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IFRS CONVERGENCE IN THE UK – SETBACKS AND CHANGES

(LECTURE A349 – 12.35 MINUTES)

The current position

Under UK law as it stands, only listed companies are required to prepare their financial statements under International Financial Reporting Standards as adopted by the European Union (IFRS). However, it has been the intention of the Accounting Standards Board (ASB) for a number of years to replace UK GAAP with an IFRS based framework.

The three tier proposal

For several years the ASB has been proposing a move in the UK to a three tier accounting framework and these proposals were put into FRED 43 “Application of Financial Reporting Standards” in 2010. The press release issued by the Accounting Standards Board set out the proposed three tier approach:

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

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

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

It was suggested at the time that these changes should come into force from periods commencing 1 July 2013.

However, the nature of these proposals has now moved on as has the timing.

The deliberations of the ASB

Through spring and summer 2011 the ASB has been refining the above proposals. Shown below is an extract from the ASB’s website which sets out the changes to the proposals that have been suggested and tentatively accepted at various ASB meetings. The notes are set out this way so that the user can correlate the current position with whatever else they might have read this year.

ASB meeting 17 February 2011

The ASB received an update report from staff on the outreach programme which sought to raise awareness of the Board's proposals.

ASB meeting 14 April 2011

The Board received an educational paper on the differences between EU-adopted IFRS and the proposed Financial Reporting Standard for Small and Medium-sized Entities. The paper was presented following feedback from the outreach programme regarding the recognition and measurement differences across the three proposed tiers for financial reporting.

ASB Meeting 5 May 2011

A second educational paper was presented to the Board that considered the recognition and measurement differences that could affect entities which currently apply UK and Republic of Ireland financial reporting standards and would be required, under the proposals to apply EU-adopted IFRS, i.e. entities with public accountability.

ASB Meeting 26 May 2011

The Board received an overview of comment letters to FREDs 43 & 44. The Board agreed that the comment letters provide sufficient support for the further development of the proposals in the FRED.

The Board considered a project plan and agreed to consider, at its next meeting to be held on 16 June, papers addressing:

1. The definition of public accountability, specifically whether the Board should amend the definition as proposed in the FRED. Any proposed amendment should evaluate the impact on affected entities;

2. The principles for amending the IFRS for SMEs and whether the principles proposed in the FRED should be altered;

3. How any decisions in (i) and (ii) above may affect the reduced disclosure regime; and

4. Feedback from the consultation on the effective date.

ASB Meeting 16 June 2011

The Board made the following tentative decisions:

1. To remove from FREDs 43 & 44 the requirement for publicly accountable entities to prepare accounts under EU-adopted IFRS. As a consequence the application of EU-adopted IFRS will not be extended beyond the current requirements in law;

2. To change the principles for amending the IFRS for SMEs to permit or require accounting options that exist in current UK & Republic of Ireland Financial Reporting Standards at the transition date that align with EU-adopted IFRS; and

3. To defer the effective date to 1 January 2014.

The Board deferred a decision on whether to introduce the proposed reduced disclosure framework set out in FRED 43. The Board requested that the staff undertake further work on the proposals in light of its decision to change the principles for amending the IFRS for SMEs.

ASB Meeting 7 July 2011

The Board considered changes that may be required to its proposals following its tentative decision to remove the definition of public accountability. The Board commissioned staff to develop proposals that addressed which entities should be eligible to apply the reduced disclosure framework (that is a revised definition of a qualifying subsidiary) and which entities may need to provide additional disclosures to those set out in the FRSME.

The Board tentatively decided to retain the proposals for a reduced disclosure framework as set out in the FRED, subject to the above.

The Board tentatively decided the SORPs should be specifically referred to in the FRSME in relation to selection of an accounting policy. It also commissioned staff to update the policy for developing the SORPs. The Board tentatively agreed that entities applying the reduced disclosure framework should follow the SORPs.

ASB Meeting 21 July 2011

As regards the definition of a qualifying subsidiary the ASB tentatively decided that all subsidiaries should be permitted to take advantage of the reduced disclosure regime, however, subsidiaries which are financial institutions would not be permitted to take advantage of 'IFRS 7 Financial Instrument: Disclosure' exemptions.

In relation to Company law formats and how these reconciled with the requirements in the draft FRSME, the ASB tentatively decided that the formats in Company law should take precedence and the draft FRSME should be amended accordingly.

Summary of the current position

The key points to note are:

- The current proposals continue with the three tier approach broadly intact but the current position is that tier 1 only includes listed entities. Other publicly accountable entities will not be required to adopt IFRS. Therefore, the legal requirement to adopt IFRS will not be extended beyond the existing Companies Act 2006 requirement.

- Choices existing in current Standards will be extended to the FRSME. This means that FRSME will be more flexible on issues such as revaluing fixed assets, capitalisation of development expenditure, amortising goodwill etc. This removes many of the objections to the overly restrictive nature of the FRSME.

- The proposed effective date for these changes has been moved back to periods commencing 1 January 2014

What happens next?

The word "tentative" is still being used by the ASB so these proposals are not necessarily finalised. Also, there is significant opposition to the three tier approach with some parties calling for the abandonment of the FRSSE for small companies.

As always there remains a certain amount of scepticism about whether these changes can be made in time for the proposed effective date of 1 January 2014. Some think 2015 or 2016 to be more realistic!

Other developments affecting the future of financial reporting

Case studies relating to the application of the proposals in FREDs 43 and 44

Case studies have been prepared by ASB staff to help constituents assess the effect of the proposals in FRED 43 and FRED 44. These case studies are currently work in progress and ASB staff would welcome any comments from constituents. ASB staff expect that, in addition to finalising the draft case studies, additional draft case studies will be released in the coming weeks. Comments on areas that might be covered by case studies are also welcome.

The draft case studies cover the format of primary statements and accounting requirements (including revenue recognition, short-term employee benefits, foreign exchange, financial instruments, current and deferred tax, grants, leases, property plant and equipment, post-employment benefits, investment properties and transition to the FRSME).

Editor's note: These case studies need to be used with caution in the light of the ongoing redeliberation of the original proposals. In particular, the ASB has decided that the format of the accounts must comply with Companies Act requirements and this may affect the ASB examples.

Micro-entities: A new era

A blog from Michael Izza, ICAEW Chief Executive on 13 June 2011

Two weeks ago, EU member states voted to let each EU country exempt very small companies, or micro-entities, from some financial reporting obligations. What this would mean, if the European Parliament agrees with the proposal, is that individual governments will be able to let companies with fewer than ten employees prepare and file simplified accounts.

This is by no means a new debate, but it is a very important area to get right. Firstly, this decision recognises that different EU countries have a wide range of different tax and legal regimes, and so a 'one-size-fits-all' regime across all of them is not appropriate. Most micro-entities are local companies – they are not generally operating outside their national borders – so it is more appropriate to determine how they should report at a national level.

I believe there is a good case to be made for exempting very small businesses from the full rigours of the current European financial reporting regime. Simplification has the potential to help small businesses prosper. Both EU Commissioner Michel Barnier and UK Business Minister Ed Davey agree this will not only save money but also help small companies to drive forward the economic recovery. When a French Commissioner and a British Business Minister manage to agree it's usually worth looking at the proposals!

But it is equally important to recognise that this would not mean that micro companies would not have to produce any financial reports at all. It would mean that each member state has greater choice over simplifying reporting regimes. Whilst simplification is important it must not have unintended consequences for the economy or for society. Any alteration to reporting requirements would, for the UK, mean changes to accounting standards and company law, and would have to be considered very carefully. It remains to be seen what effect this will have on proposals such as those mooted by Business Secretary Vince Cable in February to change reporting and audit requirements for small businesses.

There is another reason I believe this is a positive decision. With the EU recognising that micro-entities are a sector in their own right, with their own needs, this opens up the possibility of other legislative benefits for this crucial sector. With 1.5 million of these companies in the UK, and 5.2 million across the EU, this would be very good news indeed. We will be monitoring the ongoing EU legislative process closely.

Editor's note: Some of the above is inconsistent with previous ideas. Inside Track published the following brief explanation in July.

"In 2009, the Commission had proposed to give Member States an option to exempt micro-enterprises altogether from the provisions of the Accounting Directives, with micro enterprises being defined as a company that does not exceed the limits of two of the following criteria: balance sheet total 500,000 euros, net turnover 1 million euros and an average of 10 employees during the financial year. However, this proposal ran into opposition from some Member States and on 30 May, the EU Competitiveness Council agreed a compromise in which Member States might permit a lighter accounting regime (rather than a wholesale exemption) for an even more restricted category: micro enterprises, being defined as a company balance sheet total 250,000 euros, net turnover 500,000 euros and an average of 10 employees during the financial year. At the time of writing, the proposal is being considered by the European Parliament"

DEALING WITH DIVIDENDS

(LECTURE A350 – 9.09.MINUTES)

Twelve months ago, we covered dividends in our update notes. The ICAEW has now published an article on this subject on the members' section of their website. They say that the accounting for and disclosure of dividends can seem simple but members should beware of falling foul of the technical complexities.

The article is largely supportive of our notes last year but there are areas of interest as highlighted in the extracts below.

When to provide for a dividend

If a dividend is paid in the year then, as long as there are distributable reserves (see below), there is little to debate in terms of the accounting. This 'payment' could be in terms of an actual bank payment or it could be an entry in the accounting records to the director's loan account, coterminous with the decision to pay the dividend.

Editor's note: This does not seem to be entirely consistent with the guidance in Tech 02/10 published by the ICAEW. There, in the context of a group situation, it suggests that (in circumstances other than where there is settlement by way of set off) more *than just entries into the accounting records of the paying and receiving company are likely to be required.*

For dividends ‘paid’ after the year-end, reference needs to be made to accounting standards on provisions. These state that for it to be provided at the year-end there must be an obligation at the year-end.

A history of paying dividends does not generate an obligation; neither does a declaration of a dividend after the year-end. For a dividend to be provided at the year-end, it must be approved by the shareholders before the year-end.

Dividend documentation

When documenting the decision to include dividends in the accounts, firms must take great care that they document when decisions were made. For example, director-shareholders decide at a meeting on 31st December to declare a final dividend but do not ask the accountant to prepare documentation and journals until January. It would be acceptable for the accountant to date these documents and accounting entries on the date the decision was made.

Editor’s note: Let’s be totally clear what is being said in this paragraph. For the above suggestion to work, it is necessary for a shareholders’ meeting to be properly convened. Either 14 days notice (for a private company) must be given or the members must consent to short notice with all the paperwork that entails. Surely, a simpler approach (for the private company) is for the directors to pass round a written resolution for the members to approve. However, I suppose that the problem with this suggestion is that the accountant didn’t happen to be there to draft the paperwork for them on 31 December. But then, if the accountant wasn’t there, did they actually convene and hold the meetings properly? Perhaps, on second thoughts, the simplest approach is to write cheques to all of the shareholders on 31 December so that they can go away with the money in their hands.

However if, having reviewed the 31st December accounts prepared by the accountant, the director-shareholders decide to declare a dividend in January then this cannot be put into the 31st December accounts. For the accountant to do so would be fraud.

Distributable profits

Dividends must be paid out of distributable profits and directors must prepare ‘relevant’ accounts to confirm the position. If it later transpires there are no distributable profits and relevant accounts were not prepared then the dividend is illegal and repayable, and should be disclosed as such. For more information see the ICAEW Helpsheet: Illegal dividends in a private company.

Disclosure

While there has been much debate about this over recent months, the ICAEW's position is clear. As directors are clearly related parties, then dividends paid to them should be disclosed as related party transactions under the FRSSE / FRS 8. See Audit and Beyond (January 2010) for a recent article on the topic.

However it should be noted that disclosure is only required if the transactions are material. Furthermore, disclosure is only required in the full accounts and not in the abbreviated accounts.

Conclusion

Firms must take care to understand fully the issues surrounding the accounting and disclosure of dividends. They must also document decisions made and discussions with clients. It is only by doing so that firms will be able to support their treatment and disclosure.

For further advice, please call our technical specialists in ICAEW Advisory Services on +44 (0)1908 248250

Extracts taken from a recent article on ICAEW website

FAQ on dividends

Q. The sole director (and only shareholder) of a company instructed the company's bank to transfer £250,000 from the company bank account into her personal bank account on 23 December 2010. The transfer did not occur until 6 Jan 2011 because of an error by the bank. The director wants to show this dividend as paid in the company accounts for the year to 31 December 2010. Is this acceptable?

A. Let us assume that the intention was for the director to pay an interim dividend. In this case, the dividend is recognised in the accounts when it is paid. The situation described is similar to that of an uncleared cheque. As far as the company was concerned the payment was processed and was presumably recorded in the cash book before the year end. The fact that the payment did not clear does not change the fact that the intended payment and instruction was before the year end.

However, this answer assumes that the instruction was given before the year-end. Does the client have evidence that the instruction was given before the year end? Will the bank confirm in writing that the instruction was received before the year end and that it was their oversight that led to the delay? If there is no evidence as to the date of the instruction then no entry can be made in the accounts.

An alternative scenario is that the dividend was proposed by the director for approval by the member. This sort of dividend (sometimes referred to as a final dividend) is legally binding when approved by the member(s). Did this occur? Was there a written resolution proposed by the director and approved by the member before the end of December? If so, the dividend would be accrued in the accounts until such time as the liability is settled.

CASE STUDY: DISCLOSURES REQUIRED BY S 413 AND FRS 8

(LECTURE A351 – 18.36 MINUTES)

X Ltd has turnover of £5 million and satisfies the conditions to be a small company – although the directors do not wish to use FRSSE. There are two directors - John Smith who owns 4,000 shares and Jane Robinson who owns 2,000 shares.

John's wife, Jenny, owns 2,000 shares. Jenny is the senior partner in a top 20 legal practice. John's children, Jack and Jill, each own 1,000 shares. Jack is 22 years old and is a professional footballer playing for a premier league club. He has already won 5 international caps. Jill is 17 and is an impoverished student. There are no other shareholders.

John's brother, James, owns a company called Y Ltd.

The following transactions took place in the year ended 31 December 2010:

1. On 3 January 2010, the company loaned £40,000 to Jane Robinson. This was repaid on 12 December 2010.

2. On 6 March 2010, the company loaned £50,000 to Jenny Smith. The company also loaned £25,000 to Jill. Both of these amounts are still outstanding.

3. John occasionally runs short of cash and gets subbed out of petty cash. John does not have a loan or current account with the company but, when these situations arise, he repays the amounts through a deduction from his net salary for the following month. The amounts involved were £500 in March 2010 and £400 in May 2010.

4. X Ltd regularly buys goods from Y Ltd. These transactions are always at a discount of 15% on the normal prices charged by Y Ltd.

5. The company paid an interim dividend of £5 per share on 15 December 2010.

What are the issues arising from these transactions?

What control disclosure is required?

Comments on case study

1. The loan will require approval by the members. This can be done in a general meeting or by written resolution. The loan is an ‘advance’ and will require disclosure under S 413 in both the annual accounts and the abbreviated accounts. There is no need to disclose the director’s name under S 413. So the director’s name will not need to appear in the disclosure under S 413. However, the loan will require disclosure in the annual accounts under FRS 8 (if material) and this will require disclosure of the director’s name.

2. Both Jenny and Jill are connected persons (as also is Jack since age is unimportant). The loans from X Ltd to Jenny and Jill do not require approval or disclosure under CA 2006. If the situation were different and X was a plc then approval would be required of loans to connected persons. However, even in the circumstance where X is a plc there is no CA requirement to disclose loans to connected persons.

   Both Jenny and Jill are related parties of X Ltd since they are close family of a director. Therefore the loans may require disclosure in the annual accounts under FRS 8. The question here concerns materiality. See also the notes on question 5.

3. Because the amounts are less than £10,000, no approval is required. However, the transactions are advances and require disclosure under S 413 in both the annual accounts and the abbreviated accounts. There is no need to disclose the director’s name. No disclosure would be required under FRS 8 on the grounds of immateriality.

4. Y Ltd is a related party. Subject to materiality, the annual accounts will disclose the total of the purchases from Y Ltd during the year and the balance owing to Y Ltd at the end of the year. These accounts will also indicate that the transactions are not at arm’s length. There is no need to disclose the level of discount given. There is no need to disclose the transactions or balance in the abbreviated accounts.

5. The aggregate amount of dividends paid in the financial year will be disclosed in the notes to the accounts in accordance with Paragraph 43(b) of The Small Companies and Groups (Accounts and Directors’ Report) Regulations 2008.

   Dividends paid to related parties are related party transactions and therefore there will need to be disclosure. However there are two complicating issues namely aggregation and materiality. The obvious answer is to suggest the following aggregated disclosure:

> During the year, directors received dividends totalling £30,000. The directors concerned were John Smith and Jane Robinson.
>
> During the year, close family members of directors received dividends totalling £20,000. The individuals concerned were Jenny Smith, Jack Smith and Jill Smith who are all member of the close family of John Smith, one of the directors of the company.

However, it could be argued that the individual amounts are not material to the company and therefore do not require disclosure. From the company's point of view, total dividend may well be material and has already been disclosed but there is no need to give any additional disclosure.

But where the related party is a director or a member of their close family, FRS 8 requires disclosure of transactions if they are material to either the company or to the related party. It might well be argued that the amounts paid as dividends to the directors are not material to the directors. Further, Jenny and Jack are clearly fairly wealthy people. Therefore we end up with the disclosure:

> Dividends paid during the year included an amount of £5,000 paid to Jill Smith who is a member of the close family of John Smith, one of the directors of the company.

I think many would argue that this suggestion is nonsense but of course the company could avoid this disclosure as well by adopting the FRSSE which does not include the extended definition of materiality included in FRS 8.

Finally, there might be a variety of views on control disclosures but my opinion is that no control disclosure would be required for this company.

USING THE RIGHT ACCOUNTING POLICIES
(LECTURE A352 – 12.55 MINUTES)

Appropriate accounting policies

Paragraph 17 of FRS 18 requires companies to choose accounting policies that are most appropriate to their particular circumstances. This might require the entity to:

- Identify an improvement to an already appropriate accounting policy and/or

- Identify an inappropriate policy currently being applied and change it to the most appropriate policy

It is true to say that HMRC are well aware of this requirement and may challenge directors to justify their choice of accounting policies.

According to FRS 18, the objectives against which an entity should judge the appropriateness of accounting policies are:

- Relevance
- Reliability
- Comparability
- Understandability

Relevant information has the ability to positively influence an economic decision of the users of the financial statements.

Reliable accounting policies reflect the substance of transactions and are free from bias or material error and where conditions are uncertain, the accounts will be prudently prepared.

The standard specifically prescribes the treatment in conditions of uncertainty:

37. Often there is uncertainty, either about the existence of assets, liabilities, gains, losses and changes to shareholders' funds, or about the amount at which they should be measured. Prudence requires that accounting policies take account of such uncertainty in recognising and measuring those assets, liabilities, gains, losses and changes to shareholders' funds. In conditions of uncertainty, appropriate accounting policies will require more confirmatory evidence about the existence of an asset or gain than about the existence of a liability or loss, and a greater reliability of measurement for assets and gains than for liabilities and losses.

38. However, it is not necessary to exercise prudence where there is no uncertainty. Nor is it appropriate to use prudence as a reason for, for example, creating hidden reserves or excessive provisions, deliberately understating assets or gains, or deliberately overstating liabilities or losses, because that would mean that the financial statements are not neutral and therefore not reliable.

Comparability is achieved through a combination of consistency and disclosure.

Understandability by users refers to users of the financial statements who have a reasonable knowledge of business, economic activities and accounting and a willingness to study with reasonable diligence the information provided!

The standard distinguishes between accounting policies and estimation techniques and draws a sharp contrast between them. Estimation techniques implement the measurement aspects of accounting policies. For instance, methods of depreciation such as straight-line or reducing balance are estimation techniques. A change in accounting policy is a matter for a prior period adjustment whereas the change of an estimation technique is not.

Comment

Some regarded the standard as too esoteric when it was issued and the full implications were not understood by all companies. The key issue for measurement and recognition is that the concept of prudence has been downgraded. Under SSAP 2, the previous standard, prudence was a fundamental accounting concept. On this basis revenues would often be prudently shown at a lower level and expenses at a higher level. This is an obvious benefit to the tax payer. HMRC is fully aware that FRS 18 requires “reliable” rather than prudent accounting policies to be used i.e. those without the bias inherent in a prudent approach.

FRS 18 also requires that accounting policies are regularly reviewed. For a particular company the Revenue may have made enquiries about a certain accounting policy in the past and agreement reached. However, because of the requirement for regular review the Revenue are not bound by their previous agreement.

Where choices exist in accounting standards, FRS 18 further restricts a company’s freedom to make choices in accounting policy through the following requirement.

9. For certain transactions, accounting standards allow a choice of what is to be recognised. Examples arise in FRS 15 'Tangible Fixed Assets', which allows directly attributable interest to be treated either as part of an asset or as an expense, and in SSAP 13 'Accounting for research and development', which allows expenditure satisfying asset recognition criteria to be treated either as an asset or as an expense. Where accounting standards allow a choice over what is to be recognised, that choice is a matter of accounting policy.

Where a choice exists within the standards a company is expected to follow the rules contained in FRS 18 in exercising that choice, rather than making the selection on perhaps more “commercial grounds”.

The message is clear. In the view of the Revenue, companies must be able to justify the basis on which the accounting policies and estimation techniques have been determined. These should reflect:

- The nature of the company's business (particularly crucial for areas such as revenue recognition) and typical policies and techniques in the particular industry sector
- The company's past experience (for example, in relation to warranty claims where the company's claims history helps in assessing the year-end provision)
- Consistency with previous years
- Changes in business practices.

Revenue Tax Bulletin (Issue 58) makes specific reference to FRS 18. The article points out that 'accountancy is not an exact science and occasionally it is possible for different accountants to come to different conclusions, both of which are within the bounds of UK GAAP'.

FRS 18 requires companies to choose accounting policies and estimation techniques that are most appropriate to their particular circumstances. Accounting policies and estimation techniques should be reviewed regularly. In difficult areas the article states:

'…it will be necessary for the Revenue accountants to establish all the facts and to ensure that both sides have considered the alternatives before they are able to come to a conclusion one way or another'.

'If they conclude that the accounts have been prepared on a tenable basis in accordance with FRS 18, then they will not try to substitute an alternative basis that they may prefer. Where they do not feel that the accounts have been prepared in accordance with UK GAAP they will pursue the matter.'

Example - Expense recognition

AB Travel Ltd, is a privately owned tour operator with a turnover of about £20M. The company trades in a specialist market and produces its 2011 brochures in the summer of 2010. Its accounting policy is:

"Marketing expenditure, consisting mainly of brochure and promotional costs, is charged to the profit and loss account over the season to which it relates."

Based on this, the full £400K cost of the brochures incurred in 2010 is carried forward as an asset to match against the revenues of 2011. The year end is 31 December.

Is the accounting policy adopted by AB Travel Ltd in accordance with FRS 18 Accounting Policies, or is some other policy more appropriate?

Comments on example

Comparability

Paragraph 39 of FRS 18 tells us that information in an entity's financial statements gains greatly in usefulness if it can be compared with similar information about other entities. Paragraph 40 says "In selecting accounting policies, an entity will assess whether accepted industry practices are appropriate to its particular circumstances".

More specifically the Inland Revenue state that they expect companies to follow typical accounting policies in a particular industry.

The policy used by AB Travel Ltd was common in the industry 10 years ago. Indeed the wording is identical with that used by TUI Northern Europe Ltd (formerly Thomson Travel Group plc) in their accounts for 2003.

However, if we flash forward to the present day, we get in the 2010 accounts:

TUI Travel PLC: ".....brochure costs are expensed when the Group has access to the related advertising or promotional material."

Or more clearly:

Thomas Cook Group PLC: "The costs attributable to producing brochures are expensed when the brochures are available to be sent to customers or retail outlets."

This demonstrates that the accounting policy adopted by AB Travel Ltd is not comparable with those of the listed tour operators. It might be argued that the listed companies are following international standards but remember that FRS 18 is a converged standard.

Reliability

FRS 18 requires that Accounting Polices be reliable:

"Reliable accounting policies reflect the substance of transactions ......and are free from deliberate or systematic bias……….."

AB Travel Ltd is carrying the brochure cost forward to match with the revenue from the next season. On the other hand, the listed tour operators are recognising the expense at the earliest opportunity. The latter accounting policy could be described as prudent but FRS 18 reduced the status of prudence when compared with SSAP 2. FRS 18 requires that accounting polices be "free from bias" and prudence is an inherently biased concept.

So, is the approach of the listed companies acceptable? Paragraph 37 of FRS 18 indicates that where conditions are uncertain, the accounts should be prudently prepared. It could be argued that that there are significant uncertainties as to whether the costs of the brochure will be recovered in 2011. Will the companies be profitable in 2011? Will the markets in which the companies operate contract? Will another competitor enter the market? Will the brochure itself generate the bookings or will the business come from the company's website or telesales?

If it is accepted that a prudent approach is permitted for listed companies on the grounds of conditions being uncertain then it might be said that the risks and uncertainties facing AB Travel Ltd are in many ways much greater because its activities are narrow by comparison.

Matching and the definition of an asset

The approach adopted by AB Travel Ltd is an attempt to match costs with revenue. Since the revenue will not be earned until 2011, the costs are deferred to match.

Matching is still a popular idea with many companies. However, matching is not part of modern accountancy. Rather, the accountant today uses the definitions of assets and liabilities to determine what should be recognised in the accounts.

FRS 5 defines assets as "Rights or other access to future economic benefits controlled by an entity as a result of past transactions or events."

Once AB Travel uses brochures by despatching them to travel agents or customers then they can hope for a benefit but they have lost control of it. It seems clear to me that any brochure used before the year-end is no longer an asset. However, brochures retained in stock might be thought to be assets since they can be used to generate sales.

Suppose that, at the company's year end of 31 December 2010, 75% of the brochures have been distributed. If the policy suggested above was adopted £300,000 of cost relating to the production of the brochures is included as an expense in the 2010 accounts and the remaining £100,000 would be carried forward in prepayments.

Conclusion

There is no right answer here. Interestingly, HMRC are unlikely to challenge AB's existing policy – even if it is not the most appropriate!

HOW WELL DO YOU KNOW FRS 12?
(LECTURE A353 – 15.42 MINUTES)

Case studies

How would you advise your client in the following situations? The year-end in each case is 31 December 2010.

1 Your client has prepared a detailed plan for the re-organisation of one of its divisions. The plan was approved by the company's board on 14 December 2010 but was not announced or implemented until after the year-end. The company wishes to provide for the costs of re-organisation and the expected trading losses that will occur in the period until the re-organisation is complete.

2 Your client is a manufacturer who gives warranties at the time of sale to purchasers of its product. Should a provision be recognised, and, if so, how should it be calculated?

3 Your client has a major asset. This is expected to have a life of 30 years as long as major refurbishment is carried out at five-yearly intervals. Should a provision be established in respect of this expenditure?

4 Your client, a retail company with a chain of shops, decides not to insure itself in respect of minor accidents to its customers; instead it will self insure. Should provision be made for the claims expected to arise each year?

5 The government introduces a number of changes to the income tax system.

As a result of these changes, your client, a company in the financial services sector will be required to retrain a large proportion of its administrative and sales work force. Without this retraining, they could not stay in business. Should a provision be made?

Background material: Extracts from FRS 12

A provision is a liability that is of uncertain timing or amount, to be settled by the transfer of economic benefits.

A contingent liability is either (i) a possible obligation arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control; or (ii) a present obligation that arises from past events but is not recognised because it is not probable that a transfer of economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability.

A contingent asset is a possible asset arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control.

A provision should be recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable that a transfer of economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met, no provision should be recognised.

Where it is not clear whether a present obligation exists, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This will be the case only where the settlement of the obligation can be enforced by law or, in the case of a constructive obligation, the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation. The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date. Where an entity can avoid future expenditure by its future actions, for example by changing its method of operation, it has no present liability for that future expenditure and no provision is recognised.

For a liability to qualify for recognition there must be not only a present obligation but also the probability of a transfer of economic benefits to settle that obligation. A transfer of economic benefits in settlement of an obligation is regarded as probable if the outflow is more likely than not to occur.

An entity will normally be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is therefore disclosed as a contingent liability.

An entity should not recognise a contingent liability.

A contingent liability is disclosed unless the possibility of a transfer of economic benefits is remote.

Contingent assets are not recognised in financial statements because it could result in the recognition of profit that may never be realised. However, when the realisation of the profit is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

A contingent asset is disclosed where an inflow of economic benefits is probable.

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The provision is measured before tax and will take account of risks and the time value of money.

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset.

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision should be reversed.

A provision should be used only for expenditures for which the provision was originally recognised.

Comments on case studies

Examples 1 to 5 are based on the application notes included in FRS 12

1 No provision

2 Make provision based on a realistic estimate of expected cost of rectification.

3 No provision

4 No provision

5 No provision

FAQs on provisions and contingencies

Provision or contingent liability

In early February 2011, the directors of A Ltd persuaded all staff that a 10% pay cut was necessary across the board in order to reduce costs and secure the future of the company. The saving was approximately £40k per month. Therefore, by the year-end of 30 June 2011, savings had been made of about £200K

As a sweetener to the deal, the company agreed with employees that if the company hit certain targets at any time during the period to 30 June 2012, then all salary foregone since 1 February 2011 would be paid. This entitlement ceases when the employee leaves.

Q1. Based on this information, should the amount of £200K be disclosed as a contingent liability at 30 June 2011 or is a provision required?

Q2. The targets had not been met by 1 July 2011. However, at a board meeting on 1 July 2011 the company agreed, as a gesture of goodwill, to pay to each employee in July an amount equal to two months of the pay cut. How should this be accounted for?

A1. The directors should produce forecasts for the year to June 2012 based on the situation existing at 30 June 2011. The directors then need to decide whether it is more likely than not that the targets will be hit at some stage during the next accounting period. If so, then provision should be made for the anticipated cost (allowing for expected leavers) plus employers' NI.

If the probability of hitting the targets is less than 50% then disclosure will be made of the contingent liability (unless the likelihood of payment is remote).

2. This was not an obligation of the company at 30 June 2011. It should however be

disclosed with an indication that the contingent liability disclosed earlier has been partially settled after the year-end.

Contingent assets and contingent liabilities

Q. A supplier was negligent and paid the company compensation of £100k. There is an agreement with the supplier that if this is recovered from the customer the supplier will be repaid. The customer is being sued for £120k. The company therefore has a contingent asset of £120K and the best estimate of the directors is that it is probable that the company will win against the customer. It is therefore probable that the company will need to repay the supplier. As a liability is recognised when it is probable, but a gain only recognised when it is virtually certain this gives an imbalance in the result: is this correct?

A. Yes, the liability is probable and so must be recognised whereas the asset must not be recognised since this is also probable, but not virtually certain.

Valuation of a liability

Q. A company received a number of invoices from their legal advisors. The company disputed these invoices and after the year end the lawyers accepted a greatly reduced amount in settlement. Should the invoices be shown in full as liabilities at the year-end or should the liability shown reflect the reduction agreed post year end?

A. If the invoices were incorrect in some way such they should never have been issued in the first place then it would be appropriate to write them back and not show the liability. However, this does not appear to be the case here. The company has complained about the quality of the legal advice received and settled for a reduced bill in return for not suing the lawyers. This agreement was made post year end and does not affect the conditions that existed at the balance sheet date. The creditor should therefore be shown in full with a subsequent events note that explains about the deal done post year end and that this is a non-adjusting event.

Provision for a claim from a customer

Q. B Ltd develops card systems for customers for use on public transport. During the year it completed the development and sale of a system which was larger than other systems and included new technology.

The company believes that the customer has not yet fully tested the system and that when it does it might find that it does not work satisfactorily with all cards.

In view of this the company thinks the customer might make claims against it and has provided £200k in its accounts.

Is this acceptable?

A. FRS 12 states that a provision can only be made when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable that a transfer of economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met, no provision should be recognised.

You should discuss with the company whether it would have an obligation under its terms of trade and contract with that customer. Even if it does not have a legal obligation does its relationship with that customer mean that there is a constructive obligation to put things right? Does the company have a policy and a track record of correcting product problems? Or of honouring compensation claims?

It is possible that it does have an obligation as a result of a past event being the sale of the system. However, in order to make a provision, it would be necessary to demonstrate that it is reasonable to anticipate that there will be a problem when fully tested and that this will result in the customer making a claim. FRS 12 states that where it is not clear whether a present obligation exists, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

You need to look at the sale contract terms and discuss these with the company. If there was a problem, would the customer be able to make a claim or simply be able to require faulty or non working parts to be replaced? If the former, then you need to discuss how the customer might be able to assess such a claim. If the latter, then the cost to the company would be its own internal cost of identification and correction of the problem.

If the company is not able to show that a reliable estimate can be made then it cannot make a provision. FRS 12 states that an entity will normally be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is therefore disclosed as a contingent liability.

AUDIT EXEMPTION PROBLEMS

(LECTURE A354 – 7.17 MINUTES)

Those who turn straight to the Disciplinary and Regulatory reports page when they open Accountancy magazine might be surprised by what they read in the June edition. It contains details of 3 firms that ‘incorrectly issued an accountants report for a company not meeting audit exemption conditions’. Each firm was reprimanded, fined and ordered to pay costs.

From the enquiries we receive on the Technical Enquiries helpline we are not surprised. We receive a number of questions seeking clarification on claiming exemption from audit. We also receive questions on the consequences of failure to have company accounts audited.

Exemption

A company is able to claim exemption from audit if it satisfies both of the following criteria:

1. It must qualify as a small company.

2. It must, for the year in question, be below both the turnover AND the gross assets threshold. If the company is part of a group at any time during the year then the group must be a small group that also satisfies the turnover and gross asset thresholds.

People sometimes forget that both qualifications must be satisfied AND both thresholds must not be exceeded. Small property companies often exceed the gross assets threshold.

Consequences

When a firm discovers that it has incorrectly issued an accountant's report on company accounts which should have been audited it must advise the directors of this fact.

The Directors must also be made aware that they have not complied with company legislation since, if the accounts have been filed at Companies House then a statement by the directors setting out why the company is eligible to claim exemption from audit will have been included on the face of the balance sheet. This statement will appear irrespective of whether it is full or abbreviated accounts that have been filed. Note that Companies House has no obligation to check whether the company is eligible to claim exemption from audit. Indeed there may be no way that Companies House could be aware of the company's true status. .

The firm should ensure that the directors have, where applicable, informed all shareholders of the situation. If all of the shareholders are directors then life is simpler. However, any non-director shareholders are perhaps more likely to complain (to Companies House or the accountant's professional body) if they discover that an audit did not take place when required so it would usually be better to involve them in agreeing what is to be done. If the decision is made to have an audit and audited accounts are sent to Companies House as a replacement for the previously filed unaudited accounts then this might give rise to a late filing penalty.

The directors also need to consider whether there are any third parties, e.g. bank or creditors, who will be concerned and might report the directors or the firm if they become aware of the situation.

If the directors decide that they do not want to have the accounts audited, then the next year's accounts should be audited (assuming an audit is required for that year) and filed at Companies House as soon as possible.

When the firm discovers that this situation has arisen it should determine why and initiate procedures to make sure it does not happen again. It should ensure that all staff involved in accounts preparation work for companies are notified and reminded of the need to ensure that the company is eligible to claim exemption from audit. Most audit systems will include a form for this purpose and this should be completed on all company accounts preparation assignments where there is any risk that an audit may be necessary.

Previous year not audited

There will be a number of factors to bear in mind when auditing a set of accounts where the previous year was not audited:

ISA 510 Initial Audit Engagements - opening balances. Does your audit system have a programme which addresses opening balances in this situation?

ISA 710 Comparative information - corresponding figures and comparative financial statements. This standard includes a paragraph that "if the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements".

The message is clear, make sure a company is eligible to claim exemption from audit before you sign the accountant's report and ask the directors to sign the statement on the balance sheet.

Adapted from article published on www.swat.co.uk in June 2011

FAQS: DEPRECIATION
(LECTURE A355 – 11.01.MINUTES)

Change in policy concerning the splitting of the asset into components

Q. A freehold property was acquired approximately 20 years ago and since then the accounts have disclosed that no split between land and buildings is available and that the directors consider that the depreciation that has not been charged on the estimated proportion relating to buildings is not material.

New management are now involved and they are considering this in relation to both P&L and the cumulative effect on the balance sheet.

What are the options?

A. This is a fascinating question with an obvious answer, an exception to the obvious answer and then an exception to the exception to the obvious answer which takes us back to the obvious answer we started with!

The obvious answer is that all depreciation adjustments are changes in accounting estimate and are not dealt with by prior year adjustments because they are not changes in accounting policy. Depreciation adjustments are dealt with prospectively.

However, Paragraph 83 of FRS 15 says “Where the tangible fixed asset comprises two or more major components with substantially different useful economic lives, each component should be accounted for separately for depreciation purposes and depreciated over its individual useful economic life.”

Therefore it would appear that this company has failed to meet the requirements of FRS 15 ever since the asset was purchased (FRS 15 was published in 2000 and was therefore in force when the asset was purchased). Surely, a prior period adjustment should be made when a requirement of a standard has been ignored. Indeed. Paragraph 108 of FRS 15 seems to reinforce this view:

> Where, on adoption of the FRS, entities separate tangible fixed assets into different components with significantly different useful economic lives for depreciation purposes, in accordance with paragraphs 36-41 and 83-85, the changes should be dealt with as prior period adjustments, as a change in accounting policy.

Note that paragraphs 36 to 41 deal with the capitalisation of subsequent expenditure. Paragraph 83 was reproduced above and paragraphs 84 to 85 deal with land and buildings.

So there is our exception to the general principle. Paragraph 108 speaks plainly of the need for a prior period adjustment.

But wait! UITF Abstract 23 is entitled “Application of the transitional rules in FRS 15”. The consensus of the panel is contained in Paragraph 8:

> The UITF reached a consensus that the prior period adjustment required by paragraph 108 of FRS 15, where components of an asset are identified, should be restricted to the effects of treating separately only those components in respect of which:
>
> (a) any provision for repairs and maintenance (including replacement expenditure) was itself eliminated by prior period adjustment on adoption of FRS 12 or

(b) there has been a change from a previous policy of writing off as incurred relevant repairs and maintenance expenditure (including replacement expenditure) to a policy whereby such expenditure is capitalised because it replaces a separately depreciated component.

In particular, any prior period adjustment should not embrace any changes to the useful economic lives or residual values of the remainder of the asset.

The UITF even provide us with a useful example which manages to include both a prior period adjustment where it is required and a prospective adjustment.

Appendix to UITF 23 — Illustrative Example

Assume a building with a cost of £1 million, on which before FRS 15 no depreciation had been charged on the ground that any depreciation was immaterial. Inflation is ignored.

Ten years after the purchase of the building FRS 15 is adopted and the lifts within the building are identified as a separate component with a cost of £150,000 and a 20-year life. Assume (as an example of a paragraph 8 (a) situation) that a provision for the replacement of the lifts had been built up, amounting to £75,000 (10/20 × £150,000). However, on the adoption of FRS 12 the provision is eliminated as a prior period adjustment.

Clearly the lifts have been in existence since the date of purchase and have always had a cost and a life (and possibly a residual value, assumed to be nil in this case). On adoption of FRS 15 the lifts are formally recognised as a separate component in accordance with the standard and cumulative depreciation of £75,000 (being the difference between the amount of depreciation previously charged, ie nil in this case, and the recalculated amount) is charged in respect of that component by way of prior period adjustment in accordance with paragraph 108. In this case, this is equal and opposite to the prior period adjustment required on the adoption of FRS 12 (for simplicity it has been assumed that FRS 12 and FRS 15 were adopted at the same time, which may not have been the case in practice). This adjustment, of itself, should not result in revision of any depreciation previously charged in respect of the building excluding the lifts (nil in this example).

If (as an example of a paragraph 8 (b) situation) no provision had been made for replacement of the lifts, but the policy had been to write off as incurred the replacement of major components such as lifts, then the prior period adjustment on the adoption of FRS 15 would be £75,000 cumulative depreciation as above. When the lift is eventually replaced the new lift will be capitalised as it replaces a separately depreciated component.

In both examples above, any change to the life (or residual value) of the building as a whole should be accounted for prospectively under paragraph 106. Thus if the building was given a revised useful economic life of 50 years (i.e. a remaining useful economic life of 40 years) on adoption of FRS 15, the depreciation on the building (excluding the separately depreciated lift) would be accounted for prospectively, ie £21,250 per year (1/40 × £850,000).

To return to our original question, I don't think it makes any difference that the company is a bit late in adopting FRS 15. The company should split freehold property between land and buildings. They should start depreciating the buildings element this year. This would necessitate considering the remaining useful life of the buildings and their expected residual value.

The company is not permitted to charge in the current year the depreciation that it failed to charge in previous years.

As a final consideration, the directors should consider whether an impairment provision is required in accordance with the principles of FRS 11.

Change in policy concerning the charging of depreciation on freehold property

Q. An unincorporated partnership has a property that is depreciated at 2% per annum. The client now wants to stop depreciating and add back previously charged depreciation. Can they do this?

A. If the accounts are for internal use, effectively management accounts, then there is no requirement to charge depreciation. However, the accounts should make it clear that they are for internal use only and do not follow UK GAAP. However, accounts for HMRC are required to give a true and fair view (i.e. follow UK GAAP) as would any accounts presented to the bank and depreciation would have to be shown in any such accounts. It would probably be easier to continue to charge depreciation.

If the entity was a company rather than a partnership then the answer is unequivocal. Previously charged depreciation cannot be added back.

The use of different useful lives for different properties

Q. Our client, an independent boarding and day school, has the following accounting policy:

Freehold buildings, included in these accounts are depreciated at a rate of 4% per annum based on cost in order to write off over an estimated useful life of 25 years, apart from the multi-games area which is written off at the higher rate of 7.5% per annum based on cost to reflect its shorter estimated useful economic life.

During the past year the client has spent some £4.2m on the construction of a modern new building for the science block and junior classrooms.

Can the client use a depreciation rate of 2% on this building on the grounds that it is a new modern building and expected to have an economic life of 50 years?

A. Each property should be depreciated over its estimated useful economic life. It is not the case that every property must be depreciated over the same period.

The accounting policy note should give an indication of the range of lives that the entity has used in applying this policy. The policy need not describe each building so the policy note could in future simply state 2% to 7.5% or 13 to 50 years.

Over depreciated assets

Q. A company has a category of plant which the directors consider has been over-depreciated. The items in this category are factory production machines and these machines were all bought together three years ago at a total cost of £200K. The depreciation policy has been 4 years and therefore the net-book value of the plant is £50K. The directors have decided to change the policy to 10 years in the current year's accounts. An external valuation of the plant has been obtained which puts a valuation on the plant of £150K.

Can the directors re-instate the excessive depreciation charge? Would this be done by a prior period adjustment? Alternatively, can they include the revalued amount of £150K in the accounts even though this is less than cost?

A. Re-instatement is not permitted. An amendment to the expected useful life of the asset is a change of estimate not a change in accounting policy. If they are continuing with an approach based on cost then the only choice is to take the existing book value of £50K and depreciate this over the remaining useful life of seven years.

Revaluation is acceptable as long as all assets in the same class of fixed assets are revalued. This does not mean that all plant and machinery must be revalued since, in this context, a class of assets can be defined by the directors. Therefore, they could, if they wish, adopt a policy of revaluation for the factory production machines only and not for any other type of machine. It doesn't matter that the revalued amount is less than cost.

The directors should be reminded that the decision to adopt a policy of revaluation has consequences. That is, assuming they are following FRS 15, there must be a re-valuation every five years with an interim valuation at the three year point. There are strict rules about the method to use for revaluation and there are also disclosure requirements in respect of revalued assets and revaluations during the year.

Fully depreciated assets

Q. Our client has a lot of fully depreciated assets which are still in use. Should they re-instate the over-depreciation or should they remove the assets from the accounts? What is the impact of this situation on our audit work?

A. As indicated above, re-instatement is not possible. Also, the assets should not be removed from the books until they are scrapped. The existence of a large quantity of fully-depreciated assets provides information to the users of the accounts about the age of the assets.

In order to consider the audit implications, let's take a step back. Paragraph 95 of FRS 15 requires directors to review estimates of residual value at the end of each reporting period. If this is done thoroughly then the balance sheet will never contain fully depreciated assets. However, many companies allocate a standard useful life to a category of assets and do not consider the lives of the individual assets which make up the category. Fully depreciated assets can therefore occur. Also, during a recession, companies might delay the replacement of assets and an asset which the company expected to keep for four years is made to continue for longer. We are receiving a lot of questions on this topic during the current economic climate.

In the past, both directors and auditors of some companies have ignored the requirement for end of year reviews and this has led to the current glut of fully written down assets. It is too late to do anything about the past since it is unlikely that the error is sufficiently large to require a prior period adjustment. Looking to the future, the directors should place more importance on an annual review.

It is interesting that this issue has arisen in the same year that the revised ISA (UK & I) 540 has come into force. This ISA deals with the auditing of accounting estimates. Auditors might be tempted to think that this standard only applies to more difficult estimates such as warranties or revenue recognition but, in fact, depreciation is an estimate. The auditor is required to consider the outcome of previous estimates and this should rapidly reveal that the directors' estimates of useful lives have not been very accurate. Also, the auditor's understanding of the relevant financial reporting framework will show that the directors have not performed the annual reviews as required.

The auditor must also consider whether an accounting estimate gives rise to a high level of estimation uncertainty and should thus be classified as a significant risk. It is probably unlikely that depreciation estimates will be sufficiently material to give rise to significant risk but, even then, errors in the estimates for depreciation may combine with other errors in other estimates and indicate bias on the part of management.

FEEDBACK FROM QAD PRACTICE ASSURANCE VISITS IN 2010

(LECTURE A356 – 12.46 MINUTES)

The Institute of Chartered Accountants in England and Wales (ICAEW) has recently published the 2010 Practice Assurance Report. This gives feedback on the results of 2,331 Practice Assurance visits in 2010.

Of the 2,331 firms reviewed, 65 were reported to the Practice Assurance Committee. The report stresses that this action can often be avoided by a firm being proactive, with a number of instances being simply due to the firm not replying to the closure meeting notes or reports, even after reminders were sent.

The main issues arising on the 2010 Practice Assurance visits were:

Money laundering regulations

The most common issue found by the QAD is non-compliance with the Money laundering regulations 2007. There are two key concerns:

- firms don't always identify all the possible triggers to perform ongoing client due diligence; and
- some firms do too much initial client due diligence.

The QAD noted that firms often take a belt and braces approach to their due diligence the first time they complete it, but then forget about the requirement to revisit their risk assessments. The report also notes that those firms that did not carry out a regular anti-money laundering compliance review were the firms that had other issues in complying with the Money Laundering Regulations.

Further guidance on how to comply with the regulations is available at icaew.com/moneylaundering

Clients' money regulations

The next most common issue was non-compliance with the Clients' money regulations. The QAD say that some issues would be easy to fix eg the inability to locate the bank trust letter or failure to appoint an alternate.

Other issues were more serious such as the lack of 5 weekly reconciliations and the failure to perform an annual compliance review. Sometimes these failures led to client money accounts going overdrawn.

The QAD remind us that the Clients' Money Regulations changed in 2010 so that firms can now donate unclaimed money to charity. For more information, visit icaew.com/clientmoney

Statutory accounts

The report notes that the production of statutory accounts is a problem area for some firms. The QAD found disclosure errors in approximately one third of the accounts they reviewed. The QAD attribute this to the fact that some firms do not use commercial software or disclosure checklists. A quality control review before the accounts leave the office would also help reduce the incidence of errors.

Editor's note: I find the QAD findings to be almost unbelievable. In my file reviews, despite the fact that firms use software and checklists and put in a great deal of effort, I rarely find a set of accounts that are free of disclosure errors.

Engagement letters

25% of the firms visited needed to make changes to their terms of engagement to ensure inclusion of the following matters:

- the basis on which the firm charges fees; and
- the client's right to complain to the ICAEW.

These must be communicated to the client in writing and the QAD believe that an engagement letter is the best way to achieve this. Helpsheets are available from the ICAEW in this area.

Registered office address

Approximately 20% of firms do not display an up to date list of companies that use the firm's address as their registered office.

Although the QAD see this as an easy problem to fix, it is necessary to put procedures in place to keep the list up to date.

Provision of services regulations 2009

The QAD highlight this as a new area. Under the Provision of services regulations 2009, firms must provide new clients with information about their professional indemnity insurer and the territorial coverage of their policy. There are additional requirements if you're audit registered. Further information on the Provision of services regulations is available at icaew.com/helpsheets, Services Directive (PAS1/HS22).

ICAEW's Code of ethics

ICAEW's Code of ethics changed with effect from 1 January 2011 and the prohibition against firms making loans to or receiving loans from clients has been removed.

Instead of a prohibition, the firm must consider the threats arising from any such loan before accepting it. The firm may then be able to put safeguards in place to mitigate the threats.

Further guidance will be issued later this year.

Other points to watch

The issues arising from the 2009 ICAEW Practice Assurance report continue to be relevant:

- Ensuring adequate PI insurance is in place – including cover for connected entities (such as payroll companies) where relevant.

- Using the correct ICAEW logo in line with ICAEW guidance and permissions.
- Appropriate registration under the Data Protection Act.
- CPD compliance - using the ‘reflect, act, impact’ model.
- The annual practice assurance compliance review. Although the regulations do not require an annual Practice Assurance compliance review, the QAD generally finds fewer reportable issues where firms do undertake a regular review.

ISA 800: THE INDEPENDENT AUDITOR'S REPORT ON SPECIAL PURPOSE AUDIT ENGAGEMENTS

(LECTURE A357 – 6.14 MINUTES)

ISA (UK & Ireland) 700 requires that in giving a report the auditor considers whether the financial statements are prepared in accordance with a financial reporting framework. This is included in paragraph 8:

> 8 The auditor's report on the financial statements shall contain a clear written expression of opinion on the financial statements taken as a whole, based on the auditor evaluating the conclusions drawn from the audit evidence obtained, including evaluating whether:
>
> ......
>
> (c)In respect of a true and fair framework, the financial statements, including the related notes, give a true and fair view; and
>
> (d)In respect of all frameworks the financial statements have been prepared in all material respects in accordance with the framework, including the requirements of applicable law.

Whether it is a true and fair view framework or compliance framework, there has to be a framework in place. For most audit assignments this does not present any problems as the framework exists. However, recent events have highlighted assignments where such a framework does not exist but the engagement with the client is for an audit to be conducted. For an accounting professional, a report which includes the word “audit” can only be used where the APB auditing standards have been complied with.

Some key questions

Is this a new issue?

Yes, the previous version of ISA (UK & Ireland) 700 included the following:

> 1 The purpose of this International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) is to establish standards and provide guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent

auditor of the financial statements of an entity. Much of the guidance provided can be adapted to auditor reports on financial information other than financial statements.

This clearly indicates that the previous version of the standard could be adapted for other assignments. By contrast, the revised version of ISA 700 is only applicable to general purpose financial statements, a fact indicated in the title of the IAASB version of the standard. Hence this issue now requires consideration.

The revised version of ISA (UK & Ireland) 700 applies to companies for accounting periods commencing on or after 6/4/08 (excluding charitable companies) and for other entities for accounting periods ending on or after 15/12/10.

What audit assignments may be affected by this?

A current topical issue is the audit of service charge accounts. Tenants may see the audit as a method of ensuring that the landlord has accounted for the service charges in an appropriate manner. This may extend to both residential and commercial service charges. The requirement for an audit may therefore be contained in the lease and there is no accounting framework which requires an audit.

Other assignments such as charity audits where the charity prepares receipt and payment based accounts are also affected by this issue. The legal framework applied to these assignments does not require an audit as a statutory requirement. However many charity trustees may see an audit as a demonstration of their stewardship of the charity and an audit may be required by the charity's constitution.

So, can I adapt ISA 700 (revised) for these assignments?

The short answer is no. There is no framework and hence the standard is not applicable.

Is there a standard I could use?

Yes, ISA 800 is for audit assignments where the financial statements are prepared in accordance with special purpose frameworks.

ISA 800 can be downloaded from the IAASB website. We are told that the standard has been used by some firms in the UK where the reporting engagement would not allow the use of ISA 700. However, it should be noted that ISA 800 is not available on the APB website; we are not aware of any comment from the APB on ISA 800 and it is not known, therefore, whether the APB would approve of its use in the UK.

ISA 800

The effective date for the ISA is accounting periods commencing on or after 15 December 2009.

The objective:

> The objective of the auditor, when applying ISAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:
>
> (a) The acceptance of the engagement;
>
> (b) The planning and performance of that engagement; and
>
> (c) Forming an opinion and reporting on the financial statements.

Definitions

> Special purpose framework – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The reference to financial statements means a complete set of special purpose financial statements including the related notes. The related notes should include a summary of the significant accounting policies. What constitutes a set of financial statements is determined by the framework in place. Therefore it does not necessarily require an income statement and balance sheet.

The application notes give a number of examples of special purpose frameworks including:

- A tax basis of accounting for a set of financial statements that accompany an entity's tax return;
- The cash receipts and disbursements basis of accounting for cash flow information that an entity may be asked to prepare for creditors;
- The financial reporting provisions of a grant.

The application material includes the following:

> A2. There may be circumstances where a special purpose framework is based on a financial reporting framework established by an authorized or recognized standards setting organization or by law or regulation, but does not comply with all the

requirements of that framework. An example is a contract that requires financial statements to be prepared in accordance with most, but not all, of the Financial Reporting Standards of Jurisdiction X. When this is acceptable in the circumstances of the engagement, it is inappropriate for the description of the applicable financial reporting framework in the special purpose financial statements to imply full compliance with the financial reporting framework established by the authorized or recognized standards setting organization or by law or regulation. In the above example of the contract, the description of the applicable financial reporting framework may refer to the financial reporting provisions of the contract, rather than make any reference to the Financial Reporting Standards of Jurisdiction X.

A3. In the circumstances described in paragraph A2, the special purpose framework may not be a fair presentation framework even if the financial reporting framework on which it is based is a fair presentation framework. This is because the special purpose framework may not comply with all the requirements of the financial reporting framework established by the authorized or recognized standards setting organization or by law or regulation that are necessary to achieve fair presentation of the financial statements.

The standard has the following sections:

- Considerations when accepting the engagement
- Considerations when planning and performing the audit
- Forming an opinion and reporting considerations

In respect of the report the standard includes the following:

12. ISA 700 requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

13. ISA 700 deals with the form and content of the auditor’s report. In the case of an auditor’s report on special purpose financial statements:

(a) The auditor’s report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information; and

(b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management’s responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

14. The auditor's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. The auditor shall include this paragraph under an appropriate heading.

There are three example reports, two for a compliance framework and one for a fair presentation framework.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information. The financial statements have been prepared by management of ABC Company based on the financial reporting provisions of Section Z of the contract dated January 1, 20X1 between ABC Company and DEF Company ("the contract").

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the financial reporting provisions of Section Z of the contract, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements of ABC Company for the year ended December 31, 20X1 are prepared, in all material respects, in accordance with the financial reporting provisions of Section Z of the contract.

Basis of Accounting and Restriction on Distribution and Use

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist ABC Company to comply with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for ABC Company and DEF Company and should not be distributed to or used by parties other than ABC Company or DEF Company.

[Auditor’s signature]

[Date of the auditor’s report]

[Auditor’s address]

SUBSTANTIVE ANALYTICAL REVIEW

(LECTURE A358 – 7.23 MINUTES)

ISA 520 was clarified but not revised. This might lead you to believe that the changes in ISA 520 are minimal. NOT SO! For the first time, we have compulsory requirements when performing substantive analytical procedures.

Extracts from the standards: ISA (UK & I) 520

Substantive Analytical Procedures

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

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

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

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

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

Substantive analytical procedures

Paragraph A4 in the Application Material makes it clear that substantive analytical procedures will only be used where they are considered to be either more effective or more efficient than other substantive tests. In recent years, there has been a widespread belief that analytical review is the most efficient way to obtain audit evidence. Whilst this is true in some circumstances, some auditors have been over-optimistic in their view that all analytical procedures are equally effective in all circumstances. This has led to criticism from monitors and reviewers alike. The new standard should ensure that analytical review is only relied upon where that reliance is well-founded.

The availability of information is an encouragement to use analytical procedures. However, Paragraph A5 reminds us that the auditor must be satisfied as to the accuracy of that information. Where information is prepared internally, the auditor may choose to test the operating effectiveness of the controls over the preparation of that information. Alternatively, substantive tests will need to be performed.

Suitability of particular analytical procedures for given assertions

Paragraph A6 of the Application material tells us that substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

Unsophisticated models may be effective as analytical procedures but different types of analytical procedures provide different levels of assurance. Paragraph A8 tells us that analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

If controls are deficient, the auditor may place more reliance on tests of details rather than on substantive analytical procedures. Similarly, substantive analytical procedures may be considered suitable when tests of details are performed on the same assertion.

In short, the following generalisations can be stated based on Paragraphs A6 to A10 of the Application Material:

- Substantive analytical procedures are more likely to be effective in the audit of the P&L account than in the audit of the balance sheet
- Some analytical procedures can provide the auditor with all of the evidence required for a particular assertion for example tests of gross pay or rental income
- Other analytical procedures are only likely to provide some of the evidence required for a particular assertion for example tests of gross profit percentage or balance sheet tests
- If internal control is poor then it is more likely that other substantive tests will be required either in addition to or instead of analytical tests.

With respect to the final point, the application material does not go so far as to suggest that substantive analytical procedures should only be used if the operating effectiveness of internal controls has been tested. However, this could be a good suggestion in practice. If controls have been tested and found to be good then this reduces the need for substantive evidence and therefore it is more likely that sufficient substantive evidence can be obtained from analytical procedures alone.

The reliability of the data

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Paragraph A12 tells us that the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- Source of the information available
- Comparability of the information available
- Nature and relevance of the information available
- Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity
- Prior year knowledge and understanding.

Paragraph A13 tells us that the auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.

Note, once again, the emphasis on the need to be satisfied as to the reliability of the inputs into the analytical model. This confidence can be gained by tests of controls over the production of information or by other substantive tests on the input data.

Evaluation whether the expectation is sufficiently precise

When considering whether an expectation can be developed with sufficient precision. Paragraph A15 tells us that the auditor should consider:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor might expect greater consistency in comparing gross profit percentage from period to period than in comparing discretionary expenses

- The degree to which information can be disaggregated.

- The availability of the information, both financial and non-financial.

Developing an expectation

The application material makes no comment on the basic principle that all substantive analytical tests must be framed as reasonableness tests. Paragraph 5 says that ".....the auditor shall (c) develop an expectation..."

This does not mean that other techniques cannot be used but it does mean that the tests need to be framed as reasonableness tests. For example, suppose that the auditor sets out to perform a trend analysis comparing sales in each month of the current year with the equivalent month in the previous year. The auditor might now set the hypotheses for the analytical test: "It is expected that the quantity of goods sold in each month of 2011 will be the same as in the equivalent month of 2010". Alternatively, the hypothesis may be phrased in monetary terms: "It is expected that the sales revenue for each month of 2011 will be 3% higher than for the equivalent month of 2010 allowing for the price increase on 1 January".

This requirement concentrates the mind. Previously, the auditor may have performed a vague comparison or produced a time-series chart showing the two years running along roughly similar lines. Now, a precise statement is required, up-front. There is therefore pressure to try to predict what changes will occur and build them into the model. Previously, the auditor could wait and see how the comparison turned out before seeking plausible explanations.

Precision of the expectation

But the requirement to develop the expectation is only the start of the auditor's problems. The auditor must now "evaluate whether the expectation is sufficiently precise...." and this is the subject of the guidance in paragraph A15 referred to above.

Let us consider the first bullet point dealing with consistency from period to period. Suppose that the auditor has decided to use a traditional analytical review of the detailed P&L account (often used as a risk assessment procedures) as a substantive review. The starting point is the statement of the hypothesis or expectation. Some might suggest that the expectation is that the current year results should be the same as in the previous year but this route is fraught with difficulty:

- In most businesses, sales are difficult to predict. Certainly the business would hope to be increasing sales from the previous year. So, should the auditor use budgeted sales as the hypothesis figure rather than last year's sales? To bring in the budget at this point is introducing a whole set of other questions as shown above.

- You would not expect cost of sales to be the same as in previous years. Rather, you would expect it to be related to sales quantities. The auditor must also consider different price inflation on different elements of cost of sales and also the desire for efficiencies in production which may yield a higher GP%. Perhaps, it would be better to analyse the GP% rather than cost of sales as a single figure.

- We have now introduced the idea of costs which depend on sales and so the auditor, in developing an expectation, will need to decide which expenses are variable (ie vary directly with sales) and which are not. Separate predictions need to be made for each direct cost allowing again for differential inflation rates and efficiencies.

- But costs that are not variable are not necessarily fixed. Some costs, such as rent may well be fixed over a period of time. Other costs (eg rates) could be predicted based on last year's figure and the auditor's knowledge of local increases.

- Then we come to the discretionary costs where the first bullet point in A15 points out the auditor's difficulties. Why should the expenditure on advertising be the same as last year (plus inflation)? Again, the budget is probably a better starting point. However, cynics will say that the budget gives the budget holder permission to spend that amount of money and therefore it will be spent whether it is necessary or not.

Hopefully, this gives my readers an idea of the difficulties involved in trying to use a year on year P&L comparison as a substantive test. However, the difficulties are not yet over. We now need to consider the accuracy of the prediction in the light of the degree of disaggregation.

Disaggregation

Suppose that you were trying to predict the cost of sales for a company. You know that last year the revenue was £10m and cost of sales was £6m. You are aware that the client has achieved an increase in sales of £1m.

As a starting point, you might predict a cost of sales figure of £6.6m. How accurate would you expect this to be? If the actual figure turned out to be £6.2m, would you be pleased with your prediction or disappointed?

Suppose now that you know that the client sells two types of product. One with an expected GP% of 50% and the other with an expected GP% of 35%. You know the mix of sales in the previous year and the current year. How does this affect your prediction? Would you expect the new prediction to be more accurate than the original prediction? Of course you would – but how much more accurate?

We could extend this example to a client selling many different products. We could also consider the elements of the cost of sales and we could research whether the price increases on materials differ from the increase in selling price. Payroll costs and overheads may also be subject to different inflation rates. Indeed, within those headings, for example overheads, there may be several cost headings all with their own cost behaviour.

As the auditor analyses the costs in more detail, the prediction of the costs should become more accurate. This will provide the auditor with more confidence but, of course, every improvement to the model adds to the cost of the process.

The auditor needs to disaggregate to a sufficient level such that the aim of the test is achieved. However, further disaggregation will make the test inefficient.

Let's consider again the example where the auditor is testing cost of sales. Let's suppose that the materiality is 1% of turnover namely £110K. Suppose a performance materiality has been set for cost of sales of approximately 75% of this figure – let's say £80K.

If you did a simple projection of the cost of sales figure (ie the estimate of £6.6m above) would you expect this to be within £80K of the true figure for cost of sales? I think that you are unlikely to be sufficiently confident that this broad-brush prediction is sufficiently precise. So you need to analyse the data more thoroughly.

Suppose your next prediction is based on the information that 60% of the sales in the current year are of product A, the product with the higher GP%. You could make a new prediction of cost of sales as £6.16m (£11m*60%*50% + £11m*40%*65%). This figure should be more accurate when you compare it with the actual cost of sales figure. Would you now expect to predict the actual total cost of sales within £80K?

If not, then further disaggregation is required.

Another issue here is whether it is correct to use performance materiality as the measure of desired accuracy in the prediction. I would suggest that the performance materiality is the maximum figure that could be used. However, it might be argued that a lower figure should be used if the amount being predicted is only a part of the entire population.

For example, if you were seeking to project total cost of sales of the above business then a prediction which the auditor considers is sufficiently precise to predict the actual figure within £80K is probably acceptable. However, if you have decided to use disaggregated data, is it not better to compare cost of sales for product A = £3.3m with actual cost of sales for product A and likewise for product B? You would now expect the separate estimates to be each more accurate than the broad-brush estimate. So would you, as auditor, be setting a figure of £40K as your desired accuracy of each estimate? Alternatively, would you argue that errors in the disaggregated estimates may cancel out and therefore it is acceptable if the expected precision in each separate estimate is only, say £50K?

This could get very complicated. For example, if we return to our earlier example of using last year's P&L to predict this year's expenses, we may be breaking the P&L account down into, say, 20 different cost headings. Suppose we wish to predict total

P&L expenditure within £100K, does this mean that we need to be able to predict each cost heading within £5K?

Alternatively, would we be better to use percentages? Suppose that the desired precision is £100K on total P&L expenditure of £5m ie a precision of 2%. Does this mean that we would need to be confident that we can predict each individual cost heading within 2%?

Amount of difference of recorded amounts from expected values that is acceptable

This amount is influenced by materiality and the desired level of assurance. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

Paragraphs 5(c) and 5(d) must be linked but is it as simple as it might at first sight appear?

Suppose that we decided that our estimate was sufficiently accurate to predict cost of sales within £80K. Suppose we predicted a figure of £6.16m. The actual cost of sales figure (as shown in the client's draft accounts) was £6.22m. This is "only" £60K from our prediction so surely all must be well.

Maybe not.

Suppose that our prediction is working fine. It did predict within £80k of the true figure but the true figure was really £6.10m. Nobody, of course, knows that this is the true figure and the auditor is happily assuming that the actual figure in the books of £6.22m is the true figure. In reality the actual figure is incorrect by an amount of £120K which is material.

What's to be done about this? It would be illogical to set a lower figure for investigation than the estimated precision of the expectation. Perhaps, therefore, we need to divide everything by 2. That is, in our cost of sales example, the auditor needs to be confident that the estimation technique will predict cost of sales within £40K. The auditor will then investigate any difference exceeding £40K.

Now apply this to the P&L expenditure example. The auditor might set a difference for further investigation as follows:

"If the amount for any cost heading differs from the prediction by more than 1% then further investigation is required except in the situation where the difference is less than the amount set as clearly trivial for this client"

AUDIT MONITORING IN 2010

(LECTURE A359 – 12.42 MINUTES)

Introduction

These notes are adapted from Audit News Issue 49 published by the ICAEW in May 2011. This document gives a summary of the audit monitoring activities of the ICAEW in 2010. The report refers to the AIU published reports on its 2009/10 inspections which highlighted a number of challenges for the audit profession. The QAD say that their findings show that firms of all sizes are capable of delivering high quality audits, although complex audits can be a challenge for any firm.

The QAD visited 755 audit firms in 2010. In the majority of cases they concluded that firms' audit work was satisfactory. In some cases, however, firms do need to make improvements to the standard of their work. The objective of the QAD is to help firms improve. They identify the root cause of any weaknesses in audit work and discuss steps that the firm can take to resolve the issues. Firms may provide further information to show that their actions have been effective, and the QAD will offer support where they can. Nevertheless, in very serious cases they have to recommend that a firm's audit registration be withdrawn.

The report includes some of the main areas in which audit firms need to improve and these are shown below.

Make careful judgements and document them

The quality of judgments made by the audit team is critical to any audit. We will always challenge audit judgments where there is insufficient or conflicting information on the audit files and where we cannot understand how the audit team reached their conclusion.

Difficult judgments are often finally made through discussion between the audit partner (or other senior members of the audit team), and client management. In the best audit files we review, the records of this work provide persuasive evidence, and the judgments and conclusions are clearly set out in reports to those charged with governance.

Here are some examples of common but potentially difficult judgments where we cannot always understand the conclusions on the audit file.

Assessment of going concern

There may be no history of liquidity problems but shortage of credit from banks has introduced risks that the audit client has never faced before, and these need to be evaluated.

Conclusions on impairment

The input data and assumptions used in a client's or an expert's financial models may be difficult to audit and small changes to a discount rate or growth factor could result in the recognition of a significant impairment charge.

Reliance on other auditors in group audits

Auditors of UK companies can find themselves responsible for the audit of a business with most of its activities on the other side of the world. These auditors must make judgments about how much involvement they should have in the planning and audit work in those overseas entities, and the competence of another firm which may operate in a very different regulatory environment.

Assess risk

Most firms understand their clients and the related audit risks. Nevertheless, they often do not document this knowledge properly using the framework set out in ISA 315 and ISA 240 (the risk and fraud ISAs).

Where the risk assessment process is weak, it can be because engagement partners and senior audit staff had little involvement at the planning stage of the audit. Proper leadership and direction of the audit is a key requirement of ISA 220. There are clear benefits to the audit engagement if the senior members of the audit team share their knowledge of both the client and the business environment with more junior staff.

Time invested at the planning stage results in more effective and efficient audits. Good risk assessment can have added benefits for the client by identifying areas of weaknesses in its key controls and risks that it may not otherwise have considered. This is just as important in an owner-managed business as in a large multinational.

Our review of the financial statements sometimes highlights potential risk areas that the firm has not clearly identified and addressed in the audit, for example:

- warranty provisions;
- material business acquisitions; and
- the use of restricted funds in a charity.

Lack of effective risk assessment can also mean that firms do extensive audit work on low risk areas and this affects efficiency.

Gather the right audit evidence and record it

Although we see a lot of good and well documented audit work, many of the issues we raise on audit files relate to the quality of audit evidence and gaps in documentation.

Sometimes the audit work on file does not provide enough evidence to support the view that account balances are materially correct. These are the kinds of thing we see:

Design of audit tests

Evidence of the existence of fixed assets is obtained through testing of additions and disposals but without testing any items brought forward from the previous year.

Population of transactions used for sampling

The audit firm only selects items sold post year end to test net realisable value of stock.

Weakness in substantive analytical procedures

Audit work relies on substantive analytical procedures where:

- it is not possible to develop sufficiently precise expectations; or
- balances are simply compared to prior year and significant variances are discussed with management without corroboration.

Knowledge of potential related parties

Sometimes the audit of related parties focuses only on those transactions identified by management. Firms need to demonstrate that they have obtained information about all related parties with the assistance of management so that the audit team can be alert to undisclosed transactions.

Assessment of experts

Although audit evidence may include reports from experts, there is sometimes little indication that the audit team has considered the qualifications of the expert, the scope of the report, key assumptions and underlying data.

Incomplete documentation

Good audit documentation is a challenge. Firms can often provide additional explanations to show us they have obtained appropriate audit evidence, but the very fact that we need to ask the question often means that the work is not documented well enough. It may also indicate that the firm's review processes have not been as effective as they should have been; especially the final engagement partner review.

Show that you act ethically

UK statutory auditors should follow the APB Ethical Standards which set out a threats and safeguards approach to auditor independence.

Firms do generally act in accordance with the spirit of the Ethical Standards, but they sometimes take on work when they shouldn't and sometimes fail to identify or adequately safeguard potential threats to their independence. For example:

- we still occasionally see firms acting as the auditor and company secretary to a client;

- some small audit firms with listed clients do not have an engagement quality control review (EQCR) and can overlook the partner and EQCR rotation requirements for listed entities;

- firms may fail to identify that their PLUS market audit client is listed, and that the requirements of ethical and auditing standards which relate to listed companies must be applied;

- fee dependency issues for audit clients that generate significant fee income for the firm are not always properly addressed in accordance with Ethical Standard 4;

- audit partners who have acted for unlisted clients for over 10 years need to take certain steps to comply with Ethical Standard 3; the safeguards do not have to be onerous but should be properly thought through and implemented; and

- we still find instances where firms have provided prohibited accounting or tax services to their listed clients.

Documentation

More generally, we quite often find that firms do not fully document their consideration of threats and safeguards. In the case of non-audit services, for example, it may not be clear:

- that all non-audit services have been identified;

- which particular threats arise (eg, self-review or management threats);

- what, if any, safeguards the firm has implemented; or

- whether these details have been communicated to those charged with governance, as required.

Smaller audits

Firms with small audits may apply the Provisions Available to Small Entities (PASE). The PASE allows firms to provide some non-audit services to audit clients without safeguards, subject to certain other requirements. Nevertheless, we find that firms applying the PASE don't always understand how it should work, and some firms don't realise they can take advantage of these simplified provisions.

Firms that have smaller audits should therefore read the PASE carefully to help them make the most effective use of it.

Maintain appropriate audit procedures

ICAEW's audit regulations and ISQC1 require all audit firms to have policies and procedures across certain key areas as a framework for ensuring good quality audit work.

Generally we find that our audit firms have procedures suitable for their size and the nature of their audits. Our most common finding is that, although firms can explain their approach and we can see that suitable procedures are applied in practice, their policies and procedures are not fully documented as required by ISQC1.

There are a few specific areas of ISQC1 where some firms need to enhance their procedures.

Evaluate cold file review findings

Firms should properly evaluate the findings from their annual cold file reviews and implement an action plan to address weaknesses quickly. Firms that grade the results of their file reviews may find it easier to monitor their progress year on year.

EQCR procedures

An EQCR is required for all listed audits. Firms must ensure that the individuals who perform this review have enough authority and relevant experience for the role, and are involved at appropriate stages of the audit. EQCRs are often routinely implemented in larger firms for new audit clients, modified audit reports and other risk criteria. These policies that exceed the minimum requirements are very good practice.

Audit training

Regular audit training is essential, and even relatively small audit firms may now have specialist teams to concentrate on audit assignments. Training on proprietary audit systems is also important. Firms sometimes struggle when they switch audit systems, particularly to a computer-based system, without any training from the software provider.

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.

APB issues revised guidance on the audit of credit unions in the UK

The Auditing Practices Board (APB) of the FRC today issued a revision of Practice Note 27 "The audit of credit unions in the United Kingdom". An exposure draft of the revised Practice Note was issued in October 2010 for public comment.

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

Richard Fleck, APB Chairman, said:

"This Practice Note provides guidance for the audits of credit unions in the UK, many of which are undertaken by smaller audit firms. The APB hopes that auditors of credit unions will find the revised and clarified guidance helpful in carrying out their work"

25 May 2011

ASB draws attention to new/revised International Accounting Standards

The International Accounting Standards Board (ASB) has over the last two months published a number of new and revised International Financial Reporting Standards on consolidated accounts, fair values and pensions. The standards are required to be applied for years beginning on or after 1 January 2013 but are still subject to EU endorsement.

If endorsed, UK companies are likely to be particularly affected by the changes to the calculation of pension costs. Instead of crediting the expected return on pension plan assets separately and charging the calculated interest cost on the pension provision, the amended standard requires a charge or credit to be calculated by applying a AA rated bond interest rate to the net pension deficit or surplus. This is likely to reduce profit for many companies.

The new consolidation standard, IFRS 10, applies a single (revised) definition of control to all entities in determining whether they should be consolidated. Whilst many groups will be unaffected the ASB considers that all parent companies will need to consider the possible implications arising from the standard, particularly where the original decision as to whether to consolidate a company was not clear cut.

Although initial indications are that fund managers may be particularly impacted by the new standard, if endorsed, the effect cannot be fully evaluated until the IASB releases an exposure draft addressing whether an investment entity should not consolidate investments in entities that it controls, but to measure those investments at fair value, with changes in fair value recognised in profit or loss. The ED is expected to be issued in the near future.

Whilst it was originally intended that IFRS 10 be a converged standard between the IASB and the FASB, the latter have decided not to implement it. This will leave important consolidation principles unconverged.

The intention of the new fair value standard, IFRS 13, is not to bring increased fair values into accounts but to bring about consistency of fair value across IFRSs. However, there are likely to be some costs associated with clarification and alteration of current practice and there is a risk of diversity in application.

Note:

The new standards are:

a) IFRS 10 – ‘Consolidated Financial Statements’;

b) IFRS 11 – ‘Joint Arrangements’;

c) IFRS 12 – ‘Disclosures of Interests in Other Entities’;

d) IFRS 13 – ‘Fair Value Measurement’; and

e) ‘Amendments to IAS 19 – Employee Benefits’

In addition there will be a revised IAS 27 ‘Separate Financial Statements’ and amendments to IAS 28 ; ‘Investments in Associates and Joint Ventures’.

22 June 2011

Financial Reporting Council publishes its Annual Report for 2010/11

The Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment, today publishes its Annual Report for 2010/11.

Annual Report for 2010/11

The Annual Report describes the ways in which the FRC, working closely with its stakeholders, has contributed to promoting high quality confidence in corporate reporting and governance during 2010/11.

The Annual Report 2010/11 is available on the FRC website at http://www.frc.org.uk/about/annual.cfm.

Baroness Hogg, Chairman of the FRC, said:

“In the past year, we have brought into effect a new Corporate Governance Code and – the first of its kind – a Stewardship Code for investors. We have launched a consultation paper on Effective Company Stewardship and a series of discussions on best practice in fulfilment of boards’ responsibilities with respect to risk, in order to determine what changes may be needed to bring the existing Turnbull guidance up to date. We have taken the opportunity of an inquiry by the House of Lords Economic Affairs Committee into the market for audit services to express our concerns in this area, and invited Lord Sharman to conduct an inquiry into the questions raised about going concern statements. We have enhanced transparency through reports by the Audit Inspection Unit, participated in the debate on the role of accounting standards during the crisis, and consulted on the future of UK GAAP.

Our key challenge for the coming year will be to weave the disparate activities of the FRC into two functional strands: one concerned with the setting of codes and standards, the other with the conduct of companies and professionals. We will be consulting, together with our sponsoring department, on whether some elements of our current activities can be dispensed with altogether, while ensuring that our powers to discharge our core responsibilities are vested properly in the FRC, and are adequate and proportionate.

We will be keeping in particularly close touch with our stakeholders, on whom we will rely heavily for advice in our efforts to create an FRC that is:

- easier to understand, focused and clear in its purpose
- disciplined, proportionate and restrained in the execution of that purpose
- flexible, acute and sensitive to the impact of its work on companies, markets, professions and the people who work in all three.”

Annual Open Meeting

The FRC's Annual Open Meeting will be held at 4.00pm on Tuesday 28 February 2012 in the Council Chamber of the Institution of Engineering and Technology (IET), 2 Savoy Place, London WC2R 0BL. There will be an introduction by the Chair, a report by the Chief Executive and the opportunity to ask questions.

Anyone with an interest in the FRC's work on corporate governance, corporate reporting, auditing, actuarial practice and the integrity, competence and transparency of the accountancy and actuarial professions is welcome to attend. If you wish to attend, please confirm your attendance by emailing aom@frc.org.uk.

In order to make the discussion part of the meeting more effective, we invite stakeholders to submit questions or topics in advance, preferably with some detail of the particular issue(s) of concern to you. Submissions are welcome, regardless of whether or not you intend to attend the AOM. Submissions should be made, either by email at aom@frc.org.uk or by post to Jonathan Labrey, Head of Communications. Please disclose your name, address and affiliation, if any.

Baroness Hogg said:

"Holding an Annual Open Meeting is an important part of the FRC's commitment to be a transparent and accountable regulator. It will be an opportunity to discuss our work during 2011/12 and hear views on our priorities for 2012/13. If you have issues you would like to raise, but cannot attend, please send us a note."

5 July 2011

ASB issues Amendments to FRS 29 (IFRS 7) 'Disclosures - Transfers of Financial Assets'

The ASB of the FRC has today published amendments to FRS 29 (IFRS 7), 'Financial Instruments: Disclosures,' adding requirements to that standard in relation to disclosures on transfers of financial assets. The amendments enhance the information currently provided in financial statements in relation to risk exposures arising from transfers of financial assets by an entity. This will enable users of financial statements to evaluate an entity's risk exposure arising from transfers of financial assets, as well as any resulting impact on the financial position.

The need for the amendments arose as a result of the International Accounting Standards Board (IASB) amendments to the disclosure requirements IFRS 7 'Financial Instruments: Disclosures' during October 2010.

As the requirements in FRS 29 are converged with those in IFRS 7, the ASB amendments to FRS 29 (IFRS 7) are, therefore, identical to the IASB amendments and would ensure that the requirements in the two standards do not diverge.

Entities are required to apply the amendments for annual periods beginning on or after 1 July 2011.

7 July 2011

Publication of Audit Inspection Unit 2010/11 Annual Report

The Professional Oversight Board, part of the Financial Reporting Council, has today published the Audit Inspection Unit's (AIU) Annual Report for 2010/11.

The report, which provides an overview of the activities and findings of the AIU, notes:

- That its inspection results for 2010/11 are as good as, or even slightly better than, those of the last year. Of particular note is the reduction in the number of FTSE 350 audits assessed as requiring significant improvement.
- Notwithstanding this the proportion of audits assessed as requiring significant improvement, particularly at smaller firms, remains of concern.
- Changes to the AIU's scope which now includes all banks incorporated in the UK and the greater emphasis given by the AIU to bank audits.

There are a number of key issues and concerns where improvements are required if firms are to achieve the consistent performance expected. These include:

- The need for firms to exercise appropriate professional scepticism in respect of key areas of judgment.
- Firms must recognise the importance of the proper identification and assessment of threats and safeguards in maintaining auditor independence at a time when the need for more specific prohibitions is being debated.
- Firms, and in particular smaller firms, should carefully consider whether they have the appropriate resources, expertise and involvement to undertake audits of multi-national groups to the required standard.
- The auditors of UK components of international financial institutions should ensure they obtain sufficient evidence to support their statutory audit opinion of UK subsidiaries.

Commenting on the report, John Kellas, Interim Chairman of the Professional Oversight Board said:

> "I am pleased to report that the AIU's inspection activities in the current year have again found improvements in audit quality. However, further improvements are still required. The importance of audit quality needs to be continually reinforced and embedded in the culture of the firms.
>
> The inspection results are based on samples and we cannot say that this year's results will be replicated (or, better, improved upon) in future. The current difficult economic climate will throw up challenges for auditors, who will need to perform consistently at their best to meet them.
>
> We believe that having a wider range of specific actions, such as proportionate sanctions, available to the FRC would assist in promoting audit quality."

The report is available on the website at http://www.frc.org.uk/pob/audit/reports.cfm

Individual reports on the findings from the AIU's inspections at Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers, Grant Thornton and BDO will be published later this month.

19 July 2011

Note that the reports on the individual firms were published on 26 July 2011

Importance of true and fair view in both UK GAAP and IFRS reaffirmed by the Accounting Standards Board and Auditing Practices Board

The Accounting Standards Board (ASB) and Auditing Practices Board (APB) of the Financial Reporting Council (FRC) today reconfirm that the true and fair view remains of fundamental importance in both UK GAAP and IFRS. A paper published today for preparers and auditors explains the continuing primacy of the true and fair requirement and its relevance to preparers, those charged with governance and auditors.

Commenting, ASB Chairman Roger Marshall said:

"The concept of true and fair has underpinned UK GAAP for many years. Concerns have been raised about the relationship of true and fair to IFRS in some quarters, not least in evidence to the recent House of Lords Economic Affairs Committee inquiry into audit market concentration. The purpose of our paper today is to remind both preparers and auditors that the true and fair requirement remains of fundamental importance in both UK GAAP and IFRS".

21 July 2011

POB uses greater transparency to encourage more robust regulatory processes

The Professional Oversight Board, a part of the Financial Reporting Council, today publishes its Report to the Secretary of State for Business, Innovation and Skills for the year to 31 March 2011. The Report comments on the Board's responsibilities:

- for statutory independent oversight over the regulation of auditors by recognised professional bodies;
- for non-statutory oversight of the regulation of actuaries and accountants by their professional bodies;
- for regulation internationally;
- as the Independent Supervisor of Auditors General.

The main points are:

- The audit regulatory bodies continue to take their responsibilities very seriously.
- Nevertheless, there are aspects of their regulation of auditors that require improvement. In particular:
    - All the Recognised Supervisory Bodies (see note) need to make more robust their processes for approving individuals entitled to sign audit opinions on behalf of an audit firm (paras 2.18 – 2.24)
    - We are still not confident that one body will meet its statutory obligations for inspecting audit firms within a six year cycle without further decisive action (paras 2.27 - 2.28).
    - All the Recognised Qualifying Bodies need to improve elements of the way in which they award exemptions from certain examinations (paras 2.31 – 2.37).
    - Two bodies still need to do more to satisfy us that all their examinations provide a sufficiently challenging test for those wishing to be statutory auditors (paras 2.41 - 2.44).
- The Actuarial Profession's response to our recommendations (on the regulation of practising actuaries and on quality controls at actuarial firms) has started to take shape, although further work is needed (paras 6.2 – 6.4).

The report also includes a summary of the Audit Inspection Unit's (AIU) Annual Report for 2010/11, which was published on 19th July.

John Kellas, Interim Chairman of the Oversight Board, said:

> "This year for the first time we name in the report the individual regulatory bodies to which our principal findings and recommendations apply. We welcome the profession's support for this development which will bring greater transparency. We hope that this publicity will provide even more encouragement to the bodies to respond to the Oversight Board's concerns positively and in a timely way."

Note: Individuals responsible for audit at registered firms must hold an audit qualification from a Recognised Qualifying Body (RQB). Audit firms who wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, a Recognised Supervisory Body (RSB). See Section 2 of the Report.

21 July 2011

FRC says 'comply or explain' principle has important place in EU Corporate Governance

The principle of "comply or explain" plays an essential part in promoting best practice in corporate governance, says the Financial Reporting Council in a submission to the European Commission published today.

In its response to the Commission's green paper on corporate governance the FRC warns that replacing principles with a series of prescriptive regulations could stifle enterprise at a time when European economies are seeking to promote economic growth.

The FRC's submission recognises the need to make the system work better. In particular it will be promoting a dialogue with companies and investors in the coming months to seek a consensus in the UK market about what constitutes a clear explanation to shareholders if a company deviates from the UK Corporate Governance Code.

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

> "We are encouraged by the debate the green paper has generated and hope it will lead to a consensus across Europe about the appropriate balance of rules, rights and codes needed to stimulate good governance and economic growth.
>
> "We believe codes underpinned by law, as in the UK, and including a 'comply or explain' approach, are the most effective means of driving up standards. Success depends on shareholders paying attention to explanations. That is why we have developed the Stewardship Code to encourage engagement by institutional shareholders. It now has over 170 signatories. We will also consider how the quality of explanations given by companies can be enhanced. Regulators may have a role in determining whether explanations provide sufficient information but this should only be pursued if it can be done without undermining the role of shareholders and to the benefit of investors.
>
> "Confidence in Europe's financial markets will be enhanced if we can ensure that companies are properly accountable to the people who provide their capital. Good corporate governance is thus an integral part of our efforts to ensure that European businesses can raise capital at a reasonable cost to invest, grow and generate jobs".

22 July 2011

APB issues revised guidance on the audit of friendly societies

The Auditing Practices Board (APB) of the FRC today publishes a revision of Practice Note (PN) 24 "The Audit of Friendly Societies in the United Kingdom". A consultation draft of the revised PN was issued in January 2011 for public comment.

The revised guidance reflects:

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

Enhanced guidance is included in the PN with respect to:

- Auditing accounting estimates.

- Materiality.
- Evaluation of misstatements identified during the audit.

Richard Fleck, APB Chairman said:

“As Friendly Societies hold funds in excess of £16 billion on behalf of a membership of some 7.1 million, the revised Practice Note provides guidance for auditors of an important sector of the UK’s insurance industry.

The APB is aware that significant changes to the legal and regulatory environment governing insurers will be taking place over the next few years, including in particular, the implementation of Solvency II. The APB will be monitoring the effect of these developments on the guidance in the Practice Note.

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

26 July 2011

ASB draws attention to the IASB’S public consultation on its future work programme

The International Accounting Standards Board (IASB) launched a public consultation on its future work programme on 26 July 2011. The consultation seeks a broad public input on the strategic direction and overall balance of the IASB’s future work programme.

The IASB is seeking feedback on how it should balance the development of financial reporting with the maintenance of IFRSs, including considering which areas of financial reporting should be given the highest priority for further improvement. The IASB has provided details of projects previously added to the agenda but deferred and new project suggestions, which respondents may take into account in their feedback.

In relation to the IASB’s work plan and priorities the ASB has previously suggested that the IASB should:

- seek to allow a period of calm, giving new standards time to bed down;
- pursue a range of activities aimed at improving financial reporting in the longer term, including giving priority to the conceptual framework project, but also research and larger and smaller standards-level projects;
- proceed with post-implementation reviews, a number of which are already committed to.

The ASB will be responding to the IASB in due course, and contributing to EFRAG’s response. The ASB would be pleased to hear constituents’ views on the IASB’s future work programme, and encourages constituents to respond to the IASB. The consultation period closes on 30 November 2011.

Any comments constituents would like to be considered by the ASB in formulating its response should be sent to Jenny Carter (j.carter@frc-asb.org.uk), preferably by 10 October 2011.

29 July 2011