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THE FUTURE OF UK GAAP (LECTURE A360 – 19.06 MINUTES)

We have considered the ASB proposals for the future of financial reporting in the UK and Republic of Ireland in previous update courses. The most significant development over the last three months occurred at the September meeting of the board when they decided to issue a revised exposure draft.

The latest (October 2011) status report from the APB states that the ASB's significant tentative decisions include:

- To eliminate the tier system by removing the definition of public accountability, as a consequence IFRS will not be extended beyond the requirements in Company law;
- To extend the disclosure requirements in the draft FRSME for entities defined as financial institutions;
- To change the guidelines for amending the IFRS for SMEs such that accounting treatments currently available in current FRS will be introduced into the FRSME;
- To remove the presentational requirements in the draft FRSME retaining those requirements in Company law;
- To proceed with the development of a reduced disclosure framework for subsidiaries, but that entities defined as financial institutions will not be eligible for exemptions relating to financial instruments;
- To extend the application of the reduced disclosure framework to parent entities who present individual accounts alongside the group accounts; and
- To defer the application date to accounting periods ending on or after 1 January 2014.

It remains to be seen whether the new application date will be achievable given the decision to re-expose.

ACCOUNTING FOR MICRO-ENTITIES (LECTURE A360 – 19.06 MINUTES)

Summary

The discussion paper "Simpler Reporting for the Smallest Businesses" has been published by the FRC and BIS. Its purpose is to stimulate discussion and gather evidence to help the Government decide whether to take forward any further action in this area. It is therefore not a statement of Government policy.

The document sets out ideas to reduce the reporting requirements for micro-entities.

A micro-entity was defined by the EU Competitiveness Council in May 2011 as a company with

- a turnover of less than €500,000 (£440,000);
- gross assets of less than €250,000 (£220,000); and
- employing fewer than 10 people.

This covers approximately 60% of UK companies registered at Companies House and 3.5 million unincorporated businesses.

The discussion paper proposes easing corporate reporting procedures so that micro-companies are only required to prepare and file:

- a simplified trading statement (in place of the current profit and loss account);
- a simplified statement of position - which would include details of shareholder's funds, fixed assets, cash, debtors, loans and short and long-term creditors; and
- a simplified annual return.

The discussion paper complements the Office of Tax Simplification's discussion paper on options for simplifying taxation for the smallest businesses, which was published in July 2011, by proposing aligning financial reporting and tax reporting so that micro-companies would only be required to prepare one set of data, from which all reporting obligations could be met.

The discussion paper also proposes developing an integrated software package to help small businesses prepare financial information. This could allow managers to gain a better understanding of the trends in their businesses' performance and help them plan for the future.

Companies providing the financial information summarised above would not be preparing financial statements that give a true and fair view. However the proposed revised regime would not prevent Micro-Companies from using higher levels of reporting standards if these were thought to be a more appropriate way of meeting their particular business requirements. One immediate problem with the suggestions in the discussion paper is that EU directives would not currently permit a change away from true and fair accounts.

Comment

As will be seen shortly, the suggestion is that we move away from the traditional P&L account and balance sheet and adopt a process of cash accounting. Unfortunately, qualification for micro-entity status depends on satisfying thresholds for turnover and gross assets.

In order to calculate turnover and gross assets, the entity must use accrual accounting.

Obviously, this minor inconvenience can be fixed but I think it is worth mentioning it at this point so that we can make it clear that the ideas in this discussion paper are at a very early stage. The paper does not address issues such as transition from the current regime to the new regime nor does it deal with the problem of companies which move in and out of micro-entity status.

If the ideas find favour in the UK and if the EU can be brought on board, then BIS will address the detail when necessary.

Users of published information

The discussion paper states that public information should be provided which is useful to a range of users. It identifies two categories of user, firstly the owners/shareholders who have access to such information as they require and secondly those who rely on published information. The discussion paper identifies five user types in this second category:

- Employees
- Banks and other lenders
- Credit rating agencies
- Customers and other trading counter parties
- HMRC and other government agencies

Some of these users have the power to demand further information from the entity. Others must rely on what is published. On this basis, it is thought that the most important users of published information are credit rating agencies and trading counterparties.

It is against this background that the discussion paper suggests the simplified filing requirements shown above.

Trading statement

The trading statement would replace the traditional profit and loss account. The discussion paper says that, to ensure reliability, it would be necessary to provide, either by regulation or an applicable accounting standard, for the manner in which the financial information would be prepared. This would include the establishment of a standard set of pro-forma accounting policies - one of which would be that the trading statement would be prepared on a cash accounting basis.

This would mean, for example, that:

- Income would be recorded on a cash received basis (as opposed to when earned);
- Costs would be recorded when actually paid (as opposed to when incurred);
- Grants would be recorded when received (as opposed to when awarded)

BIS tell us that such an approach would remove the need to account

- On an accrual basis (removing the need to apportion receipts and payments across accounting periods);
- For stock (although the costs of acquiring or manufacturing that stock would form part of the company's expenditure);
- For changes in working capital; and
- For increases or decreases in the values of fixed assets.

Comment

The document does not deal with depreciation as such but tells us that the treatment of capital expenditure, leasing or hire purchase transactions could be addressed in the accounting standard. It would be strange if the standard required these items to be dealt with on any basis other than cash. Surely, depreciation can have no place in simplified accounting although it is mentioned in the section on tax (see below).

Statement of position

The statement of position would replace the traditional Balance Sheet. It is not related to the trading statement. The statement of position would be limited to reporting:

- Shareholder Funds
- Debtors and Creditors (short and long term)
- Cash
- Loans
- Any major assets

With respect to the final point, the document suggests that it is unlikely that micro-entities own real estate or other significant assets. Those that do should record the historical cost of such assets so that, first, the level of any loans can be seen in proper context and, secondly, because the subsequent disposal of such assets could have tax implications (e.g. in relation to capital gains).

Finally, BIS suggest that the approach summarised above could be used by both incorporated and unincorporated businesses.

Comment

I imagine that most readers of these notes are now at screaming pitch! There are many problems with the statement of position – mainly caused by the fact that the simplified trading statement is based on a cash approach but the statement of position would require accrual accounting. Debtors and creditors only make sense when we are using accrual accounting.

For example, if the micro-entity is accounting for cash received rather than sales then the accounting records will not need to maintain a figure for sales. If, on the other hand, it is decided that it would be helpful for management to know the outstanding trade debtors figure on a day to day basis (and also in order to keep adequate accounting records as required by CA 2006) then it will be necessary to record sales invoices in the accounting system. In this case, the software can produce a sales figure and we can produce a traditional profit and loss account with no difficulties.

Further problems arise with the concept of shareholders' funds. Presumably, the figure would be calculated as share capital plus the accumulated surplus of cash received over cash paid. How would this affect dividends? It might be suggested that a dividend could be paid as long as cash is available in the bank to pay it. But what if the company had significant trade liabilities or, even worse, had just taken a loan in order to pay the dividend?

Finally, in this area, the document refers to major assets. Does this mean fixed assets and does the use of the word "major" imply that "minor" fixed assets would not be reported? Also, the idea is floated that the major assets would be included at cost – presumably without depreciation. The question of how fixed assets (major or minor) are included in the statement of position and the trading statement is again a problem for the accounting standard to deal with.

Annual Return

This simplification approach can also be extended to the information required to be included in the Annual Return to be filed at Companies House.

An Annual Return would continue to be required, first, as the means by which a company would establish its entitlement to take advantage of the reporting regime available to Micro-Companies and, secondly, to provide the minimum information required by users.

At the minimum, the Annual Return would:

- Identify the ultimate owners of the company;
- Disclose the basis on which a company asserts its entitlement to 'Micro-Company' status – by reporting the average number of employees during the past year together with the financial information required.

The discussion paper suggests that any numerical data would be drawn from financial information prepared in accordance with the reporting regime described above. The financial information could be provided either by reporting the company's turnover in the financial year together with the asset value revealed by the Statement of Position, or by attaching the Trading Statement and Statement of Position.

Clearly, those that wrote the discussion paper had not appreciated the problems that we identified earlier concerning turnover and gross assets.

In order to facilitate efficient administrative and tax reporting, and to ensure that the information provided to Companies House should be up-to-date and, therefore, relevant, Micro-Companies might be required:

- to file Annual Returns within, for example, 12 weeks of the end of the financial period; and/or

- to standardise the reporting year.

Using the reported information to prepare tax returns

The discussion paper suggest that, in addition to simplifying the reporting regime, further benefits might be achieved by aligning financial reporting and tax reporting so that Micro-Companies would only be required to prepare one set of data, from which all reporting obligations could be met.

It is probably true to say that without this alignment the proposals would be a waste of time. However, it is this aspect of the discussion paper that practitioners tend to doubt. “There is no way” I am told ”that HMRC would accept such an approach”.

In response, those who produced the discussion paper say that it would not have been released if there wasn’t a possibility of harmonising with the needs of HMRC.

It is important to remember that The Office of Tax Simplification (OTS) is currently looking at the possibility of simplified tax reporting requirements for small unincorporated business. This review is due to report recommendations to Ministers ahead of Budget 2012.

The following extracts give a flavour of that document:

(A) Changing some of the existing rules to ease complexity in certain areas

2.5 One approach to simplification would be to retain profit as the measure upon which the tax charge will be based but instead of applying GAAP, as currently required, relax this requirement and, for the smallest businesses, allow a simpler approach to the calculation of profits.

They suggest that options to consider include:
- Cash accounting
- Fixed rate (%) and / or fixed amount (£) deductions for certain expenses
- Fixed rate (%) and / or fixed amount (£) deductions for total expenses
- Allowing small expenditures on capital items to be treated as revenue.

(B) Using non-profit measures as the basis for taxation

2.10 A more radical approach to the taxation of the smallest businesses would be to use, as some countries do, non-profit measures as the basis for taxation.

In this case, OTS suggests that the tax charge could be calculated on:

- Turnover, which is used as the basis for taxing small businesses in a number of countries, including France, Poland and South Africa. Variations include using adjusted turnover, for example, by removing employment related expenditure, and using a previous year's profit figure uprated by a specified amount.
- A flat charge on the business, comparable to the TV licence fee, where there is a single fixed tax charge for being in business. This approach is used in a number of Central and Eastern European countries.
- "Indicator based" measures where, for example, the tax charge is fixed by reference to number of tables in restaurants, the footprint of the business premises, or the number of employees. Indicator based measures are used in Spain and in Poland.

Users of these notes should be aware that OTS are trying to stimulate debate and are seeking views on the need for simplification and the desirability of each of the options. Therefore, they have put forward a wide range of ideas but this does not necessarily mean that all of these ideas are serious contenders for a future UK tax system.

The following extract is taken from the Executive Summary:

In this report, the OTS sets out a range of options for taxing the smallest businesses, some of which may not be appropriate for the UK. However, it is important to publicise the variety of approaches that could be used and canvass the views of businesses on whether these would represent a simplification for them.

Remember that the scope of the current OTS consultation only applies to unincorporated entities. Further, OTS has not yet proposed the threshold for entry to any new scheme but the limit of turnover is likely to be of the order of £20,000 or at most the VAT registration threshold.

There is therefore a big difference between the tax situation of:

- a teacher on PAYE with no other tax complexities does a few hours of private teaching in term time – say 3 hours a week for 30 weeks, with assumed rate of £30 per hour, so total income of £2,700 for a year (example given in the OTS discussion paper); and

- a company with turnover of £400,000

Incidentally before rejecting the OTS thresholds as being too low to be of any practical use, consider the statement in the discussion paper that there are 3 million unincorporated businesses in the UK that have a turnover of £70,000 or less, including approximately 2 million with a turnover of £20,000 or less.

Returning to the discussion paper on micro-companies, this suggests that financial information prepared as set out above could provide the basis for an annual tax return by Micro-Entities (being both incorporated and unincorporated businesses) which could offer further advantages to those Micro-Entities because:

- All filings or returns would be drawn from one set of data, so Micro-Entities might no longer be required to prepare reconciliations from financial statements to tax returns

- Accounts depreciation might be simplified to match capital allowances rates used in the tax system. With no changes to the existing capital allowances regime this might help reduce the number of calculations businesses are required to carry out

- There could be substantial alignment with the VAT cash accounting scheme, which is already available to the smallest businesses.

It is the second bullet point which seems strange since there would be no depreciation in the cash accounting scheme suggested.

Improving performance through better management information

The final section of the discussion paper refers to three areas:

- Access to better management information

This section says that SMEs would benefit from better management information. Integrated software packages could be developed to provide information for Companies House, tax and management purposes.

A footnote suggests that this would require data to be recorded on a basis that would allow management information to be compiled on an accruals basis. My comment would be that the package which is providing management information on an accruals basis could just as easily prepare company accounts on an accruals basis. Indeed, do not such packages already exist?

- Avoiding adverse credit ratings caused by delayed or late filing of financial information with Companies House

  The discussion paper reports that between April 2010 and March 2011, Companies House recorded 1.5m 'hits' for accounts information. In the vast majority of cases, these hits were made by organisations and trading counter-parties carrying out credit-related enquiries. The effectiveness of such enquiries would be substantially increased were such financial information to be up-to-date and provided in a form more useful to such users.

  Data suggests that some 60% of SMEs are described as 'high risk' or 'above normal risk', in terms of defaulting on trade payments or getting into financial difficulties because they do not file timely or detailed accounts at Companies House. The absence of such information affects companies' credit scores and, therefore, their ability to access funding, credit from suppliers and trade credit insurance.

  Therefore, a simpler and up to date means of filing essential information would benefit all SMEs.

- Responding to particular users' requests

  The availability of better management information would enhance the ability of small businesses to secure equity or debt finance and develop their businesses. This has the potential to be of particular importance to small businesses with an unproven or volatile financial record.

  Banks and other lenders would prefer to provide finance to such businesses if they were confident that they would be able to monitor the performance of those businesses on a regular basis, for example through receipt of management information of a pre-determined nature. This could be achieved using the same commercial software as discussed above.

OTHER POSSIBLE DEVELOPMENTS (LECTURE A360 – 19.06 MINUTES)

Proposals from the Department for Business Innovation & Skills

Under current legislation a company can either prepare its annual accounts under UK GAAP or under International Accounting Standards. This does not apply to charitable companies which can only prepare their accounts under UK GAAP. Once a company has chosen to prepare its accounts under International Accounting Standards it can only change back to preparing its accounts under UK GAAP in certain specified changes of circumstances. BIS has issued a consultation document on change of accounting framework. The proposal is to permit a company to make a change from preparing IFRS accounts to UK GAAP accounts once every five years.

BIS has also published proposals for consultation which would allow more small companies and subsidiaries to decide whether or not to have an audit. At present small companies have to pass the turnover and gross assets tests in order to be audit exempt. The proposal is that all small companies should be audit exempt. This proposal would particularly affect property investment companies which may have very significant assets but few employees and a turnover below the small company threshold.

The proposal from BIS also suggested that most subsidiary companies of EU parents should be exempt from audit, provided their parent is prepared to guarantee their debts.

Possible changes originating from Europe

There is a suggestion that the disclosures in SME accounts could be reduced. Disclosures would be required in five key areas:

i. accounting policies

ii. guarantees, commitments, contingencies and arrangements that are not recognised in the balance sheet

iii. post-balance sheet events not recognised in the balance sheet

iv. long-term and secured debts

v. related party transactions.

It has also been suggested that the EU might increase the thresholds applicable to small companies. Taking into account the current exchange rate between the euro and the pound, the turnover threshold could go up to between £8 million and £9 million.There are a number of suggestions on the audit side. Firms might be banned from offering both audit and non-audit services; rotation of auditors might become mandatory; and joint audits involving a larger and a smaller firm could become the norm. Presumably, these changes would only apply to the audits of listed companies and are likely to be subject to extended debate.

FRF: UK GAAP FACTSHEET (LECTURE A361 – 12.51 MINUTES)

The Financial Reporting Faculty of the ICAEW has released a new UK GAAP Factsheet. This provides an overview of questions frequently asked of the technical support services and problem areas regularly identified by regulators.

There are 27 questions in the Factsheet but many of these are similar to topics covered in recent update notes. I have selected some of the questions from the factsheet and provide my own answers below based on the guidance from the Faculty.

Q. Can a company adopt the IFRS for SMEs or the FRSME for current year ends?

A. No. UK companies may use UK GAAP (either the full standards or the FRSSE as appropriate) or EU-adopted IFRSs. The FRSME is an exposure draft of a UK standard and exposure drafts may not be adopted early. The IFRS for SMEs is an international standard but has not been adopted for use within the UK or the EU.

Q. Can non-depreciation of a freehold property be justified where residual value exceeds the carrying amount and is expected to do so for the foreseeable future?

A. The first thing to make clear is that residual value is based on prices at the date of acquisition (or most recent revaluation). It does not include inflation.

Paragraph 78 of FRS 15 states:

> 78 The fundamental objective of depreciation is to reflect in operating profit the cost of use of the tangible fixed assets (ie the amount of economic benefits consumed by the entity) in the period. This requires a charge to operating profit, even if the asset has risen in value or been revalued

Depreciation should therefore be seen as a measure of consumption, not a means of valuation. Many directors find it hard to accept this principle.

Non-depreciation can only be justified where both the depreciation charge for the period and the accumulated depreciation to date are immaterial. Depreciation may be immaterial where the building has a very long useful economic life or a high residual value or both. However, long life (on its own) is only a temporary solution to the problem because, although the annual charge will often be immaterial, the accumulated depreciation must eventually become material. Therefore, high residual value is the best way to justify non-depreciation.

Paragraph 91 of FRS 15 states:

"A high residual value will reflect the remaining economic value of the asset at the end of its useful economic life to the entity. These conditions may occur when:

a) The entity has a policy and practice of regular maintenance and repair such that the asset is kept to its previously assessed standard of performance; and

b) The asset is unlikely to suffer from economic or technological obsolescence; and

c) Where estimated residual values are material:

i. the entity has a policy and practice of disposing of similar assets well before the end of their economic lives and

ii. the disposal proceeds of similar assets (after excluding the effect of price changes since the date of acquisition or last revaluation) have not been materially less than their carrying amounts."

Q. In times of recession is an impairment review always necessary?

A. Paragraph 8 of FRS 11 tells us that a review for impairment of fixed assets and goodwill should be carried out if events or changes in circumstances indicate that the carrying amount of the fixed assets or goodwill may not be recoverable. This consideration will depend on the situation of the individual entity since not all entities are affected by recession in the same way.

Note that FRSSE does not refer to "impairment" as such but does contain the general principle that tangible fixed assets should be written down to their recoverable amount if necessary. This general principle is equivalent to the requirements of FRS 11.

The Faculty helpsheet tells us that more information on the basic principles of accounting for impairments under FRS 11 and examples of how to apply the requirements in practice can be found in the faculty's factsheet Impairment – Applying FRS 11.

Q. Should convertible preference shares be classified as a liability or equity?

A. Possibly a bit of both:

Step 1: Establish the obligations of the entity under the terms of the shares. These obligations may include a requirement to pay dividends and/or a requirement to redeem the shares.

Step 2: Calculate the net present value of these obligations. This amount will be shown as a liability in the accounts.

Step 3: Deduct this liability from the proceeds from the issue of the shares. This amount (if any) will be classified in the balance sheet as equity.

Q. If a company has a long-term loan but, at the year end, has breached the terms of the loan (for example by failing to meet a covenant requirement) such that it is technically repayable on demand, does the company have to report the loan as being due in less than one year? Is the position any different if, before the accounts are finalised, the bank agrees not to demand repayment?

A. The balance sheet should show the situation as it existed at the balance sheet date. Events after the balance sheet date are only relevant to measurement if they provide more information about the conditions that existed at the balance sheet date. The situation in this example is clear. The liability should be classified as a current liability because, at the balance sheet date, the company does not have the unconditional right to defer its settlement for at least 12 months after that date.

The subsequent decision by the lender not to demand immediate payment cannot change the position as it existed at the balance sheet date - although the fact of this decision can be disclosed in the notes to the accounts as a non-adjusting event.

Q. Do dividends paid to directors need to be disclosed as related party transactions?

A. We have covered this topic many times in recent updates and all of my readers know that the answer is yes. So why have I included this question in my notes today? It is because of the comment made at the end of the answer: “Dividends to shareholders who are close family of directors should also be stated.” Although we have been making this statement for some time in the update notes, this is the first time that I have seen it included in any “official” document.

Q. A company qualifies as a small company and the directors are satisfied that the company is a going concern and that there are no material uncertainties. Is any specific disclosure required in the accounts regarding the assessment of going concern?

A. Yes. Paragraph 21 of the FRC guidance tells us that disclosure will need to be made about liquidity risk, other uncertainties and key assumptions concerning going concern as necessary to give a true and fair view.

From the examples provided by the FRC, it seems that they have re-defined "true and fair view" so that it automatically includes such disclosures. Examples are provided in Appendix 1 of their guidance where example 1 deals with a small company where there are no material uncertainties.

HIVE-UP ACCOUNTING (LECTURE A362 – 7.11 MINUTES)

The Technical Enquiries Service published FAQ 17 in July 2011. This deals with the subject of hive-up accounting and provides a worked example of the accounting entries required. The document explains that the term "hive-up" is commonly used to describe a type of restructure within a group of companies when the net assets of, and business undertaken by, a subsidiary are transferred to the parent company. The helpsheet deals only with accounting issues and reminds readers that there may also be issues related to tax and distributable profits. These must be considered before going ahead with the hive up.

The following case study is based on the example provided by TES.

Case study

On 1 April 2011. A Ltd buys the shares of X Ltd for £100,000. Suppose that the net assets of company X at the date of acquisition have book value of £60,000.

The fair value of the net assets is the same as book value.

On the same date, the net assets and business of X Ltd are transferred to A Ltd.

The table overleaf shows the balance sheet for each company before the hive-up and also, for information, a consolidated balance sheet.

Balance sheets at 1 April 2011	A Ltd	X Ltd	Consolidated
Net assets	300,000	60,000	360,000
Goodwill			40,000
Cost of investment	100,000		
	400,000	**60,000**	**400,000**
Share capital	50,000	10,000	50,000
Reserves	350,000	50,000	350,000
	400,000	**60,000**	**400,000**

When a company acquires shares in another, separate recognition of goodwill is not appropriate in the acquirer's accounts. Goodwill on acquisition will be shown in the consolidated accounts. These principles are reflected in the balance sheets above.

The hive-up can be achieved in a variety of ways and the accounting will vary accordingly. The end product, however, will be the same – no change to the consolidated accounts.

Some suggest that the net assets are transferred to A Ltd by way of a dividend. Since this is a dividend out of pre-acquisition profits, this would reduce the cost of the investment in A's books.

However, the ICAEW come at this a different way by transferring the assets to the parent and replacing them with an inter-company balance.

Balance sheets at 1 April 2011 after transfer of net assets	**A Ltd**	**X Ltd**	**Consolidated**
Net assets	360,000		360,000
Goodwill			40,000
Cost of investment	100,000		
Inter-co balances	(60,000)	60,000	
	400,000	**60,000**	**400,000**
Share capital	50,000	10,000	50,000
Reserves	350,000	50,000	350,000
	400,000	**60,000**	**400,000**

As mentioned above, when a company acquires shares in another, separate recognition of goodwill is not appropriate in the acquirer's accounts. Goodwill on acquisition will be shown in the consolidated accounts.

However, now that the subsidiary's trade and assets have been "hived up" to the parent, it is reasonable to take the approach required for an acquisition of a business and recognise goodwill in the accounts of the acquirer. It is important to ensure that any goodwill recognised is that arising at the date of acquisition (net of any amortisation charged), not the goodwill at the date when the hive up occurs (if these dates are different).

This treatment requires the use of the true and fair override and is achieved by the following journal in the books of A Ltd:

Dr	Goodwill	£40,000	
Cr	Cost of investment		£40,000

Balance sheets at 1 April 2011 after transfer of net assets and recognition of goodwill	**A Ltd**	**X Ltd**	**Consolidated**
Net assets	360,000		360,000
Goodwill	40,000		40,000
Cost of investment	60,000		
Inter-co balances	(60,000)	60,000	
	400,000	**60,000**	**400,000**
Share capital	50,000	10,000	50,000
Reserves	350,000	50,000	350,000
	400,000	**60,000**	**400,000**

The goodwill in the parent's books will be amortised in the usual way.

The final step depends on whether it is desired to retain the subsidiary.

Assuming that the subsidiary is not required then the ICAEW suggest removing the intercompany balance by a dividend from X to A, having first reduced the capital of X Ltd under s641 of CA 2006. X Ltd can then be struck off.

In A's books, the dividend is treated as a reduction in the cost of investment leaving us with the final position shown overleaf.

Balance sheets at 1 April 2011 after completion of all steps in the hive-up	**A Ltd**	**X Ltd**	**Consolidated**
Net assets	360,000		360,000
Goodwill	40,000		40,000
	400,000		**400,000**
Share capital	50,000		50,000
Reserves	350,000		350,000
	400,000		**400,000**

An alternative way to describe this final step is to argue that the investment is impaired and write off the remaining balance of £60,000. The final dividend to clear the intercompany balances can then be credited to P&L and linked to the £60,000 investment write-off as part of an exceptional item for restructuring.

SERVICE CHARGE ACCOUNTS (LECTURE A363 – 7.08 MINUTES)

A joint working group comprising representatives of ACCA, ICAEW, ICAS, the Association of Residential Managing Agents and the Royal Institution of Chartered Surveyors has issued guidance on the subject of accounting and reporting in relation to service charge accounts for residential properties on which variable service charges are paid in accordance with a lease or tenancy agreement.

The document (referred to as Tech 03/11 by ICAEW) provides a summary of the law and professional best practice applicable to service charges. It points out that there is no statutory requirement for the routine preparation and content of service charge accounts but the accounts should comply with the provisions of the lease/tenancy agreement as otherwise there may be difficulty in recovering the expenditure.

The first thing that should be noted is that Tech 03/11 deals only with service charge accounts. During the consultation period on the draft guidance, the question was raised as to whether the service charge accounts should be kept separate from the 'landlord' company statutory accounts, even where there is 100% cross-over between membership of the landlord company and leaseholders.

Tech 03/11 deals with the subject of the statutory accounts of the landlord company in Section 1.2. The guidance confirms that where the landlord is a residents' management company (RMC) or right to manage company (RTMCo) or similar, service charge monies are subject to a statutory trust. Trust monies do not belong to the landlord company and so should not be included as an asset in its statutory accounts.

However, the guidance goes on to say that the treatment of transactions relating to service charges in the statutory accounts is subject to debate. The question of whether service charge transactions should be included in the landlord company's statutory profit and loss/income and expenditure account has been referred to the Urgent Issues Task Force. Further guidance will be issued when the underlying principles have been agreed.

Otherwise, Tech 03/11 is largely repetitive of the matters covered in previous update notes. We will not, therefore, cover it in full but the following will give readers a quick guide to the document:

- Section 2 of the guidance covers the preparation of service charge accounts for issue to the tenants/leaseholders of residential properties. An example of service charge accounts is provided in Appendix C.

- Section 3 covers reporting on service charge accounts. Section 3.1 discusses the problems which arise when the lease demands an audit. Section 3.1.5 confirms that ISA 800 provides a framework for the audit of service charge accounts. Guidance on the application of ISA 800 to the audit of service charge accounts is included in Appendix E of Tech 03/11.

- Section 3.2 deals with the situation where an audit is not undertaken. This is referred to as an engagement to deliver a report of factual findings. Appendix D sets out a comparison between such an engagement and an audit. The purpose of this Appendix is to provide factors that the landlord or managing agent might consider in deciding what type of engagement is most appropriate to the circumstances of the property. Appendix F provides a work programme for making a factual report on service charge accounts.

- Section 3.2.4 confirms that the reporting accountant need not be a registered auditor. However, if the accountant is a member of one of the Professional

Bodies issuing the guidance, then the member must hold a practising certificate and comply with the requirements of the Professional Body concerning PII, integrity and objectivity and competence. The reporting accountant should be independent (which means not an employee or director or associate) of the landlord.

- Section 3.3 mentions reporting under section 21 of the Landlord and Tenant Act 1985. The guidance does not deal with this topic in full but Appendix K contains a short explanatory note. Section 21 reports must be made by a registered auditor (except where the number of dwellings is four or less).

- Section 4 covers the tax treatment of service charges.

Other appendices to the document which have not already been mentioned are:

- Appendix A: The law governing residential variable service charges

- Appendix B: Points on which legal opinion has been obtained

- Appendix G: Paragraphs for engagement letters

- Appendix H: Example paragraphs for a representation letter from landlord/managing agent to the reporting accountant

- Appendix I: Example reports on service charge accounts

- Appendix J: Qualifications for reporting on service charge accounts

MONEY LAUNDERING REFRESHER

The feedback from the QAD in their 2010 Practice Assurance report indicated that many firms are not fully up to speed in complying with the Money Laundering Regulations as amended in 2007.

These notes are written as a reminder of the new requirements in the 2007 Regulations on ongoing monitoring and to act as a refresher on client due diligence and Suspicious Activity Reports (SAR).

The 2007 Regulations and ongoing monitoring - overview

When the 2003 Regulations came into force they did not apply retrospectively meaning that there was no need to identify clients who you acted for prior to the commencement date of the act on 1 March 2004. The 2007 Regulations effectively changed this and introduced ongoing monitoring which will apply to many pre-existing clients.

For those clients, firms of accountants will need to consider whether the information held is sufficient, based on the risk assessment of the client, to demonstrate that appropriate steps have been taken to verify the identity of the client and whether anything has changed in the period to render that information out of date.

The latest guidance published by the ICAEW is TECH 05/08 Anti-money Laundering Guidance for the Accountancy Sector. The ICAEW state that:

> For clients whose situation, address, name and business has not changed since you last considered their identity we would suggest you need do no more than commit your risk assessment and review to the file.
>
> For clients where the situation has changed or who predate 2004 you may well have obtained official verification of matters such as name and address through correspondence with government offices, bank statements and similar official channels. We suggest you undertake these checks during the planning for the next engagement for the client.

Key issues are:

- have you undertaken a risk assessment of the client ?
- do you have information which supports your verification of the client's identity and which is consistent with your risk assessment?
- can you demonstrate what you have done if asked to evidence your customer due diligence measures?

Note: It is important to recognize that the ICAEW guidance on ongoing due diligence does not demand that you must obtain a passport and utility bill from your existing clients or that you must investigate all the business affairs of your clients, in every case. However, you might decide to for high risk clients.

What is client due diligence

Accountants often refer to the need to ***identify*** new clients. The MLR 2007 and the guidance refer to the need for ***customer due diligence*** which is a broader responsibility.

The central guidance in this area is in TECH 05/08. The guidance suggests that customer due diligence procedures should be integrated into client acceptance processes and the continuing conduct of the business relationship. The required components are:

- identifying the client (i.e. knowing who the client is) and verifying the identity of the client (i.e. confirming that identity is valid by obtaining documents or other information from sources which are independent and reliable);

- identifying the beneficial owner of a client, if there is one, so that the identity of the individual(s) who is the ultimate owner or controller is known, the ownership and control structure is understood and the identity is verified, as required, on a risk-sensitive basis; and

- information on the purpose and intended nature of the business relationship.

Beneficial owners

Note, that there is a requirement to identify the beneficial owner. The guidance defines this in different ways for different clients:

Bodies corporate –beneficial owner means any individual who, in respect of any body other than a company whose securities are listed on a regulated investment market, owns or controls, directly or indirectly including through bearer share holdings, more than 25% of the shares or voting rights in the body or who otherwise exercises control over the management of the body.

Partnerships (other than limited liability partnerships established under the Limited Liability Partnerships Act 2000) - beneficial owner means any individual who ultimately is entitled to or controls (directly or indirectly) more than 25% of the capital or profits of the partnership or more than 25% of the voting rights in the partnership or who otherwise exercises control over the management of the partnership.

Trusts - beneficial owner means any individual who is entitled to a specified interest in at least 25% of the capital of the trust property, or where a trust is not set up entirely for the benefit of persons with a specified interest, the class of persons in

whose main interest the trust is set up or operates or any individual who has control (a trust controller) over the trust. Where a class of persons is identified, it is not a requirement for all members of that class to be identified.

What evidence is required to identify clients?

By way of example, here is the approach to customer due diligence for an individual. For guidance on other situations, reference should be had to the JMLSG Guidance Notes.

Met face to face and considered to be normal risk	**Not met face to face and/or considered to be higher risk**
Obtain:	**Obtain**
either: proof of identity – photo identity	*either*: proof of identity – photo identity and an additional piece of evidence
or: proof of identity – non-photo identity and proof of address (Please note P.O. Boxes are not acceptable addresses) or date of birth (can be electronic)	*or*: proof of identity – non-photo identity and proof of address (Please note P.O. Boxes are not acceptable addresses) or date of birth (can be electronic) and an additional piece of evidence

Acceptable photo identity

- valid passport; or
- valid photocard driving licence (full or provisional); or
- national identity card (non-UK nationals issued by EEA member states and Switzerland); or
- firearms certificate or shotgun licence; or
- identity card issued by the Electoral Office for Northern Ireland

Acceptable non-photo evidence of identity:

Documents issued by a government department, incorporating the person's name and residential address or their date of birth, eg,

- a current UK full driving licence old version (not provisional licences); or
- evidence of entitlement to a state or local authority funded benefit (including housing benefit and council tax benefit), tax credit, pension, educational or other grant; or
- documents issued by HMRC, such as PAYE coding notices and statements of account (NB: employer issued documents such as P60s are not acceptable)
- end of year tax deduction certificates.

Money laundering reporting – Suspicious Activity Reports (SARs) overview

In UK law, money laundering is defined very widely, and includes all forms of handling or possessing criminal property, including possessing the proceeds of one's own crime, and facilitating any handling or possession of criminal property. Criminal property may take any form, including in money or money's worth, securities, tangible property and intangible property.

Individuals in the regulated sector commit an offence if they fail to make a disclosure in cases where they have knowledge or suspicion, or reasonable grounds for suspicion, that money laundering is occurring. Disclosure must be made to their MLRO or direct to SOCA under s330, POCA. Disclosure to an MLRO is referred to as an internal report and to SOCA as a suspicious activity report or SAR. MLROs have a duty to make disclosures under s331, POCA if they have knowledge, suspicion or reasonable ground to suspect money laundering as a consequence of an internal report.

What constitutes suspicion is not defined by the Act and case law has to be relied upon.

Note: wherever there is a crime (no matter how serious) with proceeds (no matter how small) this is defined as money laundering.

Amended Practice Note 12 examples

The following examples are taken from the above APB publication which contains guidance for auditors on complying with money laundering legislation. Whilst this is written with auditors in mind, rather than accountants or tax practitioners, it is nevertheless useful to look at these examples as the principles that are applied are relevant for any SAR report.

Offences where the client is the victim

Example: shoplifting

Outline situation: Large retailer. Significant stock shrinkage in a number of stores attributed, in part, to shoplifting.

Key considerations: Do the stores maintain files which will enable those responsible to be identified? Since the auditor is not required to undertake further enquiry outside normal audit work, it is not necessary to review these files unless the auditor would have done so anyway for the purposes of the audit.

Conclusion: If the information possessed by the client would assist in identifying shoplifters or the whereabouts of any of the goods stolen by the shoplifters, the auditor must make a report to the MLRO briefly describing the situation and stating where the information on the identity of shoplifters may be found. Otherwise, no report is necessary.

Offences that indicate dishonest behaviour

Example: overpayments not returned

Outline situation: Some customers of the audit client have overpaid their invoices and some have paid twice. The audit client retains all overpayments and credits them to the profit and loss account if they are not claimed within a year

Key considerations: Is this theft? If so, the client is in possession of the proceeds of crime, a money laundering offence.

Conclusion: If there is no indication that the company has acted honestly (for example by trying to return overpayments), the auditor will follow SOCA guidance dealing with minor irregularities and multiple suspicions of limited intelligence value. The auditor must make a report to the MLRO but may do so at the end of the audit, briefly describing the situation and any other matters of limited intelligence value.

Companies Act offences that are civil offences

Example: illegal dividend

Outline situation: The client paid a dividend based on draft accounts. Distributable reserves were reduced by audit adjustments such that the dividend is now shown to be illegal under the Companies Act.

Key considerations: This is not a criminal offence so POCA is not relevant.

Conclusion: No report.

Offences that involve saved costs

Example: environmental offences

Outline situation: The client is disposing of waste from the factory without a proper licence. There are concerns about pollution. The client is currently in discussion with the relevant licensing authorities to try to get proper authorisation.

Key considerations: The only benefits arising are saved costs. The relevant government agency is already aware of the offence.

Conclusion: Because of these two facts, a limited intelligence value report can be made.

PN 12 points out that, if the client has accrued for back licence fees, fines and/or restitution costs, there may be no remaining proceeds from the original offence and therefore no need to report. This paragraph was introduced into PN 12 by the latest update. It suggests that an accounting entry might indicate the honest intentions of the entity.

Conduct committed overseas that is a criminal offence under English law

Example: bribery

Outline situation: Client is expanding abroad. It is in consultation with the overseas Government about obtaining the necessary permits (although these negotiations are proving difficult). The client has engaged a consultancy firm to oversee the implementation of its plans and liaise ‘on the ground’.

It is not clear to the auditor exactly what the consultant's role is and payments made to the consultant seem to be large in comparison to the services provided. The auditor reviews the expenses claimed by the consultant and notes that some of these are for significant sums to meet government officials' expenses.

Key considerations: Do the payments constitute bribes? Taking into account compliance with legislation relating to 'tipping off' the auditor questions the client's Finance Director about the matter and the FD admits that the consultant has told him that some 'facilitation payments' will be necessary to move the project along and the FD agreed to these payments. The FD thought that such payments were acceptable in the country in question.

Conclusion: The auditor suspects that bribes have been paid and the auditor is aware that bribery of government officials is a criminal offence under UK law, even where it occurs wholly outside the UK. Further, under the Bribery Act 2010, a commercial organisation is guilty of a bribery offence if it cannot show that it has adequate procedures to prevent bribery. Accordingly, the auditor decides to make a full report to the MLRO.

Lawful Conduct Overseas which would amount to a serious offence if it occurred in England and Wales

Example: a cartel operation

Outline situation: The client's overseas subsidiary is one of three key suppliers of goods to a particular market in Europe. The subsidiary has recently significantly increased its prices and margins and its principal competitors have done the same. There has been press speculation that the suppliers acted in concert. On reviewing the accounting records, the auditor sees significant payments for consultancy services which relate to the recent price increase.

Key considerations: Some of the increased profits have flowed back to the client parent company. The client informs the auditor that there is not a criminal cartel offence under local law.

Conclusion: No report is required about the subsidiary because this conduct is not criminal under local law. The parent company has received profits from the subsidiary and may therefore be engaged in money laundering in England. The auditor therefore makes a full disclosure to the MLRO. Further, since a cartel offence is a serious criminal offence if committed in England and Wales, the auditor would await consent from the MLRO before proceeding further.

Offences committed overseas that are not criminal offences under UK law

Examples: breach of exchange controls or importing religious material

Outline situation: The client's overseas subsidiaries have been in breach of a number of local laws as indicated above.

Considerations: These are not offences under UK law.

Conclusion: No report.

SOCA Reporting Tips

Providing the right information

SOCA understands that accountants do not always have complete information about the subjects of their reports. This may arise particularly if the accountant is reporting on subjects which are not their clients. For example, customers, suppliers, acquisition targets etc are all potential subjects for a suspicious activity report. If accountants can provide more identifying information and clear explanation of their suspicions to SOCA, then it is more likely that SOCA will be able to match the data to other intelligence and put it to active use. The following points may be helpful in compiling high quality SARs of real value:

- *Subject type.* Use the options to classify each subject as suspect, victim or unknown, this helps put each subject's role into context and also makes clear where subjects are not suspected of criminal activity

- *Subject details - individuals.* Where possible provide any middle names, date of birth (especially helpful), addresses (including postcodes where known), email addresses, web page addresses and any other known identifiers such as national insurance number, passport number, car registration or phone numbers

- *Subject details - entities.* Wherever possible include the registration number, (tax reference and VAT number is also useful), country of incorporation, addresses (including postcodes where known), email and web addresses, phone numbers and wherever possible the full legal name and designation, e.g. Limited, SA, GmbH etc.

- *Reason for suspicion.* Keep your explanation succinct and focus on what you have seen and why it is unusual or suspicious. Where you feel able to, refer to which predicate offences (i.e. the underlying criminal conduct giving rise to the money laundering) you think may have been committed. If you know the Act and section number detailing the offence (only if you know, you don't have to do legal research), put it in as it helps explain why you are reporting. Keep to plain English, or at least explain any technical terms you use even if they seem obvious to you.

Submitting your report

- Format - wherever possible use SAR Online or Moneyweb - these systems have the advantage for you of secure transmission and instant acknowledgment with a reference number. For SOCA, it greatly reduces processing time meaning quicker dissemination to law enforcement and less time tied up in administrative tasks

- Hard-copy reporting - if you don't have the facilities to use the electronic systems, then please use the SOCA standard forms and type your information - non-standard formats or handwritten reports take a lot of processing time and provide potential for error in interpretation and input

- Don't send supporting documents with your report - if SOCA need further information they will contact you

- Generally when completing the form - think what, who, why, when, how, where and keep it as short and punchy as possible. The SOCA website provides guidance.

Engagement letters and pre-engagement letters

PN 12 suggests that it may be helpful for the auditor to explain to the client the reason for requiring evidence of identity and this can be achieved by including this matter in pre-engagement letter communications with the potential client. PN 12 includes the following example:

Client identification As with other professional services firms, we are required to identify our clients for the purposes of the UK anti-money laundering legislation. We are likely to request from you, and retain, some information and documentation for these purposes and/or to make searches of appropriate databases. If we are not able to obtain satisfactory evidence of your identity within a reasonable time, there may be circumstances in which we are not able to proceed with the audit appointment.

It may also be helpful to inform clients of the auditor’s responsibilities under POCA to report knowledge or suspicion, or reasonable grounds to know or suspect, that a money laundering offence has been committed and the restrictions created by the ‘tipping off’ rules on the auditor’s ability to discuss such matters with their clients. The following is an illustrative paragraph that could be included in the audit engagement letter for this purpose:

Money laundering disclosures The provision of audit services is a business in the regulated sector under the Proceeds of Crime Act 2002 and, as such, partners and staff in audit firms have to comply with this legislation which includes provisions that may require us to make a money laundering disclosure in relation to information we obtain as part of our normal audit work. It is not our practice to inform you when such a disclosure is made or the reasons for it because of the restrictions imposed by the ‘tipping off’ provisions of the legislation.

DISCLOSURE OF AUDITOR'S REMUNERATION

Large companies and groups are required to give a more detailed analysis of remuneration payable to the company's auditor, or an associate of the company's auditor, than is required to be given by small and medium-sized companies.

The details of the analysis required are currently set out in a schedule to SI 2008/489. The disclosure requirements have been revised by SI 2011/2198 and the new requirements apply to accounting periods beginning on or after 1 October 2011 although early adoption is permitted.

A comparison of what has changed is shown in the following table:

SI 2011/2198	**SI 2008/489**
A note to the annual accounts of a company which is not a small or medium-sized company must disclose the amount of:	A note to the annual accounts of a company which is not a small or medium-sized company must disclose the amount of:
a) any remuneration receivable by the company's auditor or an associate of the company's auditor for the auditing of those accounts	a) any remuneration receivable by the company's auditor for the auditing of those accounts
b) any remuneration receivable in respect of the period to which the accounts relate by the company's auditor or any person who was, at any time during the period to which the accounts relate, an associate of the company's auditor for the supply of other services to the company or any associate of the company.	b) any remuneration receivable in respect of the period to which the accounts relate by the company's auditor or any person who was, at any time during the period to which the accounts relate, an associate of the company's auditor for the supply of other services to the company or any associate of the company.
Where the remuneration includes benefits in kind, the nature and estimated money-value of those benefits must also be disclosed in a note	Where the remuneration includes benefits in kind, the nature and estimated money-value of those benefits must also be disclosed in a note
Separate disclosure is required in respect of the auditing of the accounts in question and of each type of service specified overleaf	Separate disclosure is required in respect of the auditing of the accounts in question and of each type of service specified below (order of services changed to provide better comparison with revised SI)

1. The auditing of accounts of any associate of the company.	The auditing of accounts of associates of the company pursuant to legislation (including that of countries and territories outside the UK).
	Other services pursuant to such legislation.
2. Audit-related assurance services.	
3. Taxation compliance services.	Other services relating to taxation.
4. All taxation advisory services not falling within paragraph 3.	
5. Internal audit services.	Internal audit services.
6. All assurance services not falling within paragraphs 1 to 5.	
7. All services relating to corporate finance transactions entered into, or proposed to be entered into, by or on behalf of the company or any associates not falling within paragraphs 1 to 6.	Services relating to corporate finance transactions entered into or proposed to be entered into on behalf of the company or any of its associates.
8. All non-audit services not falling within paragraphs 2 to 7.	Services relating to information technology. Valuation and actuarial services. Services relating to litigation. Services relating to recruitment and remuneration. All other services

It can be seen from the above that remuneration for taxation services has been split into compliance and other taxation services. On the other hand remuneration for IT, valuation, litigation and recruitment services which previously required separate disclosure have now been combined into other services.

The explanatory note indicates that the list of non-audit services has been updated to correlate with the revised Ethical Standards published by the APB.

AUDITOR SCEPTICISM (LECTURE A364 – 8.30 MINUTES)

The requirement for auditors to demonstrate that they have approached the audit with a sufficient degree of scepticism is not new but in today's modern audit world the need to demonstrate 'auditor scepticism' is becoming more important. The well reported frauds in a number of large multi-national companies and the more recent collapse of the banking system and large financial institutions has led to the public outcry of 'What were the auditors doing?'

This does seem to be a valid question. In the introduction to the discussion paper 'Auditor Scepticism: Raising the Bar' published by the FRC it says:

'Unless auditors are prepared to challenge management's assertions, they will not act as a deterrence to fraud nor be able to confirm, with confidence, that a company's financial statements give a true and fair view. However, scepticism can be taken too far; challenging everything in a well run company will slow down the publication of its financial statements and risk unnecessary costs.'

Clearly the audit regulations and the regulators expect some professional scepticism but it has to be a balance. The bodies responsible for regulating the audit profession have for the last few years raised a number of concerns about the levels of scepticism that they see on audit files. The audit profession is now seeing increased interest by the regulators in how they can demonstrate an appropriate level of scepticism during the audit process. The question now becomes "How should the audit firm respond to this increased emphasis on scepticism?".

What is 'Auditor scepticism'?

Ask any accountancy student about the role of the auditor and they will quote Kingston Cotton Mills Co (1896) in which Lord Justice Lopes stated that an auditor is not bound to be a detective – he is a watchdog not a bloodhound. As some commentators, much later, have said, even a watchdog is expected to bark occasionally. Lord Denning said in the case of Fomento (Sterling Area) Limited V Selsdon Fountain Pen Co Limited (1958) 'to perform his task properly he (the auditor) must come to it with an enquiring mind - not suspicious of dishonesty – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.'

Clearly we do not have unlimited time to pursue audit inquiries and there must be a limit to the degree to which the auditor is expected to inquire about particular issues or to carry out audit procedures. The judgement in the Kingston Cotton Mills case suggests this in its comparison to a watchdog rather than a bloodhound.

ISA 200 defines professional scepticism in paragraph 13(L) as follows:

Professional scepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

What creates auditor scepticism?

Audit scepticism or professional scepticism is created by a range of factors. The core factors could be summarised as follows.

Auditor scepticism is created by:

- Character traits of the individual auditor
- The audit methodology being used for the audit
- The cultural environment created by the audit firm (this would include training, feedback and the ethos of the firm)

If the above areas can increase the level of scepticism they can also reduce or remove the level of scepticism. Thus when considering how your firm has evidenced an appropriate level of scepticism, its approach to the above areas will be critical.

Character traits

The research into this area has indicated the following character traits underlie auditor scepticism:

- Curiosity/having a questioning mind
- Deferral of judgement/not jumping to premature conclusions
- Understanding management behaviour and motivations
- Self confidence
- Freedom of action

Audit methodologies – Does your audit documentation help?

The audit documentation and approach adopted by the firm needs to have professional scepticism as one of its core goals.

Many firms over the past few years have moved to electronic working papers to help improve the efficiency of the audit approach. This has led to increased pressures on auditor scepticism through:

- The cut and paste approach to audit information. The information is not read but rolled forward and hence accepted by the audit team rather than reviewed and challenged.
- Electronic documentation creates a 'distance' between the auditor and the client. Audit personnel spend too much time looking at a screen and not 'walking the floor' and hence do not question the actions of the client as often.
- The audit approach can be too rigid thus not encouraging audit staff to ask questions or to pursue their own inquires (freedom of action).
- Electronic documentation can reduce the level of detailed comment on the audit file and hence make it difficult to show how judgements have evolved and what issues have been questioned with the client.
- The use of 'on-screen' files can also reduce the feedback and mentoring that the more junior staff receive from the managers/partners and hence they do not learn how to exercise scepticism.

Audit firms should review their documentation and audit approach to ensure that staff are encouraged to communicate with the client and ask open questions and follow up on the response that the client gives. Audit teams should be briefed to consider the audit issues before leaping in to the documentation and filling in the checklists.

The firm's ethos/cultural environment

This comes down to how firms review audit files and feed back information to the audit team. Does the firm have a mentoring approach to getting improved performance from its staff? Some key areas are considered below.

Audit reviews

The review process should show that auditor scepticism has been considered as part of the manager/partner review.

Matters that may indicate a lack of scepticism include:

- Failure to assess the likelihood of management override by the client.
- Over reliance on management representations.
- Failure to investigate conflicting explanations.
- Failure to obtain appropriate third party confirmation.
- Judgements over impairment reviews of goodwill and other intangible assets accepted without question.
- Insufficient evidence that the client's approach to assessing going concern has been questioned by the audit team. Cash flows not challenged but just accepted and so on.
- Lack of documentation showing the rationale for key audit judgements.
- Removal from the file of notes that indicate how the client's views have been challenged.
- The audit team have placed the emphasis on obtaining evidence that corroborates, rather than challenges, the judgements made by the client.

The firm's ethos with respect to managing the client relationship

Very often, firms will place great emphasis on retaining their client base and developing the client relationship. The focus in many firms is on client service and support for the client. This can detract from the requirement to exercise audit scepticism as questioning the client's approach can be seen to lead to 'unhappy clients' and hence increase the risk of losing the client.

Fees are another issue as well. The audit fee is often a fixed fee and the time taken to consider and challenge the client's views or approach may lead to increased fee pressure on the work.

The ethical standards for auditing are aimed at safeguarding some of these issues. Areas such as non-audit fees and the length of time the audit partner has acted for a client can all present risks to the firm's ability to act with the required level of scepticism. One of the research papers on promoting audit scepticism makes the following comments:

'As the auditor-client relationship lengthens, a behavioural bond develops between the auditor and the client as they become more familiar with each other and mutual trust replaces an auditor's necessary professional scepticism.'

In practice this is a very difficult issue. I am often asked "This is what the client wants to do but the standards do not allow it, can we get round the standards for the client" This does not suggest scepticism rather the opposite.

The way the partners in the firm act in relation to audit clients will have a big impact on the perceived ethos and hence the approach taken by audit managers and staff.

Mentoring/Feedback

Research in this area suggests that one way to improve scepticism is for the staff doing the audit to realise that professional scepticism is a key priority for the person who is reviewing the audit file. The approach to the review is also important. A junior member of staff who expects a face to face review is more likely to undertake their work in a thorough manner than those who expect a remote review or perhaps no review at all.

Promoting Audit Scepticism through Auditing Standards

The recent review of the ISAs as part of the clarity project has lead to some areas being revised to promote and enhance the auditor's evidence of scepticism. The changes include:

- Greater emphasis on the discussion of fraud and risk during the audit team meeting so as to include the consideration of fraud or error that could result from related party transactions.
- The requirement for a review of the outcome of the opening provisions in the accounts against the actual performance of the business.
- Increased emphasis on checking journal adjustments put through by the client.
- The requirement to treat the risk of fraud in revenue recognition as a significant risk and the impact this has on the audit approach for turnover.
- The requirement to investigate related party transactions outside the normal course of business.
- A more rigid approach to assessing the risk of management override and a set audit response relevant to all clients.

Conclusion – Practical advice

Over the next few years audit firms will come under increasing pressure to improve the level of auditor scepticism.

This should include:

- Recruiting staff with appropriate attitude and personality traits
- Using documentation that helps the audit team to record issues they have discussed with the client
- Having a review and feedback system that makes it clear that staff are expected to challenge the clients not just accept what they say.
- Making sure that the audit evidence shows how the audit team have used their initiative and investigated issues that have attracted their attention.

MANAGEMENT OVERRIDE (LECTURE A365 – 7.30 MINUTES)

The audit faculty has released a number of documents under the general heading “Right first time with the clarified ISAs”. In these notes, I want to consider their comments on management override.

What is management override and why is it important?

It is the responsibility of management and those charged with governance to design and implement a system of internal control to provide reasonable assurance about the achievement of the entity’s objectives. This includes the reliability of financial reporting.

Paragraph 31 of ISA 240 states:

“Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.”

Management override may take a number of forms such as falsifying accounting entries in order to conceal misappropriation of assets or other manipulation of accounting entries intended to result in the production of financial statements which give a misleading view of the entity’s financial position or performance.

The Faculty document tells us that, in considering management override, the auditor needs to be alert to the possibility that:

- those involved in management are perpetrating fraud for their own purposes and are attempting to conceal what they are doing from those charged with governance; and
- those charged with governance (who may also be owners of the entity) are perpetrating fraud in order to misrepresent the entity's financial position or performance.

How do auditors assess the risk of management override?

Paragraph 31 above indicated that management override of controls is considered to be a 'significant' risk. ISA 315 contains explicit requirements where a risk is considered to be significant. Paragraph 29 requires:

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

Paragraph 13 of ISA 315 explains that understanding controls relevant to the audit means that the auditor must evaluate the design of those controls and determine whether they have been implemented. This requires the auditor to perform procedures in addition to inquiry of the entity's personnel

The Faculty document comments that it is virtually impossible for an entity to have controls in this area that will be totally effective but entities should nevertheless have controls that minimise the risk, such as controls over the authorisation and processing of journals and other adjustments to the financial statements.

The document goes on to suggest that the auditor should consider whether there are any particular risk factors that would affect the risk of management override. These may include incentives or pressures for individuals to misrepresent the results or financial position of the entity such as:

- for personal gain (salary, promotion, bonuses, continued employment, etc);
- for gain on disposal of the entity or its business;
- to meet expectations or targets;

- to avoid tax;
- to obtain finance or to satisfy the requirements of lenders or other third parties.

How do auditors respond to the risk of management override?

Paragraph 32 of ISA 240 has very detailed requirements concerning the auditor's response to the risk of management override:

32. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

(i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

(ii) Select journal entries and other adjustments made at the end of a reporting period; and

(iii) Consider the need to test journal entries and other adjustments throughout the period.

(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

(i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

The auditor is also required by Paragraph 33 of ISA 240 to determine whether there is a need to perform other audit procedures where there are specific additional risks of management override that are not covered by the procedures above.

The rest of the Faculty’s document seeks to explain the requirements above.

How do auditors test the appropriateness of journal entries and other adjustments?

Material misstatement of financial statements due to fraud often involves making inappropriate or unauthorised journal entries or other adjustments to the financial statements. This may occur throughout the year or at the period end.

Inquiries of individuals may include whether they have been asked to process journals or amend accounting estimates without appropriate documentation or explanation. (Paragraph 32a(i))

Paragraph 32a(ii) requires the auditor to perform specific tests on journal entries and other adjustments made at the end of the reporting period. The Faculty suggest that where the number of such journals or adjustments is large, the auditor may test items on a sample basis. In this case, the auditor will usually focus on items that appear to be particularly large or unusual.

The auditor is also required to consider the need to test journal entries and other adjustments throughout the period as such journals may be used to conceal fraud, particularly fraud involving the misappropriation of assets. Again this may be done on a sample basis, but will also usually involve consideration of specific items that appear to be particularly large or unusual. (Paragraph 32a(iii))

When selecting items for testing, the document tells us that the auditor should consider:

- whether there are any fraud risk factors that may help the auditor identify specific classes of journal entries and other adjustments for testing;

- the effectiveness of controls over the preparation and posting of journal entries and other adjustments. This may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls;

- the characteristics of fraudulent journal entries or other adjustments. Indicators of inappropriate journal entries may include entries:

    - made to unrelated, unusual, or seldom-used accounts or without identifying account numbers;

    - made by individuals who typically do not make journal entries;

    - recorded at the end of the period or as post-closing entries that have little or no explanation or description; and

    - containing round numbers or consistent ending numbers.

- the nature and complexity of the accounts. Inappropriate journal entries or adjustments may be applied to accounts that:

    - contain transactions that are inherently complex or unusual in nature;

    - contain significant estimates and period-end adjustments;

    - have been prone to misstatements in the past;

    - have not been reconciled on a timely basis or contain unreconciled differences;

    - contain inter-company transactions; and

    - are otherwise associated with an identified risk of material misstatement due to fraud.

How do auditors perform a review for management bias?

Fraudulent financial reporting often involves intentional misstatement of accounting estimates by, for example, understating or overstating all provisions or reserves in a

manner intended either to smooth earnings over several accounting periods, or to achieve a particular level of income, profit or assets in order to mislead users of the financial statements.

Paragraph 32b shown above requires the auditor to review the accounting estimates for biases. If there is indication of a possible bias on the part of the entity's management, then the auditor is required to re-evaluate the accounting estimates taken as a whole. Neither the Faculty document nor the Application material in ISA 240 consider this matter further but in my opinion, the requirement is rather strange in that the auditor is only required to re-evaluate the estimates taken as a whole once it has been decided that there are indications of bias. In my view, the only way to identify that bias is by considering the estimates as a whole. I always recommend that every file should contain a summary of all of the accounting estimates showing the estimate made by management for each area and comparing it with the auditor's estimate. A working paper could be structured like this:

Fraud review: Accounting estimates

Estimate	Sch. ref	Estimate by management	Estimate by auditor	Effect of error on profit
Warranty	L5b	£88,904	£25,635	£(63,269)
Doubtful debts	J3a	£66,240	£14,457	£(51,783)
Amounts recoverable on contracts	P7a(i)	£190,480	£215,385	£(24,905)
Total				£(139,957)

It may be the case that the individual errors are immaterial but, taken together, the differences of opinion between the auditor and the client may indicate bias – and a material understatement of profit.

The auditor is also required to perform a retrospective review of management judgements and assumptions related to significant accounting estimates reflected in the financial statements of the prior period. (Paragraph 32b(ii)) The main purpose of this review is again to cast light on possible bias.

A retrospective review is also required by ISA 540. That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's prior period estimation process. This will give the auditor information concerning the likely accuracy of current period estimates. It will also permit an informed consideration of estimation uncertainty.

As a practical matter, the retrospective reviews required by ISA 240 may be carried out in conjunction with those required by ISA 540.

Why do auditors consider transactions outside the normal course of business?

Significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may involve fraudulent financial reporting or concealing misappropriation of assets. Recording such transactions may involve an element of management override or circumvention of normal controls. Indicators that may suggest this include instances in which:

- the form of the transaction appears overly complex (such as multiple entities within a group or with multiple unrelated third parties);
- management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation;
- management or those charged with governance place more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction; and
- transactions involve non-consolidated related parties, previously unidentified related parties or parties that do not have the financial strength to support the transaction without assistance from the audited entity.

Are there any other matters to consider?

In accordance with Paragraph 33 of ISA 240, there might be a need to perform other audit procedures in addition to those required by paragraph 32. This issue is not addressed by either the Faculty document or the Application material in ISA 240. The faculty deals with other matters including:

- The need to ensure that the audit working papers record the significant judgements made and the rationale for the auditors' response.
- When communicating with those charged with governance regarding the planned scope and timing of the audit, the auditor needs to be careful not to compromise the effectiveness of the audit by providing too much detail regarding the nature and timing of audit procedures to be performed in order

to respond to the significant risk arising from the possibility of management override.

- The requirement for the auditor to make those charged with governance and management aware, at an appropriate level of responsibility, of matters related to fraud and deficiencies in the design or implementation of internal control which have come to their attention.

- Unlike other significant risks, the absence of effective controls to prevent management override will not necessarily represent a significant deficiency in internal control, especially where those charged with governance and management are effectively the same people. Before concluding that there is a deficiency in internal control the auditor considers whether there are any effective controls that could be applied and whether or not any controls that do exist are appropriate for the size and nature of the entity.

AIU: PRINCIPAL FINDINGS 2010/11 (LECTURE A366 – 14.27 MINUTES)

The following comments are extracted from the AIU annual report for 2010/11. I have not included those issues which are only likely to be relevant to listed companies. Delegates who audit listed companies should read the full report.

Introduction

The principal findings from the AIU inspections in 2010/11 are discussed below.

A number of the matters noted below reflect the importance the AIU attaches to firms observing the principles underlying Auditing and Ethical Standards as well as the specific requirements thereof. The AIU continues to have concerns that firms focus primarily on the specific requirements of the Standards and do not give sufficient attention to the underlying principles.

Another general concern is the potential implications of an increased emphasis within a number of major firms on achieving greater efficiencies in the conduct of audit work. Firms need to ensure that initiatives of this nature do not have an adverse effect on audit quality. Similarly, the culture within firms must strike an appropriate balance between strategies to grow the business and the need to maintain and improve audit quality.

The AIU also notes the growth in off-shoring, whereby certain audit tasks and processes are undertaken on behalf of the audit team in off-shore locations.

While the proportion of audit work undertaken through off-shoring currently remains very small, it is anticipated that it will continue to increase in the future. The AIU will therefore monitor its effect on audit quality.

Other examples of efficiency measures implemented by firms include changes to their guidance on materiality, which may have the effect of reducing the levels of testing performed, and specific programmes designed to reduce audit hours and costs.

Professional scepticism

The AIU continued to identify cases where it believed insufficient professional scepticism had been exercised in key areas of judgment. In response to these concerns, firms have undertaken or are in the process of undertaking a number of initiatives to reinforce the importance of exercising professional scepticism in the conduct of their audit work. These include additional training and specific communications to staff from key management personnel. The extent to which these initiatives have been successful in changing behaviours will not be clear to the AIU for some time but it does expect to see some evidence of improvement in its 2011/12 inspections. Some firms have more work to do than others to demonstrate that professional scepticism is appropriately embedded in their processes and culture.

Group audit arrangements

Auditing Standards regarding group audits have recently been strengthened to include greater specification of the audit procedures to be performed and require greater involvement by the group auditor in the audit of significant components.

The AIU identified issues in relation to group audits at both major and smaller firms, including cases where the group auditor had insufficient involvement in the audit of significant components. The revised Auditing Standards clarify what is expected of firms when undertaking group audits. In light of this, firms need to consider carefully whether to accept or continue with certain group audit engagements, for which they might not have the required resources, expertise or involvement in the underlying audit work.

The AIU also noted that the division of work between the group auditor and the component auditor was not always clear. Group audit instructions were not always issued and the group auditor did not always ensure that the component auditor had performed sufficient work on key audit areas.

When performing the audit of a UK subsidiary of a large overseas group where the audit approach is designed for the group as a whole, firms must ensure that they obtain sufficient audit evidence to support their statutory audit opinion on the UK subsidiary. This issue is particularly relevant to the audits of UK components of international financial institutions.

Impairment of goodwill and other intangibles

The AIU continued to review a number of audits where goodwill and other intangible assets were material, in order to assess the quality of audit evidence obtained to support the carrying value of these assets. Consistent with previous years a significant number of issues were identified including insufficient evidence of challenge of the key assumptions and concerns regarding the adequacy of the related disclosures.

Going concern

While the AIU continued to identify issues in relation to the audit of going concern, fewer issues arose overall this year, although this pattern was not uniformly spread across all firms. The extensive guidance issued both by firms and the APB has, in the AIU's view, resulted in improvements in audit quality in this area. Issues identified included the extent of work performed on financial projections supporting the going concern assessment, the adequacy of the disclosures relating to going concern uncertainties and insufficient evidence of parental support which was material to the going concern conclusion.

Use of experts

Appropriate use by firms of internal or external experts in more complex audit areas contributes to audit quality. The AIU identified very significant variations amongst the largest firms in the extent to which internal experts were used by audit teams. One firm which has used internal experts extensively in the past issued new guidance on this area which, in our view, is likely to have given rise to some confusion on the part of audit teams regarding their use.

In some audits, the audit team had not given proper consideration to the need to use the work of an expert in order to obtain sufficient appropriate audit evidence in areas such as asset valuations and assessing whether goodwill or other intangible assets had become impaired. Where internal experts were used, the AIU continued to identify cases where the expert's views and advice were not properly considered and followed-up, particularly where they indicated a need for valuations determined by management to be challenged, and cases where there was insufficient evidence of the work performed and the extent of verification undertaken by the experts.

Revenue recognition

Revenue recognition was an area of focus in 2010/11 in response to the economic climate and the resultant pressure on businesses, which increases the risk of manipulation of revenues. A range of issues were identified including insufficient testing of underlying data used to calculate the revenue recognised on long term contracts; not following up discrepancies between revenue recognised in the accounting system and underlying contracts; insufficient challenge of management's explanations in relation to key judgments used to determine revenue recognition; and insufficient consideration of differences in accounting treatment for differing revenue streams. The number and nature of these issues indicates that the audit of revenue recognition is an area where further improvement is required.

Substantive analytical review

Substantive analytical review is a key procedure on many audits and often the main form of audit evidence for items in the income statement. While substantive analytical review can provide valuable audit evidence, it is frequently not performed well. Issues were identified in many audits reviewed by the AIU across firms of all sizes. Often audit teams confuse overall analytical review procedures, which are generally limited to a comparison of current year figures with the prior year, with substantive analytical review procedures which require far more precision, including the setting of expectations and the establishment of thresholds for investigating differences. Even where firms have prescriptive methodologies for the performance of substantive analytical review, audit teams often fail to justify the rationale for the expectations set and frequently fail to investigate properly discrepancies above thresholds or to corroborate explanations provided by management. This may have implications for the overall adequacy of the audit evidence obtained in particular areas and firms must take further action to address this issue.

Controls effectiveness testing

The audit approach for the largest listed entities, large retailers and financial institutions, where sufficient audit evidence often cannot be obtained on a timely basis from substantive testing alone, generally includes testing the effectiveness of controls. In respect of other types of audits, auditors often rely primarily on substantive audit procedures, with only limited testing of the effectiveness of internal controls. Other issues identified included a lack of justification regarding sample selection and sizes.

Letters of representation

Auditing Standards state that written representations from management or those charged with governance do not provide sufficient audit evidence on their own in respect of any of the matters with which they deal. The AIU has come across cases where management representations were the main source of audit evidence obtained to support conclusions that no impairment of assets such as goodwill and other intangibles was required. Over-reliance on management representations is a further example of insufficient professional scepticism being applied in the conduct of audit work.

Audit of disclosures

In a number of cases improvements were required in the audit of disclosures relating to key judgments and assumptions, particularly in respect of the valuation of assets and going concern. In respect of a significant provision relating to miss-selling, there was insufficient evidence of the consideration of the adequacy of the related disclosures.

The audit of disclosures is sometimes primarily focused on the completion of various checklists. Such an approach fails to recognise the increased importance of disclosures in financial reporting. Firms should give greater emphasis to assessing the quality and sufficiency of the disclosures in key areas of judgment, to ensure they enable the users of the financial statements to understand the assumptions used and the extent of estimation uncertainty.

Accounting records maintained by service organisations

Auditors must ensure that they obtain sufficient audit evidence where all or part of the entity's accounting records are maintained by a service organisation. Issues arose in the audits of pension schemes and charities where investment managers or custodians, from whose reports the financial statements were compiled, hold the investments and maintain the associated accounting records.

Of particular concern was the practice of obtaining direct confirmation from either the investment manager or custodian as the sole evidence of the year end investment valuations in the financial statements. Where the financial statements are compiled directly from the reports provided by the investment manager or custodian, direct confirmations of this type do not provide adequate independent evidence as they are simply copies of the accounting records. Additional evidence is therefore required and must be obtained from alternative sources.

Non-audit services

Policies and procedures designed to ensure that firms comply with the requirements and underlying principles of the Ethical Standards, together with their application on individual audits, continue to be an important focus for the AIU's inspections.

In most respects major firms have appropriate policies and procedures in place. However, these policies and procedures or their application in practice continue to focus on compliance with the specific requirements of the Standards and do not necessarily give sufficient consideration to the principles underlying them.

A range of ethical issues continued to be identified, the more significant of which related to the provision of non-audit services. Incomplete identification of the nature and extent of the threats to independence and objectivity, inadequate consideration and application of appropriate safeguards to mitigate these threats, and inadequate communication with audit committees continue to be common issues. The proper identification of threats and safeguards is crucial to the effectiveness of Ethical Standards in maintaining independence. The AIU would have expected firms to be more conscious of the importance of applying appropriate safeguards at a time when the need for more specific prohibitions is being debated.

Quality control and audit finalisation

There was little or no evidence of review by the audit engagement partner or the engagement quality reviewer in key areas of audit judgment in a number of audits reviewed. Weaknesses were also identified in audit finalisation procedures, including undetected clerical drafting errors in financial statements.

There were also instances of work papers in significant areas of the audit that were either completed or evidenced as reviewed after the date of the audit report. This was a particular concern in respect of some of the bank audits reviewed. It is possible that targets for reporting to shareholders may be placing undue pressure on audit teams to complete audit procedures to a tight reporting timetable, leaving the audit team to evidence their work at a later date. While Auditing Standards permit the administrative process of assembling the final audit file after the date of the audit report, this should not include the retrospective evidencing of key areas of audit judgment. Firms should reinforce their policy regarding the timely review of work papers, particularly in areas of complexity or significant audit judgment.

Performance evaluation

While the AIU has identified examples of good practice, it remains concerned that performance evaluation processes do not always give sufficient consideration to

audit quality. Examples of this included audit personnel being awarded top performance gradings or being promoted, notwithstanding audit quality issues having been identified in internal quality reviews.

The AIU also continues to see evidence in appraisal and promotion documentation that senior staff believe, contrary to the requirements of the Ethical Standards, that success in selling non-audit services to audited entities is a factor influencing remuneration and promotion decisions. The AIU is particularly concerned at the lack of evidence of any challenge by their superiors to the inclusion of references to success in selling non-audit services to audited entities in appraisal and promotion documentation for senior staff.

COLD FILE REVIEWS SUMMER 2011 (LECTURE A367 – 21.28 MINUTES)

Introduction

Summer is the time for cold file reviews and I have recently completed a number of reviews for firms. It's interesting that most commentators are expecting the clarified standards to be creating the most problems but I have found that the real problems are coming from the standards that have barely changed.

Summary of results

Audit evidence is a strength of many firms and generally, this continues to be the case in this year's reviews. There are, however, some weaknesses and, where these are of general interest, they are referred to in the detailed comments below. There continue to be some areas of overauditing for example auditing immaterial areas or testing all items rather than just a sample.

It is very difficult for firms to eradicate all errors from statutory accounts. However, I am pleased to report that the standard of accounts disclosures in this year's review was very high.

As mentioned in the introduction, a particular question in this year's review was how firms have responded to the new auditing standards. The biggest area of change in the audit of individual companies is the audit of accounting estimates. None of the jobs reviewed contained any material accounting estimates and so I could not really judge how staff would have dealt with the new requirements. The next most demanding area is related party transactions. I have no reason to believe that there were any problems concerning related party transactions in any of the files reviewed.

However, one criticism is that the list of related parties should be a complete list not just a list of those related parties with whom the entity transacts.

Leaving aside these two standards, there are many other changes to the ISAs. Unfortunately, non-compliance arose in many areas for example materiality; the treatment of errors; the contents of the planning meeting; and notes of meetings with client personnel. These matters are explained in the detailed report below.

Despite the quantity of the changes, the vast bulk of the requirements in the new standards are effectively the same as those in the previous standards. Not surprisingly, we are still seeing errors being repeated as identified in previous years' reviews. For example: insufficient recording of knowledge of the business and accounting systems; failure to perform walk-through tests; and weaknesses in dealing with risk. These problems (and others) are explained in the detailed comments section of the report below.

Following the introduction of the new standards, audit systems have tended to become even more demanding with a lot more standard forms for completion. However, it has to be said that, in some of the files I reviewed, straightforward jobs were made to appear unnecessarily complicated. I felt that the staff could not see the wood for the trees. At this time of change in auditing, it is vital that all partners and staff have a clear understanding of their clients and auditing theory and also have the ability to apply that theory efficiently and effectively to those clients.

Detailed comments

Accounts

There is considerable attention in the profession at the moment to the usefulness of accounting policies. The policies produced by accounting software tend to be bland and apply to a very broad range of entities. This reduces their usefulness. There were examples of the use of "boiler-plate" language in one file where the reference to compliance with accounting standards ends with the comment "....which have been applied consistently (except as otherwise stated)." This comment makes no sense since the company was in its first year of trading. I was pleased to see in another file an attempt to explain the accounting policy for revenue recognition.

The accounts reviewed did not follow FRC guidance in that there was no note in the accounts relating to the impact of the current economic environment. However, there was a clear reference to the issue in the directors' report. I understand why this approach may be thought to be adequate but I must comment that, ideally, a note should appear in the accounts or there should be a cross-reference in the notes to the accounts to the note in the directors' report.

If the accounts are prepared using the full standards rather than the FRSSE then a tax reconciliation should be included as a note to the accounts.

Permanent file

The permanent file should provide evidence that it has been updated and reviewed every year.

Money laundering requirements for a new client must be complied with before any detailed work is performed.

The “Know your client” checklist alone can never provide sufficient information about the client. It needs to be supported by narrative notes. If you do include narrative descriptions of your knowledge of the client (with suggested headings based on the requirements of ISA 315) then there is no need to place the checklist on file. The checklist should be used purely as an aide-memoire. Do not fill it in; do not place it on the file.

Extracts from the client’s website may be helpful in giving knowledge of the business but are very unlikely to provide sufficient information. Also, make sure that the extracts included in the file are relevant to the audit otherwise you are wasting the time of everybody who ever reads the file.

Try to make knowledge of the business information more useful. It should be written sufficiently clearly such that an experienced auditor, having no previous connection with the audit, would be able to understand the business sufficiently well to plan an audit. When you have prepared notes, sit back and ask yourself what questions are likely to arise in the mind of that experienced auditor. Then answer them on file.

Under the new standards, the list of related parties should be a full list. This would include all key management personnel (including all directors) and their close families. It should also include all group entities.

There is no point in listing accounting policies on file – I can look at the accounts if I want to see a list. What is needed is a consideration of any accounting policies which are unusual or contentious or a statement that you have considered this and there are no unusual accounting policies.

The policy for recognition of revenue should be clearly stated. The file should state exactly how cut-off works.

ISA 540 has detailed requirements concerning accounting estimates. The files reviewed did not meet the full requirements of the standard – although I accept that this may be because of the relative immateriality of the items concerned.

The requirements of ISA 540 may be summarised as follows:

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

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

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

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

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

The auditor is required to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The review will provide information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process. It will also provide the auditor with information about estimation uncertainty and possible management bias.

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

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

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

The purpose of a schedule detailing non-audit services is to enable the auditor to consider threats to independence. If there are no non-audit services then say so on this schedule.

The file should include up-to-date systems notes for the main transactions cycles. It should also show the control procedures that operate and record the walk-through tests that have been performed.

Note that the new standards require documentation of the process for journals and error correction.

The existence of a service organisation means that the detailed requirements of ISA 402 must be met. Where the accounts are prepared by another firm of accountants then they are a service organisation.

Planning

It may be necessary to issue revised engagement letters to all clients to reflect the new standards. In particular, according to ICAEW, the engagement letter should contain the preconditions for an audit. It may be necessary to amend standard letters to include this point explicitly. Complaints and fees should also be dealt with in the engagement letter or in standard terms and conditions.

The planning section develops areas which should have been dealt with already in the permanent file. So, for example, consideration of threats to independence will be made easier if the non-audit services have been listed fully on the permanent file. Similarly, some of the requirements concerning accounting estimates should be dealt with in the permanent file. Now, in planning the audit, the auditor needs to consider risk relating to accounting estimates including whether management has adequately addressed estimation uncertainty. A further example is the failure to identify a service organisation in the permanent file documentation will result in a failure to add the appropriate special programme at the planning stage. None of the files reviewed were good at linking the knowledge of the business to the assessment of risk.

All of the major transactions cycles should be included in the audit documentation. In order to comment on implementation, the auditor must perform a walk-through test or observe the control in operation.

Some auditors are confused as to the meaning of the term “key” control. This term is not used in the ISAs and, in my opinion is best avoided. However, some audit systems use the term to mean a control which could be relied upon to reduce the level of substantive testing in a particular area. Therefore, if you do indicate that a control is a key control then compliance tests should be performed.

Performance materiality should be specified even if it is intended to use the same level in all areas.

The materiality form should be updated at finalisation and a conclusion stated.

Paragraphs 17 and 18 of ISA 240 require a conversation with both management and those charged with governance. The file should record who you talked to, when and what was said. These paragraphs are as follows:

17. The auditor shall make inquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

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

There is a presumed risk of fraud in revenue recognition in every audit (ISA 240 Paragraph 26). Rebutting this presumption would require a very strong justification.

The risk of management override should also be presumed to be a significant risk (ISA 240 Paragraph 31).

It is important that the file indicates how the risks identified at the planning stage are dealt with during the audit.

The file should indicate when the planning meeting took place, who was there and what was said. It should cover all matters required by the auditing standards including a discussion of related parties.

Some firms include knowledge of the business information in both the permanent file and the planning schedules. This is likely to be an inefficient way to approach the

audit. Also, if there are differences between the two sets of documentation then this could be potentially dangerous for the auditor.

ISA 260 requires that a number of matters be discussed at the planning stage with those charged with governance. The file should document that this has happened. If this requirement is met in part by sending the client a letter then that letter should be included in the audit file.

The requirements are as follows:

14. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit.

Whilst dealing with the requirements of ISA 260, the auditor is also required to communicate the significant findings from the audit to those charged with governance:

a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

b) Significant difficulties, if any, encountered during the audit;

c) Unless all of those charged with governance are involved in managing the entity:

    I. Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

    II. Written representations the auditor is requesting; and

d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Audit evidence

In one job, fixed assets were immaterial. No audit work was necessary and that section of the file should have been empty. It is interesting to comment that the job concerned was a pure audit and the firm was not involved in either accounts or tax work. Despite this, the file still contained a list of additions to fixed assets.

In one job, it was necessary to test investments. If the investments are held in the name of the company then ownership can be tested by examining the share certificates (or equivalent documents). However, it is more common these days for the investments to be held by nominees. In this case, the nominee company is a service organisation and the requirements of ISA 402 should be met.

When it comes to the valuation of investments, the company may use an expert (usually the investment manager) to provide a valuation of the investments. The auditor must test such a valuation. It is not acceptable to simply accept the valuation provided by the expert.

Group balances should be tested separately from other debtors/creditors. The preferred method is to confirm each component of the group balance with the auditor(s) of the other group companies. If this can't be done for some reason, then the balance should be confirmed directly with the other companies concerned. No other audit work is required on group balances.

It can be very efficient to select a sample from the full list of debtors (excluding group balances) using value weighted selection. That is, include trade debtors, prepayments and sundry debtors in the same sample. The items selected can then be tested according to their nature. This technique avoids the overauditing of prepayments and sundry debtors.

When setting a sample size, the figure calculated for sample size should be rounded up to the next whole number.

Lists are not audit work.

Cut-off testing is very important. In many jobs this can be the major risk area. Make sure that your file covers all aspects of cut-off in detail. In particular, it is vital that the file explains clearly the company's policy for revenue recognition. This then permits the auditor to draw a conclusion as to whether the policy is acceptable and to test whether cut-off has been properly applied.

It is very common to select trade debtors for testing and to confirm their recoverability by examining cash received after the year-end.

The effectiveness of this test diminishes if the audit is being performed soon after the year-end. Where the outcome from your test is unsatisfactory, you need an alternative approach.

When selecting suppliers for testing, the emphasis should be on testing for understatement. In order to achieve this, it is usual to include in the selection those suppliers who were selected as part of the testing of purchases. In addition, suppliers can be selected for testing by sampling from the list of balances in the previous year's audit file.

Having selected trade creditors for testing as outlined above, it is vital that the balances for those suppliers are confirmed. If there is no statement available, then the supplier should be contacted directly to ask for confirmation of the outstanding balance.

You should not test payments made to suppliers selected for testing. This test has no value and is therefore overauditing. When the audit programme refers to tests of payments after the year-end, it is not referring to payments made to clear balances in the purchase ledger. Rather, it means that you should look at the cash paid records after the year-end and make a selection of payments for testing. For each item selected, the audit test will then confirm whether cut-off has been dealt with correctly.

More generally, when testing liabilities, the emphasis must be on testing for understatement. This basic principle did not seem to be clearly understood in some of the files reviewed. The commonest error which arises when testing creditors is that the auditor tests what is there rather than what should be there.

The auditor must consider the list of liabilities provided by the client and find ways to identify items that may have been omitted from the list.

All errors (other than those which are clearly trivial) should be included on the summary of errors schedule. This would include deferred tax if this has not been recognised in the balance sheet. The summary of errors schedule should show a full picture of all errors identified by the audit process – even if these are subsequently corrected.

I prefer the senior to prepare relevant extracts from minutes rather than simply photocopying them.

You need to be satisfied as to the value of preparing P&L schedules. These are not audit evidence. In particular, if a job is a pure audit and the firm has no responsibility for preparing the accounts or the tax computation then there should be no P&L schedules on file.

When testing sales, the emphasis should be on testing for understatement. This principle was not clearly understood in some files. The sources of income should be listed and the auditor should devise a method for testing each source of income for understatement.

Where tests of details are performed, the sales test must start from the first document which records a sale eg an order form.

Conversely, the emphasis for expenditure is to test for overstatement. All of the items for testing should be selected from the TB and traced to supporting documentation.

Where an item selected for testing cannot be found, then that item should be classified as an error and included on the summary of errors schedule (extrapolated if appropriate).

When testing payroll, there is a tendency to produce reconciliations. Such work does not necessarily achieve the audit objectives.

A common error is to conclude that no audit work is required on payroll because the payroll has been prepared by a firm of Chartered Accountants using standard software. This is not the case. The usual assertions must be tested. In addition, the entity preparing the payroll is a service organisation and ISA 402 is relevant.

The revised auditing standards require the auditor to perform tests of journal entries.

Finalisation

The subsequent events review should be updated to the day the audit report is signed.

All review points raised by a manager or partner should be cleared by staff. The reviewer should then confirm that the response to the points raised is satisfactory. My advice continues to be that review points should be cleared by amending the original working papers and that the schedule of review points should be destroyed.

A figure for "clearly trivial" should be shown on the summary of errors schedule. Further, the schedule should include all errors identified by the audit (other than those which are clearly trivial) and should indicate which have been corrected.

The client should be informed of all errors (other than those which are clearly trivial) and asked to correct them.

Make sure to use the correct checklist for the client's situation. In one file, the company was not using the FRSSE but the FRSSE checklist had been used. When completing a checklist, reserve the use of ticks for the situation where the disclosure requirement has been met. Reserve the use of N/A for the situation where the disclosure requirement does not apply.

Final comment

The above comments are based on a relatively small number of files reviewed. The list of weaknesses will not necessarily include all commonly occurring errors. Firms are encouraged to perform thorough cold file reviews as soon as a sufficient number of files have been completed under the new standards.

SUMMARY OF DEVELOPMENTS

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

Accounting Standards Board (ASB)

Urgent Issues Task Force (UITF)

Financial Reporting Review Panel (FRRP)

Auditing Practices Board (APB)

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

FRC acts to increase transparency in corporate reporting

Companies should improve the way they report to investors on the key strategic risks facing their businesses, according to two new reports published today by the Financial Reporting Council (FRC).

As a result of detailed consultations with companies, investors, auditors and other interested parties, the FRC proposes to ensure that company narrative reports focus primarily on strategic and major operational risks, rather than indiscriminate lists of risks that all companies face.

The ‘Turnbull Guidance’ will be updated, and the FRC will consider whether changes may also be needed to the UK Corporate Governance Code to reflect lessons from its work on risk and ensure the conclusions of the on-going Sharman Enquiry on going concern and liquidity risks are taken fully into account.

The FRC’s proposals on risk are part of a wide-ranging set of measures aimed at improving the quality of company reporting, and increasing the information provided by audit committees and auditors about the work that they have done and the judgements or decisions they have made. These include:

- A proposal that the audit committee’s remit should be extended to include consideration of the whole annual report and to ensure the report, viewed as a whole, is fair and balanced; and

- Amending auditing standards to ensure that auditors always report the outcome of their review of the whole annual report, rather than, as at present, only when they encounter information that is inconsistent with the information contained in the financial statements;

- Establishing a new Financial Reporting Laboratory to remove roadblocks to effective reporting and promote innovation;

- A proposal to require companies to put their audits out to tender at least once in every ten years, or explain why they have not done so.

These proposals form part of the FRC's response to the financial crisis of 2007 and 2008 and are the result of an extensive process of consultation with market participants since January this year.

Effective Company Stewardship: Next Steps is the FRC's response to over 100 submissions to its consultation published in January 2011. Boards and Risk

summarises detailed discussions the FRC has held over the past six months with directors and specialists from listed companies.

Commenting, FRC Chief Executive Stephen Haddrill, said:

"These reports represent another step forward in applying the lessons we have learnt from the financial crisis, to improve the overall transparency of the reporting process and the accountability of all those involved in the financial reporting chain.

"Our conversations with companies have revealed a step change in the efforts made by directors to manage risks. However, company reports often do not get to the heart of the matter. We hope that by putting an emphasis on the reporting of risks that could undermine the company's strategy or long-term viability, companies will give investors the information they need to help them decide how to allocate capital".

Commenting on the proposals relating to the role of audit committees and auditors, Richard Fleck, Chairman of the Auditing Practices Board (APB), said:

"A recurring theme in the responses to our consultation paper has been the importance of providing greater insight into the key judgements that underlie financial statements. Under these proposals, in future audit committees will report the key judgements and decisions made in the course of preparing and finalising financial statements, and auditors will report whether their review of the annual report as a whole – and not just the financial statements – has revealed any information that is inaccurate, or any other material that is inconsistent with information they obtained in the course of their audit."

01 September 2011

The Financial Reporting Review Panel's Annual Report

The Financial Reporting Review Panel today published its annual report based on findings from the Panel's review of reports and accounts in the year to 31 March 2011 in which:

- 301 sets of accounts were reviewed.
- 141 companies were approached by the Panel for further information or explanation.
- 4 companies were the subject of a Panel press release.

The Panel found the general quality of corporate reporting to be good. It continues to have concerns about the quality of reports and accounts of some smaller listed and AIM quoted companies where there is still room for improvement.

Narrative reporting was a key area of interest for the Panel during the year. Although some poor practice is still seen, the Panel was particularly pleased to note widespread improvement in the description of principal risks and uncertainties in the business review included within the directors' report. Boards are also now more likely to describe the actions they are taking to mitigate the effects of risks and uncertainties which the Panel believes is required in order to satisfy the objectives of the review.

Bill Knight, Chairman of the Panel said:

"We are very pleased that descriptions of risks and uncertainties are improving. We are also looking to the balance and fairness of the business review – we applaud honest straightforward reporting which reflects the good and the less good aspects of the company's performance."

28 September 2011

FRC announces changes to UK Corporate Governance Code and urges companies to respond rapidly

The Financial Reporting Council (FRC) today announces its decision to amend the UK Corporate Governance Code to strengthen the principle on boardroom diversity which was first introduced into the Code in June 2010.

The amendments the FRC is announcing today will require listed companies to report annually on their boardroom diversity policy, including gender, and on any measurable objectives that the board has set for implementing the policy and the progress it had made in achieving the objectives. The FRC will also update the Code to include the diversity of the board, including gender, as one of the factors to be considered when evaluating its effectiveness.

The current revised Code, which came into effect in June 2010, included for the first time a principle recognising the value of diversity in the boardroom, which states that, "The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender".

In May 2011 the FRC issued a consultation document seeking views on whether the Code should be revised as recommended by Lord Davies of Abersoch in his review of the gender diversity of the boards of UK-listed companies published in February 2011. The vast majority of respondents supported the amendments proposed, which the FRC is now in the process of implementing.

The new provisions on diversity will apply to financial years beginning on or after 1 October 2012. This will provide the FRC with an opportunity to consult on other changes to reflect the current discussions around narrative reporting and effective company stewardship. However, the FRC strongly encourages all companies voluntarily to apply and report on the diversity additions to the Code with immediate effect.

Baroness Hogg, Chairman of the Financial Reporting Council, said:

“The changes we made to the Code last year reflected the FRC’s view that gender diversity strengthens board effectiveness by reducing the risk of “groupthink”, making fuller use of the talent pool and keeping companies in touch with their customers. The changes we are announcing today, which were strongly supported in our consultation, will reinforce the Code’s principles by requiring companies to report on measurable objectives and progress in this important area. We believe this gives a further opportunity to show that Britain’s “comply or explain”, Code-based approach can deliver a flexible and rapid response and is therefore preferable to detailed legal regulation, and we urge companies to demonstrate this as quickly as possible”.

11 October 2011

APB issues Bulletin for auditors providing assurance to the FSA in relation to client assets held by regulated firms

The Auditing Practices Board (APB) of the FRC today publishes Bulletin 2011/2 “Providing assurance on Client Assets to the Financial Services Authority”.

Arising from the financial crisis, the FSA identified a number of failings of regulated firms that held client assets and also raised questions about the quality of Client Asset reports submitted to them by auditors.

This led to the FSA increasing its resource devoted to the area by creating a specialist unit focused on firms’ compliance with the FSA’s CASS Rules. Those rules require regulated firms to hold client money and custody assets (collectively ‘client assets’) separately from their own in order to minimise the risk of loss to clients in the event of the firm’s insolvency.

The FSA also revised its SUP Rules which set out the duties of auditors to report to the FSA with respect to regulated firms’ compliance with the CASS Rules.

The Bulletin issued today provides guidance on the responsibilities of auditors under these revised Rules, which are required to be followed for periods ending 30 September 2011 onwards.

An auditor is required to provide a report to the FSA (known as a 'Client Assets Report') on whether the regulated firm:

- Has maintained systems adequate to comply with the FSA's client money and custody rules; and

- Has, as a matter of fact, complied with those rules.

The Bulletin emphasises that:

- Determination of whether assets are properly to be treated as client assets is a complex issue requiring a thorough understanding of a regulated firm's business model and its internal processes and controls;

- Auditors are required to approach the evaluation of the regulated firm's compliance with the FSA rules from the perspective of the position if the regulated firm becomes insolvent;

- Auditors should focus on whether controls are designed and operated to ensure compliance with the CASS Rules (ie are preventive), rather than focusing on whether controls will subsequently detect any non-compliance; and

- The CASS auditor’s report to the FSA must report any and all breaches (irrespective of materiality) of the rules that the auditor becomes aware of. This contributes to the FSA's risk assessment of the regulated firm.

These considerations result in a quite different approach to that usually applied in the course of a financial statement audit.

Fiona King, the FSA's Technical Head of Department, Client Assets and Wholesale Conduct commented:

"Arising from experience gained in the financial crisis, important improvements to the FSA's CASS Regime have recently come into effect. The FSA welcomes the publication of this Bulletin by the APB, which we expect CASS auditors to have regard to in discharging their responsibilities, with respect to client assets, to the FSA. We would, however, remind auditors, as is noted in the Bulletin, that their engagement teams must have a thorough grasp of relevant FSA Rules in order to undertake client asset engagements. CASS audits should be seen as a distinct specialism and audit firms should resist any temptation to regard the CASS audit as an adjunct to a financial statement audit that can be undertaken by inexperienced staff".

Richard Fleck the Chairman of APB further commented:

"Difficulties exposed by the financial crisis emphasise the need for CASS auditors to have a thorough understanding of their clients' legal structures and their business rationale. To achieve such an understanding staff undertaking CASS audits should be adequately trained in the CASS Rules, in understanding firm's business models, and in the evaluation of the design and operating effectiveness of internal controls over client assets".

13 October 2011

FRC launches UK's first Financial Reporting Lab

The Financial Reporting Council today launches the "Financial Reporting Lab" which brings together companies and investors to identify practical solutions to today's reporting problems, such as the length and complexity of reports and accounts.

It is the first time the Lab concept has been used to help solve corporate reporting problems which, for many years, have been the frustration of investors and companies alike.

The Lab's participants will be drawn from a diverse range of sectors and will include investors and representatives from a wide range of companies.

The FRC hopes the Lab will take a large part of the cost and risk out of the process of innovation and reduce the need for regulatory intervention. The Lab will contribute to the Government's attempts to simplify companies' narrative reporting requirements.

Commenting on today's launch Stephen Haddrill, chief executive of the FRC, said:

"For over a decade companies, investors and regulators have raised concerns about the increasing complexity and length of company reports. Initiatives from the FRC, such as Cutting Clutter, set the ball rolling. The creation of the Lab moves the debate on from theory to practice.

"The financial reporting community has chosen to come together to thrash out ways of making reports more useful to investors. Finding solutions will not be easy. The nature of global business, complex transactions and financial reporting standards all contribute to the situation we find ourselves in today. But we are encouraged by the broad support it has received from the business, investor and accounting communities.

"I would like to thank the members of the Lab Steering Group who have brought us to this point".

Further information on the Financial Reporting Lab can be found at: http://www.frc.org.uk/about/financialreportinglab.cfm.

14 October 2011

Consultation on the future role of the Financial Reporting Council Published

A consultation proposing the refocusing and streamlining of the Financial Reporting Council (FRC) is being launched by the Department for Business, Innovation and Skills (BIS) and the FRC today.

The aim of the reforms is to create an FRC that is clearer about its role and purpose, proportionate in the execution of that purpose and in a strong position to promote the highest standards of corporate reporting, governance and auditing.

Stakeholders are invited to comment on whether the scope of the FRC's regulatory activities should be narrowed to focus on areas of greatest concern to the operation of the capital markets and, in particular, on the following proposals:

- The FRC should set standards of governance, accounting, audit and actuarial work in the interests of investors in the corporate sector, and focus monitoring and enforcement activity primarily on publicly-traded and the largest private companies; and

- The scope of the FRC's accountancy disciplinary arrangements should be narrowed to cover the quality of work and conduct of accountants in preparing and auditing reports for the capital markets, leaving other cases of potential misconduct to be dealt with by the relevant professional body.

The consultation also proposes reinforcing the FRC's independence by providing it with:

- The power to require a Recognised Supervisory Body to impose sanctions on an audit firm and/or individual auditor in respect of poor quality work; and

- The ability to make its own rules for disciplinary arrangements in relation to accountants, without needing to obtain the agreement of the accountancy professional bodies.

The consultation also proposes replacing the FRC's existing seven operating bodies with two Board Committees - one focusing on Codes and Standards, the other on Conduct.

The Minister responsible for Corporate Governance, Edward Davey said:

"This Government's ambition is to make the UK the best place in Europe to start, finance and grow a business. And the FRC has an important role to play in supporting an environment where that ambition can become a reality.

"The reforms we're proposing will help the FRC to promote transparent and high quality financial reporting, and by doing so, increase confidence in the regulation of the accounting, audit and actuarial professions in the UK. They will improve the FRC's effectiveness, clarify its role and enable it to better support economic growth.

Baroness Hogg, Chairman of the Financial Reporting Council, said:

"At present the Financial Reporting Council consists of seven bodies to do just one core job, which is to promote good reporting and governance to foster investment. A streamlined, unified FRC will help us to regulate less and carry out our role more effectively. We are consulting on reforms we believe are urgently needed to secure our independence of those we regulate, reduce the risk of overlapping, over-regulation, and help us to promote the interests of the UK in the international regulatory arena".

Responses to the consultation are invited by 10 January 2012. The intention is to implement the changes, guided by the responses to the consultation, in April 2012.

18 October 2011

The Solicitors Accounts Rules 1998 are dead! Long live the new SRA Accounts Rules 2011

On 6 October 2011 the Solicitors Accounts Rules 1998 were replaced by the SRA Accounts Rules 2011. This is in response to the move from rules based regulation of solicitors to outcomes focused regulation.

The changes to the Rules reflect both the change in the breadth of application from the traditional solicitor firm to the new Alternative Business Structures and some attempt to move to more of an outcome focused application of the Rules. It has to be said however that examples of the latter are far less evident. These Rules have now received final approval.

Firms need to ensure that if they are carrying out a client money audit for a firm of solicitors that spans the changeover period that they use the correct set of audit programmes for the post and pre 6 October date. You will not need to submit two reports but you will need to consider two sets of rules and ensure your audit programmes have been updated. Any period up to 6 October will be under the old rules; from 6 October the new rules apply.

The above is extracted from an article published on SWATUK website. The article went on to consider the changes in some detail. The full article can be found by going to:

http://www.swat.co.uk/NewsViews/TechnicalNews.aspx

and then scanning down the list of articles which are shown in date order with the most recent first in the list.

If you carry out solicitor client money audits you should ensure that you get a set of audit programmes that deal with the new Rules. You will need to ensure the correct programmes are used for the correct period. You will need to familiarise yourselves with the new rules and ensure that all relevant staff are aware of the changes. Letters of engagement will also require update for the new terminology.

October 2011

Sharman Panel recommends improvements to reporting of going concern and liquidity risks

The Sharman Panel of Inquiry, established at the invitation of the Financial Reporting Council to consider *Going Concern and Liquidity Risks: Lessons for companies and auditors*, publishes its preliminary report and recommendations today.

The Panel's key recommendations, on which it will now consult, are that the FRC should:

- Establish protocols with BIS and other regulatory authorities that will enable it to take a more systematic approach to learning lessons relevant to the scope of its functions when significant companies fail, through assessing the underlying circumstances.
- Harmonise and clarify the common purpose of the going concern assessment and disclosure process in the accounting standards and Code.
- Require the going concern assessment process to focus on solvency risks as well as liquidity risks, whatever the business, including identifying risks to the entity's business model or capital adequacy that could threaten its survival, over a period that has regard to the likely evolution of those risks given the current position in the economic cycle and the dynamics of its own business cycles. It should also include stress tests of liquidity and solvency.
- Move away from a model where the company only highlights going concern risks when there are significant doubts about the entity's survival, to one which integrates the directors' going concern reporting with the directors' discussion of strategy and principal risks.
- Move away from the three category model for auditor reporting on going concern to an explicit statement in the auditor's report that the auditor is satisfied that, having considered the assessment process, they have nothing to add to the disclosures made by the directors about the robustness of the process and its outcome.

Lord Sharman, Chairman of the Panel, said:

"The recommendations we are publishing today aim to capture key lessons from the recent past. Although this work emanates from the financial crisis, I hope there will be wide acceptance that companies in all sectors can do more to improve their management and disclosure of risks relating to going concern, liquidity and solvency.

“The aim of these disclosures is to provide information to stakeholders and they should be designed to encourage appropriate behaviours such as good risk decision-making, informing stakeholders about those risks and early identification and attention to economic and financial distress.

“Our report includes recommendations that involve companies, auditors, regulators and government and we look forward to engaging with the widest possible range of stakeholders to build a broad consensus on how to take forward these proposals."

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

"The management and disclosure of key risks is an essential part of the role of an effective company board. Lord Sharman's inquiry has revealed the vital role directors and auditors must play in bringing short term liquidity risks and longer term, but no less important, solvency risks, to the attention of investors and other stakeholders.

"There is a clear connection between Lord Sharman's work and proposals from UK Government and the FRC. I hope the consultation period will provide a useful opportunity to assess how they fit together to improve both the quality of corporate reporting and the dialogue between investors and company boards."

A copy of the Preliminary Report and Recommendations may be downloaded from the Sharman Inquiry web site: (http://www.frc.org.uk/about/sharmaninquiry.cfm).

03 November 2011

APB consults on amendments to Ethical Standards

The Auditing Practices Board (APB) today publishes a short consultation document covering two amendments to the Ethical Standards for Auditors. These involve:

Extending until 31 December 2014 the transitional arrangement for tax services provided on a contingency fee basis where contracts were entered into prior to 31 December 2010. This amendment addresses those situations where the majority of the work has been undertaken but the outcome is dependent on a decision that may not be made for some years. This avoids breaching the principle that changes should not be retrospective but brings such arrangements to an end at a future date.

Amending Appendix 1 in ES 1 to provide a simplified illustrative template for communicating information on audit and non-audit services in order to reflect amended regulations on auditor remuneration disclosures.

The comment period ends on 7 December 2011.

07 November 2011