) that become effective for periods ending on or after 15 December 2010 and recently enacted Northern Irish legislation. We welcome comments on these changes and any other aspects of the guidance from practitioners and other interested stakeholders."

21 October 2010