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RELATED PARTY TRANSACTIONS (LECTURE A368 – 18.35 MINUTES)

This continues to be a problem area for accountants and auditors with many questions asked both on courses and via help lines. I include some of these questions below.

One of the problems is the definition of a related party. FRS 8 has been revised twice in the last four years. In 2008, FRS 8 was revised to respond to the requirement in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 that the definition of related parties should be the same as in international accounting standards. The amendment to FRS 8 was limited in scope and a number of inconsistencies remained. This version of FRS 8 is described below as the existing version.

The next amendment occurred in 2010 in response to amendments to the international standard. This time the ASB gave FRS 8 a thorough overhaul. The revised standard comes into force for accounting periods commencing on or after 1 January 2011. Early adoption is permitted.

At the moment, therefore, many companies have a choice of which FRS 8 to follow. Some companies also have the choice of adopting FRSSE which contains yet another (different) definition based on the version of FRS 8 in force before 2008.

The question “who is my related party?” is also a current hot topic as a result of the requirement in ISA 550 for directors to disclose to the auditor the identity of the entity's related parties and for the auditor to include a list of identified related parties in the audit documentation. In the audit section of these notes we consider the auditor’s response when the directors refuse to provide full disclosure.

Director in common

Q. Two companies have a director in common and there are loans and transactions between the two companies. Are we required to disclose transactions between the companies?

A. On the information provided – no.

This has always been the case but paragraph 12(a) of FRS 8 (Revised November 2010) makes this absolutely clear:

‘In the context of this FRS, the following are not related parties:

(a) two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.'

However, we need to consider whether there are any other relationships which may result in the companies being related parties.

Directors in common

Q. Mr A and Ms B are the two directors of X Ltd. Mr A and Ms B are also the directors of Y Ltd. Neither Mr A nor Ms B hold any shares in X Ltd or Y Ltd. Further, the shareholders of X Ltd are not in any way related to the shareholders of Y Ltd.

We have always treated Y Ltd as a related party in the accounts of X Ltd. Is this correct?

A. In the past, this was correct. Paragraph 13 of the existing FRS 8 states:

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

Under the revised FRS 8, this is no longer automatically the position as paragraph 13 has been withdrawn. We must now make the decision based only on the definition. Relevant extracts are:

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

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

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

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

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

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

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

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

The decision as to whether X Ltd and Y Ltd are related parties boils down to deciding whether Mr A and/or Ms B control or jointly control either X Ltd or Y Ltd.

Control is defined in FRS 8 (both existing and revised) as 'The ability to direct the financial and operating policies of an entity with a view to gaining economic benefits from its activities.'

Joint control is not defined in either version of FRS 8.

Individual with an involvement with a number of companies

Q. Ms C is the owner and sole director of J Ltd. She is involved with a number of other companies as follows:

a) She is one of four directors of K Ltd but owns no shares

b) She owns 20% of the shares in L Ltd but is not on the board

c) She owns 80% of the shares in M Ltd

d) J Ltd advises N Ltd on a consultancy basis. This involves a significant amount of business. Ms C does not own any shares in N Ltd and is not a director of that company

e) J Ltd has a joint venture with V Ltd in a company called W Ltd

We are helping Ms C in the preparation of the accounts for J Ltd. Which, if any, of the other companies are related parties?

A. In order to answer this question we will need the full definition from both the existing and the revised standard:

Existing FRS 8	Revised FRS 8
A party is related to an entity if: (a) directly, or indirectly through one or more intermediaries, the party: (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries); (ii) has an interest in the entity that gives it significant influence over the entity; or (iii) has joint control over the entity; (b) the party is an associate (as defined in FRS 9, Associates and joint ventures) of the entity; (c) the party is a joint venture in which the entity is a venturer (as defined in FRS 9, Associates and joint ventures); (d) the party is a member of the key management personnel of the entity or its parent; (e) the party is a close member of the family of any individual referred to in subparagraph (a) or (d); (f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with directly or indirectly, any individual referred to in (d) or (e); or (g) the party is a retirement benefit scheme for the benefit of employees of the entity, or of any entity that is a related party of the entity.	A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity'). (a) A person or a close member of that person's family is related to a reporting entity if that person: (i) has control or joint control over the reporting entity; (ii) has significant influence over the reporting entity; or (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. (b) An entity is related to a reporting entity if any of the following conditions applies: (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others). (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member). (iii) Both entities are joint ventures of the same third party. (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity. (v) The entity is a retirement benefit scheme for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a scheme, the sponsoring employers are also related to the reporting entity. (vi) The entity is controlled or jointly

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

The following comments assume that there is no additional relevant information other than that included in the question above. In practice, there may be other issues to take into account.

Company	**Existing FRS 8**	**Revised FRS 8**
K Ltd (Ms C is a director)	K Ltd is not a related party of J Ltd. (Note that J Ltd is a related party of K Ltd.)	Related party under b(vii) because Ms C is in category a(i)
L Ltd (Ms C owns 20% but is not on the board)	Under f, L Ltd is a related party if it is significantly influenced by Ms C (or alternatively, if it is considered that she has significant voting power) Since Ms C is not a director, it may well be argued that the shareholding on its own does not give significant influence. Significant influence is not defined by the standard.	Similar to existing FRS 8. Under b(vii) the question is whether Ms C has significant influence over L Ltd. Notice however the slight change in emphasis. In the existing FRS 8, to be a related party, L Ltd must be 'significantly influenced'. That is, the influence is having some effect. Under the revised FRS 8, it could be the case that Ms C has significant influence but perhaps she doesn't exert it. L Ltd would be a related party but may not be influenced by her. Splitting hairs perhaps. As before, significant influence is not defined by the standard.
M Ltd (Ms C owns 80%	Related party under f.	Related party under b(vi)
N Ltd (J Ltd is a consultant)	Paragraph 4 (below) implies that N Ltd is a related party but that there is no need to disclose the transactions with N Ltd. 'The FRS does not require disclosure of the relationship and transactions between the reporting entity and the parties	Not a related party under Paragraph 12 (below). 'In the context of this FRS, the following are not related parties: (d) a customer, supplier, franchisor, distributor or general agent with whom an entity

	listed in (a)-(d) below simply as a result of their role as: (d) a customer, supplier, franchiser, distributor or general agent with whom an entity transacts a significant volume of business.	transacts a significant volume of business, simply by virtue of the resulting economic dependence.'
V Ltd	Not a related party	Not a related party under Paragraph 12(b): 'In the context of this FRS, the following are not related parties: (b) two venturers simply because they share joint control over a joint venture'
W Ltd	Related party under c	Related party under b(ii)

Members of the same household

Q. Jane is the sole shareholder and director of P Ltd. She shares a flat with David and Tracey and all three have been friends since they met at University five years ago. They share the running of the flat in all respects and therefore can be regarded as members of the same household. None of them have a domestic partner.

David is the owner and sole director of Q Ltd. Q Ltd provides consultancy services to P Ltd. The amounts concerned are material to P Ltd.

We have always treated Q Ltd as a related party in the accounts of P Ltd and disclosed the transactions and balance. Is this correct?

A. In the past, this may have been correct. The existing version of FRS 8 refers to members of the same household in the definition of close family:

'Close family: Close members of the family of an individual are those family members, or members of the same household, who may be expected to influence, or be influenced by, that person in their dealings with the reporting entity.'

From this definition the assumption has grown that all members of the same household are automatically related parties. This is not necessarily so since the definition goes on to qualify the definition by requiring influence in one direction or the other. Does influence exist between Jane and David?

Under the revised FRS 8, the problem changes. Here is the new definition:

'Close members of the family of a person are those family members, who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner;

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner.'

Notice that the requirement for influence is still there but we never even reach that part of the definition if David is not a family member or domestic partner of Jane. This question is easy for Jane to answer although the accountant may feel uncomfortable in asking it!

While on the subject of the accountant's discomfort, I would try to avoid asking intrusive questions. If you have previously treated Q Ltd as a related party then there must have been an occasion when you explained the definition to Jane. It is reasonable to inform Jane of the change in the rules and to ask whether she still considers Q Ltd to be a related party.

If, on the other hand, you are dealing with a new client then I would err on the side of caution when it comes to asking personal questions. It is the directors' responsibility to identify related parties and to prepare accounts which show a true and fair view. I would inform the directors of the need to disclose related party transactions and would explain the definition of related party to them. I would encourage them to ask me questions to help them understand the definition. It is then up to the directors to fulfil their responsibilities.

If the company is audit exempt then you have no further responsibilities except in the circumstance where you become aware of an omission.

If on the other hand, the client is an audit client then you will need to satisfy the requirements of ISA 550. This topic is considered in the audit section of these notes.

Aggregation and dividends paid to directors

Q. Mr A and Ms B are the two directors of X Ltd. The shareholders are:

Mr A	*30%*
Mrs A	*15%*
Master A	*15%*
Ms B	*30%*
Mr C (Ms B's domestic partner)	*10%*

During the year, X Ltd paid total dividends of £200,000. Each shareholder received an amount appropriate to their shareholding. Materiality from the company's point of view has been set at £20,000.

Can we use aggregation and make the following disclosures:

Dividends paid to directors:	*£120,000*
The directors concerned are Mr A and Ms B.	
Dividends paid to close family members of directors:	*£80,000*
The individuals concerned are Mrs A the spouse of Mr A; Master A the son of Mr A; and Mr C the domestic partner of Ms B.	

A. I have always considered that aggregation is perfectly acceptable as long as a list of names is given along with an indication of their relationship to the company (i.e. why they are related parties).

I am aware that not all technical experts agree with this. Presumably their argument is that individual disclosure is necessary for an understanding of the impact of the transactions on the financial statements. See the sentence below (taken from paragraph 6 of FRS 8 both existing and revised):

'Transactions with related parties may be disclosed on an aggregated basis (aggregation of similar transactions by type of related party) unless disclosure of an individual transaction, or connected transactions, is necessary for an understanding of the impact of the transactions on the financial statements of the reporting entity or is required by law.'

Disclosures in a group situation

Q: B is the parent of a group of companies. C, D and E are wholly owned subsidiaries whereas F is 75% owned.

All of the companies trade with each other and there are balances outstanding at the year-end.

Do the transactions need to be disclosed in the individual accounts of the companies concerned? What about the consolidated accounts?

A. Paragraph 3 from FRS 8 (both existing and revised) includes:

‘Financial Reporting Standard 8 applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period. The FRS does not, however, require disclosure:

(a) in consolidated financial statements, of any transactions or balances between group entities that have been eliminated on consolidation;

(c) of transactions entered into between two or more members of a group, provided that any subsidiary undertaking which is a party to the transaction is wholly owned by a member of that group.’

‘Reporting entities taking advantage of the exemption in (c) above are required to state that fact.’

Paragraph 16.2 of FRSSE permits the same exemptions.

Therefore:

In B’s consolidated accounts, no need to disclose group transactions or inter-group balances eliminated on consolidation.

In B’s individual accounts, no need to disclose transactions with C, D and E. Disclosure is required that the company has taken advantage of this exemption. Transactions with F must be disclosed. Balances with group companies must be disclosed – an aggregated basis is acceptable.

In the individual accounts of C, D and E, no need to disclose transactions with B, C, D and E. Disclosure is required that the company has taken advantage of this exemption. Transactions with F must be disclosed. Balances with group companies must be disclosed – an aggregated basis is acceptable.

In F’s individual accounts, all transactions and balances must be disclosed with all of the other companies. An aggregated basis is acceptable.

Related parties and the FRSSE

Q. S Ltd prepares accounts using the FRSSE. Should the directors continue to use the definition in FRSSE or should they switch to the new definition in FRS 8 revised?

A. In asking the above question, you may be thinking of Paragraph 5 of FRSSE. This says:

'Financial statements will generally be prepared using accepted practice and, accordingly, for transactions or events not dealt with in the FRSSE, smaller entities should have regard to other accounting standards and UITF Abstracts, not as mandatory documents, but as a means of establishing current practice.'

This means that where FRSSE does not deal with a situation then it is appropriate to refer to the full standards.

However, FRSSE does deal with the subject of related parties and gives a definition of the term 'related party'. Therefore the definition in FRSSE should continue to be used. It would not be acceptable to switch to an alternative definition provided by FRS 8. 'Close family' is also defined in FRSSE and includes the same reference to members of the same household as the existing FRS 8. Therefore this is still relevant when dealing with FRSSE clients.

On the other hand, the definition of 'close family' in FRSSE does not go on to include spouse, domestic partner, children etc. Does this mean that Paragraph 5 would require you to expand your list of related parties to include these individuals? This is a matter for debate.

In my opinion, FRSSE deals with the entire subject of related parties and there is no need to 'have regard' to FRS 8. However, the interpretation of the definition in FRSSE requires the directors to exercise their judgment. It would be strange if that judgment was not influenced by their accountant's knowledge that the most up-to-date thinking on related parties is that certain individuals must be included.

THE FUTURE OF UK GAAP (LECTURE A369 – 15.41 MINUTES)

Introduction

'The Accounting Standards Board (ASB) has published financial reporting exposure drafts (FREDs) 46 to 48 setting out revised proposals for the future of financial reporting in the UK and Republic of Ireland.

The ASB is issuing these FREDs following feedback to its previous exposure drafts (FREDs 43 to 45). Having listened carefully and considered the matters raised, the ASB is proposing significant changes to its previous proposals.

The ASB's objective in developing its revised proposals is to enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.'

It is in these words that the press release from the ASB announced the latest steps forward in the development of UK GAAP. The three FREDs are accompanied by a 31 page explanation, an 80 page description of the development of the FREDs and a 20 page document referred to as 'The key facts'. Finally, there is also a document setting out an alternative view from a member of the ASB whose opinions deviated from the rest of the Board.

We will consider each of the new FREDs briefly in the notes below. We will also consider some of the comments in the other documents – particularly concerning the future of FRSSE and small company reporting.

FRED 46: Application of financial reporting requirements

The title of FRED 46 also refers to it as [Draft] FRS 100. This suggests that the new UK GAAP will use a revised system of numbering.

FRED 46 sets out the accounting regime which will apply to different types of entities. This is in paragraph 7 under the heading 'Basis of preparation of financial statements'.

An entity that is required by the IAS Regulation (or other legislation or regulation) to prepare consolidated financial statements in accordance with EU-adopted IFRS must continue do so.

The individual accounts of such an entity, or the individual accounts or consolidated financial statements of any other entity within the scope of the [draft] FRS, must be prepared in accordance with the following requirements:

a) if the entity is eligible to apply the FRSSE, it may prepare its financial statements in accordance with that standard;

b) if the entity is not eligible to apply the FRSSE, or if the entity is eligible to apply the FRSSE but chooses not to do so, the entity must apply either:

- [draft] FRS 102; or

  - EU-adopted IFRS; or

  - for financial statements that are the individual accounts of a qualifying entity, [draft] FRS 101.

FRED 46 also covers:

- The need to disclose compliance with a relevant Statement of Recommended Practice (SORP)

- Statement of compliance with either [draft] FRS 101 or [draft] FRS 102

- Effective date and transitional arrangements

- Withdrawal of existing SSAPs, FRSs and UITF abstracts

- Consequential amendments to the FRSSE.

With respect to the effective date, this is now seen as being periods beginning on or after 1 January 2015. Early adoption will be permitted once the standards are final although for a public benefit entity this is subject to the availability of an updated SORP.

The exposure drafts are open for comment until 30 April 2012. Subject to the feedback received it is expected to issue the final standard by the end of 2012.

Major change from previous proposals

The ASB has scrapped the three tier approach. Public accountability is no longer relevant in determining which accounting regime to apply.

FRED 47: Reduced disclosure framework ([draft] FRS 101)

'Qualifying entity' is defined in [draft] FRS 101 as a member of a group that prepares publicly available financial statements, which give a true and fair view, in which that member is consolidated.

FRED 47 proposes reduced disclosures for subsidiaries and ultimate parents which are qualifying entities. These entities are applying the recognition, measurement and disclosure requirements of EU-adopted IFRS but following the reduced disclosure framework of [draft] FRS 101.

The reduced disclosures can be found in paragraph 8 of the [draft] FRS. There are some restrictions on the exemptions available for financial institutions and entities which have financial liabilities held at fair value.

Important matters to note include:

- The exemptions are available in the parent company's individual accounts but not in the consolidated financial statements.

- The shareholders of the qualifying entity must be notified in writing about the use of the disclosure exemptions. See paragraph 7(a) of the [draft] FRS for details as to the circumstances in which a shareholder can object.

- The accounts of a qualifying entity under [draft] FRS 101 are "UK GAAP" accounts not IAS accounts. They must therefore comply with the CA 2006 and the related Regulations. Application Guidance included in [draft] FRS 101 sets out the amendments to EU-adopted IFRS to achieve compliance with the Act and Regulations.

- There must be disclosure of the exemptions taken, the name of the parent preparing the publicly available consolidated accounts and where those accounts can be obtained. There is no requirement for the consolidated accounts to follow EU-adopted IFRS but, if this is not the case, then the need for the accounts to show a true and fair view will mean the consideration of 'equivalence'. This is currently covered in UITF Abstract 43 but will, in future, be contained in the Application Guidance in FRS 100.

- A reduced disclosure framework is also available to qualifying entities applying the recognition and measurement principles of [draft] FRS 102; the relevant financial reporting requirements and disclosure exemptions are set out in that standard.

Major changes from previous proposals

The original proposals only applied to subsidiaries within a group. The revised proposals apply also to the ultimate parent company when preparing its individual accounts.

FRS 8 does not require disclosure of any transaction with other group companies where all subsidiaries involved in the transaction are wholly owned within the group. This exemption is now included in [draft] FRS 101.

FRED 48: The financial reporting standard applicable in the UK and the Republic of Ireland ([draft] FRS 102)

Introduction

The new UK GAAP comes in at just under 250 pages (as promised by the ASB). The material is organised by topics in 35 sections. There is a glossary and several appendices. Some appendices are attached to individual topics (eg provisions and revenue recognition) and others are at the end of the standard. Appendix 1 gives a list of the significant differences between the [draft] FRS and the IFRS for SMEs. Helpful to some, no doubt, but for many of us a list of differences from existing UK GAAP would probably be more useful.

However, the reason for Appendix 1 is that FRED 48 is based on IFRS for SMEs. Amendments to IFRS for SMEs are necessary for a number of reasons:

- Compliance with UK company law.
- The scope of IFRS for SMEs excluded publicly accountable entities and this approach was followed in FRED 44. As a result of the abandonment of the tier system, FRED 48 must now include standards appropriate for publicly accountable entities.
- IFRS for SMEs simplified full IFRS by restricting the accounting policy choices available. This approach was followed in FRED 44 but did not find support in the UK. Therefore, FRED 48 includes accounting policy choices to reflect the policy choices available in current UK GAAP (see below).

[Draft] FRS 102 is designed to apply to all entities. The name has therefore been changed to remove the reference to medium-sized. Unlike FRED 44, FRED 48 includes specific accounting requirements relevant to public benefit entities.

Since FRED 48 is designed to apply to a broader group of entities, it includes additional disclosure requirements for financial institutions and pension funds. In addition, certain entities are required to apply the relevant EU-adopted IFRS for insurance contracts (although the ASB is consulting on amendments in this area), interim financial reporting, segmental reporting and earnings per share.

The ASB has also decided that it will issue a further FRED proposing amendments to FRED 48 for financial instruments when the IASB updates IFRS 9 Financial Instruments. This is because FRED 48 does not reflect the most up-to-date thinking for financial instruments and incorporates weaknesses in IAS 39.

Major changes from previous proposals

Part 3 of the revised FREDs deals with the development of the FREDs. This document provides us with a summary of the changes that have occurred following consultation on FREDs 43 to 45. The following notes are adapted from part 5 of Section 1 of that document.

The ASB is proposing to retain accounting treatments permitted under current accounting standards and international accounting standards rather than its previous policy which was to make minimal changes to the IFRS for SMEs. These changes from FRED 44 have already been reported extensively and allow:

- Revaluation of land and buildings
- Capitalisation of borrowing costs
- Carry forward of certain development expenses
- Hedge accounting for a net investment in a foreign operation
- Merger accounting for group reorganisations.

The ASB is also proposing a number of clarifications in FRED 48. These include:

- The presentation requirements for discontinued operations to ensure compliance with CA 2006. An example is provided in the appendix to the section.
- Treatment of loan covenants so that these are now consistent with IFRS 9, Financial Instruments.
- A puttable financial instruments that is classified as equity in a subsidiary's financial statements is classified as a liability in the consolidated group financial statements.

- An employee benefit trust, ESOP or similar arrangement is a special purpose entity. This should be consolidated where the entity is a parent and prepares consolidated financial statements. An entity applies paragraphs 2.53 to 2.55 of FRED 48 in its individual accounts.

- An investor that is not a parent but has an investment in one or more associates and/or jointly controlled entities shall account for its investments and/or jointly controlled entities using either cost or fair value.

- FRED 48 proposes that a subsidiary should be excluded from consolidation where the interest in the subsidiary is held exclusively for resale and is held as part of an investment portfolio.

- The presumed life for goodwill and intangible assets, in particular when an entity is otherwise unable to make a reliable estimate, is 5 years.

- Accounting treatment for group share-based payments where the award is granted by the parent or another group entity.

- Option pricing models are not required for the valuation of shared-based payments, particularly for unquoted shares or share options.

- Presentation requirements for post-employment benefit plans specifically concerning where the difference between the return on plan assets and expected return on plan assets should be presented.

- The presentation formats required by company law should be followed – although these formats would continue to be supplemented by the requirements of accounting standards.

In addition, FRED 48 proposes a new approach to deferred tax and revision to the accounting treatment of grants. Note also that Sections 11 and 12 (Accounting for financial instruments) may be subject to change in a subsequent FRED to bring them into line with IFRS 9.

The ASB refers to the new approach to deferred tax as being a ‘timing differences plus’ approach. This means that deferred tax will be recognised on timing differences but with additional recognition requirements where there are temporary differences that are not clearly timing differences. The ASB says that this is a simple solution that is close to current FRS and gives the same answer as IFRSs in most cases.

The most significant change to the requirements in current FRS is that the proposed approach requires the recognition of the deferred tax implications of the revaluation of assets. In the ASB's view gains and losses recognised on a revaluation are timing differences the effects of which should be recognised. Such a requirement is consistent with that of IAS 12 and the IFRS for SMEs.

The ASB has acknowledged that the timing difference plus approach does not achieve complete consistency with IAS 12, Income Taxes but they consider differences between the proposals and IAS 12 are likely to be relatively rare.

It is proposed that disclosures should be changed so that entities would disclose when timing differences are expected to reverse.

On the subject of grants, the first thing that changes is the title of the section. It now deals with grants of any kind – not just government grants. FRED 44 proposed that grants should be recognised based on when an entity fulfilled the performance criteria stipulated in the grant. This approach was copied from the IFRS for SMEs whereas existing UK GAAP (and EU-adopted IFRS) both use an approach that attempts to match grant income with the related expenditure.

The ASB has decided to adopt an interim solution permitting either method until completion of a research project.

The future of FRSSE

Perhaps the most telling reference to FRSSE is in FRED 46. This makes consequential amendments to FRSSE as a result of the changes to be brought about by the new FRSs. These amendments are minor with the exception of:

- The introduction of a presumed life for goodwill of five years
- Clarification that the entity must assess annually whether there is any indication of impairment of fixed assets
- The change in the definition of related party to be consistent with the definition in FRS 8 (revised).

These changes are effective from January 2015 - the same date as the new standards. The reason that I consider this important is because it implies that a) the FRSSE will not be amended until 2015 and b) the FRSSE will continue to exist beyond 2015.

However, we must also refer to the comments in Section 5 of the explanation document. Here the ASB tells us that, in light of recent proposals from the European Commission on small company reporting the ASB intends to retain the FRSSE but that the FRSSE (effective April 2008) will have to be significantly updated to maintain consistency with company law.

The EC proposals issued in October 2011 would:

- raise the thresholds for defining small companies, which would mean that more companies would be eligible to use the FRSSE
- require specific disclosures in the notes to the financial statements, which would focus on information such as commitments, borrowings and arrangements not included in the balance sheet
- reduce the mandatory information provided in small company financial statements and allow Member State options that could reduce the information provided further through, for example, restricting accounting policy choices.

Further, Member States will have an option to treat micro-entities as a separate category of company and to exempt them from certain accounting requirements.

It is planned to include all of the above proposals in a new Accounting Directive to be made effective by Member States by 1 July 2014. This date may well change and there will also be a time lag before the changes affect UK companies so the exact date at which FRSSE will need to be updated for these changes is not clear. Presumably, the ASB must consider that this date will be after 1January 2015 or they would not have bothered with the consequential amendments mentioned above.

You should be aware of one other quote from the explanation document:

‘When UK and Republic of Ireland legislation implementing the Directive becomes effective the FRSSE (effective April 2008) will no longer be consistent with the law, although many of its requirements may still be valid. In particular as the proposed Directive restricts Member States from requiring additional disclosures to those set out in the proposed Directive, the FRSSE (effective April 2008) will need to be withdrawn.’ (Paragraph 5.6)

The ASB is proposing to consult on how to amend the FRSSE once the EU proposals for small and micro-entities become clear.

Previously, some commentators had suggested the FRSSE could be withdrawn and small entities required to follow the same standard as medium-sized companies. Now, the ASB believes that the requirements of the proposed Directive, in particular in relation to restricting disclosures, make this impractical.

So there will be a FRSSE in the long term but not as we currently know it.

UK GAAP: KEY REPORTING ISSUES (LECTURE A370 – 8.20 MINUTES)

The Financial Reporting Faculty of ICAEW has identified a number of key issues which are considered to be particularly important at the moment. These issues are listed below. I have made my own comments based on the document issued by the faculty.

Going concern

The current economic environment continues to pose problems for many companies. This is an area of focus for regulators as well as the users of accounts.

The faculty indicates that the board of directors should consider:

- Liquidity and solvency
- The potential need to restructure debts or raise new funds
- Future compliance with debt covenants

Where there are concerns, the directors may conclude there are significant doubts about the entity's ability to continue as a going concern. If this is the case, whether the entity is using FRS 18 or FRSSE, the material uncertainties leading to the significant doubts must be disclosed, together with management's plans to mitigate the uncertainty.

Most accountants are aware of the above requirement but compliance is not as strong when it comes to situations where there are no material uncertainties. FRC guidance 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' indicates that even in those situations where there are no material uncertainties, relevant disclosures, including those about liquidity risk, should still be made in the financial statements to the extent necessary to give a true and fair view.

Impairment

The current economic environment increases the possibility that assets may be impaired. FRS 11 requires a review for impairment to be carried out if events or changes in circumstances indicate that the carrying amount of fixed assets or goodwill may not be recoverable. FRS 11 provides a list of indicators of impairment.

FRSSE does not contain such a list but says 'Fixed assets and goodwill shall be carried in the balance sheet at no more than recoverable amount'. It is interesting to observe, however, that one of the few changes in FRSSE proposed by FRED 46 is to incorporate a requirement for annual review. The list of indicators from FRS 11 will also be included in the revised FRSSE.

Impairment is an area of focus for the coming year. The directors should ensure that they consider this area and make adequate disclosures.

Particular areas of interest for regulators and reviewers are:

- Discount rates
- Growth rates
- Explanation of how forecasts exceeding five years have been put together
- Sensitivity analysis

For further details on the impairment of fixed assets and goodwill, see faculty factsheet Impairment – Applying FRS 11.

Discount rates

Discount rates may be used in the preparation of financial statements. In various circumstances the discount rates used might be risk-free rates, risk-adjusted rates or rates for high quality corporate or government bonds. The Financial Reporting Faculty warns that care needs to be taken so as to choose the right rate.

Refinancing and renegotiation of debt

Under this heading, the faculty deals with two issues:

‘Debt for equity swaps’

The company must account for the profit (or loss) on this transaction and comply with the requirements of company law. There is a factsheet ‘Debt for Equity Swaps’ available from the faculty.

Breaching the terms of a long-term loan

If the terms of a long-term loan are breached at the year end, the loan is repayable on demand and the liability is classified as current. This classification is not affected by the lender’s agreement after the balance sheet date not to demand payment as a consequence of the breach. For more detail see the factsheet UK Company Accounts FAQ.

New reporting requirements

New or revised requirements coming into force in 2011 are:

- UITF 48 Accounting implications of the replacement of the Retail Price Index with the Consumer Prices Index for Retirement Benefits

- Amendment to FRS 8 Related Party Disclosures.

Review of existing accounting policies

The faculty tells us that companies are required to review their accounting policies every year and consider whether they remain appropriate. This is not exactly what FRS 18 says. In fact paragraph 45 of FRS 18 says:

‘An entity's accounting policies should be reviewed regularly to ensure that they remain the most appropriate to its particular circumstances for the purpose of giving a true and fair view. However, in judging whether a new policy is more appropriate than the existing policy, an entity will give due weight to the impact on comparability, as explained in paragraph 49.’

Paragraph 49 says:

‘Frequent changes to accounting policies will not enhance comparability over the longer term, because they make it more difficult for users to compare an entity's financial statements with those of earlier periods. Consequently, the impact of past and expected future changes is considered when determining whether a potential

change is desirable, and accounting policies are not changed unless the benefit to users outweighs the corresponding disadvantages. Nevertheless, consistency is not an end in itself and therefore does not impede the introduction of improved accounting practices that result in an overall benefit to users.'

Returning to the faculty's document, this indicates that a review of accounting policies is important at the moment since directors may have made changes to the operations of their business. For example, the accounting policy for revenue recognition may need to be changed to reflect the fact that sales terms and conditions have changed.

Good narrative reporting

Large and medium-sized companies are required to disclose principal risks and uncertainties as part of the business review section of the directors' report. On 1 February 2011, the Financial Reporting Review Panel issued a press release with questions for directors to consider when reviewing the disclosures:

- Do the disclosures state clearly which are the principal risks and uncertainties facing the business?
- Are those risks and uncertainties described as principal the main risks and uncertainties that currently face the business? For example, have the risks and uncertainties listed as principal been the subject of recent discussions at board or audit committee meetings? Are there risks which have been the subject of such discussions which should be considered as principal?
- Is the description of each principal risk and uncertainty sufficient for shareholders to understand the nature of that risk or uncertainty and how it might affect the company?
- Are the principal risks and uncertainties described in a manner consistent with the way in which they are discussed within the company?
- Are the principal risks and uncertainties shown consistent with the rest of the report and accounts? Are there risks and uncertainties on the list which are not referred to elsewhere or are there significant risks and uncertainties discussed elsewhere which do not appear on the list?
- Is there a description, in the directors' report, or elsewhere in the report and accounts and explicitly cross-referenced from the directors' report, of how the company manages each of the principal risks and uncertainties?

For more information on narrative reporting, see the faculty factsheet The Business Review.

POSSIBLE CHANGES ORIGINATING FROM EUROPE

The EU parliament has voted to agree proposals for simplified accounting requirements for micro companies. The earlier proposal to exempt micro companies from the accounting requirements of the directives has not been adopted.

The definition of micro companies has changed again and the limits are now set as:

Total assets	€350k
Turnover	€700k
Employees	10

It would be necessary to satisfy two out of three of these limits.

The exemption is optional and member states can decide on the next step. We await some comment from BIS but it should be noted that the exemptions do not permit cash-based accounting as suggested in the recent BIS discussion paper.

The exemptions would permit fewer categories to be disclosed on the face of the balance sheet and profit and loss account and a reduction in notes to the accounts.

It has to be asked, however, whether this will lead to any significant savings for such companies – particularly in the light of the proposed simplifications for all small companies (covered in December's update notes).

So the rumours of change continue to circulate but until we see some sort of proposal from the UK government we have no certainty as to where these proposals will take us.

DEFERRED TAX

The ASB and the European Financial Reporting Advisory Group (EFRAG) have issued a Discussion Paper: 'Improving the Financial Reporting of Income Tax'. The purpose of the paper is to seek views on how the financial reporting of income tax might be improved. This is a complex area, they say, because the tax effects of

transactions do not always fall in the same period as they are reported in the financial statements.

The ASB and EFRAG are primarily interested in IAS 12 but any change in the international standard is likely to result in changes in the UK. The discussion paper approaches the subject in two ways. Firstly, there is consideration of how information currently disclosed in accordance with IAS 12 could be improved. This includes possible changes to:

- Disclosure relating to current and future tax charges
- Reconciliation of tax expense to a standard rate
- The requirements in respect of uncertain tax positions
- Discounting of deferred tax.

The second part of the paper takes a more fundamental approach and looks at the conceptual foundations of deferred tax accounting. It starts with a review of the current method used in IAS 12 – based on temporary differences. Under this method, provision is made for a liability where the carrying amount of an asset is greater than the amount attributed to the asset for tax purposes.

This produces broadly similar results to the method employed in FRS 19 but there are differences of detail between the standards.

The method in IAS 12 is based on the premise that recovery of the asset will necessarily entail a tax expense at higher than the standard rate. There are, however, exceptions to this principle in IAS12 which call into question the basic principle on which IAS 12 is based. Some commentators question whether a deferred tax 'liability' is in reality a liability at all.

The paper reviews four alternative approaches.

- Flow-through accounting: Using this method, the tax expense in the accounts is simply the tax payable based on the taxable income for the period. Enhanced disclosure could be employed to provide information about future tax charges.
- Partial allocation: This was the method used in the UK under SSAP 15. Deferred tax is recognised only for timing differences that are expected to

reverse in the future. Once again, the discussion paper envisages the need for enhanced disclosures.

- Valuation adjustment: In this method, the tax effects are reflected in the amount at which other assets are stated. There is concern that this method obscures the difference between pre-tax and post-tax amounts.

- The accruals approach: This requires that the tax effect of all transactions in the current period is recognised in the current period. This is the case whether a transaction will be assessed to tax for the current period or a future one. Tax effects of future transactions should be reported as assets or liabilities, to be released to income in the same period as the underlying transaction. In practice, such an approach yields similar figures to a 'timing difference' approach.

The full document can be obtained at:

http://www.frc.org.uk/asb/publications/documents.cfm?cat=4

It is long (c 60 pages) and detailed but surprisingly easy to read!

REVENUE RECOGNITION Q&A

The following Q&A is based on a question asked by a delegate on an update course in 2011. You cannot make this up!

Q A consignment of agricultural chemicals has been sold by X Plc (a UK manufacturing company) to Y (a Libyan company, distributing agrochemicals locally).

X Plc is responsible for shipping the consignment and control of the goods passes to the customer's shipping agent once the goods are landed. The point of revenue recognition for X Plc has been when the goods are landed and have passed from their control to the customer's.

In April 2011 a large delivery was landed at the port of Misrata. Immediately after landing the docks became the scene of a gun battle between forces loyal to Muammar Gaddafi and the anti-Gaddafi rebels. The customer's shipping agent has yet to secure the consignment and X Plc has been told by the agent that the barrels of chemicals have been commandeered to form a defensive barricade. It is unclear what effect the gun fire and exposure to the sun has had on the chemicals so it is not known whether the goods are useable.

In September 2011, X Plc are finalising their accounts for the year to 30 June 2011. As at that time there is no new information about the goods. The finance director is of the view that the sale took place upon landing and that the revenue should be recognised in the 2011 accounts. He is also considering the need for a bad debt to be provided for as the client has not paid. Is this the correct accounting treatment?

A. The main question is whether a sale has taken place or not. The contract implies that legal ownership has transferred upon landing and that the goods (and whatever misfortune befalls them) are now the responsibility of the customer. This would appear to support the FD's view that revenue should be recognised.

Alternatively, Appendix G to FRS 5 might be of help. Has X Plc got a right to consideration at the year end? Whilst they might have fulfilled all their obligations under the contract to supply goods, realistically they cannot expect to be paid. The risks and benefits of ownership may have passed from the vendor, but they have not yet truly passed to the purchaser. If this is the case then the chemicals remain as stock/goods in transit at the year end, although their condition is uncertain. The directors should consider writing down this asset to net realisable value.

CHARITIES BACK ON TRACK (LECTURE A371 – 11.31 MINUTES)

The Charity Commission's website contains the following explanation:

> The Commission's annual report Charities Back on Track is aimed at raising awareness among charity trustees to help them avoid the problems that have led other charities into serious difficulties. It contains real case studies of investigations that the Commission has undertaken in the last financial year. It also includes some detail of other types of Commission regulatory casework of a less serious nature but that nevertheless cause problems in charities. In addition the report provides basic statistical information on our casework and performance.

The following comments are extracted from the Charity Commission's annual report for 2010/11.

Financial mismanagement

The total value of the fraud and theft reported to us, through Reporting Serious Incidents and whistleblowing reports, was £6m against a total income of £3.66bn for these charities. While this represents a relatively small proportion of the income of the entire charity sector (£53.4bn), our view is that there remains significant under-reporting in this area.

Surveys and research carried out by other agencies and organisations, for example the 2010 survey of charities carried out by the National Fraud Authority (NFA), also conclude that there is substantial under-reporting of fraud by the charity sector.

Issues of fraud and theft featured in:

- 266 assessments (14% of the total)
- 38 of 158 completed regulatory compliance cases (24%)
- 13 of 144 new investigation cases opened in the year (9%)
- 371 out of 849 Reports of Serious Incidents (44%)
- 15 out of 35 whistleblowing reports (43%)

Concerns about financial mismanagement are not confined to fraud and theft. Our assessment work showed that in a further 242 cases (13% of the total) there were other concerns about financial mismanagement including alleged misapplication of funds, accounting and financial issues, and fundraising problems. Completed investigation cases also highlighted the prevalence of concerns relating to accounting issues, allegations of fraud, trading and fundraising.

Our scrutiny of the accounts of 277 charities, which were the subject of our targeted compliance monitoring work, also revealed evidence of problems in connection with financial management, including:

- High support or administration costs
- Low expenditure on the charity's purposes
- High staff costs
- Poor financial controls
- Inadequate accounting and record keeping
- Failure to submit annual accounts and returns

- Failure to comply with the requirements of the Charities Statement of Recommended Practice ('SORP')

Sound financial management is an increasingly important factor in determining people's trust and confidence in charities, as the results of the Commission's last Public Trust and Confidence Survey show. It is therefore vital for charities to reassure the public that the money they donate to charity is used properly and goes to the causes for which it is intended.

Inadequate financial controls

Good financial controls in charities are basic essentials for all charities. This includes implementing and managing proper systems for the collection, holding and application of charity funds and ensuring a charity's financial position is monitored. Trustees must also keep proper records of all financial transactions and produce clear and accurate accounts. It is vital that charities are properly accountable to donors and the public about how they raise and spend funds.

Case study: London Philharmonic Orchestra (charity no. 238045)

The Commission opened an investigation in November 2009, after becoming aware of a substantial fraud at the charity. Approximately £666,000 was stolen by the Charity's former Finance Director between June 2005 and August 2009 but the total loss resulting from the fraud was considerably higher.

The charity has now recovered £1.2m of its losses, through legal action. The individual responsible has been convicted of fraud by abuse of position and acquiring and using stolen property, and sentenced to four years in prison.

The Commission's involvement focused on ensuring that trustees were acting responsibly as charity trustees in responding to the fraud and that there were no further risks to the charity's property.

The Commission was satisfied that, having detected the fraud, the trustees fulfilled their legal duties and responsibilities in responding to it. For example by: co-operating with the Commission and the police; obtaining professional advice including commissioning a forensic investigation by an independent accountancy firm; taking appropriate steps to recover the funds lost; and managing the reputational risks to the charity. The charity has also reviewed and strengthened its internal financial controls.

Case study: the Mohiuddin Trust (charity no. 1105585)

The charity is established to advance education and training, to relieve poverty, and to establish schools or colleges, including the provision of financial support.

The Commission opened an investigation after receiving complaints from members of the public alleging that a charity trustee had misappropriated a substantial sum of charity money and was personally benefitting from charitable funds. The Inquiry looked at a number of issues, including potential misapplication of the charity's funds, the management of conflicts of interest relating to a loan to a company connected with two of the trustees, and the trustees' role and financial management of the charity.

The Inquiry found that serious breaches of financial controls had taken place in this charity. The financial governance of this charity was poor, its record-keeping poor and there were weaknesses in its internal financial controls and procedures. Conflicts of interest were not properly managed, and the evidence gathered during the Inquiry showed acts of mismanagement in the administration of the charity. However, additional trustees have now been appointed and improvements made to the charity's management and administration. An action plan is being implemented and the charity's progress is being monitored by the Commission.

Issues for other charities

It is the fundamental duty of all charity trustees to protect the property of their charity and to secure its application for the objects of the charity. Internal financial controls are essential checks and procedures that help charity trustees to:

- Meet their legal duties to safeguard the charity's assets
- Administer the charity's finances and assets in a way that identifies and manages risk
- Ensure the quality of financial reporting, by keeping adequate accounting records and preparing timely and relevant financial information.

Internal financial controls do not eliminate the risk of losses, including through theft and fraud. Internal financial controls should, however, reduce the risk of those things happening. If they do happen then internal financial controls should also help the trustees to find out sooner and take necessary action.

Charities vary considerably in terms of their size, activities and complexity. Where activities or transactions are complex then trustees may need to seek professional advice on, or to carry out a review of controls in those areas to ensure they are appropriate and adequate. This would usually be undertaken as a separate piece of work from the routine audit or independent examination of the charity's accounts.

The Commission has produced guidance to assist trustees in implementing robust internal financial controls that are appropriate to their charity. Internal Financial Controls for Charities (CC8) is available on the Commission's website. There is also a self check-list for trustees which has been produced to enable trustees to evaluate their charity's performance against the legal requirements and good practice recommendations set out in Internal Financial Controls for Charities.

Trustees have and must accept ultimate responsibility for directing the affairs of a charity, and ensuring that it is solvent, well-run, and delivering the charitable outcomes for the benefit of the public for which it has been set up. Charity trustees must not let their personal interests conflict with their duty to act in the best interests of their charity.

Accounts scrutiny

The report for 2010/11 did not contain much detail of issues arising from accounts scrutiny. The following list is taken from the report for 2009/10. It is reproduced here on the grounds that most of the problems are likely to arise consistently from year to year.

- High support costs
- High legal and professional fees
- High administration costs
- High advertising costs
- Low expenditure on charitable purposes
- High staff costs
- Grants being applied incorrectly
- Insufficient information in TAR and accounts

BRIBERY ACT 2010: FIRST SENTANCING (LECTURE A372 – 7.57 MINUTES)

Background

The Bribery Act 2010 came into force on 1 July 2011 and by way of a reminder here is a brief summary of its key provisions:

There are four offence types in the Act:

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

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

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

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

First sentencing

Sentencing has taken place in the first ever prosecution under the Bribery Act 2010. Munir Patel, a court clerk at Redbridge Magistrates Court pleaded guilty to accepting bribes contrary to s.2 of the Bribery Act 2010. Section 2(1) of the Bribery Act states that a person is guilty of an offence if they request, agree to receive, or accept a financial or other advantage intending that a relevant function or activity should be performed improperly. In his position as court clerk, Mr Patel accepted £500 from an undercover reporter in return for influencing the course of criminal proceedings relating to a motoring offence.

At Southwark Crown Court, His Honour Judge McCreath sentenced Mr Patel to three years in prison for the bribery offence and six years to run concurrently for misconduct in public office. Of note was the judge's remarks concerning the absence of sentencing guidelines for the new Bribery Act offence.

Whilst the prosecution was against an individual and not related to business activities, the case is a timely reminder to directors and boards of companies who have not yet addressed bribery risks. Under s.14 of the Act, individual criminal liability can attach to directors and senior officers of companies if they consent to or

connive in corporate bribery. The SFO has recently made it clear that they are keen to prosecute s.14 cases against directors and senior officers of companies where there is knowledge of bribery occurring but it is permitted to continue.

Where bribery has taken place, individual criminal liability for directors can also arise under the Proceeds of Crime Act if bribery is discovered but a choice is made to "sweep it under the carpet". Penalties under the Proceeds of Crime Act are even higher than the Bribery Act with unlimited fines and up to 14 years imprisonment.

With the SFO confirming at the beginning of November that it is already engaged in Bribery Act enforcement activity and the new facility for employees to report bribery direct to the SFO, it is only a matter of time before we see the first corporate prosecution.

What has changed under the Bribery Act 2010?

With regard to the Munir Patel case outlined above the answer is: not a lot! Look at this pre-Bribery Act 2010 case where a prosecution was successful without the new legislation.

Mars bars and prison bars

Mr Welcher was employed by Mars and was responsible for contracts for maintenance and repair of its machinery. This was carried out by precision specialists, Excel. For over a decade Mr Welcher authorised overpayments to Excel, and received bribes in return. Mr Welcher was tried with a number of co-defendants at Excel who made a gain of over £3m over the course of a decade. All were convicted of conspiracy to corrupt and conspiracy to defraud. Another Mars employee was also convicted. Sentences ranged from between 15 months to several years behind metal (as opposed to chocolate) bars.

The case is interesting on another couple of counts. First, it is a purely commercial bribery case. Second, the bribery emerged following the sale of a business. An SFO press release records:

"In 2001 Excel Engineering was sold to new owners but thereafter the volume of business and income did not match past levels. It became apparent to the new owners that the company's success had been largely dependant on contracts from Mars in return for improper inducements. These bribes were usually in the form of regular cash payments, or in the form of gifts, to Tony Welcher and to others, including Georgina Welcher. Examples include electrical items, power tools, car hire, garden furniture and equipment, domestic boilers, cameras and car repairs/metalwork. The Welchers' home was fitted with a conservatory which was

paid for in part by Excel Engineering. The cost of the conservatory was ultimately recouped by Excel Engineering by over-charging Mars.

Suspicions were reported by the new owners of Excel Engineering to Thames Valley Police and then referred to the SFO in summer 2002."

MODIFICATIONS TO AUDIT REPORTS (LECTURE A375 – 15.13 MINUTES)

Introduction and example of clean report

Example auditor's reports can now be found in Bulletin 2010/2: Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements for periods ended on or after 15 December 2010. This document was revised in February 2011 to reflect the requirements of the version of ISA (UK and Ireland) 700 that was issued in February 2011 and which is effective for periods ending on or after 23 March 2011.

Example 2 of Bulletin 2010/2 gives an example of a clean report for a non-publicly traded company preparing financial statements under UK GAAP. The following illustrative auditor's report is based on that example. Readers of these notes are advised to look at the full text of Example 2 to identify how the report has been adapted for the purpose of this illustration.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF EG LIMITED

We have audited the financial statements of EG Limited for the year ended 31 December 2011 set out on pages 6 to 13. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice). (Note 1)

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed. (Note 2)

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 3, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. (Note 3)

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2011 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit. (Note 4)

A Tickett

12 March 2012

Anthony Tickett (Senior statutory auditor)
for and on behalf of Ticket & Co, Statutory Auditors

Guildford

Notes:

1. It is common these days to refer to the contents of the financial statements rather than to page numbers. However, auditor's reports of entities that do not publish their financial statements on a website or publish them using 'PDF' format may refer to the financial statements by reference to page numbers.

2. ICAEW recommends the inclusion of a ‘Bannerman’ disclaimer as the second paragraph in the first section of the report. An example of such a paragraph has been included above.

3. I have used the description of the scope of the audit provided by ISA 700. This is the most popular approach in practice. Alternatively, the auditor could refer to a description of the scope of an audit of financial statements either on the APB’s website at www.frc.org.uk/apb/scope/private.cfm or elsewhere in the Annual Report.

4. Another matter which may appear in the reporting by exception section is ‘the directors were not entitled to prepare the financial statements in accordance with the small companies regime and take advantage of the small companies’ exemption in preparing the directors’ report’.

There should be no surprises in the above for readers of these notes. Now try this quick quiz:

- When will the auditor’s report contain a basis of opinion section?

- Is a qualified report always a modified report?

- Is a modified report always a qualified report?

- Is an emphasis of matter a modified report, a qualified report or neither?

If you are uncertain as to the answer to any of the above questions then you need to study ISAs 705 and 706.

Types of modified opinions

There are three types of modified opinion, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends on the nature of the matter giving rise to the modification and the auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

This is summed up in the following table adapted from paragraph A1 of ISA 705:

Nature of the matter giving rise to the modification	Auditor's judgment about the pervasiveness of the effects or possible effects on the financial statements	
	Material but not pervasive	Material and pervasive
Financial statements are materially misstated (disagreement)	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence (limitation of scope)	Qualified opinion	Disclaimer of opinion

The terms 'disagreement' and 'limitation of scope' are not used in this way in ISA 705. However the terms are used in Bulletin 2010/2 and are commonly understood by auditors so I have included them in the table above.

Examples of disagreement

Disagreement may well arise because the accounting policies or disclosures are not in accordance with the requirements of accounting standards. The areas referred to below are reported instances of non-compliance by private companies.

FRS 15

- Depreciation not provided on freehold buildings.
- Failure to mention CA requirement to depreciate.
- Lack of quantification of departure (or a statement that this is impracticable).

SSAP 19

- Investment properties stated in the balance sheet at either historical cost, or a previous year valuation.
- No reference to true and fair override.
- No explanation of effect of non-compliance.

FRS 3

- Incorrect treatment of exceptional items.
- Dissimilar items lumped together under an inappropriate heading.
- Operating exceptional items not allocated to natural format heading (e.g. administrative expenses or cost of sales).
- Operating exceptional items wrongly positioned below operating profit.
- Non-operating exceptional items described as ‘extraordinary’.

SSAP 9

- Disagreement over basis of arriving at stock provision.

SSAP 21

- Leases which auditor regards as finance leases accounted for as operating leases.

FRS 19

- Failure to provide deferred tax where it is clear that the amounts involved are material.

FRS 25

- Failure to classify shares as financial liabilities when required to do so by the standard.

Examples of limitation on scope of the audit

- Accounting records withheld.
- Directors prevent audit procedure being carried out.

- Valuations not made or obtained.
- Refusal to provide information required by statute, e.g. advances to directors.
- No evidence provided to support going concern basis of preparation.
- Appointment after stock count and no alternative procedures available.
- Cash sales and no evidence of completeness.
- Natural disaster.
- Preceding year not audited.

Pervasive

Pervasive is defined as a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

I. Are not confined to specific elements, accounts or items of the financial statements;

II. If so confined, represent or could represent a substantial proportion of the financial statements; or

III. In relation to disclosures, are fundamental to users' understanding of the financial statements.

Notice that we already have our answer to two of the questions posed in our quick quiz. A qualified opinion is a modified opinion but a modified opinion is not necessarily a qualified opinion. In passing. let's add the comment that an emphasis of matter is neither a modified opinion nor a qualified opinion.

There is no need to reproduce the requirements in paragraphs 6 to 9 of ISA 705 since these simply put into words the information in the above table.

One matter that should be noted is the comment in paragraph 7(a) which only permits the auditor to express a qualified opinion (re disagreement) having obtained sufficient appropriate audit evidence to conclude that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.

Similarly, in paragraph 7(b) where the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, the auditor can only express a qualified opinion if the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Paragraph 10 indicates that a disclaimer of opinion is also appropriate in ‘extremely rare circumstances involving multiple uncertainties where the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements’.

Limitation on scope imposed by management

Paragraphs 11 and 12 deal with a limitation on the scope of the audit imposed by management. If this is likely to result in the need to express a qualified opinion or to disclaim an opinion then the auditor requests management to remove the limitation.

If management refuses to remove the limitation, the auditor communicates the matter to those charged with governance (unless all of those charged with governance are involved in managing the entity) and determines whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, then two situations may arise. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, then a qualified opinion is appropriate.

Conversely, the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. In this case, the auditor should withdraw from the audit, if practicable and possible under applicable law or regulation. Only if withdrawal is not practicable or possible would the auditor go on to disclaim an opinion on the financial statements.

It is interesting that the Application Material admits that ‘the practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor

has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation in the Basis for Disclaimer of Opinion paragraph prior to withdrawing.' (ISA 705 paragraph A13)

If the auditor withdraws from the audit as suggested above then, before withdrawing, the auditor is required to communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

A UK-plus at this stage reminds us of the need to comply with the requirements of sections 519 and 521 of the Companies Act 2006 regarding the statement to be made by the auditor in relation to ceasing to hold office. The auditor may also need to notify the appropriate audit authority in accordance with section 522 of the Act.

Other considerations relating to an adverse opinion or disclaimer of opinion

'When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.' (ISA 705 Para 15)

Form and content of the auditor's report when the opinion is modified: Basis for opinion paragraph

ISA 705 (as also Bulletin 2010/2) presents only the changes required as a result of modification.

Firstly there will be a new paragraph in the auditor's report giving the reasons for the modified opinion. This paragraph appears immediately before the opinion paragraph. The heading of the paragraph is "Basis for Qualified Opinion", "Basis for Adverse Opinion", or "Basis for Disclaimer of Opinion", as appropriate.

Disagreement

The basis for modification paragraph would include (as appropriate):

- a description and quantification of the financial effects of the misstatement or a statement that such a quantification is impracticable

- an explanation of how narrative disclosures are misstated

- unless prohibited by law or regulation, the nature of any omitted information and disclosure of that information if practicable and if the auditor has obtained sufficient appropriate audit evidence about the omitted information.

Limitation on scope

The basis for modification paragraph would include the reasons for the inability of the auditor to obtain appropriate audit evidence.

Adverse opinion or disclaimer of opinion

As well as the basis for the adverse opinion or disclaimer, the basis for modification paragraph would also include the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

Examples

Qualified opinion: Disagreement – failure to comply with accounting standard

Basis for qualified opinion on financial statements

Included in tangible fixed assets, in note 7 to the accounts, are investment properties with a book value of £580,000. These properties have not been revalued. This treatment is not in accordance with the Financial Reporting Standard for Smaller Entities (FRSSE) which requires investment properties to be stated in the accounts at their market value at each balance sheet date. In the absence of any formal valuation it is not possible to quantify the effect that such a valuation would have on the accounts both in respect of tangible fixed assets and reserves. There is no effect on reported profits for the year.

Bulletin 2010/2 contains examples as follows:

Qualified opinions

Disagreement – Inappropriate accounting treatment of debtors – Example 37

Disagreement – Non-disclosure of a going concern problem – Example 38

Disagreement – Non-disclosure of information – Example 39

Scope Limitation – Auditor not appointed at the time of the stocktaking – Example 40

Scope Limitation – Directors did not prepare cash flow forecasts sufficiently far into the future to be able to assess the going concern – Example 41

Adverse opinions

No provision made for losses expected to arise on long term contracts – Example 42

Significant level of concern about going concern status that is not disclosed in the financial statements – Example 43

Disclaimer of opinion on financial statements

Auditor unable to attend stocktaking and confirm trade debtors – Example 44

Multiple uncertainties – Example 45

Opinion paragraph

The heading of the opinion paragraph will change to "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate.

The required wording of the opinion paragraph is stated clearly in the ISA. Because the details are given in the Basis of Modified Opinion Paragraph, no detail needs to be given in the opinion paragraph. As such, the opinion paragraph for all situations of disagreement will be the same.

For a modified opinion on the grounds of:	The opinion paragraph includes the words (taken from paragraphs 23 to 25 of ISA 705):
Qualified for disagreement	"except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph"
Qualified for limitation on scope	"except for the possible effects of the matter(s) described in the Basis for Qualified Opinion paragraph "
Adverse opinion	"because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view in accordance with the applicable financial reporting framework"
Disclaimer of opinion	"because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly we do not express an opinion on the financial statements."

Examples

Qualified opinion: Disagreement (or for limitation on scope, see additional word in brackets)

Qualified opinion on financial statements

In our opinion, except for the (possible) effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements:

- *give a true and fair view of the state of the company's affairs as at 31 December 2011 and of its profit [loss] for the year then ended;*

- *have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and*

- *have been prepared in accordance with the requirements of the Companies Act 2006.*

Adverse opinion

Adverse opinion on financial statements

In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion paragraph, the financial statements:

- *do not give a true and fair view of the state of the company's affairs as at 31 December 2011 and of its profit [loss] for the year then ended; and*
- *have not been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice.*

In all other respects, in our opinion the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

Disclaimer of opinion

Disclaimer of opinion on financial statements

Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion on Financial Statements paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly we do not express an opinion on the financial statements.

Other changes in the auditor's report

Where there is an adverse opinion or disclaimer of opinion, the paragraph relating to the director's report will change. If the auditor's opinion is that the Directors' report is consistent with the financial statements then the following paragraph will be included:

Opinion on other matter prescribed by the Companies Act 2006

Notwithstanding our adverse opinion on the financial statements, in our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

The auditor should also consider whether the reason for the modification of the opinion affects the matters on which the auditor is required to report by exception.

For example, if the auditor was appointed after stocktaking had taken place, then the following may be appropriate:

Matters on which we are required to report by exception

In respect solely of the limitation on our work relating to stock, described above:

- *we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and*
- *we were unable to determine whether adequate accounting records had been kept.*

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- *returns adequate for our audit have not been received from branches not visited by us; or*
- *the financial statements are not in agreement with the accounting records and returns; or*
- *certain disclosures of directors' remuneration specified by law are not made.*

When the auditor expresses a qualified or adverse opinion, the description of the auditor's responsibility should be amended to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the introductory paragraph of the auditor's report should state that the auditor was engaged to audit the financial statements. The auditor's responsibility and the description of the scope of the audit should be amended to state only the following: "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with International Standards on Auditing. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

Example

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF EG LIMITED

We were engaged to audit the financial statements of EG Limited for the year ended 31 December 2011 set out on pages 6 to 13. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 3, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Communication with those charged with governance

When the auditor expects to modify the opinion in the auditor's report, Paragraph 28 of ISA 705 requires the auditor to communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

In practice, of course the auditor will have discussed the issues at length with management/directors before reaching the conclusion that modification is necessary.

AUDITING FAQS (LECTURE A373 – 9.35 MINUTES)

Independence

Q. We have a client, John, who is involved with a number of companies and other businesses. He owns 80% of a medium-sized company and is one of the two directors of that company. He also owns all of the shares in two small property companies that require audit because of the value of their assets. We perform all three audits. John owns several other companies – either on his own or with his wife. These companies are all audit exempt. He is a partner in three partnerships. We act for most of these businesses providing accounting, payroll and tax services. We also provide personal tax compliance work and advice to John and his wife.

The problem is that the total fees from all of the businesses add up to more than 10% of our total practice income. This percentage is increasing and may exceed 15% in the next couple of years. Do we have a problem?

A. With respect to the audit clients, Ethical Standard 4 only deals with the situation where the fees arise from a group of companies (Paragraphs 32 and 39). This is, perhaps, surprising particularly in the light of the recent changes to ES1 to bring in more references to connected parties. However, the ES is clear in its statements.

Therefore the rules do not require you to resign from the audit appointments.

However, I feel that this is a case where you should go on to consider the spirit of the rules and not just the letter of the rules. There is clearly a self-interest threat arising from the fact that you receive a lot of income from a set of clients who are connected through this individual. You have raised the issue as a point of concern and that, I think, is a good thing. You need to record this possible threat to your independence on the audit files of the companies concerned. You can then consider safeguards. May I suggest that, in every year, your annual cold file review process should make sure to select one of these audits for review.

Hopefully, in the long term, business growth from other clients will take care of the fee dependency problem.

Turning to the entities which are not subject to audit, there is a need to consider the ethical guidelines of your professional body. For example, paragraph 200.4 in the ICAEW code of ethics identifies undue dependence on total fees from a client as being an example of a self-interest threat. Notice that, since we are now removed from the audit situation, there are no stated percentages and it is for the accountant to make a judgment call on the issue of dependence. However, surely any percentage applying to non-assurance work would be considerably higher than 15%?

Remember that the threats referred to in the ethical guidelines are threats to compliance with the fundamental principles of integrity, objectivity, professional competence, confidentiality and professional behaviour. Independence, per se, does not figure on this list except where lack of independence might affect integrity and objectivity. As I have indicated above, I think the self-interest threat will only become an issue at a much higher percentage.

However, before we leave this example let me return to the original question in which you described John as your client. In reality, John is only your client with respect to the work you perform for John personally. It is the separate entities which are your clients. With respect to the audit clients, you might ask yourself whether there is also a threat arising from the relationship you have with John. This might be a familiarity threat or even an intimidation threat if John is a dominant individual.

Auditors frequently misuse the term 'client' and I just wanted to point out that your duty is to the companies concerned not to any individual who happens to be involved with those companies.

Risk of material misstatement

Q. I have recently set up in practice and have been reviewing the publicly-available audit manuals. I am interested that all of the manuals that I have seen seem to adopt a two-stage approach to the assessment of risk rather than the one-stage approach required by ISA 315. How do these manuals meet the requirements of ISA 315?

A. Can I first congratulate you on your excellent knowledge of ISA 315.

(Editor's note: for those disbelievers amongst my readers I can assure you that this conversation really took place! It turned out that the practitioner had recently been employed by a firm in a technical capacity and was now setting out in business on his own.)

The two stage approach starts from the risk model:

Audit risk = inherent risk x control risk x detection risk

The auditor assesses the levels of inherent risk and control risk and then uses these two inputs to determine that value of detection risk which will reduce audit risk to an acceptable level.

Notice that the auditor's assessment of control risk can be confirmed by the use of a compliance test. However, the inherent risk cannot be confirmed and so remains an assessment.

Some audit manuals use a separate assessment of inherent risk and control risk. Other manuals retain a two stage approach but the stages have changed and are now overall risk assessment and individual area risk assessment.

None of this really matters to ISA 315 which requires an assessment of 'risk of material misstatement' (ROMM).

Paragraph 25 of ISA 315 says:

'The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level; and

(b) the assertion level for classes of transactions, account balances, and disclosures

to provide a basis for designing and performing further audit procedures.'

It is interesting that ISA 315 does not mention inherent risk at all which might lead you to think that the assessment of risk in two stages is not correct.

However, the glossary of terms contains this definition:

'Risk of material misstatement—The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(a) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(b) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.'

This tells you that the two-stage approach is a perfectly acceptable way to arrive at an assessment of ROMM. Some audit manuals have picked up on that part of the definition which says that ROMM is the risk that the financial statements are materially misstated prior to audit. The writers of these manuals refer to ROMM as pre-detection risk. This is a term that I like particularly because it stresses the idea that the auditor's response to risk is directly related to the risk that exists before the auditor starts the audit work.

ISA 330 refers to inherent risk and control risk in Paragraph 7:

'In designing the further audit procedures to be performed, the auditor shall:

(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

(i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and

(ii) Whether the risk assessment takes account of relevant controls that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and

(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.'

In conclusion, therefore, risk of material misstatement can be assessed by either the one-stage or two-stage method. What matters is documentation of the assessment and the response to that assessment.

RELATED PARTIES + THE AUDITOR **(LECTURE A374 – 10.20 MINUTES)**

QAD feedback on the implementation of the clarified ISAs

In our notes in the middle of last year we reported feedback from the QAD on implementation of the clarified ISAs. The QAD reminded us that Paragraph 28 of ISA 550 requires the auditor to include in the audit documentation the names of the identified related parties and the nature of the related party relationships. They followed this up with a case study.

Case Study

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

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

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

Are the QAD correct in this conclusion or are they over-reacting?

Before we consider the above question, let's review recent comments in the accountancy press.

Recent comments in the accountancy press

Audit and Beyond October 2011

Related parties is the hot topic of the moment and Andy Holton of SWAT UK wrote an article in Audit & Beyond, newsletter of the ICAEW Audit and Assurance Faculty in October 2011 explaining the requirements of ISA 550.

Paragraphs 12 to 15 of ISA 550 require:

- The audit team discussion to give specific consideration to the risk of material misstatement that could arise from related party relationships and transactions.
- The auditor to make enquiries of management about the identity of related parties, the nature of the relationships and any transactions that have taken place.
- The auditor to obtain an understanding of any controls that apply to related party relationships and transactions.

- The audit team to remain alert throughout the audit to the possibility of undisclosed related party transactions. In particular, for this purpose, the auditor is required to inspect bank and legal confirmations, minutes of board and shareholder meetings and such other records or documents considered necessary.

The ISA goes on to consider transactions outside the normal course of business, identification and assessment of risk, significant risks and the auditor's response to previously unidentified related parties or transactions discovered during the audit. I will not consider these issues further in these notes.

Paragraph 17 of ISA 550 requires the auditor to share relevant information obtained about the entity's related parties with the other members of the engagement team.

There is a specific requirement in Paragraph 26 for the auditor to obtain written representations from management, and, where appropriate, those charged with governance, that they have disclosed all related party relationships and transactions. This will be considered further below.

Audit and Beyond December 2011

Moving forward in our review of the accountancy press, we have some FAQs in the December 2011/January 2012 edition of Audit & Beyond, newsletter of the ICAEW Audit and Assurance Faculty. Here John Selwood answers questions arising on his recent courses. In the first question, the finance director had supplied the auditor with a list of related parties that included the names of all four directors together with the names of their close families. However, there was a note stating that one of the directors had refused to supply details about his family with a threat to take the audit firm to the European Court of Human Rights if the auditor persisted in demanding the information. What should the auditor do?

John says that the auditor should explain to the directors that auditors are bound by client confidentiality and that the information will remain private. Further, the information falls under the data protection legislation if it is stored on a computer. The hope is that the director concerned will be persuaded to provide the information requested.

If the information is still not forthcoming, John's response is that there can only be one outcome - that is a qualified audit opinion.

In the second question, the audit client has only one supplier and two customers. There are no transactions with any entity other than these three parties, none of whom is a related party. The auditor is asking whether it would be acceptable to ignore the requirement in ISA 550 (UK&I) to obtain details of related parties from

management since it is clear that related party transactions cannot possibly be an issue for this entity.

John's response is that the auditor should continue to enquire about, and record the names of, related parties.

His reasoning is that the auditor is not only concerned with transactions and balances that appear in the accounts but also with completeness. He explains that the primary reason that auditors need to focus on related parties is because of the elevated risk of fraud in these transactions. Fraudulent misstatement of the financial statements could involve transactions or balances being omitted from the accounts, and this would usually be easier to achieve if a related party were involved, as they might be more compliant if asked to assist.

Response to the QAD case study

With the above in mind, let's return to the QAD's case study. I accept that the situation quoted is not extreme and I know that this sort of problem does arise in practice. But whilst the situation is not extreme, many auditors will wonder if the response of the QAD is extreme.

My initial reaction is to suggest that the request for information from the directors is part of the auditor's risk assessment procedures. Indeed, this is the heading used in the appropriate section of ISA 550. Where the directors are open and controls are good, the auditor may decide that the risk of misstatement in this area is low. Conversely, if the directors appear to be hiding information then this is likely to result in a high risk assessment which will lead to the need to perform more audit work. So, in this case, I would want to extend my examination of detailed transactions so as to be satisfied that the risk of misstatement in the accounts is reduced to an acceptable level.

The QAD are saying that the lack of information from one of the directors means that a qualification must follow. I wonder if this is correct. If the auditor can make up for that lack of information by additional work then it might be argued that a qualified report can be avoided.

The problem derives from the following requirements in ISA 550:

26. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

(a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and

(b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

28. The auditor shall include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

Failure to provide a written representation is dealt with in ISA 580. In this circumstance, the auditor is required to:

- Discuss the matter with management
- Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general
- Take appropriate actions, including determining the possible effect on the opinion in the auditor's report

The final bullet point is subject to Paragraph 20 of ISA 580 which requires the auditor to disclaim an opinion on the financial statements if management does not provide the written representations required by Paragraphs 10 and 11 of the standard. Paragraph 10 requires the auditor to request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements. Paragraph 11 requires the auditor to request management to provide a written representation that it has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and all transactions have been recorded and are reflected in the financial statements.

Paragraph 20 also requires a disclaimer if there is sufficient doubt about the integrity of management to cast doubt on the reliability of the representations given under Paragraphs 10 and 11.

Consideration of these paragraphs should enable us to decide whether the QAD’s solution to the example posed is the correct response or whether it is extreme.

Frequently asked questions

Q. Do we have to ask the directors about their children (and their partners' children) and what is the impact of them refusing to tell us? Our view at the moment is that this should be reduced to a letter to the client asking for the information and giving them the new definition of close family from FRS 8. If they return the form blank can we accept this?

A. I agree that you need to ask the client for the information. I think a letter is a reasonable approach. A blank response is not acceptable. My comments earlier are relevant if the directors have refused to provide a small amount of peripheral information (e.g. names of infant children). It does not provide an excuse for total non-co-operation.

Q. The FRSSE has not yet been updated but should we ask the same question concerning identity of related parties?

A. It doesn't matter what accounting framework is used, the auditing standard requires the same enquiries and documentation. If you approach this by a letter (as suggested in the previous question) then the definition to include in the letter will be that in the FRSSE. It appears that FRSSE may not be updated for some years so the definition will not change until then.

See FAQ earlier in these notes for the impact on FRSSE of FRS 8 revised.

Q. What about charities and trustees? Do we need to go through the same process? I have a charity run by 4 Nuns do we need to ask them intrusive questions about their family relationships?

A. It doesn't matter what type of entity is being audited, the auditing standard requires the same enquiries and documentation. Again, I think the best approach is to send the letter (including the definition) and offer to explain any elements of the definition which they don't understand. It is then over to the management and trustees to respond to you appropriately.

Auditors sometimes expect a lighter regime for charities – particularly smaller charities. My attitude is that there should be no relaxation for charities since they are using money which has been given to them by outsiders.

Some charities have a large number of trustees and auditors say that the requirement for the trustees to provide information is onerous. This is not the case. Each trustee only has to provide their own information and there is nothing onerous about that.

Finally, I see no need to ask intrusive questions of anybody. I'm not giving favoured treatment to religious people; I am simply suggesting that the best way forward for the auditor is to avoid a situation which might be confrontational. Therefore, send the letter, answer questions and deal with the consequences.

Q. We have assessed the risk of unrecorded related parties as very low. Do we need to ask the Directors about their close family anyway?

A. You are not asking them about their close family; you are asking them to provide you with a list of individuals and entities which are related parties of the company. Your assessment of risk may change if they refuse to provide you with the information you request.

NEW YEAR'S RESOLUTION – MUST MAKE AUDITS PROFITABLE

Introduction

This is the time of year for making resolutions so it seems a good time to review areas of your practice that may need improvement. Audit has always been a difficult area to make money on as it is a highly regulated activity and the quality of your work is going to be checked by an outside body at some stage. Some audit professionals take the view that the work must be done properly and if that means making a loss or writing off time then so be it. I agree that the work needs to be done to a quality standard but disagree that this means the work cannot be profitable.

If you have resolved to review or improve audit profitability here are five areas that I would look at.

1. Risk & Response

2. Budgets

3. Focussing the audit work

4. Recording audit evidence on the file

5. Completion

Let me consider some key points in each of the above areas.

Risk & response

A modern audit is based on the concept of risk and response. It is important that all members of the audit team have an understanding of what is meant by ‘audit risk’ and the impact that the assessment of risk has on the audit approach (i.e. the response). The assessment of risk is based on the background or permanent information that you have about the client and the industry in which they operate. To make the audit planning more efficient the background information should have a risk conclusion that makes clear what risks are highlighted by the information that is held. In some cases the audit permanent file or the background information need only indicate the risk issues rather than include extensive documentation. This will make it more efficient to record and review. Here are some examples of how information could have a risk summary to make the use of that information more efficient at the audit planning stage.

Leases – a number of permanent files that I review have photocopies of all the leases held by the client (or scanned leases if the information is held electronically). The question is why do they hold this information? The answer is to assess the risk represented by the leases. Most leases have the following key risks:

- Who is the lease with? (i.e. is it a related party?)
- When are the break clauses or end of the lease? (i.e. is the client going to be exiting the building during the year or soon after?)
- Does the lease have any rent free periods? (accounting treatment issues)
- Does the lease create a need for dilapidations to be considered? (accounting treatment issues)
- When are the rent reviews? (Cost issues, impact on going concern etc)

The above information could be summarised on the front of the lease so that the audit team do not need to read the whole 40 page document every year. (It may be the case that the lease is not read at the moment but then there is a possibility that the audit team may miss the risk issues.) You may need a copy of the lease for tax reasons but if the risks are summarised on the permanent file why have a full copy of the lease on that file as well? This would save time spent scanning if your normal practice is to put the lease on to an electronic audit file. A summary of the key issues makes it much easier for the audit team to re-assess the impact of the lease on the audit each year and hence have a good quality and cost effective response to the issues.

Other documents that would benefit from this treatment could be bank loan agreements and shareholder agreements. From a cost viewpoint all information on the permanent file or background documentation should be justified in terms of a risk conclusion relevant to the assessment of audit risk. If the risk issues are clear the audit team can make a faster assessment of the current status of the risks and thus their impact on the audit approach. This may reduce the time spent on assessing risk issues and also make the technical identification of risks much better.

Budgets

A lot of files that I review either do not use budgets or misuse budgets. I believe that all files in the office should have a budget of some form on them. Audit budgets should achieve the following:

- They are a target for the audit team to aim for.
- They should indicate the order of attack that the audit team should take. This should be to deal with the high risk issues first and push the lower risk areas towards the end of the audit.
- The comparison of actual with budget should be completed in real time and not after the job has been finished. In this way the budget can be used to track the performance of the job and used to identify issues as they arise and not after the event.
- A budget should be a communication tool. The individual in charge of the detailed audit work should report to the manager/partner on the progress being made. If the job is running in to difficulties (i.e. the budget is not being met) then the reasons for this should be communicated to the partner/manager as they happen not some time after the event.
- The budget should set deadlines for the key stages of the job so that its progress can be tracked.

Using budgets to meet the key areas highlighted above should improve the performance of any job not just audits.

Focussing the audit work

The audit planning should create a focus for the audit team which is centred on risk. To do this the risks should be linked to the assertions. For example if I tell you that debtors is low risk this does not give much of a clue as to how the audit work should

be approached other than to suggest that I consider it to be a low risk issue. If I were to say that the risks are low for completeness of trade debtors but high for valuation (recoverability) of debtors this now starts to give the audit approach some focus. In this situation, I would not spend a lot of time checking the completeness of the trade debtors listing but would focus my efforts on the recoverability of the debtors.

By linking the risk assessment to the assertions I give a more detailed profile of the audit area and hence a more focused or tailored approach to the audit in that area. This is often more efficient and can reduce the amount of audit work that is needed as low risk issues are highlighted. The approach can also improve the quality of the audit work as the response becomes linked more closely to the risk assessment.

Risk should be viewed as a speed limit on the audit file. A high risk area represents a 20 mph speed limit and the audit team should slow down and make sure that they get good quality audit evidence and they fully understand the area and have assessed the issues. A low risk area is a 70 mph speed limit. The audit team should drive through this area of the file at 70ish and not spend too much time getting a lot of audit evidence that is not needed.

The problem with a lot of audit files is that the audit team drive through them at 40 mph. This has the effect of being too fast in the high risk areas and hence the file has poor technical quality and too slow in the low risk areas and hence the cost goes over budget. This has to be the worst of both worlds a poor file that is over budget.

Recording audit evidence

Many audit files over record the information needed to support the audit test. Sometimes this is because the information is needed for other reasons such as accounts preparation. However the information is often recorded in this way because that is the way it has always been done and audit staff believe that that is the way it should be recorded. ISA 230 paragraphs 8 & 9 deal with the recording of audit evidence on the file. These paragraphs require the audit test to be recorded so that the audit test could be re-performed by another auditor. The requirement is to record the items tested so that they can be identified, to show how they were tested and the outcome of the testing and to record what your conclusion is from the areas tested together with any follow on work required. Audit working papers often have copies of the invoices tested or a lot of detail from the invoice tested when all that is needed is a unique reference for the document tested.

Paragraphs 8 and 9 of the requirement section of ISA 230 say the following:

Form, content and extent of audit documentation

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

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

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

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

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

(a) The identifying characteristics of the specific items or matters tested;

(b) Who performed the audit work and the date such work was completed; and

(c) Who reviewed the audit work performed and the date and extent of such review.

Paragraph 8 makes clear that an experienced auditor should be able to tell what the audit team has done from the audit file. In other words the experienced auditor should not need to discuss the audit approach or the results with the audit team to understand the approach and the results.

Paragraph 9 makes clear that when recording items that have been tested we need to record the 'identifying characteristics' of the items. This is often rephrased as recording sufficient information to enable another person to re-perform the test carried out by the audit team.

Example

Let us say that the audit team have tested all journals over £10,000. There is no need to list the journals as the description adequately identifies what has been tested and would enable the test to be re-performed. If the working paper then says that the journals have been reviewed to ensure that they are for an acceptable business reason then you know how they have been tested. The results might say that all

journals over £10K have been reviewed and that no unusual journals have been identified. The conclusion would then say that the review of journals has not identified any unusual journals and indicates that journals have not been used by management to manipulate or override the controls within the nominal ledger.

When reviewing audit files managers should consider if the level of detail recorded for the audit test can be justified and, if not, audit staff should be asked to record audit tests more succinctly.

Completion

Anyone who is reviewing the audit following the completion of the detailed work should always first ask the question 'Is this audit file ready for review?' The audit team must produce a file that is ready for review. A lot of expensive time is wasted through managers/partners finishing off files that should have been finished before they hit their desks.

Set a completion deadline and then review to this deadline. Try not to over review the file by approaching the review from a risk perspective. Start with the risk issues identified at the planning stage and then work your way through the key areas of the file.

Application Note A13 ISA 230 says:

> ISA (UK and Ireland) 220 requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

The above application note indicates that not all documents need to be reviewed by the partner. If the file has an effective manager review then the partner review can be focused on the planning and completion sections and any other areas of interest to the partner. If the file has no manager review then the partner review should be more detailed. Managers and partners should ensure that audit files are not 'over reviewed' as this represents poor use of expensive charge-out time.

Conclusion

Improving audit efficiency is about understanding what is required and then identifying the most cost effective way of dealing with the requirements. The key is in the planning. Get the audit team to have good habits and not only will the efficiency improve but the quality of the audit files should improve as well.

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.

Charity commission refuses to grant charitable status to a community-activity Christian group

Uturn UK, a Christian group that supports community activities, has appealed to the charity tribunal against the Charity Commission's decision not to register it as a charity.

The Commission decided in August 2011 that one of its objects, "to advance citizenship and community development by the promotion and activation of the Street Associations initiative, which will seek to bring together residents of streets in local groupings within a framework which will engender civic responsibility and volunteering" was not charitable. Another of its proposed objects is the promotion of the Christian faith.

In its decision, the Commission said Uturn UK's objects were not exclusively charitable, and noted that "Although phrased as being about community development and civic responsibility, the object doesn't fall within what the law has recognised as charitable."

The Commission also noted that the term "street associations" did not have a definition, and the establishment of these projects would not necessarily "result in an exclusively charitable outcome", and even if the organisation's objects were charitable, it would not necessarily provide the required public benefit.

"In reaching its conclusion, the commission is not to be taken as making any judgement in relation to whether street associations are or are not a good thing. As the court has recognised, not everything that is a good thing is charitable," the decision said.

SWATUK website

01 November 2011

ARC's advice to smaller firms on undertaking complex audits

Before smaller audit firms accept a new appointment or continue to act for an existing audit client, they need to make sure they have the right resources.

The Audit Registration Committee (ARC) is keen to highlight the need for smaller firms to ensure, when accepting a new audit appointment or continuing to act for an existing audit client, that they have adequate competence and capabilities to undertake the engagement.

This is particularly important if the client (or proposed client) is complex or higher-risk, such as:

- a UK-based parent company of a large, multi-national group with overseas material subsidiaries; or
- any client whose shares are listed on a recognised stock exchange (including the Alternative Investment Market and PLUS markets).

The Audit Inspection Unit's 2010/11 public report on inspections of firms auditing 10 or fewer entities within its scope highlighted a specific concern involving the audits of multi-national groups, where the majority of the operations are based and managed outside the UK.

In a number of instances, the AIU found that the firm undertaking the audit in the UK was, due to its size, not usually affiliated to an overseas firm. As a result, the overseas operations were audited by other firms (component auditors) and the extent of participation of the UK auditor in the group audits was generally limited.

The ARC reminds firms (as required under ISQC1), that they must establish policies and procedures for acceptance and continuance of client relationships which give

reasonable assurance that the firm will only undertake the engagement if it has the capabilities, including time and resources, to do so.

Taken from Audit News 50 published December 2011

The Financial Reporting Review Panel announces priority sectors for 2012/13

The Financial Reporting Review Panel today announced that its review activity in 2012/13 will focus on the following sectors:

- Commercial property
- Retail
- Support services

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

The Panel will pay particular attention to the reports and accounts of companies whose shareholders have raised concerns about governance or where there have been specific complaints. It will continue to liaise with the FSA, particularly in relation to financial service companies including banks.

The Panel will focus on disclosures relating to the reporting of risks, including principal risks and uncertainties and risks arising from financial instruments. In the current uncertain economic climate, the degree of estimation in accounts may increase. It will be important that the appropriate disclosures of judgements and key assumptions underpinning estimates and sensitivities around them are included and the Panel will be giving this area its attention. The Panel will continue to review the application of IFRS 3 (Revised) to business combinations.

The Panel will consider whether business reviews are fair, balanced and comprehensive which means that they cover both good and bad news during the period.

Bill Knight, Chairman of the Panel said:

"Directors are facing significant challenges in managing risks and in arriving at estimates for their accounts. Transparency is vital. If risks and uncertainties can be clearly explained, much will have been achieved".

09 December 2011

APB finalises amendments to Ethical Standards

The Auditing Practices Board (APB) today publishes 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.
- Amending the appendix in Ethical Standard 1 to provide a simplified illustrative template for communicating information on audit and non-audit services to those charged with governance which reflects amended UK regulations on auditor remuneration disclosures.

Revised versions of Ethical Standards 1 and 5 have immediate effect and may be downloaded free of charge from the publications section of the APB's web site at: http://www.frc.org.uk/apb/publications/ethical.cfm. A feedback paper is also available at: http://www.frc.org.uk/apb/publications/pub2658.html.

16 December 2011