TABLE OF CONTENTS

RELATED PARTY DISCLOSURES AND TRANSACTIONS – A COMPREHENSIVE CASE STUDY 5

(Lecture A341 – 26.56 minutes) 5
Application to small companies – CA 06 6
Who is a related party of Prime Target Ltd? 6
FRS 8 pre 1/1/11 6
FRS 8 post 1/1/11 10
FRSSE - 2008 13
ED FRSME 14
What control disclosure is required for Prime Target Ltd? 14
Disclosure requirement 14
FRS 8 pre 1/1/11 15
FRSSE - 2008 16
FRS 8 post 1/1/11 16
ED FRSME 17
Group situations 17
FRS 8 pre 1/1/11 18
FRSSE - 2008 19
FRS 8 post 1/1/11 19
Common investor 20
FRS 8 pre 1/1/11 20
FRSSE - 2008 20
FRS 8 post 1/1/11 20
Joint control and significant influence 21
IAS 24 21
Practical application 22
Individuals with investments 22
FRS 8 pre 1/1/11 23
FRSSE - 2008 24
FRS 8 post 1/1/11 25
Common control 26

PROPERTY COMPANIES ACCOUNTING ISSUES 28

(Lecture A342 – 12.10 Minutes) 28
Investment properties 28

Definitions ... 28
Examples ... 29
Comments on examples ... 29
Requirements ... 29
Examples ... 30
Comments on examples ... 30
Revaluation losses ... 31
Examples ... 31
Comments on examples ... 31
Legal requirements in UK ... 31
Changes under FRSME ... 32
Property held as current asset ... 33
Example ... 33
Comments on Example ... 33

CASE STUDY: ASSET OR EXPENSE? ... 34

COMMON DISCLOSURE ERRORS IDENTIFIED ON AUDIT MONITORING AND ACCA QUALITY CHECKED VISITS. ... 37

(Lecture A343 – 15.42 minutes) ... 37
Related party disclosure ... 37
Accounting Policies ... 37
Fixed Assets ... 37
Secured loans ... 37
Other disclosures ... 37

COMMON DISCLOSURE ERRORS IDENTIFIED ON RECENT FILE REVIEWS ... 38

Directors' report ... 38
Auditor's report ... 38
Balance sheet ... 39
Accounting policies ... 39
Notes to the accounts ... 39
Comment ... 40

BRIBERY ACT 2010 – WHAT ACCOUNTANTS NEED TO KNOW ... 40

(Lecture A344 – 18.46 minutes) ... 40
Introduction ... 40
The offences - overview ... 41

Failure to prevent Bribery 41
Example 42
Audit Issues arising 43
What is a bribe? 44
Penalties 45
Money Laundering Implications 45
Frequently asked questions 45
Is corporate hospitality a crime? 45
What happens if I am in a threatening situation? 46
Can I pay routine facilitation payments? (Sometimes it is the only way to get things done promptly) 46

UPDATE ON CHARITABLE INCORPORATED ORGANISATIONS (CIOS) 47

AUDIT REPORTS 48

(Lecture A345 – 10.39 minutes) 48

IMPLEMENTATION OF THE CLARITY ISAS 49

ISA (UK & IRELAND) 540: AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES 49

(Lecture A 346 – 11.48 minutes) 49
Selected extracts 49
Practice note 26: guidance on smaller entity audit documentation 51
Knowledge of the business 51
Extract from working paper on provisions 52

ISA (UK & IRELAND) 550: RELATED PARTIES 53

(Lecture A 347 – 7.15 minutes) 53
Selected extracts 53
Practice note 26: guidance on smaller entity audit documentation 54
Knowledge of the business 54
Extracts from notes of team meeting: 55

ISA (UK & IRELAND) 600: SPECIAL CONSIDERATIONS - AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS) 55

Introduction 55
FAQs on group audits 55
Practice note 26: guidance on smaller entity audit documentation 57

FEEDBACK FROM THE QAD 57

(Lecture A348 – 23.00 minutes) 57
Introduction 57
Avoiding Clarified ISA Pitfalls 58
1. Recognising that the Standards have changed 58
2. Documentation of the names of related parties 58
3. Significant risk 59
4. Accounting estimates 61
5. Documentation of oral communications with those charged with governance 62
6. Materiality 63
7. Standard letters 64
8. The group auditor’s involvement in component audits 64
9. The risk ISAs – including the risks resulting from management override of controls 66
10. New mandated procedures 68
Read the standards 70

SUMMARY OF DEVELOPMENTS 70

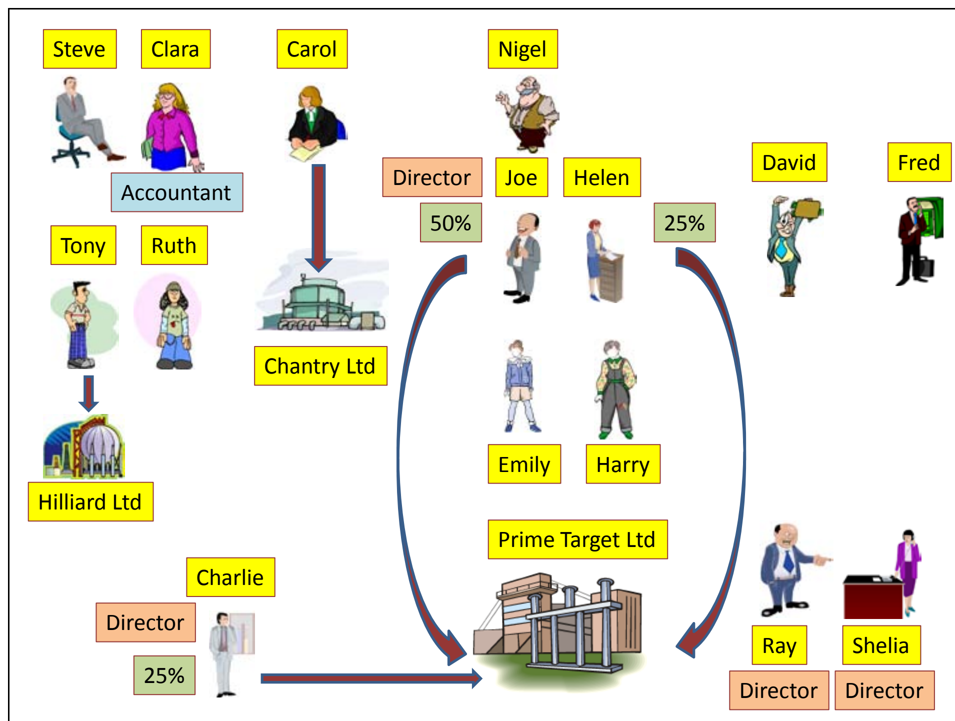
ASB issues a Financial Reporting Exposure Draft: Amendments to FRS 29 (IFRS 7) 'Disclosures - Transfers of Financial Assets' 71
FRC announces Inquiry into Going Concern Assessments 71
The APB issues Feedback Paper on Auditor Scepticism 72
Statement by the Financial Reporting Review Panel in respect of the report and accounts of Rio Tinto Plc 73
APB publishes Practice Note 11 (Revised) - The Audit of Charities in the UK 74
The APB also issued revised guidance on the Audit of Banks and Building Societies in the United Kingdom (a revision of Practice Note 19) on 29 March 2011 74
Proposals for a Public Benefit Entity Standard for Tier 2 Entities 74
The Professional Oversight Board announces the Scope of the Audit Inspection Unit's Work for 2011/12 75
The Audit Inspection Unit: Scope of Independent Inspection 2011/12 76
FRC commits to playing full role in supporting Government's Plan for Growth 77
ASB publishes Report on Cutting Clutter from Annual Reports 78

RELATED PARTY DISCLOSURES AND TRANSACTIONS – A COMPREHENSIVE CASE STUDY

(Lecture A341 – 26.56 minutes)

Joe and his domestic partner Helen reside in a property with their two children, Emily and Harry. Joe has his own business; Prime Target Ltd. Prime Target was founded by Joe's father Nigel. Nigel no longer takes an active part in the business but is retained as a consultant. Joe's mother is deceased. Joe owns 50% of the shares, Helen owns 25%, and is not a director. The remaining 25% is held by Charlie, a director, who is not related to any of the family. There are two other directors Shelia and Ray who have no interest in the shares. Joe has two children, Tony and Steve, from his previous marriage to June. Tony and Steve are both married, to Ruth and Clara respectively. Tony is the sole director and shareholder of Hilliard Ltd. Clara is a professional accountant with her own practice, she provides accounting services to Prime Target Ltd. Helen also has a child, David, from a previous relationship. David, is based overseas. Joe has a sister Carol who has her own business, Chantry Ltd, and Helen has a brother Fred who is a civil servant.

The above is represented by the following:



Application to small companies – CA 06

It is important to remember that if Prime Target is a small company which files abbreviated accounts then related party transactions do not need to be disclosed in those accounts unless disclosure is also required by statute. If the company is medium sized then the transactions would need to be included in the abbreviated accounts.

Who is a related party of Prime Target Ltd?

FRS 8 pre 1/1/11

Definitions which are relevant to this part of the case study:

2.5 Related parties: A party is related to an entity if: (a) directly, or indirectly through one or more intermediaries, the party: (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries); (ii) has an interest in the entity that gives it significant influence over the entity; or (iii) has joint control over the entity; (d) the party is a member of the key management personnel of the entity or its parent; (e) the party is a close member of the family of any individual referred to in subparagraph (a) or (d); (f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with directly or indirectly, any individual referred to in (d) or (e);

Joe, Charlie, Ray, Shelia

The easiest group to identify is key management; that is Joe, Charlie, Ray, and Shelia. As directors they are related parties. It should be noted that with a holding of 50% Joe has an interest that gives significant influence if not joint control. Charlie with a holding of 25% may be covered by the same consideration. However, as both are directors there is no requirement to consider their shareholdings.

Suppose the situation was slightly different. What would be the position if Charlie was not a director? He is not related to any other shareholder so it would be necessary to consider whether a 25% shareholding gives significant influence. FRS 8 does not include a definition for this term. The only definition within UKGAAP is contained in FRS 9.

> Exercise of significant influence:– The investor is actively involved and is influential in the direction of its investee through its participation in policy decisions covering aspects of policy relevant to the investor, including decisions on strategic issues such as:
>
> (a) the expansion or contraction of the business, participation in other entities or changes in products, markets and activities of its investee; and
>
> (b) determining the balance between dividend and reinvestment.
>
> Companies legislation provides that an entity holding 20 per cent or more of the voting rights in another entity should be presumed to exercise a significant influence over that other entity unless the contrary is shown. For the purpose of applying this presumption, the shares held by the parent and its subsidiaries in that entity should be aggregated. The presumption is rebutted if the investor does not fulfil the criteria for the exercise of significant influence set out above.

This definition refers to “exercise of significant influence” whereas FRS 8 refers to “gives it significant influence”. It may be thought that there is no difference between these two terms but the reference to “exercise” clearly indicates an active role rather than passive. It is suggested in FRS 9 that an investor exercising significant influence will be directly involved in the operating and financial policies rather than passively awaiting the outcome of its investee's policies. The investor's active involvement in the operating and financial policies requires that it should have a voice in decisions on strategic issues such as determining the balance between dividend and reinvestment. The investor's involvement is usually achieved through nomination to the board of directors but may result from any arrangement that allows the investor to participate effectively in policy-making decisions. It is unlikely that an investor can exercise significant influence unless it has a substantial basis of voting power. A holding of 20 per cent or more of the voting rights suggests, but does not ensure, that the investor exercises significant influence over that entity.

If Charlie is a director, that would give significant influence. However, if he is a director, then we have already said that, for the purposes of FRS 8, there is no requirement to consider influence. If Charlie is not a director then the application of “significant influence” in these circumstances may be open to interpretation.

Given the current debate over the disclosure of dividends paid to related parties this consideration of investors with significant shareholdings will have an impact on disclosures.

Helen

Helen is likely to be a related party for two reasons. She is Joe’s domestic partner and hence a member of his close family and she has a 25% shareholding. Consideration of the latter would require the same matters discussed in the “what if” above for Charlie.

Emily and Harry

Emily and Harry are also members of Joe's close family and hence related parties.

Nigel

Nigel is likely to be determined as a member of Joe's close family. If the remuneration received as a consultant is as an employee then those transactions would be exempt from disclosure. If they are received as self employed then they would have to be disclosed subject to a consideration of materiality.

Tony and Steve

The position of Tony and Steve requires consideration of the definition of close family.

> 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.

Clearly Tony and Steve are family members of Joe but would it be expected that there is influence (in either direction) between themselves and their father? One of the issues from this definition is the implication that influence is measured on a general expectation rather than what may occur. The term influence is not defined in the standard. There is a reference in the summary which refers to one party subordinating its own interests but this is in the context of influence having been exerted rather than an expectation.

It is likely that many practitioners would assume that a person's children are members of their close family and hence related parties.

Hilliard Ltd

If Tony is a member of Joe's close family then Hilliard (controlled by Tony) is also a related party. Refer 2.5(f).

Clara and Ruth

Whether Clara and Ruth are related parties would require similar consideration as for Tony and Steve. As with the sons, they are not members of the same household but the difference now is that they are not directly related to Joe. They could be

considered to be in the same family group. Since there are transactions between the company and Clara consideration would have to be given.

From a practical perspective it is likely that if there had been no transactions with either of these individuals the question of whether they are related parties may not have been raised. However, in an audit environment there is a requirement to consider the requirements of ISA (UK&I) 550.

> 13. The auditor shall inquire of management regarding:
>
> (a) The identity of the entity's related parties, including changes from the prior period;
>
> ....
>
> A11. Where the applicable financial reporting framework establishes related party requirements, information regarding the identity of the entity's related parties is likely to be readily available to management .... to enable the entity to meet the accounting and disclosure requirements .... Management is therefore likely to have a comprehensive list of related parties and changes from the prior period. ....

This requirement is often overlooked by auditors but would indicate a need to consider relationships in a real situation in the same way as in this case study.

For non audit assignments, if the accountant becomes aware of an issue, then there would be a need to enquire of management.

David

For David, the considerations may be similar but given the fact he is a child of Helen the link to Joe may be considered to fall outside “close family”. Once again there are no transactions so comments made above re ISA 550 may also be relevant.

Carol

Carol could be seen to be a member of Joe’s close family. She is a family member but the situation can be seen as perhaps more distant that that applied to Joe’s children. It would be a matter of judgement as to whether one would expect influence to exist between brothers and sisters.

From a practical perspective there may be a review of the transactions between Prime Target and Chantry. If these are all on an arms’ length basis the decision may be made that there is no related party relationship but this considers actual occurrence rather than an expectation.

If the decision is made that she is not a member of Joe's close family but it was found that an interest free loan had been made by Prime Target to Chantry would this be disclosed? If the decision has been made that she is not a related party then, by definition, this is not a related party transaction. It may be a transaction where influence has existed, demonstrated by the fact that it is not on normal commercial terms. However, FRS 8 is concerned with the disclosure of related party transactions so the party has to be related first. It is not concerned with the disclosure of transactions where normal commercial terms have not been applied. On this basis the relationship should be considered first before the nature of the transactions.

Fred

The relationship between Fred and Joe is likely to be considered too distant for him to be within the close family definition.

On the basis of "what if?", if Helen was also a director then that would change the consideration for both Fred and David.

FRS 8 post 1/1/11

The amended FRS 8 applies to periods commencing on or after 1/1/11. Early adoption is permitted.

Definitions which are relevant to this part of the case study (extracts from Paragraph 2.5 of the amended FRS 8):

A related party is a person or entity that is related to the entity that is preparing its financial statements.

(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:

(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).

Joe, Charlie, Ray, Shelia

There is no change to key management. Joe, Charlie, Ray, and Shelia are related parties. The position as regards Joe and Charlie in respect of their shareholdings is unchanged.

On the basis of "what if?", what would be the position if Charlie was not a director? The considerations are identical to those above. The revisions to the standard do not include any clarification in this area.

Helen

Helen – considerations are identical.

Emily and Harry

Emily and Harry would be considered members of Joe's close family.

Nigel

Nigel's relationship may be reviewed as a result of changes to the close family definition.

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.

A comparison with the previous definition identifies the following differences.

There is no longer a reference to household. The relevance of this may only relate to a limited number of situations. This could be considered in the context of how many households can you be a member of?

The other change is the list of those who are definitely included as close family members. However, this does not create a complete list of family members in the sense that those listed are definite but that does not mean that those not listed are not close family. There is no change to the emphasis on influence and expectation. For this reason one could argue that there should be no changes to relationships

that have been identified in the past, unless the person was excluded and is now included in a) to c).

There is, however, a practical issue. When definitions containing little detail are amended to include some detail, some practitioners may interpret that this is an "in and out" list. However, recall that the main thrust of the definition is unchanged.

For example, if in the past, Nigel was determined to be a related party on the basis of being Joe's father this should not change. In reality whether a person's parents are members of their close family has been open to judgement, some are of the opinion yes, others no. If the decision had been made in the past to exclude Nigel, but he is a dependant of Joe, then that decision will need to be revised.

Tony and Steve

The position of Tony and Steve requires similar consideration of the changes to the definition of close family. The comments made above relating to Nigel would be applicable. However, the changes clearly state that a persons' children are members of their close family. The uncertainty under the previous version of FRS 8 has been removed.

Hilliard Ltd

Hilliard remains a related party under 2.5(b)(vi).

Clara and Ruth

Whether Clara and Ruth are related parties requires the same considerations as before. They are not specifically in the list of a) to c).

David

For David, the considerations are different. He is within (b) so would be deemed to be a related party. If there are no transactions then this may be no more than a documentation change for audit assignments. But this may be a big problem in practice. The existence of children from previous relationships is now relevant. If this has not already been recognised then there could be a requirement to enquire of the directors whether any of these exist. This may be a difficult discussion.

Another difficult discussion will occur if Joe is not divorced from June. It could be argued that she is still his spouse.

Carol

For Carol, the considerations are similar to those that apply to Nigel. Otherwise, the issues are unchanged from those listed above relating to the previous version of FRS 8.

Fred

Fred – same considerations as previously.

Conclusion

There will be a need to revisit relationships and a need to assess whether any parties now fall to be included or excluded. However, there should be no major changes.

FRSSE - 2008

The FRSSE contains the following definitions which are relevant to this part of the case study:

Related parties:–

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

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

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

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

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

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

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.

Comparison with the requirements of FRS 8 highlights the following.

For the directors there is no change. The "what if" for Charlie would require a consideration of the term "influence". If the assumption is made that the reference to investors with significant influence is directly linked to (c) then for influence to exist one has to consider whether influence was used. This may be easier to determine than under FRS 8 as the use of influence would normally leave some evidence. This could be in the form of reduced or increased interest rates, preferential trading terms, etc. On this basis one may assume that the existence of a 20% shareholding would not be sufficient. There would have to be this together with evidence that the party is influential over the company's activities. An investor with no Board representation and who is not regularly consulted by management may not be able to exert influence as determined by the FRSSE.

The definition of close family is identical with FRS 8 prior to 1/1/11. Therefore, the considerations in the appropriate section of the notes above would also apply to FRSSE based entities.

The definition in the FRSSE makes no reference to entities controlled by individuals. On this basis Hilliard and Chantry would not be related parties, even if the close family relationship of the controlling party has been established.

It is expected that the definitions in the FRSSE will be changed in due course so that they are identical to those within the FRSME.

ED FRSME

The definition of "Related party" used in the ED is identical to that in the revised FRS 8. There is no definition, at present, of "close family".

What control disclosure is required for Prime Target Ltd?

The disclosure requirements in FRS 8 and the FRSSE are unchanged. However, other changes to the standards may have an impact on these disclosures.

Disclosure requirement

FRS 8 and FRSSE

When the reporting entity is controlled by another party, there should be disclosure of the related party relationship and the name of that party and, if different, that of the ultimate controlling party.

FRS 8 pre 1/1/11

The key question is whether you include Helen's shareholding with Joe's. If you do, then, at 75%, control must exist; if not, it is debatable.

The requirement above refers to the party in the singular and not the plural. Does this indicate that it is only an individual, or an entity, that is able to exercise control?

Prior to 1/1/11 FRS 8 included references to "groups of individuals and entities". This is in the following paragraph from the explanatory section:

> 11 The definition of a related party encompasses both an individual or an entity, such as a company or unincorporated business, and a group of individuals or entities acting in concert. Groups of individuals or entities are included in this definition because, although a single individual or entity (having, for example only a small shareholding) might not be able to divert a particular reporting entity from pursuing its own separate interests, this could be achieved by the individual or entity acting in concert with others.

In many instances, where control is exercised through family relationships, disclosure is made. These disclosures may or may not include the names of the family members. If the names are not included there is just a reference to "and members of their close family". This is not seen as an issue as the standard requires disclosure of the name of the person who has control, the fact they do so by way of family shareholdings is not seen as a problem.

Where control is exercised by a number of individuals who are not related there is often no control disclosure. This is on the basis that there is uncertainty as to whether they exercise control by acting in concert or whether decisions are made by the company on the basis of each person exercising their rights. If they all agree, or a majority do, then this commits the company to a particular course of action. It also recognises that some companies may be "deadlocked".

Whether the directors should be named as a controlling party has been open to debate but the Financial Reporting Faculty of ICAEW has recommended disclosure as follows:

> *Example disclosure: ultimate controlling party*
>
> The company is controlled by its directors.

But some commentators argue that this sort of statement is meaningless – of course the company is under the control of its directors – that's what they are there for!

Returning to the key question, should Helen's shareholding be combined with Joe's?

The combination of family assumes that Joe and Helen are "acting in concert". If that is the conclusion, a control disclosure would be given.

FRSSE - 2008

The requirement in the FRSSE is identical with FRS 8 above except that the paragraph covering groups of individuals does not appear. However, despite this difference, most accountants have applied the FRSSE in the same way as FRS 8.

FRS 8 post 1/1/11

Although there is no change in the disclosure requirement, paragraph 11, referred to above, has been removed. This would appear to indicate that grouping of individuals and entities is no longer considered. The definition of "acting in concert" has also been removed.

The revised definition in 2.5 also refers to singular; "A person or a close member of that person's family". This would indicate that individuals are considered on an individual basis.

In the example of Prime Target Ltd does any individual have control. In this respect there is a need to distinguish between control and joint control. Control is defined in FRS 8 as

> The ability to direct the financial and operating policies of an entity with a view to gaining economic benefits from its activities.

It could be argued that Joe with a 50% holding and being a director, against Charlie with 25% and Helen (not a director) also with 25%, controls the company. However, in Board composition, Joe is one of four and in voting terms the company could be deadlocked. Hence there are questions as to whether any individual party would be deemed to control the company.

If the decision is made that no party is recognised as having control then no disclosure is required. If the company is using the FRSSE and previously the decision was made to follow FRS 8, then, presumably, it would now be appropriate to follow the approach of FRS 8 as amended.

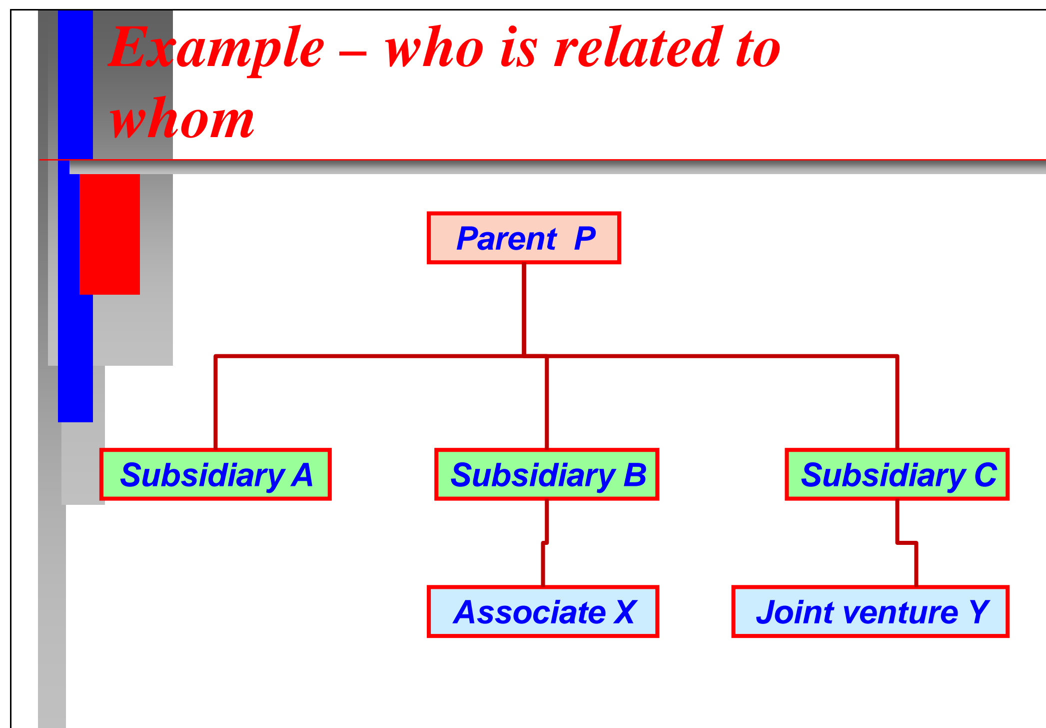
ED FRSME

Disclosure of parent-subsidiary relationships 33.5 Relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been related party transactions. An entity shall disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so (if any) shall also be disclosed.

The fact that this disclosure requirement is contained under the heading “Disclosure of parent-subsidiary relationships” raises doubts as to whether FRSME is referring to the same idea of control as that included in FRS 8. The ASB has not yet produced a case study dealing with related party disclosures – we wait with baited breath!

Group situations

Consider the following:



FRS 8 pre 1/1/11

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 of the entity;

(c) the party is a joint venture in which the entity is a venturer;

Parent P

P would include all the subsidiaries as related parties in accordance with (a)(i). It would also include both X (associate) and Y (joint venture) on the basis that indirectly, through the subsidiaries, it has significant influence or joint control. Given the definitions in FRS 9 the implication of associate or joint venture indicates either significant influence or joint control.

On occasions users have included both associates and joint ventures in the group structure. This is incorrect under UK GAAP. A group is comprised of parent(s) and subsidiaries. Associates and joint ventures are sometimes referred to as “hanging off the bottom of the group”.

Subsidiaries A, B, and C

Each would be related parties of each other and would include the parent as a related party, (a)(i). B would include X as a related party under (b). C would include Y as a related party under (c). However, A would not include either X or Y as related parties as there is no relationship between them. In this situation FRS 8 has been referred to as “vertical relationships exist but horizontal do not”.

Associate X

B has significant influence and hence would be a related party under (a)(ii). P also has the same influence on the basis it can control the actions of B. X would not include A or C as a related party. A and C are not related parties as references to significant influence and joint control from the same source (as dealt with in paragraph (f) of the definition) only apply to the situation where the significant influence or joint control is exercised by individuals.

Joint venture Y

Similarly, for Y, C and P would be related parties under (a)(iii).

FRSSE - 2008

> Two or more parties are related parties when at any time during the financial period:
>
> (a) one party has direct or indirect control of the other party; or
>
> (b) the parties are subject to common control from the same source; or
>
> (c) one party has significant influence over the financial and operating policies of the other party. Significant influence would occur if that other party is inhibited from pursuing its own separate interests.
>
> For the avoidance of doubt, related parties of the reporting entity include the following:
>
> (i) parent undertakings, subsidiary and fellow subsidiary undertakings;
>
> (ii) associates and joint ventures;

Application of the above would create no differences from that discussed under the previous version of FRS 8.

FRS 8 post 1/1/11

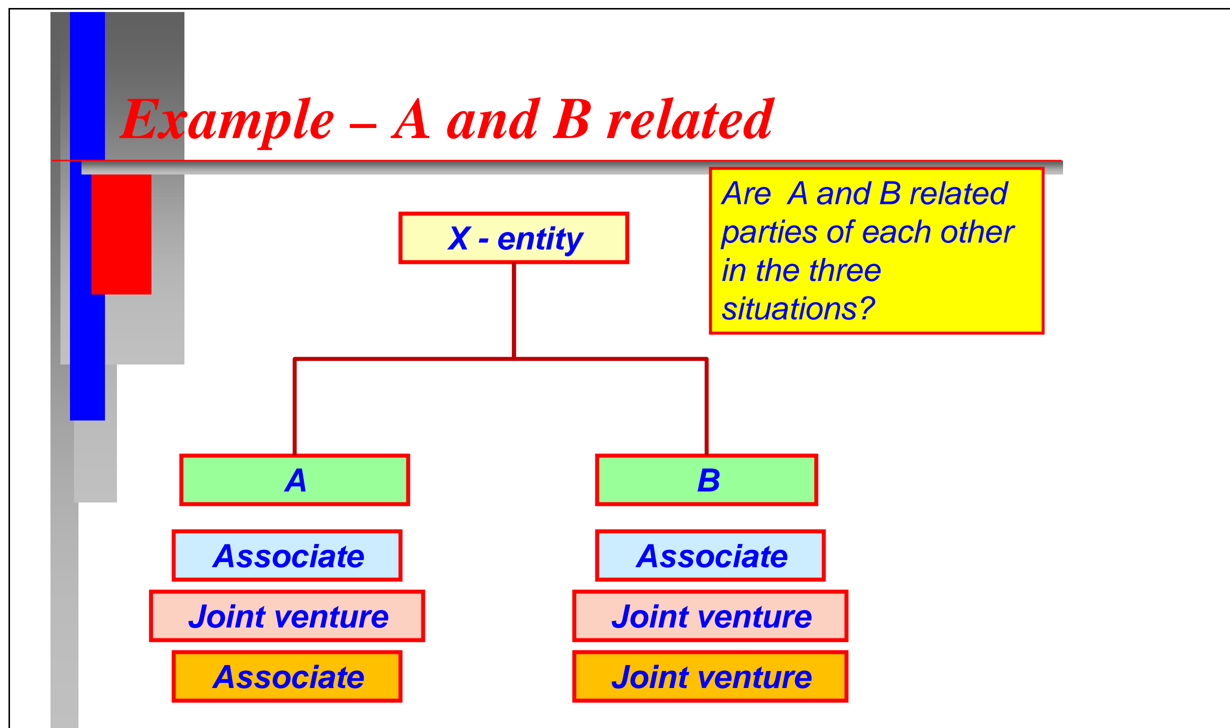
> A related party is a person or entity that is related to the entity that is preparing its financial statements
>
> (b) An entity is related to a reporting entity if any of the following conditions applies:
>
> (i) The entity and the reporting entity are members of the same group (which means that each 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).
>
> (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

A consideration of the above indicates that in the scenario being considered all the parties are related to each other. This would include X and Y as effectively one is an associate of P and the other a joint venture.

Hence a comparison with the requirements pre 1/1/11 indicates that the companies would need to recognise the new related parties and the potential for additional disclosures that may not have been included in previous years.

Common investor

Consider the following:



FRS 8 pre 1/1/11

This is similar to the situation discussed above. The additional consideration is whether A and B are related parties of each other. The definition within 2.5 would not create such a relationship. We consider the situation where X is an individual later in these notes.

FRSSE - 2008

Identical to above.

FRS 8 post 1/1/11

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

(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.

Therefore if both are joint ventures then they are related, if one is a joint venture and the other an associate they are related. If both are associates then they are not related.

This is another example of a change from 1/1/11.

Joint control and significant influence

FRS 8 refers to significant influence and joint control but neither of these terms is defined. There was a discussion above in relation to significant influence. Now, we need to consider joint control.

Joint control is not defined in FRS 8 and the only standard in UK GAAP that includes such a definition is FRS 9. The definition is used in the context of joint ventures and therefore a different context from that considered in this instance.

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

This indicates for there to be joint control there has to be a consensus among the parties such that each has to give their consent before any action can be taken. Further extracts from FRS 9 show the following.

The effect of the requirement in the definition for consent to high-level strategic decisions of joint control is to give each venturer a veto on such decisions. This veto is what distinguishes a joint venturer from a minority holder of the shares in a joint stock company because the latter, having no veto, is subject to majority rule (except for the limited statutory protection for the minority). The requirement for each venturer's consent to high-level strategic decisions does not have to be set out in the joint venture agreement, provided that the joint venture works in practice on the basis of securing such consent.

This indicates that the consensus is not by way of majority voting, a party with joint control has an effective veto on strategic decisions.

IAS 24

As the UK is now using the same definition of related party as IAS 24 it may be appropriate to review definitions contained in the international standard. The terms are defined as follows.

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.

Practical application

Tom and Fred each own 50% of the voting rights in A Ltd. Do they each have significant influence or joint control?

Tom, Dick, and Harry each own 33.3% of the voting rights in B Ltd. Do they each have significant influence or joint control?

What difference does it make?

That question is answered in the next section.

Individuals with investments

For many practitioners the most common situation is individuals with investments in several entities and/or common directorships. In these situations it is important to identify the reporting entity.

Example: Mike has a relationship with two companies A and B. That relationship may take a variety of forms as shown in the following table:

Mike's relationship with A	**Mike's relationship with B**			
	Control	Joint control	Significant influence	Key management
Control				
Joint control				
Significant influence				
Key management				

FRS 8 pre 1/1/11

A party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

(ii) has an interest in the entity that gives it significant influence over the entity; or

(iii) has joint control over the entity;

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

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

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

In the above, the starting point is (f); the reporting entity is A and the question is:

is B a related party of A?

Mike's relationship with A	Mike's relationship with B			
	Control	Joint control	Significant influence	Key management
Control	Yes	No	No	No
Joint control	No	No	No	No
Significant influence	No	No	No	No
Key management	Yes	Yes	Yes	No

This table applies the definition as shown above but there is an illogicality in that definition which can be illustrated by the following extension to the example:

Suppose that Mike has no relationship with company B but his wife, Sarah, does have a relationship with B. So the question is

is B a related party of A?

Mike's relationship with A	Sarah's relationship with B			
	Control	Joint control	Significant influence	Key management
Control	Yes	Yes	Yes	No
Joint control	Yes	Yes	Yes	No
Significant influence	Yes	Yes	Yes	No
Key management	Yes	Yes	Yes	No

As I stated above, this cannot be logical but it seems to be what the definition is saying. Perhaps it is a good thing that FRS 8 has been amended!

FRSSE - 2008

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

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

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

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

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

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

(ii) associates and joint ventures;

Applying the definition gives the following:

Is B a related party of A?

Mike's relationship with A	**Mike's relationship with B**			
	Control	Joint control	Significant influence	Key management
Control	Yes	No	No	No
Joint control	No	No	No	No
Significant influence	No	No	No	No
Key management	No	No	No	No

FRS 8 post 1/1/11

(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:

(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).

(b) (vi) and (vii) are the relevant sections, (a) clarifies the relationship.

is B a related party of A?

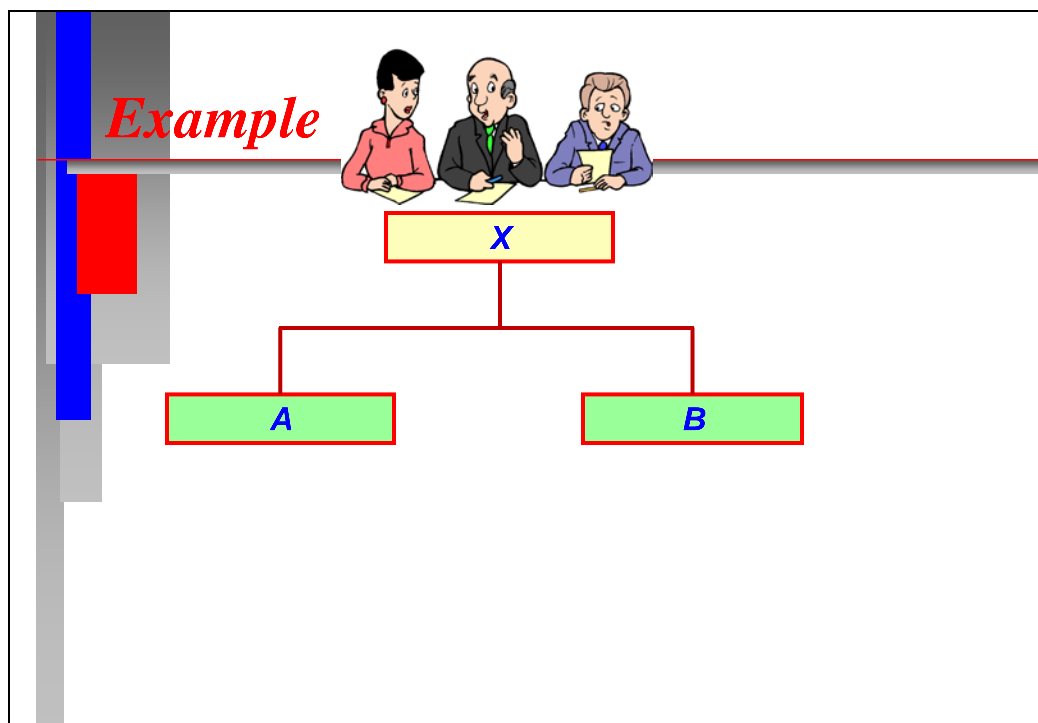
Mike's relationship with A	Mike's relationship with B			
	Control	Joint control	Significant influence	Key management
Control	Yes	Yes	Yes	Yes
Joint control	Yes	Yes	Yes	Yes
Significant influence	Yes	Yes	No	No
Key management	Yes	Yes	No	No

Common control

FRS 8 pre 1/1/11 included the following in the explanatory section.

> 13 Entities subject to common control are included in the definition of a related party because the controlling entity could cause such entities to transact or not to transact with one another or to transact on particular terms. The relationship could therefore have a material effect on the performance and financial position of the reporting entity. Common control is deemed to exist when both parties are subject to control from boards having a controlling nucleus of directors in common.

This has been removed post 1/1/11.



In the above example.

1. Assume the three individuals are the three directors for both A and B but hold no shares in either company. Will A and B be related parties of each other?

   Under the old FRS 8, the application of paragraph 13 would indicate yes. With that paragraph removed under the new FRS 8, the table above will apply and the answer would be no.

2. If the three individuals are the three directors and three shareholders of both companies A and B, would A and B be related parties?

   Under the old FRS 8, the application of paragraph 13 and paragraph 11 (discussed above) would indicate yes. However, post 1/1/11 both of these have been removed. From the table above the question becomes whether there is joint control of A and/or B or significant influence over A and B.

PROPERTY COMPANIES ACCOUNTING ISSUES

(Lecture A342 – 12.10 Minutes)

Investment properties

Definitions

SSAP 19

7 For the purposes of this statement, but subject to the exceptions in paragraph 8 below, an investment property is an interest in land and/or buildings:

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

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

8 The following are exceptions from the definition:

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

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

FRSSE

An investment property is an interest in land and/or buildings:

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

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

(i) a property that is owned and occupied by a company for its own purposes; and

(ii) a property let to and occupied by another group company.

ED FRSME

16.2 Investment property is property (land or a building, or part of a building, or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes, or

(b) sale in the ordinary course of business.

16.4 Mixed use property shall be separated between investment property and property, plant and equipment. However, if the fair value of the investment property component cannot be measured reliably without undue cost or effort, the entire property shall be accounted for as property, plant and equipment in accordance with Section 17.

Examples

Company A owns a freehold office block which is rented out on an arm's length basis to

1) An unrelated third party
2) A company which is a related party of the entity due to common control
3) A company which is a 90% owned subsidiary of A
4) A company which is unrelated to A but the lease commenced part way through the year. Prior to the commencement of the lease A occupied the property but moved to new premises following a period of expansion.

How should the property be treated in A's accounts?

Comments on examples

1) Investment property
2) Investment property
3) Not an investment property (Paragraph 8b, SSAP 19)
4) Investment property. Apply rules under FRS 15 until date of transfer. Therefore, the transfer will occur at net book value. The revaluation to market value will occur at the balance sheet date in the usual way.

Requirements

The requirements below are from the FRSSE but these are, in effect, identical to those contained in SSAP 19. The only difference is a requirement in SSAP 19 for the investment revaluation reserve to be shown in a prominent position. This is a requirement of the CA 06 and hence the reason why it is not specifically mentioned in the FRSSE.

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

6.51 Investment properties shall be included in the balance sheet at their market value and the carrying value shall be displayed prominently either on the face of the balance sheet or in the notes.

6.52 The names of the persons making the valuation, or particulars of their qualifications, shall be disclosed together with the bases of valuation used by them.

If a person making a valuation is an employee or officer of the company or group that owns the property this fact shall be disclosed.

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

Examples

In respect of the above the following scenarios are often encountered.

1. Who is permitted to value investment properties?
2. What basis should be used for the valuation?
3. Are there any other disclosure requirements included in the CA 06?

Comments on examples

1. Paragraph 6 of SSAP 19 says The statement does not require the valuation to be made by qualified or independent valuers; but (in paragraph 12) calls for disclosure of the names or qualifications of the valuers, the bases used by them and whether the person making the valuation is an employee or officer of the company. The PWC manual of accounting adds this comment “there is an underlying assumption that the persons responsible for making the valuation are sufficiently knowledgeable about property valuation principles to enable them to undertake the valuation in a competent manner”.

   Paragraph 6 continues by indicating that, where investment properties represent a substantial proportion of the total assets of a major enterprise (e.g., a listed company) the valuation thereof would normally be carried out:

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

   - at least every five years by an external valuer.

2. Market value. In practice, a variety of methods could be used to approximate market value.
3. No - other than the need for disclosure of the application of the true and fair override. See below.

Revaluation losses

Requirement for **other** assets at valuation

6.25 Revaluation losses caused only by changing market prices shall be recognised in the statement of total recognised gains and losses until the carrying amount of the asset reaches its depreciated historical cost. Other revaluation losses shall be recognised in the profit and loss account.

But the above does not apply to investment properties.

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

Examples

In respect of the above the following scenarios are often encountered.

1. If there are a number of investment properties, can the reserve be maintained on a combined basis and hence there would be no requirement to monitor surpluses and deficits on individual properties?
2. What happens if the property reduces in value to the extent that it falls below cost and in a subsequent period the value increases to an amount above historic cost?

Comments on examples

1. It is necessary to maintain a separate reserve for each property so as to be able to monitor the possibility of a permanent diminution in value.
2. No problem in principle. The revaluation reserve is permitted to be negative.

Legal requirements in UK

The application of this standard will usually be a departure, for the overriding purpose of giving a true and fair view, from the otherwise specific requirement of the law to provide depreciation on any fixed asset which has a limited useful economic life. In this circumstance there will need to be given in the notes to the accounts 'particulars of that departure, the reasons for it, and its effect'. UITF Abstract 7 'True and fair view override disclosures' gives guidance.

In accordance with the [Statement of Standard Accounting Practice 19: Accounting for Investment Properties][Financial Reporting Standard for Smaller Entities

(effective April 2008)] no depreciation is provided in respect of freehold properties which are classified as investment properties. This is a departure from the requirements of the Companies Act 2006 which requires all properties to be depreciated. Such properties are not held for consumption but for investment and the directors consider that to depreciate them would not give a true and fair view.

Changes under FRSME

Investment property whose fair value can be measured reliably without undue cost or effort shall be measured at fair value at each reporting date with changes in fair value recognised in profit or loss. All other investment property as property, plant and equipment using the cost-depreciation-impairment model.

An entity shall disclose the following for all investment property accounted for at fair value through profit or loss:

a) the methods and significant assumptions applied in determining the fair value of investment property.

b) the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and class of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.

c) the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.

d) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

e) a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing separately:

    i. additions, disclosing separately those additions resulting from acquisitions through business combinations.

    ii. net gains or losses from fair value adjustments.

    iii. transfers to property, plant and equipment when a reliable measure of fair value is no longer available without undue cost or effort.

    iv. transfers to and from inventories and owner-occupied property.

    v. other changes.

Property held as current asset

Example

A property trading company purchases a property in November 2010 at a cost of £1.3m. Their intention is to develop the property and resell it.

By the company's year-end which is 31 March 2011, they have incurred further costs of £100,000 but, due to the state of the property market, the company has decided to defer any further development. The carrying value of the property is £1.4m.

The directors estimate that the property value has fallen to £1m.

Should the value be written down?

Comments on Example

Extracts from the standards

SSAP 9 Paragraph 26: The amount at which stocks are stated in periodic financial statements should be the total of the lower of cost and net realisable value of the separate items of stock or of groups of similar items. SSAP 9 Paragraph 21: Net realisable value (of stocks and long-term contracts):- The actual or estimated selling price (net of trade but before settlement discounts) less: (a) all further costs to completion; and (b) all costs to be incurred in marketing, selling and distributing.

The property developer is holding this property within stock. The rules of SSAP 9 apply. The key question is whether the eventual sale of the property will be made at a profit.

Write-downs to recoverable amount Apply to capitalised goodwill and all fixed assets (i.e. tangible fixed assets, intangible assets and investments) except investment properties and financial instruments (other than investments in subsidiaries, associates and joint ventures). Per FRSSE Paragraph 6.44.

CASE STUDY: ASSET OR EXPENSE?

The following question arose on a recent file review.

X Ltd hires out major items of plant such as generators – usually on short term hire. The plant is capitalised and depreciated over five years. When a generator is hired out to a contractor, it is hired with a full tank of diesel. The contractor returns the generator with a full tank or pays for the cost of replenishing the tank. When an item of plant is sold at the end of its useful life, it is usually sold with a full tank.

With the increased cost of fuel, some generators cost as much as £3,000 to fill with diesel. Therefore, in total, the cost of fuel in generators and other equipment is material. In the past, the cost of the diesel has been expensed. Now, the auditors are questioning whether this treatment is correct or whether the cost should be included in stock or even fixed assets.

The starting point in the analysis of this question is to decide whether the entity has an asset or not. The definition of an asset in Paragraph 2 of FRS 5 is:

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

The future economic benefits are realised by the hiring out of plant. It seems that the definition of an asset is met.

Should the asset be included in stock? SSAP 9 does not define the term stock but Paragraph 16 includes the following comment:

"Stocks comprise the following categories:

a) goods or other assets purchased for resale;
b) consumable stores;
c) raw materials and components purchased for incorporation into products for sale;
d) products and services in intermediate stages of completion
e) long-term contract balances; and
f) finished goods."

Categories c) to f) are clearly irrelevant but what about the first two possibilities. I don't think the diesel is held for resale since there is no intention to sell the diesel. You could, perhaps, describe the diesel as "consumable stores" but while the diesel is consumed, it is then replaced. At the end of the life of the asset, the diesel is not consumed, it is sold as part of the asset.

So it seems that the diesel must be a fixed asset. The definition of a fixed asset is in Paragraph 4 of Schedule 10 of SI SI 2008/410 - The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008:

""Fixed assets" means assets of a company which are intended for use on a continuing basis in the company's activities"

Paragraph 8 of FRS 15 states:

"The cost of a tangible fixed asset (whether acquired or self-constructed) comprises its purchase price (after deducting any trade discounts and rebates) and any costs directly attributable to bringing it into working condition for its intended use."

Since the intended use of the plant is to hire it out and since it cannot be hired out without diesel, then the cost of the diesel is directly attributable to the plant in terms of bringing it into its intended use.

But what about depreciation? There is no necessity to depreciate the diesel over the same life as the machine since the asset could be considered to consist of separate elements with different useful lives. However, if a five year life was chosen for the diesel then it could be argued that its residual value (ignoring inflation) would probably be equal to or higher than its original cost therefore the depreciation charge would be zero.

Under this approach, the purpose of the subsequent expenditure on refilling the generator when returned empty would be to ensure that the tangible fixed asset maintains its previously assessed standard of performance. In this case, the subsequent expenditure should be recognised in the profit and loss account as it is incurred.

There is, I think, one other way to look at the diesel under FRS 15. Could renewals accounting be used? It's fair to say that diesel in a fuel tank does not readily fit the explanation provided in FRS 15 which talks about the use of renewals accounting for minor assets in an infrastructure system. Presumably, we would argue that the diesel in each separate tank is a minor asset forming part of the infrastructure of all diesel held by X Ltd.

Paragraph 97(a) says that the infrastructure asset is a system or network that as a whole is intended to be maintained at a specified level of service potential by the continuing replacement and refurbishment of its components.

I have most recently encountered renewals accounting in the hotel trade. Bedding and other soft furnishings are largely interchangeable between rooms. There is a significant cost when acquiring these items when fitting out the hotel. Thereafter, the intention is to maintain the service capacity of the items by “refurbishment” (laundry and dry cleaning) and replacement, if necessary.

Paragraph 97 goes on to say that (b) the level of annual expenditure required to maintain the operating capacity (or service capability) of the infrastructure asset is calculated from an asset management plan that is certified by a person who is appropriately qualified and independent; and (c) the system or network is in a mature or steady state.

Where renewals accounting is adopted, Paragraph 98 says that the level of annual expenditure required to maintain the operating capacity of the infrastructure asset is treated as the depreciation charged for the period and is deducted from the carrying amount of the asset (as part of accumulated depreciation). Actual expenditure is capitalised (as part of the cost of the asset) as incurred.

It is in complying with Paragraph 98 that the use of renewals accounting for the diesel begins to be questionable. Would we argue that the expenditure required to maintain the operating capacity is zero since this cost should not fall on the owner of the asset or would we seek the view of a qualified expert to estimate an average level of default. If this approach were adopted then the actual expenditure to be capitalised would be net of recovery from customers.

What’s your conclusion?

Impact of FRSME: Note that FRSME continues to apply the same basic principles as SSAP 9 and FRS 15. However, renewals accounting is not mentioned in FRSME.

COMMON DISCLOSURE ERRORS IDENTIFIED ON AUDIT MONITORING AND ACCA QUALITY CHECKED VISITS.

(Lecture A343 – 15.42 minutes)

Related party disclosure

Disclosure can sometimes be inadequate. In particular, both FRS 8 and FRSSE require disclosure of:

- Nature of the relationship
- Nature of the transactions
- Balance due to or from related party
- Comparatives
- Ultimate controlling party

Accounting Policies

- The inclusion of a policy for amortisation of land and buildings where no such asset exist
- Reliance on standard ("boiler-plate") disclosures for stock and income recognition that can be misleading if not tailored to be more factual

Fixed Assets

- No disclosure of historical cost of revalued properties
- No disclosure of the details of valuation of properties

Secured loans

- Not always disclosed
- Time apportioning of loan not always done correctly

Other disclosures

- Non disclosure of audit fees
- Non disclosure of other fees paid to auditor for non audit services
- Directors' emoluments not including benefits in kind
- Adequate disclosure, when accounting policies depart from the FRS
- Auditor's reliance on PASE

COMMON DISCLOSURE ERRORS IDENTIFIED ON RECENT FILE REVIEWS

I have identified the following errors and weaknesses in my recent cold file reviews.

Directors' report

Some business reviews could be extended. Weak areas are key performance indicators and risks arising from the current economic environment.

If the market value of land differs substantially from the book value, then the directors should indicate the difference with such degree of precision as is practical.

If charitable or political donations are made, make sure to comply with the extended disclosure requirements in CA 2006.

For political donations and expenditure which in aggregate exceed £2,000, this requires:

- the name of each political party, other political organisation or independent election candidate to whom any such donation has been made, and
- the total amount given to that party, organisation or candidate by way of such donations in the financial year; and
- the total amount incurred by way of political expenditure in the financial year.

Concerning charitable donations which in aggregate exceed £2000:

- for each of the purposes for which money has been given, a statement of the amount of money given for that purpose.

Auditor's report

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

Balance sheet

It is no longer acceptable for the company number to appear only on the front sheet of the filed accounts. Most software packages are now including the company number on the same page as the balance sheet.

Accounting policies

If an accounting policy is not relevant then the policy should be removed.

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

If the accounting policies section contains a basis of preparation note indicating that the accounts have been prepared on a going concern basis then this implies that the directors consider that material uncertainties exist. The note should include all of the matters required by FRS 18 and ISA 570. There should also be an emphasis of matter paragraph in the auditor’s report (if there is such a report).

Notes to the accounts

Recall also the guidance from the FRC which indicates that the accounts should always refer to the impact of the current economic environment even if there is no material uncertainty. This note would not be included in the accounting policies section of the report.

Where accounts are prepared using the full standards, there should be a tax reconciliation.

If there is a large amount of tax losses, this should lead to disclosure of a deferred tax asset even if the directors decide not to recognise the asset in the balance sheet.

There are a number of examples of “common disclosure errors” namely failure to disclose pension costs, the number of directors who are members of pension schemes or obligations under operating leases.

Balances with related parties that are related through common ownership should not be referred to as group undertakings

There is no need to disclose authorised share capital.

If a subsidiary company wishes to take advantage of the exemption in FRS 8 from disclosing transactions within the group, the reason for non-disclosure must be stated in the financial statements. Further, the revised FRS 8 requires that all of the subsidiaries involved in the transactions must be wholly owned not just the reporting entity.

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

Comment

For a number of years, as a result of the increased use of software packages, the quality of accounts disclosures has been improving. As may be obvious from the above, my recent file reviews show a decline in quality.

BRIBERY ACT 2010 – WHAT ACCOUNTANTS NEED TO KNOW

(Lecture A344 – 18.46 minutes)

These notes give an introduction to the Bribery Act 2010 focussing on matters that accountants may need to be aware of. This includes the impact for auditors (laws and regulations) and those responsible for reporting Money Laundering offences. These notes are not intended to be an exhaustive description or analysis of the Act.

Introduction

The Bribery Act 2010 is a consolidation of the existing anti-bribery legislation plus some enhancements, bringing the UK's law in this area up to the required international standard.

It was originally intended to come into force on 1 April 2011 but after a government review the Ministry of Justice announced on 30 March that it would come into force on 1 July 2011.

On the same day it published

- The Bribery Act 2010 Quick Start Guide and

- Guidance about procedures which relevant commercial organisations can put in place to prevent persons associated with them from bribing.

Both of the documents are available at:

http://www.justice.gov.uk/guidance/making-and-reviewing-the-law/bribery.htm.

The offences - overview

There are four offence types in the Act:

I. 'Giving' offences ie, promising, offering or giving bribes whether directly or indirectly.

II. 'Receiving' offences ie, requesting, receiving or agreeing to receive a bribe.

III. Bribery of a foreign public official, which includes foreign government officials and also individuals working for international organisations.

IV. A corporate offence of failing to prevent bribery where a commercial organisation may be guilty if someone who is acting on its behalf commits an offence (under i or iii above).

Note that the final offence can only be committed by a commercial organisation. Whilst the act as a whole has far reaching implications for businesses, the failure to prevent bribery is considered to present particular problems.

Failure to prevent Bribery

Auditors should be particularly aware of the last offence 'Failure by a commercial organisation to prevent bribery' as this might be an issue when considering compliance with laws and regulation – see the relevant section of the notes below.

A commercial organisation may be guilty of the new offence if an associated person is or would be guilty of the offence of bribing another person or bribing a foreign public official with the intent to obtain or retain business or an advantage in the conduct of business for the commercial organisation.

An associated person could be an employee, agent, supplier, consultant, distributor, service provider or subsidiary company, in other words anyone acting for the company.

The only defence to this would be for the company to show that it had in place adequate procedures to prevent bribery. The Government's final guidance sets out six principles on which those procedures should be based:

I. Proportionate procedures;

II. Top level commitment;

III. Risk assessment;

IV. Due diligence;

V. Communication (including training); and

VI. Monitoring and review.

For those interested more detailed guidance is available – see the link above.

The legislation also has the ability to make the directors personally liable if the directors have consented to the offence.

Example

Company A provides computer equipment to large commercial organisations across the world. They use agents to negotiate the sales contracts and pay these agents on a commission basis. The agents are all self-employed. Mr Jones is one of the firm's agents and is very successful in winning a number of very valuable contracts for the company. There is a rumour that he is very successful because he offers gifts/entertainment/cash in return for the contracts. What should Company A's directors do about this and do they have any risk under this new act?

Response

The company could be committing an offence under the Bribery Act as the agents are acting on their behalf. The company should investigate the rumours and if they are found to be true should cease to use Mr Jones as an agent.

The company should also put in place guidelines for all agents on what is acceptable business practice in winning contracts. Indeed once the act is force it should have certain procedures in place regardless of whether it has heard a rumour or not! As a minimum, it should do the following:

- Carry out a risk assessment of their activities and of appropriate due diligence into third parties such as agents and suppliers

- Based on this first step, compile anti-bribery policies and procedures considered and approved by senior officers of the company

- Publish the policies and procedures and amend employment contracts/contracts for services as necessary in a proportionate manner.

If the directors fail to do this they could be accused of consenting to the act of bribery.

Audit Issues arising

Auditors will have to be aware of the implications of the Act, particularly, where an audit client operates in jurisdictions or regions that have a reputation for payments being made which might be considered to be bribes.

ISA 250A deals with laws and regulations and requires the auditor to have an understanding of the legal and regulatory framework in which the client operates. From this understanding the auditor must assess if there are any issues which may cause the entity operational difficulties if it fails to comply with them.

The audit team should consider whether the client's operations are such that there is a risk that they may be affected by the Bribery Act. If the auditor assesses that such a risk may exist then management should be asked what steps they have put in place to mitigate the risk.

For businesses that may be affected by the act, the directors should:

- Consider the level and areas of their business that may be exposed to this type of activity
- Identify those areas of the business that they consider could be most exposed to this activity
- Develop guidelines, policies and procedures for these areas aimed at ensuring the company has adequate procedures to prevent bribery.

The procedures and policies should include guidance on giving and receiving gifts, sponsorship, political donations, corporate hospitality, expenses, facilitation payments and relationships with agents, contractors and distributors.

If the directors are aware that some areas of their business may already be engaging in this type of activity they should investigate and consider taking legal advice as they may have a personal exposure.

What is a bribe?

There is no specific definition of 'bribe' in the Act. However, it outlines cases that would constitute bribery. The key elements of those cases are:

I. A financial or other advantage; and

II. Intention to induce improper performance of a function or, in the case of bribery of a foreign public official, intention to influence the recipient in their capacity as such an official (so no impropriety is required).

The function must be of a public nature, in connection with a business or in the course of employment or on behalf of a body of persons. In other words, the function does not relate to the private life of the recipient of the bribe. It must be a function that the recipient is expected to perform in good faith, or impartially, or from a position of trust. What constitutes improper performance is breach of a relevant expectation that the function will be performed in that way and the test of what is expected is an objective one – what would a reasonable person in the UK expect? Local custom is not relevant.

Penalties

A commercial organisation found guilty of an offence under this act may receive an unlimited fine. Individuals may face imprisonment of up to 10 years and/or an unlimited fine.

Money Laundering Implications

Ignoring the new legislation, bribery is already a criminal offence. Under the new legislation there is more clarity as to when those within the accounting profession are required to report suspicions of money laundering.

Accountants are required to report whenever they are aware of the proceeds of crime so bribery is reportable. Clearly, proceeds of crime exist when a bribe is received. However, when a bribe is given, proceeds of crime also exist because, for example, the organisation has obtained a contract through the giving offence.

Some might ask whether the overseas conduct exemption applies. This is explained in Paragraph 2.4 of TECH 04/08 “Anti-Money Laundering Guidance For The Accountancy Sector”:

> 2.4 None of these offences are committed if:
>
> .....the conduct giving rise to the criminal property was reasonably believed to have taken place outside of the UK, and the conduct was in fact lawful under the criminal law of the place where it occurred, and the maximum sentence if the conduct had occurred in the UK would have been less than 12 months ..... In this Guidance, this is referred to as the overseas conduct exemption.

Therefore, given the maximum sentence of 10 years for a bribery offence the overseas conduct exemption will not apply.

Frequently asked questions

Is corporate hospitality a crime?

Maybe!

The government has issued guidance and makes it clear that ‘The Government does not intend for the Act to prohibit reasonable and proportionate hospitality and promotional or other similar business expenditure... it is, however, clear that hospitality and promotional or other similar business expenditure can be employed as bribes‘.

The guidance states:

‘...there must be an intention for a financial or other advantage to influence the official in his or her official role...‘ [for the section 6 offence].

Therefore, intention is the issue. What is intended with the hospitality being offered? What should be avoided is hospitality that is disproportionate to the situation.

Example

Extending an invitation to a client’s finance director for a match at Twickenham may be reasonable, but an all expenses paid trip to the World Cup final in Auckland in October could be deemed to be excessive. In several places the guidance uses the terms ‘reasonable and proportionate‘ and refers to taking account of the circumstances, including the relevant industry sector, in deciding what is reasonable and proportionate.

What happens if I am in a threatening situation?

What should you do if you are stopped by armed police in a foreign country and a bribe is demanded?

Again, the guidance addresses this specific point. Where ‘life, limb or liberty‘ is threatened, the guidance suggests that the common law defence of duress is very likely to be available. Should this happen it might be advisable to make a report to the relevant person in one’s organisation as soon as practicable.

Can I pay routine facilitation payments? (Sometimes it is the only way to get things done promptly)

The government guidance is clear on this – No.

It states:

"Facilitation payments, which are payments to induce officials to perform routine functions they are otherwise obligated to perform, are bribes. There was no exemption for such payments under the previous law nor is there under the Bribery Act."

It goes without saying that this is extraterritorial and applies everywhere in the world – even where facilitation payments are customary. However, legally required administrative fees or fast-track services are not bribes.

UPDATE ON CHARITABLE INCORPORATED ORGANISATIONS (CIOS)

A CIO has the advantages of being an incorporated entity (e.g. can enter into contracts in its own right, its trustees will normally have limited or no liability for its debts etc) with the added bonus of sole regulation by the Charity Commission. CIOs have been on the table since the Charities Act 2006 received Royal Assent back in November 2006, and remain one of the most eagerly awaited provisions of the Act to be implemented.

However, the history of the CIO has been a long and tortuous one. On 17 September 2009, the (now defunct) Office of the Third Sector finally published the responses to its consultation on CIOs which closed at the end of 2008. At this point, the aim was for further details to be published by the end of 2009, with the CIO becoming an option for charities starting from Spring 2010. However, Spring came and went, and, as many practitioners in the charity sector are aware, no real progress was then made for some time.

However, on 28 March 2011, in advance of final regulations being released by the government, the Charity Commission published the first part of its guidance plus two model constitutions for anyone considering the setting up of a CIO. Once final regulations have been debated in Parliament and agreed, the Office for Civil Society will set out a timetable for implementation. It is worth noting that the documents may be subject to change once Parliament has agreed the regulations, however any changes are expected to be fairly minor.

Following the recent trend with excepted and exempt charities, implementation will be phased in. It is expected that new organisations will be among the first to be able to register as CIOs, with existing charitable companies being able to convert to CIOs later.

In the meantime, the Scottish Government made provision for the Scottish CIO Regulations, which commenced from 1 April 2011. The Office of the Scottish Charity Regulator (OSCR) has also produced detailed guidance and a set of FAQs available on its website, covering some of the key points relating to Scottish CIOs and the issues to consider before applying. OSCR is also taking a phased approach, whereby existing charitable companies and charitable industrial and provident societies will have to wait a year until 1 January 2012 before they can convert.

The Charity Commission has indicated that CIO will be most suitable for small to medium-sized organisations that employ staff or enter into contracts.

The guidance and the model constitutions are available to download from the Charity Commission's website

Published on SWAT UK website, 13 April 2011

AUDIT REPORTS

(Lecture A345 – 10.39 minutes)

The APB has issued ISA 700 (Revised) "The Auditor's report on financial statements". It applies for accounting periods ending on or after 23 March 2011. It amends the short form description of the scope of an audit to refer to the auditor's responsibility under ISAs (UK and Ireland) to read all the financial and non-financial information in the annual report to identify material inconsistencies with the financial statements.

The new short form description of the scope of an audit included in this ISA is as follows:

''An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the [describe nature of entity] circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by [describe those charged with governance]; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the [describe the annual report] to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.''

The final two sentences "In addition………………..for our report" are new. They were not included in the original ISA 700 issued in October 2009 which applies, like all other clarified ISAs to accounting periods ending on or after 15 December 2010.

This revised ISA 700 indicates that early adoption is encouraged. There would therefore be no harm in adding these two new sentences in the scope of the audit section of the report, if the short form description approach is adopted, for accounting periods ending on or after 15 December 2010.

The APB has also issued a revised version of 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 revision amends each of the illustrative auditor's reports in the bulletin to reflect the change to the short form description of the scope of an audit. The effective date included in the title has not been changed.

Published on SWAT UK website: 23 February 2011

IMPLEMENTATION OF THE CLARITY ISAS

Most firms have, by now, had some experience of the clarity ISAs. Some firms have chosen to accelerate their annual file review process to get early feedback on their progress from their external reviewers. The indications are that the APB's prediction of problem areas is being realised in practice. For example, a common response to ISA 540 is to complete the audit programme with N/A in the mistaken belief that "our clients don't perform accounting estimates".

We will provide you with full feedback from our cold file reviews in due course but, in the meantime, we will look again at the problem areas. We have produced example working papers dealing with some of the requirements of ISAs 540 and 550. These working papers are not presented as perfect illustrations but rather as aids to discussion. ISA 600 is covered by way of FAQs. Finally, in this section of the course, we present feedback from the QAD which provides advice on what they see as the major problems in ISA implementation.

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

(Lecture A 346 – 11.48 minutes)

Selected extracts

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

- Provision for doubtful debts
- Stock write-downs
- Warranty obligations
- Depreciation

- Outcome of long term contracts

The auditor's knowledge of the business is required to include an understanding of the following:

1. The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.

2. How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements.

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

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

The auditor is required to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period.

The review will provide information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process. It will also provide the auditor with information about estimation uncertainty and possible management bias.

The auditor is required to evaluate the degree of estimation uncertainty associated with an accounting estimate. The auditor must then determine whether any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

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

The auditor must consider whether there are indicators of possible management bias. Such indicators do not necessarily mean that individual accounting estimates are misstated. A change in the method of making an accounting estimate may be seen as an indicator of possible management bias if assumptions are being selected which give estimates favourable for management objectives or if the auditor's opinion of misstatements in estimates show a pattern of over- or under-optimism.

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

Practice note 26: guidance on smaller entity audit documentation

The amended version of PN 26 provides an illustrative working paper dealing with property valuation. Whilst this is a perfectly adequate working paper, I don't think it covers all of the issues in ISA 540. I offer therefore the following suggestion as an example of the sort of documentation that may be appropriate.

Knowledge of the business

Accounting estimates

Initially, management rely on us to advise them if an accounting estimate is required. We will then discuss with them methods that could be used which might be appropriate to their business. Once a method has been established it will be used consistently from year to year except where there is evidence that the estimate is yielding inappropriate results.

The same methods are used in the management accounts. The only controls in place are supervisory controls ie the board reviews the management accounts and would highlight unexpected fluctuations for further examination.

Discussed with John Smith (MD) on 14 July 20xx and he was not aware of the need for any new accounting estimates or of a need to revise any existing methods. They do not assess the effect of estimation uncertainty – John said that they leave it to us to highlight any problems requiring attention.

Warranty provision

The company delivers products with a one year warranty which guarantees to repair all defects which are reported within that period. Prior to 1999, the warranty provision had been carried forward at the round sum figure of £150,000. Expenditure on warranty work was not separately accounted for. With the issue of FRS 12, management started to charge costs incurred on warranty work to a separate cost code. The costs charged include time costs (calculated using the same rates as used for stock valuation purposes so as to include direct overheads) and material costs. There is no charge included for administration. This analysis showed that, on average, warranty work was costing the company 0.8% of turnover. This percentage has been used in the accounts ever since.

Recent results show the following:

Year	*Provision*	*Actual costs charged to warranty cost code*
Last year	*£84,365*	*£36,687 (in first 6 months of this year)*
Previous year	*£91,320*	*£65,809 – actual 0.58%*
Year before that	*£75,800*	*£48,967 – actual 0.52%*

This shows that provisions made in previous years have tended to overestimate the costs involved. In fact, discussion with Alf Brown (operations manager) on 15 July 20xx seems to indicate that the manufacturing process is becoming more reliable and therefore less claims are arising. Also, with recession, claims are examined more carefully and a conscious attempt is made to perform the necessary repairs in a cost-effective way.

Our evaluation of estimation uncertainty: the maximum possible overstatement in the warranty provision is 0.8% of turnover. However, some claims are bound to arise and therefore some provision is appropriate. It is unlikely therefore that there could be a material misstatement in the warranty provision taken alone. It is not therefore a significant risk. However, the potential error is sufficiently large such that, taken with other estimates, there could be a material misstatement and/or an indication of management bias.

Extract from working paper on provisions

Provision in draft accounts (0.8% of turnover)	*74,902*	*(Last year: £84,365)*

Calculation checked and found to be consistent with previous year's method.

Our review of previous years suggests that an estimate of between 0.5% and 0.6% may be more appropriate. However, not all of the claims which arise within a financial year relate to sales of the previous financial year. The method in use is not therefore completely appropriate.

Discussed with directors (John and Jenny) on 23 July 20xx. They preferred to keep the provision at 0.8% on the grounds of consistency and prudence. I pointed out that Alf Brown thought that claims were getting lower because of improvements in the product. John dismissed this view and Jenny added that they were bracing themselves for more claims because the impact of recession on their customers may make a claim more likely.

The directors were surprised at my comment that the method may not be appropriate since nobody had ever complained before. However, they agreed that they would set up separate cost codes in the future so that claims could be analysed between those that applied to the current year and those that applied to the previous year. John thought that most defects did not show themselves until near the end of the 12 month period and said he was confident that the new analysis would back up his view.

Conclusion

I estimate that the claim rate is now running at about 0.6%. If we assume that defects arise equally over the 12 month warranty period then the provision should only be half of this amount ie 0.3%.

This suggests that the warranty provision should be £28,088. The difference of £46,814 has been taken to the summary of errors schedule as a judgemental error. It has also been noted on the audit summary schedule for consideration of management bias alongside other accounting estimates.

ISA (UK & IRELAND) 550: RELATED PARTIES

(Lecture A 347 – 7.15 minutes)

Selected extracts

This is one of the clarity ISAs where the APB expects the auditor’s costs to increase considerably.

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

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

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

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

Practice note 26: guidance on smaller entity audit documentation

The amended version of PN 26 does not deal in any detail with the impact of the new ISA 550. However, guidance from the ICAEW suggests that working papers may need to include the sort of detail shown in the extracts below.

Knowledge of the business

Related parties

Directors of XYZ Ltd: John Smith and Jenny Robinson

Other key management personnel: Alf Brown (operations manager)

Close family members:

John: Jean is his wife, Jake and Jilly are their children. None of these three have any contact with XYZ Ltd although Jean holds 10% of the ordinary shares.

John has two brothers called Jim and Jack (Smith). John has a sister called Judy Jones.

John's parents are deceased.

Jenny: (similar comments).

Alf: (similar comments)

Companies etc controlled by the above:

Jim Smith is the major shareholder in a company that imports bananas. XYZ Ltd has no use for bananas.

Jack Smith controls A Ltd. A Ltd is a customer of XYZ Ltd. The directors have authorised that sales should be made to A Ltd at a discount of 15% on book prices. Note: this requires disclosure as a transaction not at arm's length and this fact has always been included in the related party transactions note – noted on points for partner to ensure that this disclosure is correct this year.

Judy Jones is a chartered accountant and sole practitioner. She does not do any work for XYZ Ltd.

Similar comments for Jenny and Alf's close family.

The above information was discussed with John Smith on 14 July 20xx. He confirmed that there had been no changes in the above. The only related party with which the business transacts continues to be A Ltd. There are no formal controls over related party transactions but he confirmed that there are no customers (other than A Ltd) which receive discounts and that any discounts would require the approval of a director.

Extracts from notes of team meeting:

Related parties

Jane Johnson (partner) drew attention to the list of related parties in the PAF. She said that there was no history of problems in this area and there had been no previous occasions where the audit team had detected undisclosed related parties. Nevertheless Jane emphasised the importance of maintaining professional scepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions. She reminded the team to be alert throughout the audit for indications of related party transactions or transactions outside the normal course of business.

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

Introduction

ISA 600 is the most changed of all the Auditing Standards. In the APB research, it was considered that this standard alone would add 3% to the cost of the audit of large and listed entities. From this it might be interpreted that there is no great impact on the auditors of smaller entities. However, many audit firms of all sizes have UK clients with subsidiaries abroad and, in this case, there will be some significant changes in how they conduct their work.

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

FAQs on group audits

Q1. My firm audits a small UK company which is part of a large international group. We do not audit any other members of the group. I understand that the new clarity ISA on groups is more onerous than the previous ISA. How will this affect me?

A. It won't – or, to be more precise, it will not affect you directly. Whilst the clarified ISA 600 contains many requirements which affect component auditors, the responsibility for meeting these requirements falls only on the parent company auditor. It is, therefore for the parent company auditor to decide how they are to meet the requirements of ISA 600.

As far as you are concerned your work on the UK company should be sufficient to support your own opinion on that company's accounts. It is the responsibility of the parent company auditor to comply with the requirements of ISA 600 and this might lead them to make more demands of you than they have in the past.

Q2. My firm audits all of the members of a group of UK companies. I understand that the new clarity ISA on groups is more onerous than the previous ISA. How will this affect me?

A. There are no major complications here since your firm audits all of the components of the group. You need, however, to be aware of the requirements concerning the consolidation process in paragraphs 32 to 37 of ISA 600. In essence, these paragraphs require:

- An understanding of the consolidation process
- The design and performance of further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process which includes evaluating whether all components have been included in the group financial statements
- The evaluation of the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and the evaluation of whether any fraud risk factors or indicators of possible management bias exist
- Where the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the evaluation of whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements.
- The determination of whether the financial information identified in the component auditor's communication is the financial information that is incorporated in the group financial statements.
- If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the evaluation of whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.

Paragraph 38 reminds us that the consideration of subsequent events in the group accounts may be made difficult where the financial statements of some components have been finalised at a date before that of the group accounts

Further FAQs concerning group audits are provided later in these notes. See part 8 in the section of the notes dealing with feedback from the QAD.

Practice note 26: guidance on smaller entity audit documentation

The amended version of PN 26 gives an example of a planning memo for the audit of a small group. Materiality is dealt with in the following way:

> Group materiality is set at £22,500. Performance materiality for the group accounts is £20,000 and materiality for the subsidiary audits is £15,000. We will audit the parent company's holdings of investments in the subsidiaries to a materiality of £15,000.

The approach for each of the subsidiary companies is then set out in the memo and this shows the decision to treat some components as significant because of individual financial significance whilst others are significant because of significant risks. The planned audit approach for each significant component is recorded along with a brief indication of the communications required with component auditors. Other components are considered to be not significant and the plan is that these should be audited by the group auditors using analytical procedures only.

FEEDBACK FROM THE QAD

(Lecture A348 – 23.00 minutes)

Introduction

The QAD have organised a series of webinars to assist auditors with the implementation of the Clarified ISAs. The first was held in February 2011 and further webinars are planned for later in 2011.

The webinars are presented by QAD reviewers currently under secondment to ICAEW member services. These reviewers have been helping members adopt the new Clarity standards and have a useful perspective to judge where the problem areas are going to be.

Below is a summary of the most interesting tips and pitfalls that they identified during the webinar, together with anecdotal evidence from other QAD reviewers. It has to be remembered that the new Clarity ISAs are in force from periods ending 15 December 2010, so there is little practical feedback from the QAD at the time of writing. More useful feedback from the QAD is only likely after the first complete cycle of audits under the new Clarity Standards has been completed.

Avoiding Clarified ISA Pitfalls

1. Recognising that the Standards have changed

Even three years after the ISAs came into force some firms still said they were unaware that the SASs had been replaced. The QAD reported that when they visited these firms, auditors had said that they did not implement the International standards because they did not have any international or listed audits.

Predictably, not knowing that the Standards have changed is likely to lead to some serious regulatory implications!

2. Documentation of the names of related parties

Paragraph 28 of Clarity ISA 550 Related Parties, requires the auditor to include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

At first sight this does not appear to be an onerous requirement however sometimes auditors and directors alike are much more concerned with related parties with whom there are transactions because these have to be disclosed in the financial statements. The Clarity Standard requires the auditor to document the names and relationship for all related parties.

Theoretically, this should be fairly straightforward because, as the application material in the Standard states, management should have this information to hand to assist with the preparation of the financial statements. In reality, however, many directors are not as diligent or knowledgeable in this area as they should be and the auditor may have to encourage them or even help them compile this information. It needs to be remembered that any assistance in this process will invariably be a non-audit service related to the preparation of the accounts rather than part of the audit and, as such, the threats and safeguards relating to the auditor's independence will need to be considered.

Case Study

The auditor asked the company directors for details of the names and relationships of related parties. Three out of the four directors provided the auditor with a list of companies that they control/influence and close family members.

The fourth director refused to provide what he considered to be confidential information. What does the auditor do?

In this particular case there are two issues. Firstly the scope of the audit has been limited so a qualified audit report would be appropriate. Secondly, the auditor has not received the information and explanations requested from management and this should also be reported in the auditor's opinion. This case study might sound extreme but it is based upon a real case in February 2011!

3. Significant risk

Under the existing standards auditors sometimes do not properly document their consideration of and response to significant risk. ISA 315 defines significant risk as:

"An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration"

The Clarity standards expand the auditors' responsibilities in a number of areas to consider various risks and whether they are significant or not.

Identifying significant risks

Throughout the Clarity auditing standards, particularly in ISAs 240, 315 and 330, there are references to significant risk but the areas that are most often overlooked are:

Fraud in revenue recognition

There is a rebuttable presumption that there is a significant risk of fraud in revenue recognition. This means that the risk needs to be considered (and documented) even in its absence. More often than not there are significant risks of fraud in revenue recognition which the auditor needs to address.

Related parties

The auditor must always consider whether there is a risk of fraud concerning related parties (ISA 550, para 18). In particular, where there are significant transactions with related parties outside the entity's normal course of business, the auditor must always treat this as a significant risk.

Accounting estimates

Where there is high estimation uncertainty in accounting estimates the auditor must consider whether there is a significant risk (ISA 540, para 11)

Management override of controls

The implications of this are often overlooked. This is covered in more detail later in these notes.

The increased focus in the Standards on fraud in revenue recognition has been present since the ISAs were first implemented in 2005. Clarity has added the risks involving related parties and accounting estimates.

However, these are not the only significant risks that auditors will come across. In considering whether a risk is a significant risk auditors should consider:

a) Whether the risk is a risk of fraud;

b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;

c) The complexity of transactions;

d) Whether the risk involves significant transactions with related parties;

e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

Responding to significant risk

Where significant risks have been identified there are a number of consequences for the auditor:

- The nature of the risks and the audit approach in these areas will require more careful documentation.

- The auditor is specifically required to gain an understanding of internal controls in the relevant area. This involves understanding the design and implementation of internal controls which will include walkthroughs.

- Where internal controls are to be relied upon the auditor has to perform compliance tests on those controls in the period and cannot rely on a three year rotational approach that they might have otherwise adopted.

- Tests of detail are required i.e. analytical procedures alone will not be sufficient.

4. Accounting estimates

ISA 540 Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures has a number of new requirements. The particular requirement that is likely to not receive the attention that it deserves, by some auditors is paragraph 9. This requires auditors to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period.

The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time.

This requirement is intended to ensure that the auditor properly understands the way that accounting estimates are made and will assist in the risk assessment process. Auditors may already be doing this but of course it needs to be documented in a way that adequately demonstrates that the auditor has complied with the Standard.

Documentation

By way of example the audit documentation on understanding the accounting estimates and the related risk assessment could centre around a single document on the permanent file similar to the one below:

Accounting estimate	How is it made	Accounting framework	Risk assess-ment	Significant risk	PY Review
Trade debtors – bad debts	All debts older than 6 months are provided against	FRS 12	L	N	B32

Revenue recognition – incomplete contracts at the year end	Contracts not complete at the year end are brought to revenue at fair value – estimated to be 80% of the value of recorded time on the cost cards.	UITF 40 – fair value	H	Y Recovery rates vary in practice and due to the length of contracts this is highly significant	B30
Stock provision	The operations director reviews post year end sales for low NRVs	SSAP 9 – lower of costs and NRV	M	N	B33

5. Documentation of oral communications with those charged with governance

Under the Clarity ISAs the requirement to communicate in writing with those charged with governance has been removed. In ISA 260 Communication with those charged with Governance, paragraph 19 requires the auditor to communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit.

It is predicted that some auditors will choose to communicate with those charged with governance using oral communications alone where possible, rather than produce what many call a management letter.

However, it would be easy for auditors to miss another change in the Standard which requires them to document oral communications with those charged with governance.

The formal process of producing a management letter encourages auditors to document their work, but there is a danger that a move to oral communications alone will result in less clear documentation of what was communicated.

The following is not meant to be an exhaustive list of what needs to be communicated but it does highlight the scope of what is required:

- The auditor's responsibilities in relation to the audit
- Timing and scope of the audit
- Significant difficulties encountered during the audit
- Significant matters discussed with management
- Accounting issues
- Auditor independence
- The audit report
- Significant findings from the audit
- Other significant matters
- Significant deficiencies in internal control

Also, it must not be forgotten that ISA 265, specifically requires the communication of significant deficiencies in internal control to be in writing, even where the auditor has taken the decision not to send a management letter to communicate other issues.

6. Materiality

The new Auditing Standards (ISA 320 Materiality in planning and performing an audit and ISA 450 Evaluation of misstatements identified during the audit) address materiality differently from the previous ISAs and some of these detailed changes are the subject of a number of questions from delegates on CPD courses.

We included the QAD comments on these issues in the previous set of update notes.

7. Standard letters

Many auditors use a bank of standard letters such as scoping or planning letters, engagement letters, written representations and management letters.

All of these standard letters need to be carefully reviewed to ensure that all new aspects of the Clarity Standards have been addressed.

It is likely that most standard letters will need amendment to comply with the Clarity Standards.

Note, ICAEW has produced a help sheet that assists with the drafting of an audit engagement letter under the Clarity Standards. It is titled PAS2/HS13 February 2011 and is available from www.icaew.com.

8. The group auditor's involvement in component audits

The changes in auditing resulting from the Clarity ISAs tend not to be radical. However, the Standard that addresses group audits (ISA 600) is regarded by many as an exception to this. Where a component of the group is significant to the group financial statements then the group auditor has to be involved in the audit of the component.

There is a danger that group auditors don't read the Standard properly and consequently don't change how they approach group audits to respond to the challenges of ISA 600. For significant components, group auditors need to be involved in the component auditor's risk assessment. This involves at a minimum:

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

Where the group auditor does not have a very good understanding of the component and the component audit this work will often be best done face to face rather than over the phone.

Other interesting questions are:

Q: My audit client is a UK subsidiary of a holding company in the US. The holding company auditor has asked for my audit file to be scanned and sent electronically to them. I am concerned about the safe custody of the file, but, I understand that they have a right of access so do I have to comply with their request?

A: In short, you are not required to comply with their request. Firstly, the Companies Act only imposes a duty on UK auditors to co-operate with other UK auditors. It does not apply to overseas auditors. However, subject to your client consenting to waiving your duty of confidentiality to them to enable you to communicate with the US auditor, paragraph A59 of ISA 600 indicates that you would provide them with access to relevant audit documentation if not prohibited by law or regulation.

However, “access to relevant audit documentation” does not necessarily mean there is a duty to provide access to the file, and definitely not a duty to provide a copy of the file. As possible alternatives to providing a copy of the file:

- ISA 600 suggests that a component auditor might supply the group auditor with a summary memorandum or similar outlining the component auditor's conclusion with regard to the identified significant risks and a summary of their conclusions thereon.

- The group auditor could come to the UK and review the file here.

Q: I audit a small charity with income of approximately £1M which has recently started to prepare group accounts. Nearly half of the group’s activity takes place in a component in Kenya. Under the new clarity ISA 600, I understand that I am required to be more involved in the audit in Kenya, which is undertaken by a large international audit firm. If I visit Kenya to fulfil my responsibilities, the time and travel costs would be overly burdensome on such a small charity. Is there a more practical solution?

A: It is correct that the new clarity ISA 600, Special Considerations - Audit of Group Financial Statements, does require more involvement in the component audit. However, subject to the requirements of the Standard, it is important to underline at the outset the extent of your involvement in the component audit is largely a matter for your professional judgment.

The component in Kenya appears to be an individually financially significant component. As such the standard requires you to participate in the component auditor’s risk assessment by, at a minimum, discussing with them the key issues affecting the business and the key risk areas. In addition, at a minimum, you should

review the component auditor's work on the areas of significant risk. The higher the risks of error in the component's financial statements the more you will need to be involved in the audit.

Also, the extent of your work as group auditor is dependent upon your understanding of the component auditor. You will need to make enquiries to understand their regulatory environment, their quality control systems and the way they approach their work. If, after making appropriate enquiries, you have no concerns about the work of the component auditor then you may be able to communicate with them by telephone and electronically, rather than visiting in person.

In order to assist the client in avoiding heavy additional costs the component auditor might provide you with copies of relevant workings papers and/or a summary memorandum so that you can evaluate their work without the expense of visiting. However, professional judgment in this is a key and it has to be recognised that face-to-face meetings (if not every year, at least on a periodic basis) and reviews of working papers might be required.

For more information on this, read the faculty guidance on Auditing in a Group Context

9. The risk ISAs – including the risks resulting from management override of controls

With all the excitement over new requirements in revised Clarity Standards it is going to be easy to forget that the Standards that really sit at the heart of the audit are the risk ISAs, namely:

- ISA 315 – Understanding the entity and its environment and assessing the risks of material misstatement
- ISA 330 – The auditor's procedures in response to assessed risks
- ISA 240 – The auditor's responsibility to consider fraud in an audit of financial statements

The requirements where auditors might continue to poorly document their work may continue to be:

- The audit team discussion
- Recording of internal controls
- Walk through procedures on internal control
- Addressing the significant risk of fraud in revenue recognition and
- The documentation of issues in an entity that relate to the risk assessment

Also, whilst these Standards have only been redrafted rather than revised it is easy to miss that some things are different. For instance the way that auditors address the risk of management override of internal controls is much more focused.

The standard states that management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

So where management override exists, it has to be treated as a significant risk and that has a number of implications for the auditor's work and documentation. See the section earlier in these notes which addresses that point.

ISA 240 also states in para 32 that irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

In designing and performing audit procedures for such tests, the auditor shall:

I. 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;

II. Select journal entries and other adjustments made at the end of the reporting period; and

III. Consider the need to test journal entries and other adjustments throughout the period.

So auditors cannot simply ignore closing journals. These always need to be tested in some way.

10. New mandated procedures

These could be a remarkably big problem. There are numerous new requirements in the redrafted standards that do not get discussed much, because there are much more obvious issues in Clarity such as groups, accounting estimates and related parties.

It will be very easy for auditors to miss these new mandated procedures in various redrafted standards because auditors might be under the impression that a redrafted standard that has not been revised is unchanged. This is only partly true. The requirements might not have changed from what the IAASB meant in the original standard but they might have changed from what auditors thought they meant.

The Redrafted standards include a number of new mandated procedures. Here are some examples below. This is not intended to be an exhaustive list these are merely representative examples of what auditors might find in numerous standards:

Stock takes – the procedures that the auditor must undertake at stocktake have been extended and now include:

- Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
- Observe the performance of management's count procedures;
- Inspect the inventory; and
- Perform test counts

Litigation and claims

Auditors are now required to design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel

b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

c) Reviewing legal expense accounts.

Laws and regulations

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

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

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

Initial audit engagements

The auditor is now required to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements, when conducting an audit for the first time, by:

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

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

c) Performing one or more of the following:

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

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

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

Conclusion

Some auditors might look at these new mandated procedures and say that this is what they are doing anyway. Indeed any competent auditor will be doing these things because they are usually the most sensible way for an auditor to fulfil their responsibilities. However, care must be taken to ensure that these are always undertaken and properly recorded to demonstrate through the audit documentation that the relevant standards have been complied with.

Read the standards

With this in mind, in order to get to grips with the detailed requirements of the standards, auditors should read the new Clarity Standards. Many auditors are going to become tired of this point! Because the Clarity Standards are long and intimidating to some there is a risk that many auditors won't actually read them.

However, complying with something that you have not read is always going to be a challenge. Open the book and read the Standards!

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.

ASB issues a Financial Reporting Exposure Draft: Amendments to FRS 29 (IFRS 7) 'Disclosures - Transfers of Financial Assets'

The Accounting Standards Board (ASB) of the FRC has today published a Financial Reporting Exposure Draft (FRED) for public comment aimed at improving the disclosures on transfers of financial assets. The proposals amend the disclosure requirements in FRS 29 (IFRS 7) 'Financial Instruments: Disclosures'. They incorporate new disclosure requirements that would help users of financial statements evaluate an entity's risk exposure arising from transfers of financial assets as well as any resulting impact on its financial position.

The need for the proposed amendment has arisen as a result of the International Accounting Standards Board (IASB) amendments of the disclosure requirements in International Financial Reporting Standard (IFRS) 7 'Financial Instruments: Disclosures' during October 2010. The amendment enhances the information currently provided in financial statements in relation to risk exposures arising from transfers of financial assets by an entity. As the requirements in FRS 29 are converged with those in IFRS 7, the proposals in this ASB amendment to FRS 29 (IFRS 7) are identical to those IASB amendments and would ensure that the requirements in the two standards do not diverge.

The FRED is open for comment until 30 April 2011.

28 February 2011

FRC announces Inquiry into Going Concern Assessments

The FRC today announces the launch of an Inquiry to identify lessons for companies and auditors addressing going concern and liquidity risks. The Inquiry will draw on the experience of companies and auditors who have had to address these issues in times of difficulty, including during the credit crisis. The Panel of Inquiry will recommend measures, if any, which are necessary to improve the existing reporting regime and related guidance for companies and auditors in relation to these matters.

The Panel of Inquiry will be led by Lord Sharman of Redlynch, and will additionally include David Pitt-Watson and Roger Marshall.

Announcing the Inquiry, FRC Chairman Baroness Hogg said:

> "Two years ago, at the height of the credit crisis, we looked into and provided guidance on addressing the exceptional risks to going concern and liquidity facing companies, which was updated after extensive stakeholder consultation in November 2009. This met the immediate need for guidance at a time when bank lending to companies was being dramatically curtailed. Although credit markets have since stabilised, going concern and liquidity risk continue to be critical corporate reporting and audit issues. In launching this inquiry, our aim is to ensure the lessons of the recent past are captured, our guidance developed as necessary and best practice in dealing with a range of related issues shared widely."

Lord Sharman said:

> "I am pleased to have been asked to lead this important Inquiry. The quality of the information companies provide about their financial health and their ability to withstand the stresses they face in the short to medium term underpin market confidence.
>
> The Panel of Inquiry looks forward to receiving input, through written submissions and discussions, from a wide range of interested parties including executive and non-executive directors and members of audit committees, the auditing profession, representatives of shareholders and other providers of capital, regulators and others. We expect to issue a call for evidence in the near future."

08 March 2011

The APB issues Feedback Paper on Auditor Scepticism

The Auditing Practices Board (APB) of the FRC today issues a Feedback Paper that summarises the comments received in response to its Discussion Paper *Auditor Scepticism: Raising the Bar* and outlines the action that the APB, and other parts of the Financial Reporting Council (FRC), intend to take. In developing this paper, the APB worked closely with the Professional Oversight Board (POB), which through its Audit Inspection Unit, monitors the conduct of audits of larger entities.

A copy of the Feedback Paper may be downloaded free of charge from the publications section of the APB's web site (http://www.frc.org.uk/apb/publications/pub2343.html).

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

"While responses to the Discussion Paper demonstrate widespread agreement on the critical importance of auditor scepticism to audit quality, there is less agreement on the nature of scepticism and its role in the audit. The APB intends to undertake further work in this area to ensure there is a consistent understanding of its nature and role, increased transparency of its application and appropriate consideration of the financial statement presentation of matters subject to significant challenge by auditors. In addition, the POB will consider what policies and procedures are needed to ensure that audit firms develop and nurture the appropriate mindsets in their

partners and staff and the AIU will continue to focus on the extent to which scepticism has been applied in practice in those audits subject to inspection".

In light of the responses to the Discussion Paper, the APB has decided to undertake work in the following areas:

- Ensuring that there is a consistent understanding of the nature of professional scepticism and its role in the conduct of an audit.
- Reviewing ISAS (UK & I) for possible ambiguities in relation to the nature and importance of professional scepticism, and proposing such changes as may be needed to make sure the position is clear.
- Reviewing ISQC (UK & I) 1 to ensure that it has sufficient requirements and guidance relating to the need for firms to have appropriate policies and procedures for promoting the competencies that underlie professional scepticism.
- Considering how the application of scepticism can be made more transparent.
- Considering, with other parts of the FRC, whether there is a need for guidance on the approach to be taken by auditors when considering the presentation in the financial statements of matters that have been the subject of significant challenge by the auditors.

In addition the Audit Inspection Unit will continue to focus on the extent to which scepticism has been applied in practice and the Professional Oversight Board will explore how scepticism is recognised within the audit firms' competency frameworks.

10 March 2011

Statement by the Financial Reporting Review Panel in respect of the report and accounts of Rio Tinto Plc

As a result of a complaint made in July 2010 the Financial Reporting Review Panel of the FRC has had under review the report and accounts of Rio Tinto plc for the year ended 31 December 2008. In this review the Panel has taken into account Rio Tinto's directors' report for the year ended 31 December 2009.

The Companies Act 2006 provides that the business review included in the directors' report must contain a fair review of the company's business and that the review required is a balanced and comprehensive analysis of the development and performance of the company's business during the financial year and the position of the company's business at the end of the year. In discussions with Rio Tinto the Panel has been considering whether additional information about some of the company's operations referred to in the 2008 business review ought to have been included in the review in order to comply with the Act's requirement for a balanced analysis.

Following these discussions, in their report and accounts for the year ended 31 December 2010, published today, the directors of Rio Tinto include more information

about environmental matters, social and community issues and related reputational risk.

The Panel welcomes the action taken by the directors and regards its enquiries as concluded.

15 March 2011

APB publishes Practice Note 11 (Revised) - The Audit of Charities in the UK

The Auditing Practices Board (APB) of the FRC today publishes a revision of Practice Note 11 “The Audit of Charities in the UK”. An exposure draft of the revised Practice Note was issued in October 2010 for public comment.

The revision updates the current guidance to reflect:

- the new International Standards on Auditing (ISAs) (UK and Ireland) which apply to audits of financial statements of charities for periods ending on or after 15 December 2010; and
- changes in the legislative and regulatory framework, in particular to recognise a new regulator in Northern Ireland and changes to reporting thresholds.

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

“This Practice Note provides guidance for auditors of charities. It is used extensively by the auditing profession. The APB hopes that auditors of charities will find the revised and clarified guidance helpful in carrying out their work."

16 March 2011

The APB also issued revised guidance on the Audit of Banks and Building Societies in the United Kingdom (a revision of Practice Note 19) on 29 March 2011

Proposals for a Public Benefit Entity Standard for Tier 2 Entities

The Accounting Standards Board (ASB) of the FRC has today published Financial Reporting Exposure Draft (FRED) 45. This sets out proposals to be included in a Financial Reporting Standard for Public Benefit Entities (FRSPBE) to accompany the proposed Financial Reporting Standard for Medium-size Entities (FRSME).

The FRSPBE has been developed because IFRS based standards are written for the ‘for-profit’ sector and do not address some transactions that are specific to the public benefit entity sector.

It is proposed that the FRSPBE will be mandatory for entities which meet the definition of public benefit entity that apply the proposed FRSME.

A public benefit entity has been defined as:

An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members.

Issues which have been addressed include:

- Concessionary loans;
- Property held for the provision of social benefits;
- Entity combinations;
- Impairment of assets;
- Funding commitments; and
- Incoming resources from non-exchange transactions (donations etc).

Roger Marshall, Chairman of the ASB said:

> "The proposals in FRED 45 clarify how some PBE sector specific transactions should be accounted for. Many of the proposals mirror the requirements in existing literature and Statements of Recommended Practice, and therefore are consistent with current practice."

FRED 45 also contains a consequential amendment which will in effect reinstate the requirements of FRS 30 'Heritage Assets' into the FRSME.

The ASB is grateful to the members of the Committee on Accounting for Public Benefit Entities for their efforts in developing these proposals.

The consultation period will run until 31 July 2011. It is proposed that the new Standard will be effective at the same time as the FRSME which is currently proposed for annual reporting periods beginning on or after 1 July 2013.

The consultation period for the draft FRSME ends on 30 April 2011. The ASB will be considering the responses it receives to the draft in May 2011 and will post on its website its tentative decisions as this redeliberation work progresses.

18 March 2011

The Professional Oversight Board announces the Scope of the Audit Inspection Unit's Work for 2011/12

The Professional Oversight Board of the Financial Reporting Council today publishes a description of those entities whose audits will be deemed to be "major audits" for the purposes of audit inspections in the year from 1 April 2011 to 31 March 2012. Such audits will fall within the scope of the work of its Audit Inspection Unit ("the AIU"). The AIU selects the audits it reviews from this population, using a risk-based approach.

The Board decided last year to bring all UK incorporated banks within the scope of inspection in 2010/11. This greater level of focus on the banking sector will continue

in 2011/12. The Board has also decided to remove the assets threshold previously applied for building societies. All UK building societies will therefore fall within scope in 2011/12.

The Board has also decided to simplify the definition of UK unquoted companies, limited liability partnerships and industrial and provident societies within scope by applying only a turnover measure from 2011/12.

There are no other significant changes to the statutory scope of the AIU's work for 2011/12.

The Board has agreed that the AIU should have particular regard in 2011/12 to fair value accounting estimates and disclosures, impairment of assets, revenue recognition, related parties and going concern, including whether appropriate professional scepticism has been applied in these areas. It will also place emphasis on the quality of reporting to Audit Committees and assess how the revised Auditing Standards that became effective from December 2010 financial year-ends ("Clarified ISAs") are being applied by firms and individual audit teams in practice.

The Board welcomes comments on the scope of the AIU's work. Any comments received are taken into account by the Board in reviewing the AIU's scope each year.

21 March 2011

The Audit Inspection Unit: Scope of Independent Inspection 2011/12

(Note: This constitutes the list of "major audits" for the purposes of audit inspection and the requirement placed on audit firms under Regulation 3.15 of the Audit Regulations and Guidance 2008 to notify new "major audit" appointments to the relevant Audit Registration Committee. The Professional Oversight Board has issued separate statutory guidance on the meaning of the term "major audit" for the purposes of the statutory requirements placed on audit firms and companies, under sections 522 to 525 of the Companies Act 2006, to notify changes of auditors to the Appropriate Audit Authority:)

Audits of the following entities are within the scope of the work of the Audit Inspection Unit (AIU) of the Professional Oversight Board in 2011/12. The AIU will review a sample of relevant audit engagements at each firm selected for an inspection visit. The AIU will normally review the last completed audit of an entity. In 2011/12, the relevant financial year is likely to have ended in either 2010 or 2011.

- All UK incorporated companies with listed equity and / or listed debt.
- AIM or Plus-quoted companies incorporated in the UK with a market capitalisation in excess of £50 million.
- UK unquoted companies, groups of companies, limited liability partnerships or industrial and provident societies with Group turnover in excess of £500million.
- UK incorporated banks not already included in any other category.
- UK Building Societies.

- Private sector pension schemes with either more than £1,000 million of assets or more than 20,000 members.
- Charities with incoming resources exceeding £100million.
- Friendly Societies with total net assets in excess of £1,000 million.
- UK Open-Ended Investment Companies and UK Unit Trusts managed by a fund manager with more than £1,000 million of UK funds under management.
- Mutual Life Offices whose “With-Profits” fund exceeds £1,000 million.

If the AIU receives a request from an overseas audit regulator to review the audit of a UK entity or a UK subsidiary of an entity within that regulator’s scope, and agrees to do so, the audit of the UK entity will be deemed to be within the AIU’s scope for this purpose.

In addition, the scope of the AIU’s work at an individual audit firm may be extended by agreement with the audit firm or recognised supervisory body with which the firm is registered.

FRC commits to playing full role in supporting Government's Plan for Growth

Following the Chancellor’s Budget speech in the House of Commons, the Treasury and the Department for Business, Innovation and Skills have published “The Plan for Growth”. The document includes a number of recommendations relevant to the work of the Financial Reporting Council (FRC), including proposals to:

- Reduce the number of UK SMEs required to undertake audits and reduce financial reporting burdens for these firms.

- Bring forward legislation in 2012 to exempt many subsidiaries from producing audited accounts.

- Encourage the European Commission to exempt the smallest companies from reporting requirements.

- Simplify narrative reporting for quoted companies to make it clearer and more focused.

The Government also makes clear the FRC’s role in reinforcing the principle that independent regulation and enforcement should focus on risk and outcomes rather than process.

The FRC expressed its concern about the impact of restrictive lending covenants to the House of Lords Economic Affairs Committee and welcomes the Government’s call on the Office of Fair Trading (OFT) to investigate whether clauses in lending agreements made by the banks are unfairly restricting competition in the audit market.

23 March 2011

ASB publishes Report on Cutting Clutter from Annual Reports

The Accounting Standards Board (ASB) of the FRC has today published a report – *Cutting Clutter: Combating clutter in annual reports*.

Clutter in annual reports is a problem, obscuring relevant information and making it harder for users to find the salient points about the performance of the business and its prospects for long-term success.

The report provides preparers of annual reports with practical aids for reducing clutter, giving ideas for how disclosures might look without the clutter, and factors to consider when planning the annual report process.

However, it's not just preparers that can cut clutter. All of those involved in regulating, reviewing, preparing and using annual reports have to change their behaviours if we are to remove clutter and improve corporate reporting. The Government will be consulting further on the framework of narrative reporting. The FRC will coordinate its work with that. We also seek further debate on how materiality should be applied to financial statement disclosures.

The ASB hopes that the report will stimulate debate and action on this issue, and welcomes any comments by 30 September 2011. It plans to follow up on this work in the autumn.

06 April 2011