TABLE OF CONTENTS

FRED 43: APPLICATION OF FINANCIAL REPORTING STANDARDS 5

(Lecture A330 – 15.15 Minutes) 5
The three tier approach 5
Public accountability 5
FRSME or FRSSE 6
Subsidiaries 6

FRSME: SOME MATTERS WHICH MAY REQUIRE FORWARD PLANNING 7

(Lecture A331 – 12.41 Minutes) 7
Bank covenants 8
Research and development 8
Holiday pay accruals 8
Financial instruments 8

AMENDMENTS TO FRS 8: RELATED PARTY DISCLOSURES 9

(Lecture A332 – 10.12 Minutes) 9
Introduction 9
Changes to the summary 10
Changes to the definitions 11
Changes to scope 15
Changes in the explanation section 16

FAQS: STOCK VALUATION 16

(Lecture A333 – 8.40 Minutes) 16
What is cost? 16
Can we use selling value as cost? 17
Stock purchased in a foreign currency 17
Net realisable value 18

ACCOUNTING FOR SERVICE CHARGES 18

(Lecture A334 – 18.25 Minutes) 18
What is a service charge? 18
ICAEW guidance: TR 01/10 19
The tenants do not require any service charge account 20

A tenant or tenants have exercised their right under s21 ... 20
Provisions in S21(1) ... 20
Provisions in S21(5) ... 21
Provisions in S21(6) ... 21
The tenants require a service charge account but no tenant has exercised their right under s21 LTA 85 for a service charge statement ... 22
Section 42 LTA 87 ... 23
Application when the landlord is a company ... 23
Summary of ICAEW proposed guidance ... 23
The accounting complications ... 26

FAQS: SOFTWARE COSTS ... 30

(Lecture A335 – 8.58 Minutes) ... 30
Q1 Capitalising software costs ... 30
Q2 What costs can be included? ... 31
Q3 Depreciation of capitalised software costs ... 31

APB ETHICAL STANDARDS (REVISED DECEMBER 2010): SUMMARY OF CHANGES32

(Lecture A336 – 19.35 Minutes) ... 32
Introduction ... 32
Key changes made to each standard ... 33
ES1: Integrity, objectivity and independence ... 33
ES2: Financial, business, employment and personal relationships ... 34
ES3: Long Association with the audit engagement ... 34
ES4: Fees, remuneration and evaluation policies, litigation, gifts and hospitality ... 35
ES5: Non-audit services provided to audit clients ... 35
ES Provisions Available for Small Entities: ... 37
Glossary: definitions ... 38
Affiliate – extended definition ... 38
Audit team – clarified definition ... 39
Connected parties – new definition ... 39
Entity in distress – new definition ... 40
Significant affiliate – new definition ... 40

ISA (UK AND IRELAND) 220 QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS ... 40

(Lecture A337 – 6.27 Minutes) ... 40
Introduction ... 40
Objective ... 41

Requirements ... 41
Leadership responsibilities for quality on audits ... 41
Relevant ethical requirements ... 41
Independence ... 42
Acceptance and continuance of client relationships and audit engagements ... 42
Assignment of engagement teams ... 43
Engagement performance and review ... 43
Consultation ... 45
Engagement quality control review ... 45
Differences of opinion ... 46
Monitoring ... 46
Documentation ... 46

MATERIALITY – PITFALLS AND TIPS ... 47

(Lecture A338 – 10.34 Minutes) ... 47
Background ... 47
Three ways of thinking about materiality ... 47
Materiality for the financial statements as a whole ... 47
Performance materiality ... 47
Class level materiality ... 48
FAQs ... 48
Determining the level of materiality ... 49
Follow up ... 51

CLIENT ACCEPTANCE AND CONTINUANCE ... 51

Determining the integrity of prospective clients ... 51
Determining the competency of the firm ... 51
Compliance with ethical requirements ... 52
Additional considerations ... 52
Client continuance ... 53
Conclusion ... 53

ISA (UK AND IRELAND) 240 THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS ... 53

(Lecture A339 – 9.41 Minutes) ... 53
Introduction ... 53
Objectives and definitions ... 54
Requirements ... 55

ISA (UK AND IRELAND) 315 IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT 63

(Lecture A340– 10.34 Minutes) 63

Objective 63

Requirements 63

SUMMARY OF DEVELOPMENTS 77

The Financial Reporting Review Panel announces priorities for 2011/12 77

ASB says more informative disclosures about capital management are needed 78

Findings of the Financial Reporting Review Panel in respect of the accounts of Hot Tuna (International) PLC for the year ended 30 June 2009 79

Urgent Issues Task Force: Information sheet No. 91 80

APB issues a Bulletin setting out revised Example Auditor's Reports on UK Private Sector Financial Statements 81

APB issues revised guidance on the audit of insurers 82

FRC proposes enhancements to company reporting and audit to deliver greater value to investors 83

APB issues revised guidance on the Audit of Friendly Societies 85

APB issues revised guidance on the Audit of Occupational Pension Schemes 86

FRED 43: APPLICATION OF FINANCIAL REPORTING STANDARDS

(Lecture A330 – 15.15 Minutes)

The three tier approach

The press release issued by the Accounting Standards Board (and covered in the previous update notes) referred to the proposed three tier approach:

Tier 1: Companies that are publicly accountable would apply EU-adopted IFRSs.

Tier 2: Medium-sized and large companies without public accountability would be required to adopt the proposed FRSME, unless they elect to adopt EU-adopted IFRSs.

Tier 3: Companies entitled to follow the small companies regime can continue to use the FRSSE, unless they elect to apply a higher tier.

The Financial Reporting Faculty of the ICAEW (the Faculty) has produced a factsheet on the proposed FRSME. This is a very useful document and provides a lot of practical tips for the transition from existing UK GAAP. In these notes we are going to consider those practical tips which are relevant now because they might require accountants and company directors to plan ahead.

Public accountability

The exposure draft sets out the definition of public accountability as follows:

An entity has public accountability if:

(a) as at the reporting date, its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the counter market, including local and regional markets); or

(b) as one of its primary businesses, it holds assets in a fiduciary capacity for a broad group of outsiders and/or it is a deposit taking entity for a broad group of outsiders. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds or investment banks.

The factsheet points out that the definition in the exposure draft includes a number of entities which currently apply UK GAAP and which would have to apply EU-adopted IFRSs under the proposals. These include all PLUS quoted companies, all investment trusts and all pension funds. The ASB explains that investment trusts includes (in the UK) venture capital trusts, mutual funds, exchange traded funds, unit trusts, open-ended investment companies, custodian banks and stockbrokers, Whilst employee share ownership plans and employee benefit trusts also fall within the scope of Tier 1, these entities are not required to prepare or publish financial statements.

There is an exemption for some smaller publicly accountable entities as long as they are also subject to prudential regulation. Such entities would be permitted to apply the proposed FRSME if they meet all three of the CA 2006 small company size criteria. The reason that the ASB requires all three criteria to be met (rather than the usual two out of three) is that they want to include in the publicly accountable category those entities which have responsibility for a high value of assets. The Board considers that it would be inappropriate to permit such entities to follow the FRSME because of the risk involved. Notice that the application of this new approach uses the “Years rule” in exactly the same way as the Company’s Act.

The factsheet points out that many entities who may not consider themselves ‘publicly accountable’ could be captured by the definition in the standard so care will be required to ensure the correct accounting framework is applied.

FRSME or FRSSE

At present, a significant number of entities that are eligible to use the FRSSE choose not to do so. Such entities will be in Tier 3 and have the choice to use FRSSE, FRSME or EU-adopted IFRSs. The switch from full UK GAAP to FRSME may require a change in accounting policies which could be avoided if the entity adopted FRSSE instead. The factsheet points out that this may be simply delaying the inevitable, but some small businesses may wish to wait for any teething problems with the proposed FRSME to be resolved, before adopting it themselves.

Subsidiaries

The exposure draft sets out the definition of a qualifying subsidiary as follows:

> A qualifying subsidiary undertaking is an undertaking that does not have public accountability, and whose parent undertaking prepares publicly available financial statements in which that subsidiary is included.

Most qualifying subsidiaries will be entitled to exemptions from disclosure provided there is no objection from any shareholder. These exemptions cover cash flow statements, financial instruments, share-based payments and employee benefits. Note, however, in the exposure draft, there is no exemption for related party transactions with group undertakings although the ASB is consulting on this point.

The factsheet presents a practical tip suggesting that some subsidiaries in Tier 2 may choose to use EU-adopted IFRSs. This is because FRSME restricts accounting policy choices which are available in full IFRS (for example revaluation of property, plant and equipment) and occasionally mandates accounting policies which are contrary to full IFRS (for example the expensing of development expenditure).

So, the subsidiary preparing accounts under FRSME would expense development expenditure. The publicly accountable parent is capitalising development expenditure. This would require consolidation adjustments when the subsidiary is incorporated into the group accounts. In this sort of situation, it may be more convenient for the subsidiary to use EU-adopted IFRSs. The reduction in disclosures for qualifying subsidiaries makes this approach a more attractive option than it would have been.

The factsheet also suggests that any company contemplating a listing in the near future may also wish to use EU-adopted IFRSs rather than the FRSME This is because the company will need to prepare for the listing particulars a three year historical financial record and this will need to be in accordance with EU-adopted IFRSs.

FRSME: SOME MATTERS WHICH MAY REQUIRE FORWARD PLANNING

(Lecture A331 – 12.41 Minutes)

There is a tendency to delay any consideration of FRSME until it comes into force – tentatively set as periods commencing on or after 1 July 2013. However, if this date is confirmed, this will mean a transition date of 1 July 2012 and there are some things which would need to be done before 1 July 2012 if they are to be effective.

The Faculty has provided a number of practical tips concerning planning ahead. We will consider the detailed accounting issues in future notes but, for the moment, I want to give notice of potential areas of difficulty which can, perhaps, be addressed by forward planning.

Bank covenants

Bank loans secured against property may include covenant tests which assume the balance sheet reflects the current value of the asset. The directors can adopt a policy of revaluation under both FRS 15 and the FRSSE and they may have done this in the past to meet bank covenants. The FRSME does not allow revaluations and this could result in the company failing to meet covenant tests in existing bank loans. It may be necessary to renegotiate the terms of loans – for example, valuations could be obtained for bank purposes but not reflected in the financial statements. If a client is negotiating a loan in the next few months it would be wise to plan ahead for the possible change in UK GAAP since this may be easier than trying to renegotiate the terms of a loan after FRSME is introduced.

Another potential impact on bank covenants is the change in the method of dealing with borrowing costs. Existing UK GAAP permits borrowing costs to be capitalised in certain circumstances. FRSME requires that borrowing costs are written off as incurred. Therefore, interest cover may decrease significantly under FRSME when compared to existing UK GAAP and this could mean some businesses are at risk of failing covenant tests in existing bank loans.

Research and development

FRSME requires all research and development expenditure to be written off as it is incurred. If a company currently reporting under UK GAAP has significant levels of capitalised development assets then this could have a major impact on its balance sheet when FRSME is adopted. Such a company may wish to consider opting to apply EU-adopted IFRSs which would allow it to retain its capitalised development assets on the balance sheet. It would be important to consider the wider implications of such a course of action before going ahead.

Holiday pay accruals

FRSME requires that payments to employees for accumulating compensated absences (such as paid annual leave) should be accrued as the employees earn the right to them. In the past, many UK companies have not accrued such amounts. When these accruals are introduced, this will necessitate a prior period adjustment (if material) in order to restate comparatives. The factsheet points out that it is important that adequate records are retained to enable these calculations to be performed.

Financial instruments

Entities adopting the FRSME will need to categorise their financial instruments between ‘basic’ and ‘other’ financial instruments. Most basic financial instruments are measured at amortised cost whereas almost all other financial instruments are

measured at fair value. The first practical tip is that there may be benefit in reviewing the terms of financial instruments such as loan agreements and preference shares to see whether they are 'other' financial instruments and, if so, whether the terms could be amended to make them 'basic'.

For example, an investment in non-convertible preference shares is a basic financial instrument whereas investments in convertible preference shares or equity are other financial instruments.

If financial instruments are to be measured at fair value than it will be necessary to obtain fair values as at their transition date. Requests to banks for fair values will need to be made at an early stage as it is unlikely that they will retain historical data for financial instruments and later requests may lead to problems on transition.

Any entity considering entering into hedging arrangements over the next 12 months or so should consider whether they will be eligible for hedge accounting under the proposed FRSME. Some entities may wish to reconsider their hedging strategies or set up the hedge so that they comply with the criteria in Sections 12.16 to 12.18 of FRSME.

AMENDMENTS TO FRS 8: RELATED PARTY DISCLOSURES

(Lecture A332 – 10.12 Minutes)

Introduction

In the previous set of update notes we reported that the ASB had issued an exposure draft proposing to amend the definition of a related party. This amendment has now occurred but the ASB has also taken the opportunity to make other amendments to the standard. In their words:

> Paragraphs b, c and d of the Summary for FRS 8 are deleted. Paragraphs 2.1, 2.5, 11, 12 and 13 of FRS 8 are amended (new text is underlined and deleted text is struck through), and paragraphs 2.4, 4 and 14 are deleted. The headings associated with paragraphs 11 to 14 are also deleted (deleted text is struck through). Paragraph 7C is added.

Paragraph 7C requires the amendment to be applied for annual periods beginning on or after 1 January 2011.

Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

Is there any great significance to these amendments or is it all part of a tidying up process to achieve greater convergence to IAS 24 – the international standard?

The problem was caused by the Companies Act 2006 – or more precisely “The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008”.

In paragraph 72(5) of Schedule 1 of those regulations we read “(5) In this paragraph, “related party” has the same meaning as in international accounting standards.” This means that every time the definition in the international standard changes then FRS 8 must be changed to match.

Notice that there is no equivalent to paragraph 72(5) in the regulations for small companies and the definition in FRSSE has remained unchanged for many years.

Changes to the summary

Paragraph b repeated the definition of a related party. Apart from the obvious fact that this is superfluous, the problem was that the definition in the summary was not updated in 2008.

In other words, for the last three years, the definition in the summary of the standard has been inconsistent with the definition in the standard itself.

Paragraph c referred to the exemption available to parent companies in both the consolidated accounts and their individual accounts.

Paragraph d of the summary referred to the exemption available to 90% owned subsidiaries. Readers will spot immediately that the exemption was changed in the 2008 version of FRS 8 and is now only available if any subsidiary undertaking which is a party to the transaction is wholly owned by a member of that group.

So, the changes to the summary were essential to remove inconsistencies in the standard.

Changes to the definitions

Old definition	New definition
2.1 Close family: Close members of the family of an individual are those family members, or members of the same household, who may be expected to influence, or be influenced by, that person in their dealings with the reporting entity.	2.1 Close members of the family of a person: Close members of the family of a person are those family members, who may be expected to influence, or be influenced by, that person in their dealings with the entity and include: (a) that person's children and spouse or domestic partner; (b) children of that person's spouse or domestic partner; and (c) dependants of that person or that person's spouse or domestic partner.
2.2 Control: The ability to direct the financial and operating policies of an entity with a view to gaining economic benefits from its activities.	Unchanged
2.3 Key management personnel: Those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.	Unchanged
2.4 Persons acting in concert: Persons who, pursuant to an agreement or understanding (whether formal or informal), actively co-operate, whether by the ownership by any of them of shares in an undertaking or otherwise, to exercise control or influence over that undertaking.	Deleted

2.5 Related parties: A party is related to an entity if: (a) directly, or indirectly through one or more intermediaries, the party: (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries); (ii) has an interest in the entity that gives it significant influence over the entity; or (iii) has joint control over the entity; (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.	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).
2.6 Related party transaction: The transfer of assets or liabilities or the performance of services by, to or for a related party irrespective of whether a price is charged.	Unchanged

Notes:

2.1: In the definition of close members of the family there is no reference in the new definition to members of the same household. Note however that there is specific reference to domestic partners and their children as well as dependants.

2.2: This definition is unchanged. It is vital in determining whether or not disclosures of a controlling party are required. The fact that the directors control a company (in the sense that they are managing that company) does not necessarily mean that they are doing so “with a view to gaining economic benefits from its activities”.

2.3: Unchanged in this amendment but recall that the 2008 amendment changed this definition into its present form.

2.4: The pre 2008 definition of related party included a reference to persons acting in concert. This was removed in the 2008 rewrite. There was a reference to entities acting in concert in the explanation section (Paragraph 11) but that has been removed in this update. Therefore, the definition is no longer required.

2.5: There are many changes of detail in this definition and I’m sure the technical experts will be picking over it for years to come. The following changes are immediately apparent:

- The definition has been made more user-friendly but plain English can sometimes be a danger – we wait to see!
- The previous definition referred to the related party being an associate or a joint venture of the reporting entity. The new definition extends this idea so that the reporting entity could be an associate or joint venture of the related party. Symmetry is achieved.
- We also have the extension to situations where a) the associate/joint venture relationship is with other group entities; (b) both entities are joint ventures of the same third party; and (c) one entity is a joint venture of a third entity and the other entity is an associate of the third entity.
- The standard now deals with the situation where the reporting entity is itself a retirement benefit scheme.

- The new definition has very carefully separated b(vi) from b(vii). In the old definition, this was all dealt with in subparagraph (f). Two implications seem to follow: (a) suppose that an individual (X) has significant influence over a company A. A close member of X's family has significant influence over company B. Under the old standard, A and B would be related parties. Under the new FRS 8, they are not. (b) If an individual (P) controls company Q and is a director of company R then Q and R are related parties under the new standard. This works both ways – symmetry is achieved. Under the old standard, Q is shown as a related party in the accounts of R but R is not necessarily shown as a related party in the accounts of Q.
- Neither standard makes two companies related parties just because they have a director in common.

Another interesting issue arising from the definition of related parties is that there is no definition in FRS 8 of either joint control or significant influence. Are we supposed to look at IAS 24? That standard contains the following definitions:

- Joint control is the contractually agreed sharing of control over an economic activity.
- Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement.

Or are we to look at FRS 9?

It is at this point in my notes that I go back to my original comment that the technical experts will be picking over FRS 8 for years to come.

No doubt my comments made above will also be debated.

Perhaps the minutiae of the changes are unimportant to the great mass of clients but clearly the issues must be relevant to some companies for the changes to be made at all.

No doubt, we will return to these issues in future notes.

Changes to scope

Paragraph 4 has been deleted. This stated:

> The FRS does not require disclosure of the relationship and transactions between the reporting entity and the parties listed in (a)-(d) below simply as a result of their role as:
>
> (a) providers of finance in the course of their business in that regard;
>
> (b) utility companies;
>
> (c) government departments and their sponsored bodies, even though they may circumscribe the freedom of action of an entity or participate in its decision-making process; and
>
> (d) a customer, supplier, franchiser, distributor or general agent with whom an entity transacts a significant volume of business.

The way that paragraph 4 was expressed implied that these entities were related parties but that there was an exemption from disclosing the transactions. There is new text in paragraph 12 which makes matters clearer.

> 12 In the context of this FRS, the following are not related parties:
>
> (a) two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.
>
> (b) two venturers simply because they share joint control over a joint venture.
>
> (c) (i) providers of finance, (ii) trade unions, (iii) public utilities, and (iv) departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity,
>
> simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).
>
> (d) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.

Changes in the explanation section

The old paragraphs 11 to 14 contained guidance on applying the definition of related parties. These have been deleted and replaced with the following.

11 In considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form.

12 Reproduced above

13 In the definition of a related party, an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture. Therefore, for example, an associate's subsidiary and the investor that has significant influence over the associate are related to each other.

There is no paragraph 14 in the revised standard.

FAQS: STOCK VALUATION

(Lecture A333 – 8.40 Minutes)

What is cost?

Q. The client has a high volume of stock levels. When a new batch is purchased, any items already held in stock are being valued at the new purchase price. Purchase prices have increased greatly recently and this has caused stock values to rocket. Am I right in thinking that the client's method is not acceptable and that it should be the average purchase price?

A. You are right that this method is not acceptable under SSAP 9. Paragraph 13 in Appendix 1 states: "The method of arriving at cost by applying the latest purchase price to the total number of units in stock is unacceptable in principle because it is not necessarily the same as actual cost and, in times of rising prices, will result in the taking of a profit which has not been realised.

Ideally the client should use FIFO and value each batch at its invoice cost. If this is not practicable then average cost is usually acceptable but you need to check that the way the average is calculated is reasonable.

Can we use selling value as cost?

Q. The company is a UK company but 99% of its activities are in Bangladesh. The company is valuing tea at selling price. Is this acceptable under UK GAAP?

A. Under UK GAAP the tea should be valued at cost so you would need to look at the cost of planting, tending the plants, picking etc. This would then give you the cost.

However. Paragraph 14 of SSAP 9 Appendix 1 states "One method of arriving at cost, in the absence of a satisfactory costing system, is the use of selling price less an estimated profit margin. This is acceptable only if it can be demonstrated that the method gives a reasonable approximation of the actual cost."

Stock purchased in a foreign currency

Q. The client purchases stock in $. It records it in its valuation of stock at an estimated exchange rate which it calls standard rate. We have calculated what the stock would be at the year-end exchange rate and have a material difference. Which is correct?

A. Possibly neither. The stock should be recorded at the exchange rate ruling at the date of purchase as if it had been debited to purchases and stock on the date of purchase. Once purchased it remains at that £ equivalent until sold.

Q. Due to the movement in the Euro, an audit client has valued stock upwards by a material amount. Please can you confirm that this is not allowed.

You are correct, this is not allowed under SSAP 20 as stock is not a monetary item.

Q. The client purchases stock in US$, each purchase being covered by a forward exchange contract. The original entry Dr purchases Cr purchase ledger is recorded in £ at the forward contract rate. At the year end the cost of stock is calculated in £ by using the average exchange rate for the month. Is this OK?

A. No; stock must be recorded at cost which must be based on the original recording at the time of the purchase which will be at the forward exchange rate that applied to that purchase.

Net realisable value

Q. The client has an item of stock called a widget. There were 4,132 in stock at the year end at cost of £22 per item. We are performing our audit six months after the year-end and our audit tests show that the client has recently sold some widgets at £23. Around the year-end, widgets were being sold at about £20. What is the correct figure on which to base NRV?

A. NRV should strictly be that at the year end. Subsequent sales are often a good guide to this but if there has been an increase in selling price since the year end and the price was below cost at the year-end then the client should use the selling price at the year end.

ACCOUNTING FOR SERVICE CHARGES

(Lecture A334 – 18.25 Minutes)

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. The distinction between the two is made in the Landlord and Tennant Act 1985 (LTA 85). For commercial service charges, the terms of the lease will be the prime source of information on the accounting for such charges.

The definition of a service charge covered by the statutory provisions is contained in s18 LTA 85.

> 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.
- The service charge can be additional to the rent or included as part of the rent.
- The service charge can vary and therefore the provisions would not apply to a fixed service charge, 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 and landlord companies, whether owned by the landlord or by the tenants. There are exemptions for Local Authorities but these are outside the scope of these notes. Registered Social Landlords are included within the provisions and further information is available from PN 14 but is not included as part of these notes.
- 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 publications available 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.

ICAEW guidance: TR 01/10

The ICAEW issued TR 01/10 in draft form in October 2010. This provides guidance on accounting and reporting in relation to company statutory accounts and service charge accounts for residential properties on which variable service charges are paid in accordance with a lease or tenancy agreement. The guidance has been issued jointly between ICAEW, Royal Institution of Chartered Surveyors (RICS) and Association of Residential Managing Agents (ARMA).

Tech 03/07 was issued as a consultation document in October 2007 in response to a consultation on changes to this area under the Commonhold and Leasehold Reform Act 2002 (CLR 02). These changes were never brought forward and hence Tech 03/07 was never brought into force.

TR 01/10 identifies three possible outcomes in respect of accounting for service charges. These are discussed below.

The tenants do not require any 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.

A tenant or tenants have exercised their right under s21

If a tenant or 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 tenants may decide not to request a s21 statement. If a statement is provided under the terms of the lease this does not need to meet the other requirements of s21. 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. Therefore, in practice, it is probably 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.
- It must summarise any costs in respect of which no payment has been demanded from the landlord within the period (this usually equates to accruals but there have been cases where tribunals have held to a different interpretation).
- It must summarise any costs in respect of which a demand for payment was received but no payment was made in the period (this usually equates to creditors but there have been cases where tribunals have held to a different interpretation).
- It must provide a summary of any costs in respect of which a demand for payment was received and payment made by the landlord within the period.
- The summary must show 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 s21statement. Provided the information above is provided it would satisfy the requirements. If the landlord provided a statement under the terms of the lease rather than under s21 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. However, 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.

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

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 (Section 5)

If the tenants require a service charge account but not under S21then the work to be completed by the accountant 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 to indicate that the audit was not in compliance with auditing standards. This would also be included in the engagement letter. Such an approcah is prone to misunderstandings. It is therefore important that the accountant manages the risk carefully. If the lease refers to auditing standards then this must be complied with.

Part 11 of the Residential Service Code (RSC) indicates that unless the costs of an audit cannot be recovered then an audit in compliance with APB standards should be completed. The RSC was originally published by RICS in 1997 and revised in 2009. 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 although 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 proposed guidance

This applies in respect of a Residents' Management Company (RMC) or Right to Manage Company (RTM). It also applies in other situations where the company receives the service charges and administers them on behalf of the tenants. In the case of investor landlords, they should keep separate service charge accounts for each property and not treat the trust funds as their own as required by s42 above.

3.2 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, may be income of the company. Ground rent will belong to the company if it owns the freehold but not 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 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'.

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

As a result of the above, the company may not need to prepare an Income and Expenditure account because there may be no transactions to show.

In the same way, Paragraph 3.4 tells us that the balance sheet will contain only items that belong to the company. This may include the freehold of the property 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.

If the company uses a separate trust account for service charge monies, that bank account will not be included on the company's balance sheet. If, contrary to best practice guidance, the service charge money is held in the management company's bank account, then the cash and any transactions affecting the cash balance may need to be reflected in the statutory accounts of the management company

Note that a balance sheet must still be prepared even if the company is limited by guarantee and there are no items to be included on the balance sheet. The balance sheet is prepared without figures, but containing the statements required under s475 of the Companies Act 2006. It should be signed and dated as approved by the board.

The fact that the company may not have any figures to disclose in the balance sheet or income and expenditure account does not necessarily mean that it is dormant for the purposes of the Companies Act. See below.

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 latter arises, the ownership of the rented 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 does not represent expenditure of the company.
- 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 ICAEW guidance points out that RMCs and RTMs may 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 in the name of the property or the client company. This means that there may be transactions that 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 owed 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.

- 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 are met. If there are no transactions to be included in the income and expenditure account then this statement will not be prepared.

The accounting complications

The following questions arise in practice. They are not addressed by existing guidance 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 possible to justify the exclusion of the bank account if it is under the company's control but holds only trust funds. If it is under the company's control and contains mixed funds then it would be more likely to be included.

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 to 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 – the Act 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 of subsequent charges or otherwise.

It is beyond the scope of these notes 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 for 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 has 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?

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 sometimes 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 an 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 sections 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 to be 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 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 or 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 would need to be separated on a fully retrospective basis. This could involve some substantial costs.

FAQS: SOFTWARE COSTS

(Lecture A335 – 8.58 Minutes)

Q1 Capitalising software costs

Q. Should software costs be included in tangible fixed assets or intangible fixed assets?

A. In the past, software costs were frequently expensed. Now it is more likely that they will be capitalised as either tangible or intangible fixed assets - both approaches are seen in practice. However, if the software is developed internally, FRS 10 does not permit internally developed intangible assets to be capitalised. This problem does not apply in the situation where costs are external – even if those charges come from a group company.

Recognising the difficulty with internally generated software, the definition section of FRS 10 tells us that software development costs that are directly attributable to bringing a computer system or other computer-operated machinery into working condition for its intended use within the business are treated as part of the cost of the related hardware rather than as a separate intangible asset.

Conclusion. The normal treatment would be to capitalise software costs as a tangible fixed asset - usually within plant and machinery.

Q2 What costs can be included?

Q. Is it acceptable to capitalise training and implementation costs which were incurred as a result of the introduction of new hardware and software?

A. Paragraph 7 of FRS 15 states: “Costs, but only those costs, that are directly attributable to bringing the asset into working condition for its intended use should be included in its measurement.”

Paragraphs 9 says that directly attributable costs are (a) the labour costs of own employees arising directly from the construction, or acquisition, of the specific tangible fixed asset; and (b) the incremental costs to the entity that would have been avoided only if the tangible fixed asset had not been constructed or acquired.

Paragraph 10 gives guidance on directly attributable costs that can be capitalised whereas Paragraph 11 gives examples of those that cannot.

We can draw the following conclusions:

- Costs incurred in the installation of the software and ensuring it is working correctly can be capitalised.

- Internal costs incurred in staff training on the use of new software could not be capitalised because they are not additional costs.

- It might be argued that third party costs on staff training could possibly be capitalised since they would have been avoided if the software had not been purchased. However, the PWC manual of accounting (Paragraph 16.61) states: “Such costs should not be capitalised as they are operating costs rather than directly attributable to the tangible fixed asset. As operatives may leave at short notice, their training costs would not meet the definition of an asset and, therefore, may not be capitalised, since the access to future economic benefits is not controlled by the entity.”

Q3 Depreciation of capitalised software costs

Q. Approx £1m has been spent on state of the art software for a customer database which includes billing. The system can handle a very large number of customers and should provide sufficient capacity for at least ten years. The problem with technology is that it may become obsolete. With respect to depreciation rates, the managing director wants ten years although the finance guys are trying to talk him into five. What advice can you offer?

A. If you accept the guidance in Q1 above, the correct standard to use is FRS 15. There is no fundamental difference between software and any other asset. The depreciable amount of the software should be allocated on a systematic basis over its useful economic life.

If a software package is purchased to run on a particular computer then the useful life of the software cannot exceed that of the hardware. However, I would suggest that this consideration does not apply here. Another factor to consider is the period before an upgrade might be necessary; unless such an upgrade is minimal it might be more appropriate to amortise over the period to such anticipated upgrade.

Looking at the accounts of other entities, I have found a number of examples of five year life but, in my limited research, none of lives beyond five years. This may support the arguments of the finance people. Whatever decision is made, FRS 15 requires the useful economic life to be reviewed at the end of each reporting period and revised if necessary.

APB ETHICAL STANDARDS (REVISED DECEMBER 2010): SUMMARY OF CHANGES

(Lecture A336 – 19.35 Minutes)

Introduction

On 17 December 2010, the APB issued revised ethical standards for audit engagements. This followed a consultation in July 2010 in respect of non-audit services. At the same time, the Financial Reporting Council (FRC) issued revised guidance to audit committees.

The revised ethical standards are effective on 30 April 2011, with transitional provisions. The ABB say that the revised standards are compulsory for audits of periods commencing or after 31 December 2010.

The format and approach of the revised standards follows the same methodology as the previous standards. Threats to the auditors' integrity, objectivity and independence must be identified and safeguards put in place to mitigate them. Alternatively, the assignment must be declined. Documenting the issues considered by the audit team is of great importance. Additional considerations apply to listed companies.

The APB press release (PN 136) highlights measures designed to address perception concerns so as to:

- Increase the rigour with which auditors assess threats to their independence;
- Introduce a new non-audit services disclosure regime;
- Increase the role of audit committees in overseeing the retention of a company's auditors to undertake non-audit services;
- Extend the guidance to auditors in relation to conflicts of interest and to require them to consider the consequential implications for their independence;
- Prohibit the provision of restructuring services in certain circumstances; and
- Broaden the definition of a contingent fee and further prohibit the circumstances in which non-audit services may be provided on such a basis.

The APB believes that the changes introduced, taken as a whole, represent a significant tightening of the requirements relating to the provision of non-audit services by auditors and will also result in greater transparency.

Whilst these changes have been driven by the need to address the audit of listed entities, the Ethical Standards apply to all audited entities and auditors will need to address these changes in their work.

Key changes made to each standard

ES1: Integrity, objectivity and independence

- Integrity requires that we are not affected by conflicts of interest with the audited entity and its connected parties (Para 8).
- Role of Ethics Partner (Para 23):
    - Ethics Partner to have access to independent non-executives of audit firm with listed clients (Para 24).

  - Ethics Partner to be proactive in considering developments in the business of the audit firm (Para 25).

  - Matters delegated by the Ethics Partner to support staff to be made clear as relating to Ethics Partner role (Para 27).

- Threats may arise where the auditor has a relationship with any connected party of the audited entity (Para 37).

- Threats to objectivity and perceived loss of independence may arise when a non–audit service is provided by the audit firm to a third party which is connected (through a relationship) to the audited entity and the outcome of that service has a material impact on the financial statements of the audited entity (Para 41).

- Where Engagement Quality Control Review (EQCR) [Also known as Independent Partner Review (IPR)] involvement provides safeguard to threats from non-audit services, the EQCR must specifically address that threat (Para 53).

- Audit Engagement Partner (AEP) to assess cumulative impact of all threats identified and effectiveness of safeguards applied (Para 55).

- In addition, in the case of listed clients:

  - AEP to provide written details of non-audit services and fees charged to audit committee (Para 67/68).

  - Details of all fees charged to client to be disclosed to the audit committee (Para 70). Appendix 1 of ES1 provides a template.

ES2: Financial, business, employment and personal relationships

- Allows for the delay of the disposal of financial interests held by person joining audit firm as a partner with the approval of the Ethics Partner (Para 9).

ES3: Long Association with the audit engagement

- Not revised at this time

ES4: Fees, remuneration and evaluation policies, litigation, gifts and hospitality

- Contingent fee arrangements in respect of non-audit services can create significant self-interest threats (Para 14).
    - Audit firm shall not undertake non-audit services where contingent fee is material to audit firm (or that part of the firm by reference to which the AEP's profit share is calculated) or the outcome of the non-audit services is dependant on future or contemporary audit judgement of a material matter in the financial statements (Paras 15/16/17) This is not intended to prohibit a lower fee being charged if matter is aborted or prematurely terminated (Para 17).
    - For permitted non-audit services provided on a contingent fee basis AEP considers threats and possible safeguards (Paras 18/19).
- Objectives of Engagement Team (ET) should not include selling non-audit services. Criteria for evaluating performance/promotion not to include success in selling non-audit services and no specific element of remuneration to be based on selling non-audit services (Para 44 strengthened). This does not apply to specialist practice members of the ET whose involvement is insignificant (Para 46). ET may, however, indentify areas for improvement and provide general business advice (Para 45).

The previous version of ES4 had the same requirements but these related only to the "Audit team" not the engagement team.

The engagement team consists of the audit team plus professional personnel from other disciplines involved in the audit engagement and those who provide quality control or direct oversight of the audit engagement.

ES5: Non-audit services provided to audit clients

- Definition of "audit work" (Paras 6/7/8).
- Definition of "other work" and "audit related service" (Paras 9/10).

10. If additional work on financial information and/or financial controls is authorised by those charged with governance, but the objective of that work is not to enable the auditor to provide an audit opinion on the entity's financial statements, it will be considered as an 'audit related service' for the purpose of this Standard provided that it is integrated with the work performed in the audit and performed largely by the existing audit team; and is performed on the same principal terms and conditions as the audit. As a consequence of these factors, any threats to auditor independence arising from the performance of such additional work are considered to be clearly insignificant.

- Definition of "other non-audit services" (Paras 11/12).

- Non-audit services:

    - AEP to assess threat from non-audit services (Paras 18/19/20).

    - Where there are regular substantial fees from non-audit services and these are greater than the audit fee, the AEP should assess threat to independence and objectivity. Additionally, in the case of listed entities where fee for non-audit services is greater than the audit fee, details are to be provided to the Ethics Partner (EP) (Paras 27/28). NB (This is a significant change and it may possibly be missed by some auditors).

    - Cannot accept non-audit services on a Contingent Fee Arrangement where the contingent fee is material or dependent on audit judgment of material matter (Para 30).

    - Communication with those charged with governance regarding the impact on auditor objectivity of non-audit services will be facilitated by distinguishing between "audit related services" and "other non-audit services" (Paras 50/56).

- Audit related services are such that the threat to independence is clearly insignificant and, as a consequence, safeguards need not be applied . Other services closely related to the audit are not necessarily clearly insignificant and safeguards may be required (Paras 54/55/57).

- The nature of internal audit services is wide and threats to independence will vary (Paras 59/60).

  - In the case of listed companies, examples of unacceptable work are listed (Para 64).

  - Management threat is too high where internal audit services are outsourced to audit firm, management decisions are taken and this is significant to the audited entity. Other unacceptable internal audit work is listed (Para 65).

- If extended audit work on financial information and/or financial controls is authorised by those charged with governance, it will be considered an "audit related service" provided it is integrated with the audit work and performed largely by the existing audit team. Other additional work may fall outside this and will require threats and safeguards to be considered and communicated to those charged with governance (Paras 68/69).

- Tax calculations for listed companies. The restriction in Para 99 for listed clients is not intended to prevent an audit firm preparing tax calculations for the submission of tax returns after the completion of the audit (Para 101).

- New section on "Restructuring Services" (Paras 143/155).

  - Audit firm shall not provide restructuring services where taking a management role in or on behalf of the audited entity or acting as an advocate for the audited entity on matters that are material to the financial statements (Para 145).

  - Audit firm shall not undertake restructuring services where it would give rise to a self review threat in the case of a contemporary or future audit unless such threats can be reduced to an acceptable level by safeguards (Para 147).

  - Where audit entity is a distressed listed company or a significant affiliate restructuring services shall be limited to those defined (Para 153).

ES Provisions Available for Small Entities:

- Various inconsequential amendments made to extend the exemptions.

Glossary: definitions

Affiliate – extended definition

Old definition:

Any undertaking which is connected to another by means of common ownership, control or management.

New definition:

An entity that has any of the following relationships with the audited entity:

a) An entity that has direct or indirect control over the audited entity if, the audited entity is material, quantitatively or qualitatively, to such entity;

b) An entity with a direct financial interest in the audited entity if that entity has significant influence over the audited entity and the interest in the audited entity is material, quantitatively or qualitatively, to such entity;

c) An entity over which the audited entity has direct or indirect control;

d) An entity in which the audited entity, or an affiliate of the audited entity under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material, quantitatively or qualitatively, to the audited entity and its affiliate in (c); and

e) An entity which is under common control with the audited entity client (a "sister entity") if the sister entity and the audited entity are both material, quantitatively or qualitatively, to the entity that controls both the audited entity and sister entity.

Factors that may be relevant in determining whether an entity or an interest in an entity is material to another entity include:

- the extent and nature of the relationships between the audited entity and the other entity and the impact these have on the relationships of either entity with the auditor of the audited entity, and

- the extent and nature of the relationship(s) between the auditor of the audited entity and the other entity and the impact that this has on their independence as auditor of the audited entity.

Audit team – clarified definition

Old definition:

All audit professionals who, regardless of their legal relationship with the auditor or audit firm, are assigned to a particular audit engagement in order to perform the audit task (e.g. audit partner(s), audit manager(s) and audit staff).

New definition

All audit professionals who, regardless of their legal relationship with the auditor or audit firm, are assigned to a particular audit engagement in order to perform the audit task (e.g. audit partner(s), audit manager(s) and audit staff).

This does not include internal audit personnel who are involved in directly assisting the external auditor in carrying out external audit procedures provided that appropriate quality control arrangements are established as described in ISA (UK and Ireland) 610.

Connected parties – new definition

An audited entity's connected parties are:

a) its affiliates;

b) key members of management (including but not limited to directors and those charged with governance) of the audited entity and its significant affiliates, individually or collectively; and

c) any person or entity with an ability to influence (other than in the capacity of professional advisors), whether directly or indirectly, key members of management or those charged with governance of the audited entity and its significant affiliates, individually or collectively, in relation to their responsibility for or approach to any matter or judgment that is material to the entity's financial statements.

Entity in distress – new definition

An entity with actual or anticipated financial or operational difficulties that threaten the survival of that entity as a going concern.

Significant affiliate – new definition

An affiliate identified by the group audit team:

i. that is of individual financial significance to the group; or

ii. that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

ISA (UK AND IRELAND) 220 QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

(Lecture A337 – 6.27 Minutes)

Introduction

Under ISQC (UK and Ireland) 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) The reports issued by the firm or engagement partners are appropriate in the circumstances.

ISQC (UK and Ireland) 1, requires the system of quality control for audit engagements to include policies and procedures addressing:

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

Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.

Objective

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and applicable legal and regulatory requirements; and

(b) The auditor's report issued is appropriate in the circumstances.

Requirements

Leadership responsibilities for quality on audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

Relevant ethical requirements

Paragraph 9 requires the engagement partner to remain alert throughout the audit engagement for evidence of non-compliance with relevant ethical requirements by members of the engagement team. This will involve observation and enquiry as necessary. In the event of non-compliance, Paragraph 10 requires the engagement partner, in consultation with others in the firm, to take appropriate action .

The IFAC Code establishes the fundamental principles of professional ethics, which include:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behaviour.

Compliance with the APB Ethical Standards for Auditors should ensure compliance with the IFAC Code. UK auditors are also subject to the ethical requirements of their own professional bodies.

Independence

Paragraph 11 sets out the familiar threats and safeguards approach to compliance with independence requirements. The engagement partner is required to obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence. Threats to independence may also arise from breaches of the firm's independence policies and procedures.

The engagement partner is then required to take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards. Alternatively, it may be necessary to withdraw from the audit engagement. The engagement partner is required to report to the firm promptly any inability to resolve the matter for appropriate action.

Acceptance and continuance of client relationships and audit engagements

The engagement partner must be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and that conclusions reached in this regard are appropriate.

The Application Material tells us that information such as the following assists the engagement partner in this respect:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

In some circumstances, the engagement partner may obtain information later that would have caused the firm to decline the audit engagement had that information been available at the time of appointment. In this case, Paragraph 13 requires the engagement partner to communicate the information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

Assignment of engagement teams

Paragraph 14 is concerned with the competence and capabilities of the engagement team, and any auditor's experts who are not part of the engagement team. The engagement partner must be satisfied that, collectively, they have the appropriate competence and capabilities to perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and enable an auditor's report that is appropriate in the circumstances to be issued.

Engagement performance and review

The engagement partner is required by Paragraph 15 to take responsibility for the direction, supervision and performance of the audit and for the appropriateness of the auditor's report.

Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional scepticism.
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team. This includes whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach.
- Addressing significant matters arising, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members.

The engagement partner is required by Paragraph 16 to take responsibility for reviews being performed in accordance with the firm's review policies and procedures. In accordance with Paragraph 33 of ISQC (UK and Ireland) 1, this will mean that the work of less experienced team members is reviewed by more experienced team members.

The Application material informs us that a review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

Notice that the above review will be performed in accordance with the firm’s policies. Whilst the engagement partner takes responsibility to ensure that this occurs, the detail of the review can be delegated. It is in Paragraph 17 that there is a requirement for a personal review by the engagement partner on or before the date of the auditor's report.

This will involve a review of the audit documentation and discussion with the engagement team so that the engagement partner is satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

The review will include:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. The partner documents the extent and timing of the reviews.

An engagement partner taking over an audit during the engagement would normally apply the procedures described above to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

Consultation

Paragraph 18 is concerned with consultation. The engagement partner is required to take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters and be satisfied that such consultation has occurred. Further, the engagement partner must be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted and that the conclusions resulting from such consultations have been implemented.

Engagement quality control review

An engagement quality control review (EQCR) is required for audits of listed entities and other entities which meet the criteria established by the firm’s internal policies. In this case, Paragraph 19 requires the engagement partner to ensure that an engagement quality control reviewer has been appointed; discuss significant matters with the engagement quality control reviewer; and not date the auditor's report until the completion of the engagement quality control review.

Paragraph 20 requires the engagement quality control reviewer to perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation involves:

(a) Discussion of significant matters with the engagement partner;

(b) Review of the financial statements and the proposed auditor's report;

(c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and

(d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

Paragraph 21 contains additional requirements for the engagement quality control review of a listed entity. These include procedures concerning independence, consultation and the quality of audit documentation.

The Application Material tells us that this extended EQCR may include consideration of significant risks and the responses to those risks; judgments made, particularly with respect to materiality and significant risks; corrected and uncorrected misstatements identified during the audit; and matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

The additional requirements for listed entities may also be applicable for the EQCR of other entities.

Differences of opinion

If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, Paragraph 22 requires the engagement team to follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

Paragraph 23 requires the engagement partner to consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

Documentation

24. The auditor shall include in the audit documentation:

(a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

Paragraph 25 requires the engagement quality control reviewer to document that the procedures required by the firm's policies on EQCR have been performed; that the EQCR was completed on or before the date of the auditor's report; and that the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

MATERIALITY – PITFALLS AND TIPS

(Lecture A338 – 10.34 Minutes)

Background

The new Clarity Standards are in force for periods ending on or after 15 December 2010. There are now two auditing standards dealing with materiality - namely ISA (UK & Ireland) 320: Materiality in planning and performing an audit and ISA (UK & Ireland) 450: Evaluation of misstatements identified during the audit. These standards address materiality differently from the previous ISAs and the detailed changes which have been made are the subject of a number of questions from delegates on CPD courses. This section of the notes seeks to address some of the issues arising.

Three ways of thinking about materiality

Whilst the new Clarity Standards are more detailed in their requirements, ultimately materiality is a single concept i.e. what matters in the accounts. But the auditor is asked by the Clarity Standards to think about this from a number of perspectives.

Materiality for the financial statements as a whole

This is used to develop the overall strategy of the audit. Later in the audit process its determination may be revisited and it will play a part in assessing the impact of errors in the financial statements.

Performance materiality

ISA (UK & Ireland) 320 defines performance materiality as:

“For purposes of the ISAs (UK and Ireland), performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the

aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures."

Performance materiality is determined at the planning stage and will be used for the purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. Many commentators see this as similar in concept to tolerable error.

Class level materiality

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

Class level materiality is relevant where a higher degree of accuracy is expected by the users of the financial statements.

Pitfall

An auditor might misinterpret the above and think that materiality needs to be assessed separately for every audit assertion. This is not the case. The determination of class level materiality is not directly linked to the risk of error in the financial statement amount. It is used to reflect the increased interest of the users of the financial statements as the FAQs below demonstrate.

FAQs

Q. My audit client is a UK based manufacturer and the directors are under pressure to improve performance to meet banking covenants. For various reasons I have assessed debtors, stock and work in progress (WIP) as high risk areas. Should I adjust class level materiality in these areas as well?

A. As a rule, no. Class level materiality is not responsive to the risk of error. The nature of audit work in these riskier areas should be influenced by the risk assessment. However, if as part of the planning it came to your attention that a user of the financial statement was planning to place particular reliance on specific

balances or disclosures in the accounts then this may influence your determination of materiality for this class of transactions.

For example if the bank manager has said that the bank is particularly interested in the level of work in progress as presented in the financial statements, this might indicate the need for a lower class level materiality assessment in WIP.

Q. I am auditing a financial institution where the high level of directors' pay has been the subject of much media and shareholder attention. Should I adopt a lower level of class materiality for the relevant director's remuneration disclosures in the financial statements?

A. Yes. Provided that you are of the opinion that these disclosures are likely to particularly effect the decision making of the users of the financial statements, then a lower materiality assessment might be appropriate.

Determining the level of materiality

The determination of materiality at the planning stage is driven by the audit methodology that the audit firm adopts and the professional judgment of the auditor. In practice auditors use benchmarks to determine materiality and ISA (UK & Ireland) 320, without specifying particular benchmarks, provides some guidance on factors that might be taken into account in establishing such benchmarks. These include:

- the elements of the financial statements such as assets, liabilities, equity, revenue or expenses;
- whether there are items to which users of the entity's financial statements will pay particular attention, such as profit, revenue or net assets;
- the nature of the entity, where the entity is in its life-cycle, and the industry and economic environment in which it operates; for a developing entity, for example, more attention might be paid to revenues than to profits;
- the entity's ownership structure and the way it is financed; if an entity is financed solely by debt rather than equity, for example, users may focus on assets and claims on them, rather than on the reported profits; and
- the relative volatility of the benchmark.

Whilst it is hard to be specific about how materiality should be determined, the following observations might be useful:

- ISA 320 includes an example in the Application Material of how materiality could be calculated:

  "Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances."

  This is only an example and not a model. Other methods of determining materiality are still widespread. In particular it is common to use slightly higher percentages for smaller entities

- Performance materiality is responsive to risk at the financial statement level and is commonly between 90% and 50% of materiality at the financial statement level.

  Some audit firms and auditors may have previously been using a materiality figure that had the attributes of performance materially i.e. it was set at a lower level with error detection in mind.

  If this is the case then care needs to be taken when applying the new standard or performance materiality may be set too low resulting in excessive work being performed.

- When a lower class level materiality is thought necessary, class level performance materiality will also need to be determined and applied.

- Materiality as determined at the planning stage of the audit is not necessarily the right amount to use for assessing the impact of misstatements in the financial statements. Materiality needs to be revisited upon completion of the audit when assessing the impact of errors.

Follow up

Materiality is one of the more technical areas affected by the clarity standards and careful thought is needed before amending an audit firm's methodology. As well as reading ISA (UK & Ireland) 320 and ISA (UK & Ireland) 450, readers should also refer to Practice Note 26 Guidance on Smaller Entity Audit Documentation (in particular the illustrative examples) and the ICAEW document "Right First Time with the Clarity ISAs"

CLIENT ACCEPTANCE AND CONTINUANCE

A recent article in "Audit and Beyond" has provided advice on the client acceptance and continuance process. The article is based on a recent paper published by the Forum of Firms – a group of 21 international networks who are committed to adhering to and promoting the consistent application of high-quality audit practices worldwide. The forum has produced a number of publications which can be found at web.ifac.org/publications/forum-of-firms.

The notes that follow are based on the article but also include my own comments.

Determining the integrity of prospective clients

The auditor must evaluate the risk presented by the potential client in this area and consider whether to refuse the engagement. Amongst the matters to consider are the identity and business reputation of the client's owners, directors/management and related parties. Management's attitude should also be considered concerning the aggressive interpretation of accounting standards; the internal control environment; the payment of fees; and potential scope limitations.

The auditor may obtain information to aid this consideration through personal knowledge, inquiries, research or other investigations.

Determining the competency of the firm

How good is the auditor's understanding of the entity and its industry? Particular care is needed if there is complexity in the entity's structure, tax arrangements, transactions or accounting. Off-shore transactions, specialised industries and public interest entities would also merit further consideration.

Compliance with ethical requirements

Firms will typically have their own checklists to deal with this area. The threats and safeguards approach is familiar to all of us. Particular issues are:

- The need for consultation when providing new services to existing clients. Remember also the need to get the approval of the audit engagement partner when providing a new non-audit service to an existing audit client. This is an area that should be documented carefully since there has been criticism by regulators.

- The need for enquiry as to whether partners or staff may have shareholdings or other relationships with prospective clients which would present independence issues.

Safeguards may be appropriate but it is vital that safeguards are operated not merely listed on file.

Additional considerations

The suggestions covered in the article include:

- An independent partner should review the decision to accept the potential client.

- Specialist input should be sought if the client is in a specialised industry.

- The firm's audit risk or quality control specialist should be involved in the acceptance decision if risks are higher than normal.

- Acceptance and continuance should be considered before it is too late to pull out.

- Engagement letters should be issued and agreed by the client before work commences.

Client continuance

Client continuance should be considered every year at the end of the audit. Generally, the considerations noted above will continue to apply but the auditor must take particular care to evaluate new or altered risks.

Events which may be relevant include the following:

- Has the client requested a change in the audit partner or manager?
- Has the client appointed new staff at a senior level?
- Has there been a disagreement with the client?
- Has a significant matter been communicated to the client's regulator?
- Are there any unpaid fees?

Conclusion

The article reminds us that not all prospective clients are good news and that continuing with a good client that turns bad is as bad as taking a bad one on. Auditors needs to think carefully about their own competence and the need to terminate client relationships in some circumstances.

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

(Lecture A339 – 9.41 Minutes)

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.

Objectives and definitions

The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement of the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to fraud or suspected fraud identified during the audit.

Fraud - An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud risk factors - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Requirements

Professional scepticism

There are three paragraphs dealing with the subject of professional scepticism:

- Paragraph 12 requires the auditor to maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.
- Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor must investigate further.
- The auditor is required to investigate where responses to inquiries are inconsistent.

Discussion among the engagement team

ISA (UK and Ireland) 315 requires a discussion among the engagement team members. ISA (UK and Ireland) 240 requires this discussion to place particular emphasis on fraud. This will include how and where the entity's financial statements may be susceptible to material misstatement due to fraud and how fraud might occur. Professional scepticism is particularly important when taking part in this discussion.

The Application Material explains the value of this discussion in identifying susceptibility to fraud and the appropriate response. Paragraph A11 gives a detailed

description of the matters that may be included in the engagement team discussion. This Paragraph should be studied carefully by auditors since, in many cases, audit files contain little in the way of documentation of the team discussion.

Risk assessment procedures and related activities

ISA (UK and Ireland) 315 requires the auditor to perform risk assessment procedures and related activities when obtaining an understanding of the entity and its environment, including the entity's internal control. ISA (UK and Ireland) 240 identifies a number of additional procedures which must be performed when the auditor is identifying the risks of material misstatement due to fraud.

Paragraph 17 requires the auditor to make inquiries of management regarding its assessment of the risk that the financial statements may be materially misstated due to fraud; its process for identifying and responding to the risks of fraud in the entity; its communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and its communication, if any, to employees regarding its views on business practices and ethical behaviour.

Paragraph 18 also requires the auditor to make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

This is another area where documentation in audit files can be sadly lacking. Remember that the note on file of any discussion with client personnel needs to indicate with whom the matter was discussed and when as well as the matters covered.

Paragraph 19 requires the auditor to make similar inquiries of internal audit (if relevant), and to obtain its views about the risks of fraud.

Paragraphs 20 and 21 refer to the situation where not all of those charged with governance are involved in managing the entity. In this case the auditor must obtain an understanding of how those charged with governance exercise oversight of management's processes concerning fraud. Also the auditor is required to make inquiries of those charged with governance similar to the inquiries of management referred to in Paragraph 18 above. These inquiries are made in part to corroborate the responses to the inquiries of management.

Paragraph 22 deals with unusual or unexpected relationships identified in performing analytical procedures (including those related to revenue accounts). The auditor is required to evaluate whether such relationships may indicate risks of material misstatement due to fraud.

Similarly, Paragraph 23 requires the auditor to consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud.

The Application Material suggests that information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity may be relevant in this respect.

Paragraph 24 requires the auditor to evaluate whether the information obtained from the procedures described above indicates that one or more fraud risk factors are present. Fraud risk factors have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1of the ISA (UK and Ireland). These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists namely:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalise the fraudulent action.

The information presented in Appendix 1 is familiar to all experienced auditors however, users of these notes are strongly recommended to review the Appendix in order to refresh their thinking about fraud. Note that the requirement in paragraph 24 to evaluate the possibility that fraud risk factors are present may require a statement on the audit file even where there are no risk factors present.

In accordance with ISA (UK and Ireland) 315, Paragraph 25 of this ISA (UK and Ireland) requires the auditor to identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

I do not think that this requires a separate assessment relating to fraud. I think that the fraud assessment required by this ISA can be part of the assessment required by ISA (UK and Ireland) 315. Indeed, it is clear that fraud risks are included alongside other risks in ISA (UK and Ireland) 315 since Paragraph 28 of ISA (UK and Ireland) 315 requires that risks arising from possible fraud should be classified as significant risks along with other risks such as risks arising from complexity or subjectivity.

The previous version of ISA (UK and Ireland) 240 contained a grey print paragraph which said "......Therefore, the auditor ordinarily presumes that there are risks of fraud in revenue recognition and considers which types of revenue, revenue transactions or assertions may give rise to such risks....."

It has to be said that a lot of firms have ignored this guidance in the past. The clarity ISA includes this issue as a requirement:

> 26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

Paragraph 47 specifies that, if the auditor concludes that the presumption is not applicable in the circumstances of the engagement, then the auditor shall include in the audit documentation the reasons for that conclusion.

Paragraph 27 repeats the requirements of Paragraphs 28 and 29 of ISA (UK and Ireland) 315. The auditor treats risks of material misstatement due to fraud as significant risks and therefore obtains an understanding of the entity's related controls, including control activities, relevant to such risks.

The Application Material refers to the situation (common in smaller entities) where management may conclude that it is not cost effective to implement and maintain a particular control. In this situation, it is important for the auditor to be aware of this decision since this understanding may be useful in identifying fraud risks factors that may affect the auditor's assessment of risks due to fraud.

Responses to the assessed risks of material misstatement due to fraud

Paragraph 28 requires the auditor to determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. Paragraph 29 gives more detail of this response and covers the assignment and supervision of appropriate personnel; evaluation of accounting policies; and unpredictability in the selection of the nature, timing and extent of audit procedures.

Paragraph 30 requires the auditor to design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

The Application Material tells us that this may include changing the nature, timing and extent of audit procedures in a number of ways. The auditor may decide to seek audit evidence that is more reliable and relevant or seek to obtain additional corroborative information. For example:

- Physical observation or inspection of assets may become more important.
- External confirmations may be designed 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.

- Audit procedures to extend audit conclusions from an interim date to the period end may be considered to be ineffective.
- Sample sizes may be increased or analytical procedures at a more detailed level may be appropriate.

Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud are presented in Appendix 2 of the ISA (UK and Ireland).

Paragraph 31 introduces another presumed significant risk namely the risk that management may override controls. The ISA (UK and Ireland) tells us that, even though the level of this risk will vary from entity to entity, the risk is nevertheless present in all entities. This is because management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Therefore, irrespective of the auditor's assessment of the risks of management override of controls, Paragraph 32 requires the auditor to design and perform audit procedures relating to journal entries and other adjustments, accounting estimates and significant transactions that are outside the normal course of business.

With respect to journal entries and other adjustments, the auditor is required to make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments. The auditor is also required to test a selection of journal entries and other adjustments made at the end of the reporting period and to consider the need to test journal entries and other adjustments throughout the period.

Moving on to accounting estimates, the auditor is required to review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. The requirement recognises that the accounting estimates included in the financial statements may be individually reasonable but, when taken together, may indicate a possible bias on the part of the entity's management. If this is the case then the auditor is required to re-evaluate the accounting estimates taken as a whole. A further requirement is that the auditor must perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.

Finally, for significant transactions that are outside the normal course of business or appear to be unusual, the auditor is required to evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

If there are specific additional risks of management override that are not covered as part of the procedures required by Paragraph 32, then Paragraph 33 requires the auditor to determine whether there is a need to perform other audit procedures in addition to those specifically referred to above.

Evaluation of audit evidence

ISA (UK and Ireland) 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures.

Appendix 3 to ISA (UK and Ireland) 240 contains examples of circumstances that may indicate the possibility of fraud. Again, the circumstances included in the Appendix are familiar to auditors but, nevertheless, all auditors should ensure that they read the Appendix carefully in order to comply with Paragraph 19 of ISA (UK and Ireland) 200. This Paragraph requires the auditor to have an understanding of the entire text of an ISA (UK and Ireland), including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

ISA (UK and Ireland) 240 refers particularly to final analytical procedures (Paragraph 34) which might indicate a previously unrecognised risk of material misstatement due to fraud and the effect of misstatements (Paragraphs 35 to 37).

If the auditor considers a misstatement to be indicative of fraud then this will have implications for other aspects of the audit since an instance of fraud is unlikely to be an isolated occurrence. There may be an impact on the reliability of management representations and/or a need to re-evaluate the assessment of risk. The reliability of evidence previously obtained may be affected – particularly if collusion is present. Ultimately, if the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.

Paragraph 38 deals with the situation where there is doubt over the auditor's ability to continue performing the audit. In this situation, users of these notes should refer to the full text of the ISA.

Written representations

The requirement for written representations is explicit and detailed. Auditors should ensure that their pro-forma representation letters cover all of the issues required by Paragraph 39.

This requires the auditor to obtain written representations from management and, where appropriate, those charged with governance that:

- They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:
    - Management;
    - Employees who have significant roles in internal control; or
    - Others where the fraud could have a material effect on the financial statements; and
- They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

Communications

Paragraphs 40 to 42 require communication:

- On a timely basis with the appropriate level of management where the auditor has identified a fraud or has obtained information that indicates that a fraud may exist.
- On a timely basis with those charged with governance (except where they are all involved in management), if the auditor has identified or suspects fraud. If the auditor suspects fraud involving management, the auditor will need to discuss with those charged with governance the nature, timing and extent of audit procedures necessary to complete the audit.
- With those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:
    - Concerns about management's assessments of the controls in place to prevent and detect fraud.
    - Failure by management to appropriately address identified significant deficiencies in internal control.

  - The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
  - Actions by management that may be indicative of fraudulent financial reporting.

Paragraph 43 deals with the auditor's responsibility to report the occurrence or suspicion of fraud to a party outside the entity. This would include regulatory or enforcement agencies.

There is a specific documentation requirement in Paragraph 46 which demands that the auditor include in the audit documentation communications about fraud made to management, those charged with governance, regulators and others.

Documentation

The following documentation is compulsory under Paragraphs 44 and 45:

- The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud.
- The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
- The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- The results of the audit procedures, including those designed to address the risk of management override of controls.

Paragraphs 46 (re communications about fraud) and 47 (re the rebuttal of the presumption that there is a risk of material misstatement due to fraud related to revenue recognition) have been dealt with earlier in these notes.

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

(Lecture A340– 10.34 Minutes)

Objective

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.

Requirements

Risk assessment procedures and related activities

Risk assessment procedures are defined as the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Paragraph 5 requires the auditor to perform risk assessment procedures as defined above. The ISA points out that risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion.

The extent of the understanding required is a matter of professional judgment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this ISA (UK and Ireland).

Paragraph 6 indicates that risk assessment procedures must include inquiries of management and others within the entity; analytical procedures; and observation and inspection.

Analytical procedures as risk assessment procedures (which I shall call preliminary analytical review) are no longer dealt with in ISA (UK and Ireland) 520. Therefore the only information about preliminary analytical review is in ISA (UK and Ireland) 315.

The following issues are covered by the Application Material:

- Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.
- Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. This may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- When such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.
- Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

There may well be other information that the auditor can use in identifying risks of material misstatement:

- Paragraph 7 requires the auditor to consider the relevance of information obtained from the auditor's client acceptance or continuance process.
- Paragraph 8 requires the engagement partner to consider the relevance of information obtained from other engagements performed for the entity.
- Paragraph 9 permits the auditor to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits. In this case, the auditor is required to determine whether changes have occurred since the previous audit that may affect the relevance of the information to the current audit.

Paragraph 10 requires a discussion between the engagement partner and other key engagement team members. This should consider the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances.

Notice the change in emphasis from the previous version of ISA (UK and Ireland) 315 which implied in the bold print paragraph that all members of the engagement team would attend the discussion (although this was modified in the guidance material). The clarity ISA recognises that only the key members of the team must attend the meeting. The Application Material tells us that it is not necessary for all members of the team to attend the discussion but Paragraph 10 adds that the engagement partner must determine which matters are to be communicated to engagement team members not involved in the discussion.

The required understanding of the entity and its environment, including the entity's internal control

In Paragraph 11, we have the list of headings for the section of the audit file covering knowledge of the business. In line with other standards, some matters have been promoted from "grey print" status to "requirement" status. Similarly, presumably in an attempt to raise their level of importance, the matters which were previously included in the Appendix to ISA (UK and Ireland) 315 are now included in the Application Material in Paragraphs A17 to A41. Further information about the conditions or events which may indicate risks of material misstatement is contained in Appendix 2 of ISA (UK and Ireland) 315.

11. The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

(b) The nature of the entity, including:

(i) its operations;

(ii) its ownership and governance structures;

(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) the way that the entity is structured and how it is financed

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting

policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity's financial performance.

Most firms will achieve compliance with Paragraph 11 by following a checklist or pro-forma. Documentation provided by commercially available audit systems is likely to be largely unchanged but users have not always been conscientious about following such documentation. In particular, weaknesses occur quite commonly in failure to consider the appropriateness of accounting policies, objectives and strategies and measurement and review of financial performance.

In order to determine the level of detail required, refer back to the objective of ISA (UK and Ireland) 315:

“..... to identify and assess the risks of material misstatement, ... thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.”

Knowledge of the business is not an end in itself but is only relevant if it affects the auditor’s risk assessment or response to risk. Practice Note 26 gives a case study approach to this problem which indicates the level of detail which is considered appropriate by the APB.

Internal control is defined as the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

Paragraph 12 requires the auditor to obtain an understanding of internal control relevant to the audit. The ISA (UK and Ireland) points out that although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is then stated to be a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Despite this statement that it is the auditor’s judgement which will decide whether a control is relevant to the audit, this is not entirely true. The auditor cannot ignore

controls based on the belief that there are no controls which are relevant to the audit. This is clear from the detailed requirements which follow.

Also, whilst the auditor may judge that it is not necessary or practical to seek to rely on the operating effectiveness of controls it will always be necessary to evaluate the design and implementation of controls as required by Paragraph 13.

The procedures used to perform this evaluation may include inquiry, observation, inspection of documents and reports or tracing transactions through the information system (walkthrough test).

Paragraph 13 indicates that the auditor will need to perform procedures in addition to inquiry of the entity's personnel.

Components of internal control

1 Control environment

Paragraph 14 requires the auditor to obtain an understanding of the control environment.

The Application Material explains that the control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organisation, influencing the control consciousness of its people.

Paragraph 14 continues with a requirement for the auditor to evaluate whether management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour. Further, the auditor must evaluate whether the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

The auditor’s evaluation will involve a combination of inquiries and the corroboration of inquiries through observation or inspection of documents.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls and thereby, the auditor's assessment of the risks of material misstatement.

2 The entity's risk assessment process

A risk assessment process involves the following four elements:

- Identifying business risks relevant to financial reporting objectives.
- Estimating the significance of the risks.
- Assessing the likelihood of their occurrence.
- Deciding about actions to address those risks.

The auditor is required to understand whether the entity has established such a process. If so, Paragraph 16 requires the auditor to obtain an understanding of the process and the results thereof. The auditor may identify risks of material misstatement that were not identified by management's process. In this case, the auditor will need to consider whether the process is appropriate to its circumstances or whether there is a significant deficiency in internal control.

In some businesses (and many small entities) there is no formal risk assessment process. In this case, Paragraph 17 requires the auditor to discuss the issue with management. The auditor must then evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or whether there is a significant deficiency in internal control.

3 The information system, including the related business processes, relevant to financial reporting, and communication

Care must be taken to read the clarity ISAs carefully. It is easy to assume that an ISA which is clarified but not revised will not contain any significant changes. Paragraph 18 contains some slightly extended requirements concerning the auditor's understanding of the information system, including the related business processes, relevant to financial reporting.

The auditor's understanding must include the following areas for both manual and electronic systems:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.

  There is no detailed reference to business processes in Paragraph 18. Business processes include the activities designed to develop, purchase, produce, sell and

distribute an entity's products and services and to ensure compliance with laws and regulations. The Application Material makes the point that business processes result in the transactions that are recorded by the information system. Obtaining an understanding of the entity's business processes assists the auditor in obtaining an understanding of the entity's information system in a manner that is appropriate to the entity's own circumstances.

- The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; *this includes the correction of incorrect information and how information is transferred to the general ledger*.
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- *Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.*

The italics have been added for emphasis to show where the requirements have been extended. Auditors should consider their systems notes to ensure that they meet the new requirements. The reference to journal entries in the final bullet point reflects the increased interest in this area which has also resulted in changes to ISA (UK and Ireland) 240.

Paragraph 19 repeats the requirement from the previous ISA concerning the need for an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. This includes communications between management and those charged with governance and external communications, such as those with regulatory authorities.

4 Control activities relevant to the audit

Control activities are the policies and procedures that help ensure that management directives are carried out. Examples of specific control activities are given in the Application Material as follows:

- Authorisation.
- Performance reviews.
- Information processing.
- Physical controls.
- Segregation of duties.

It is important to use correct terminology. Many auditors use the term “internal controls” whereas the proper term is “control activities”. ISA (UK and Ireland) 315 uses the term “internal control” in the much broader sense shown above – internal control has five elements, one of which is the control activities.

Paragraph 20 requires the auditor to obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.

As with Paragraph 12 above, the reference to the auditor’s judgement does not give the auditor free reign to decide to ignore control activities. The Application Material explains that control activities that are relevant to the audit are those that are required to be treated as such (see paragraphs 29 and 30 below) and those that are considered to be relevant in the judgment of the auditor.

Paragraph 20 continues with the comment that an audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.

Paragraph A90 of ISA (UK and Ireland) 315 helps us to understand when a control activity is relevant to the audit.

A90. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

The following extracts are taken from the old ISA:

90. **The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks.**

91. In obtaining an understanding of control activities, the auditor’s primary consideration is whether, and how, a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. The auditor’s emphasis is on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that material misstatements are more likely to occur. When multiple control activities achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

92. .... In considering whether control activities are relevant to the audit, the auditor considers the risks the auditor has identified that may give rise to material misstatement.....

Whilst there is a great deal of overlap between the old ISA and the new requirement in Paragraph 20, there are two (possibly significant) changes. Firstly, the words "relevant to the audit" now appear in the requirement itself. This may not be significant since the old bold print paragraph 90 could be seen as a subsidiary element of the old bold print paragraph 41 "**The auditor should obtain an understanding of internal control relevant to the audit."**

The second difference is the inclusion of the words "....whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control...". So the intention to test controls is now seen as being a relevant factor in determining whether control activities are relevant to the audit.

Many auditors do not see the relevance of testing controls at their smaller clients. Does this new Paragraph A90 mean that there is no longer a need to consider control activities at such clients? Before, we accept this suggestion, we need to consider extracts from the considerations for smaller entities in the Application Material:

A93. ..... small entities may find that certain types of control activities are not relevant because of controls applied by management. ....

A94. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Does A94 imply that such control activities will automatically be relevant because of the materiality of the main transaction cycles? Or is it acceptable to say that there are no control activities relevant to the auditor at client X because there are no relevant control activities in the judgement of the auditor?

There are, however, difficulties with this latter route since Paragraph 8 of ISA (UK and Ireland) 330 tells us that the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively.

In many client situations, justification of low inherent risk (and therefore small sample sizes) is based on a belief that controls are operating. Such controls must therefore be relevant to the audit and it will be necessary to test whether they are operating effectively.

This is a confused area and it will be interesting to see whether the nuances identified above will lead to any changes in the standard audit methodologies.

Paragraph 21 contains a specific requirement for the auditor to obtain an understanding of how the entity has responded to risks arising from IT. This includes both general IT controls and application controls.

5 Monitoring of controls

The auditor is required by Paragraph 22 to obtain an understanding of the major activities that the entity uses to monitor internal control and how the entity initiates remedial actions to deficiencies in its controls. This includes an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose (Paragraph 24).

Paragraph 23 refers to the situation where the entity has an internal audit function. In this case, the auditor is required to obtain an understanding of the responsibilities and activities of the internal audit function in order to determine whether the internal audit function is likely to be relevant to the audit.

Identifying and assessing the risks of material misstatement

Paragraph 25 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures. The purpose of the assessment is to provide a basis for designing and performing further audit procedures.

Some auditors find it difficult to grasp the concept of risks at the financial statement level. The Application Material explains this in a straightforward manner. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. For example, the risk of management override of internal control would be a risk at the financial statement level as would a deficient control environment or management's lack of competence. Risk of fraud also potentially affects many assertions.

Risks of material misstatement at the assertion level are dealt with in Paragraphs A109 to A113. It is here that the ISAs deal with the use of assertions. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

The assertions are classified as follows:

- Assertions about classes of transactions and events for the period under audit: - Occurrence, completeness, accuracy, cut-off and classification
- Assertions about account balances at the period end: - Existence, rights and obligations, completeness, valuation and allocation
- Assertions about presentation and disclosure: - Occurrence and rights and obligations, completeness, classification and understandability, accuracy and valuation.

The principles involved in auditing by assertion are familiar to UK auditors but the classification may seem unusual. No problem. The Application Material says that the auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered.

Grey print guidance from an old ISA is often promoted to be a requirement in the new clarity ISAs. Paragraph 26 mandates the process that the auditor will follow in identifying and assessing risks. This Paragraph requires the auditor to:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that require special audit consideration

Paragraph 27 requires the auditor to determine whether any of the risks identified in the risk assessment are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor excludes the effects of identified controls related to the risk.

A significant risk is defined as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration. In

exercising judgment as to which risks are significant risks, Paragraph 28 says that the auditor should consider at least the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
- The complexity of transactions.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

This list is identical to the list in the previous ISA (UK and Ireland) but is, once again, promoted to the level of a requirement.

If the auditor has determined that a significant risk exists, then Paragraph 29 requires the auditor to obtain an understanding of the entity's controls, including control activities, relevant to that risk.

The above risks are unlikely to be subject to routine controls but the ISA envisages that management may have other responses intended to deal with such risks. Accordingly, the auditor needs to understand how management responds to the risks. If management has not responded appropriately to significant risks of material misstatement by implementing controls over these significant risks then this failure by management is an indicator of a significant deficiency in internal control.

The consequences for further audit procedures of identifying significant risks are described in Paragraphs 15 and 21 of ISA (UK and Ireland) 330.

Risks for which substantive procedures alone do not provide sufficient appropriate audit evidence

In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. In such cases, the entity's controls over such risks are relevant to the audit and Paragraph 30 requires the auditor to obtain an understanding of them.

The consequences for further audit procedures of identifying such risks are described in Paragraph 8 of ISA (UK and Ireland) 330.

Revision of risk assessment

Paragraph 31requires the auditor to revise the risk assessment and modify the further planned audit procedures if circumstances change as the audit progresses. This may occur as audit procedures are performed or if new information is obtained either of which is inconsistent with the audit evidence on which the auditor originally based the assessment.

Examples of such changes in circumstances are:

- The original risk assessment was based on an expectation that certain controls were operating effectively but tests of those controls proved that they were not operating effectively at relevant times during the audit.
- In performing substantive procedures the auditor detected misstatements which were inconsistent with the auditor's risk assessments.

Documentation

32. The auditor shall include in the audit documentation:

(a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;

(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and

(d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30.

It is for the auditor to determine how the documentation requirements of the above Paragraph are to be met. The Application Material suggests that, in audits of small entities, the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.

For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not

necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement. This Paragraph (A132) is the guiding light behind Practice Note 26.

For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

SUMMARY OF DEVELOPMENTS

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

Accounting Standards Board (ASB)

Urgent Issues Task Force (UITF)

Financial Reporting Review Panel (FRRP)

Auditing Practices Board (APB)

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

The Financial Reporting Review Panel announces priorities for 2011/12

The Financial Reporting Review Panel, part of the Financial Reporting Council (FRC), today announced that its review activity in 2011/12 will focus on the following sectors:

Commercial property
Insurance
Support services
Travel

The Panel will have a particular interest in companies which operate in niche markets or which are outside the FTSE 350 because they are seen to be facing more risks in the current economic climate than larger, more diversified companies. In looking at companies which provide support services the Panel will focus on those with significant exposure to public spending cuts.

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

Panel letters to companies increasingly include questions about the business review and in particular about the identification and description of principal risks and uncertainties. The Panel challenges companies whose disclosures are boiler-plate or take the form of a long list of generic risks. It considers whether the risks identified are the principal risks and whether descriptions are sufficiently specific to enable a shareholder to appreciate the threat to the company.

For quoted companies, the business review is required to include information about environmental matters, the company's employees and social and community issues to the extent necessary for an understanding of the development, performance or position of a company's business. Where companies present such information there is an obvious temptation to focus on good news, but the Panel tries to ensure that the information is presented in a fair, balanced and comprehensive manner as required by the Companies Act 2006.

The Panel will continue to focus on the disclosure in the financial statements of those areas where management has made key judgements.

Bill Knight, Chairman of the Panel said:

"Transparency and clarity in financial and narrative reporting is the starting point for shareholder engagement. Bland high level statements in the business review do not help members to judge how the directors have performed their duty to promote the success of the company.

There is an obvious temptation for directors to put the best face on things, but a balanced account is more credible."

25 November 2010

ASB says more informative disclosures about capital management are needed

Adequate capital is essential to well run businesses particularly those seeking to fund future growth or manage a crisis. Investors have told the Accounting Standards Board (ASB) that they are interested in how much financial capital a business needs and whether there is a surplus or a deficit.

This ASB study of the quality of capital management disclosures concludes that there is good practice in places. But too often there is excessive boilerplate text and too many companies have missed essential elements of the required disclosures.

Commenting on the study, Roger Marshall, Chairman of the Accounting Standards Board said:

"Capital management is a key discipline that should be on the regular agenda of all Boards. Adequate capital supports growth and provides a buffer against significant economic shocks so reducing the risk of a liquidity crisis. This is particularly important at present given the pressures on particular sectors facing the impact of reduced government spending."

Informative disclosures made by some companies highlight good practice. For example, some linked capital to business strategy and to dividend policy. Markets are keen to avoid surprises so these disclosures need to explain the potential for future events such as a rights issue or a share buy back programme.

The ASB will continue to monitor the quality of capital disclosures in view of the importance of adequate capital during this phase of the business cycle.

14 December 2010

Findings of the Financial Reporting Review Panel in respect of the accounts of Hot Tuna (International) PLC for the year ended 30 June 2009

The Financial Reporting Review Panel ("the Panel") has had under review the annual report and accounts of Hot Tuna (International) PLC ("the company") for the year ended 30 June 2009.

In the group accounts to 30 June 2009, an impairment loss of £1.474 million in respect of certain intangible assets was charged to a merger reserve. Both the intangible assets and the merger reserve arose as part of the accounting for a business combination.

Following enquiries by the Panel, the company identified that the fair value exercise undertaken at the time of the business combination had established the historical cost of the intangible assets for the purposes of its group accounts and was not a revaluation. This means that charging the impairment loss to the merger reserve did not comply with the requirements of IAS 36 "Impairment of assets" which requires such impairment losses to be recognised in profit or loss. In its group accounts for the year ended 30 June 2010, the company has restated its comparative amounts for this error, increasing the 2009 loss before tax to £3.7 million.

The Panel welcomes the corrective action taken by the directors and regards its enquiries into the company's accounts for the year ended 30 June 2009, initiated on 21 May 2010, as concluded.

17 December 2010

Urgent Issues Task Force: Information sheet No. 91

This information sheet reports the issue of Abstract 48 '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 that the government has decided that the Consumer Prices Index (CPI) should replace the Retail Prices Index (RPI) as the inflation measure to use in determining the minimum pension increases which must be applied to the statutory index-linked features of retirement benefits. The UITF received a request to provide guidance on the accounting implications of the government decision.

In summary the Abstract states that:

(i) whether there is a reduction in Scheme liabilities (

This depends on the facts and circumstances.

(ii) how the effect of a reduction in Scheme liabilities should be presented

The UITF reached a consensus that the presentation of a reduction in Scheme liabilities is dependent on whether the obligation is to pay benefits with increases based on RPI, or more generally with inflation–linked increases.

Where the obligation is to pay benefit increases based on RPI the UITF reached a consensus that the change in Scheme liabilities is a change in benefit and gives rise to a past service cost in accordance with FRS 17.

Where there is no obligation to pay benefit increases based on RPI then a change to CPI is a change in the financial assumption about inflation used to measure the Scheme liabilities and represents an actuarial gain or loss in accordance with FRS 17.

(iii) when the effect of a reduction in Scheme liabilities should be recognised.

Where there is a reduction in the obligation to pay benefit increases based on RPI the past service cost should be recognised in the accounting period when any necessary consultations have been concluded or employees' valid expectations have been changed.

If there is no obligation to pay benefit increases based on RPI an entity should use financial assumptions to measure Scheme liabilities that reflect market expectations at the balance sheet date.

17 December 2010

APB issues a Bulletin setting out revised Example Auditor's Reports on UK Private Sector Financial Statements

The Auditing Practices Board (APB) of the FRC today publishes Bulletin 2010/2 "Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements for periods ended on or after 15 December 2010".

The Bulletin contains 46 examples of auditor's reports, illustrating the reporting requirements of the ISAs (UK and Ireland) effective for financial periods ending on or after 15 December 2010. They also illustrate the reporting requirements of the law and regulations applicable to the financial statements of particular types of entity.

Richard Fleck, APB Chairman said:

"In response to the suggestion of a number of practitioners, APB is consolidating all of its private sector illustrative auditor's reports into a compendium. The compendium will be an annual publication which will provide a single source of APB's illustrative auditor's reports on private sector financial statements. Previously these illustrations have been set out in a number of separate Bulletins and Practice Notes.

I am sure that this publication will become a useful reference source for practitioners and that including all the reports within one publication will simplify the task of finding a particular illustration."

22 December 2010

Editor's Note: At the time of writing these notes, the APB is consulting on a proposal to amend ISA (UK & Ireland) 700. The proposal is that an additional paragraph should be included in the audit report concerning scope of the audit. The Compendium described above does not anticipate this proposed change. If, following consultation, the change is made it will be effective for auditor's reports for periods ending on or after 23 March 2011. Presumably, the compendium will then be re-issued.

APB issues revised guidance on the audit of insurers

The Auditing Practices Board (APB) of the FRC today publishes a revision of Practice Note (PN) 20: "The Audit of Insurers in the United Kingdom". A consultation draft of the revised PN was issued in May 2010 for public comment.

The revision applies to audits of financial statements of Insurers for periods ending on or after 15 December 2010. The guidance reflects:

- the provisions of the clarified ISAs (UK and Ireland) (which apply to the audits of financial statements of Insurers for periods ending on or after 15 December 2010); and
- changes in the legislative and regulatory framework.

New, enhanced or revised guidance is included in the PN with respect to:

- Auditing accounting estimates.
- Materiality.
- Evaluation of misstatements identified during the audit.
- The illustrative examples of various regulatory auditor's reports.

Richard Fleck, APB Chairman, said:

"The revised Practice Note provides guidance for auditors of Insurers. The clarified ISAs have significantly improved the quality of auditing standards and these improvements are reflected in the revision to the Practice Note.

The APB is aware that significant changes to the legal and regulatory environment governing Insurers will be taking place over the next few years, including, in particular, the implementation of Solvency II. The APB will be monitoring these developments with a view to further updating the guidance provided in the Practice Note at the appropriate time.

The APB is grateful for the contribution made by the Insurance Committee of the Institute of Chartered Accountants in England & Wales in the course of the development of this guidance."

06 January 2011

FRC proposes enhancements to company reporting and audit to deliver greater value to investors

The UK's Financial Reporting Council (FRC) today publishes recommendations aimed at improving the dialogue between company boards and their shareholders.

The FRC's report, 'Effective Company Stewardship: Enhancing Corporate Reporting and Audit', contains seven key recommendations. It responds to lessons of the financial crisis and builds on changes already made, such as the new UK Corporate Governance Code and the introduction of the Stewardship Code for institutional investors.

The report proposes that the whole of the annual report and accounts should be balanced and fair, including the chairman and chief executive reports, rather than just specific parts of it as at present. While the best annual reports continue to improve, research by the FRC shows that some companies fall short of fulfilling their Companies Act requirements. Of 50 companies studied, a half to two thirds fell short in some areas, including in their reporting of principal risks.

The FRC also proposes a more substantial communication role for Audit Committees so that they provide fuller reports to shareholders, particularly in relation to the risks faced by the business. The auditors' report should, in turn, include a new section on the completeness and reasonableness of the Audit Committee report, particularly in relation to the dialogue between them and the Committee.

Stephen Haddrill, Chief Executive of the Financial Reporting Council, said:

"Corporate reports have improved in many respects in recent years. At the same time they have become more cluttered and this has reduced their value in the eyes of investors. The aim of these recommendations is to provide more balanced and comprehensive information to investors and thereby support the effective operation of the capital markets.

"Annual reports are more than marketing documents: they are a vital source of narrative and financial data which are used by shareholders to make investment decisions. We want to encourage all companies to follow the example of the best. We believe it is particularly important that directors explain clearly how they identify and manage risk and what keeps them awake at night".

To assist the FRC in promoting high quality corporate governance and reporting, it proposes to create a new market participants group to spot market developments and identify best practice. It also proposes to form a 'financial reporting lab' which will test financial reporting opportunities and enable trials to take place to encourage greater innovation in the market.

In July 2010 the FRC formed an advisory group made up of senior business leaders and members of the accountancy profession to help the FRC examine lessons from the financial crisis as they apply to corporate reporting, accounting and auditing of non-financial services companies. The advisory group has supported the FRC in identifying and evaluating the recommendations contained in this report.

The FRC will consult on any specific proposals resulting from this publication and, in particular, will seek the views of investors, company directors and auditors. The deadline for stakeholder responses is 31 March 2011.

Key recommendations included in the report:

1. Directors should take full responsibility for ensuring that an Annual Report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.

2. Directors should describe in more detail the steps that they take to ensure:

- The reliability of the information on which the management of a company, and therefore directors' stewardship of the company, is based; and

- Transparency about the activities of the business and any associated risks.

3. The growing strength of Audit Committees in holding management and auditors to account should be reinforced by greater transparency through:

- Fuller reports by Audit Committees explaining, in particular, how they discharged their responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors); and

- An expanded audit report that:

    - includes a separate new section on the completeness and reasonableness of the Audit Committee report; and

    - identifies any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

4. Companies should take advantage of technological developments to increase the accessibility of the annual report and its components.

5. There should be greater investor involvement in the process by which auditors are appointed.

6. The FRC's responsibilities should be developed to enable it to support and oversee the effective implementation of its proposals.

7. The FRC should establish a market participants group to advise it on market developments and international initiatives in the area of corporate reporting and the role of assurance and on promoting best practice.

07 January 2011

APB issues revised guidance on the Audit of Friendly Societies

The Auditing Practices Board (APB) of the FRC today publishes a consultation draft of a revision of Practice Note (PN) 24: "The Audit of Friendly Societies in the United Kingdom (Revised)". The consultation period ends on 15 April 2011.

The consultation draft updates the current guidance, which was issued in January 2007, to reflect:

- the provisions of the clarified ISAs (UK and Ireland) (which apply to audits of financial statements of Friendly Societies for periods ending on or after 15 December 2010), and
- changes in the legislative and regulatory framework.

The core guidance contained in the consultation draft is largely unchanged from the current guidance. However, new, enhanced or revised guidance has been included with respect to:

- Auditing accounting estimates.
- Materiality.
- Evaluation of misstatements identified during the audit.
- The illustrative examples of various regulatory auditors' reports.
- Corporate Governance.

Richard Fleck, APB Chairman, said:

"Friendly Societies comprise a significant element of the UK's insurance sector having a membership of 7.1 million and funds in excess of £16 billion. This Practice Note provides important guidance for auditors of Friendly Societies."

13 January 2011

APB issues revised guidance on the Audit of Occupational Pension Schemes

The Auditing Practices Board (APB) of the FRC has today published a revision of Practice Note (PN) 15: 'The Audit of Occupational Pension Schemes in the United Kingdom (Revised)'. An exposure draft of the revised PN was issued in July 2010 for public comment.

The revision updates the current guidance to reflect:

- the issuance of the new International Standards on Auditing (ISAs) (UK and Ireland) (which apply to audits of financial statements of occupational pension schemes for periods ending on or after 15 December 2010); and

- changes in the legislative and regulatory framework.

New guidance has been included on:

- Communicating deficiencies in internal control to those responsible for governance and management.

- Audit considerations relating to an entity using a service organisation.

- Auditing accounting estimates, including fair value accounting estimates and related disclosures.

- Going concern.

Richard Fleck, APB Chairman, said:

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

31 January 2011