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NEW UK GAAP V EXISTING UK GAAP (LECTURE A376 – 15.01 MINUTES)

On the 6th March 2012, the Financial Reporting Faculty of the ICAEW published a new factsheet on the future of UK GAAP. A lot of the material in this is similar to that included in the previous set of update notes. However, they do produce a list of ten significant differences between (draft) FRS 102 and current UK GAAP.

These differences are included below along with other differences which have been highlighted by various commentators.

Prior period adjustments

Under (draft) FRS 102, all material prior period errors must be adjusted by a prior period adjustment. This contrasts with FRS 3 which only requires a prior period adjustment where an error is 'fundamental'.

Financial instruments

(Draft) FRS 102 divides financial instruments into two categories – 'basic' and 'other'. Basic financial instruments are mostly measured at amortised cost whereas other financial instruments are measured at fair value with movements recognised in the profit and loss account.

Under current UK GAAP, transactions such as forward foreign exchange contracts are not usually recognised in the balance sheet. Under (draft) FRS 102, such contracts are 'other' financial instruments and are measured at fair value.

The Faculty considers that the changes in this area will probably be the most difficult for accountants to deal with and therefore there is a significant training need. We will address this area in detail in future update courses.

Investments in shares

Investments in shares are financial instruments. Under (draft) FRS 102, investments in non-puttable ordinary shares are basic financial instruments. If the shares are publicly traded then they must be included in the balance sheet at fair value. This rule also applies if the shares are not traded but fair value can be measured reliably. Investments in other ordinary shares are measured at cost less impairment.

Under the alternative accounting rules of CA 2006, investments in shares held as fixed assets may be included in the balance sheet at market value and current

assets investments may be included at current cost. However, these rules are the alternative accounting rules and CA 2006 does permit the measurement of such investments at cost. As can be seen from the above, (draft) FRS 102 proposes to remove this choice.

There is also a change when it comes to the treatment of movements in the value of investments. CA 2006 requires changes in the value of investments to be credited or debited to a revaluation reserve (subject to detailed rules). (Draft) FRS 102 requires changes in the value of investments to be included in the profit and loss account.

The Faculty do not comment on this inconsistency between the proposed standard and CA 2006. They do, however, comment on the fact that this and other changes envisaged by (draft) FRS 102 may affect tax payable. They make no further comment on this point or on the impact on distributable profits.

Investment properties

Under (draft) FRS 102, investment properties will be included in the balance sheet at fair value. As with investments in shares, movements in value are recognised in the profit and loss account rather than the revaluation reserve.

This measurement rule only applies to investment property whose fair value can be measured reliably without undue cost or effort. All other investment property is treated as property, plant and equipment using the cost-depreciation impairment model.

Tangible fixed assets – revaluation

FRS 15 permits a negative balance on revaluation reserve. This is not permitted by (draft) FRS 102. See later in these notes for further consideration of this point.

Tangible fixed assets – depreciation

FRS 15 states that a variety of methods can be used to allocate the depreciable amount of a tangible fixed asset on a systematic basis over its useful economic life. It mentions two methods specifically – the straight line method and the reducing balance method.

(Draft) FRS 102 says ‘An entity shall select a depreciation method that reflects the pattern in which it expects to consume the asset’s future economic benefits. The possible depreciation methods include the straight-line method, the diminishing

balance method and a method based on usage such as the units of production method.'

(Draft) FRS 102 only permits a change in the method of depreciation 'If there is an indication that there has been a significant change since the last annual reporting date in the pattern by which an entity expects to consume an asset's future economic benefits'. This contrasts with the current position in FRS 15: 'A change from one method of providing depreciation to another is permissible only on the grounds that the new method will give a fairer presentation of the results and of the financial position.'

Merger accounting

FRS 6 permits the use of merger accounting subject to detailed conditions. (Draft) FRS 102 only permits merger accounting for group reconstructions.

Goodwill and intangible assets

When intangible assets are acquired in a business combination, more intangible assets are likely to be recognised under (draft) FRS 102 than under current UK GAAP. This is because, FRS 10 states that intangible assets are non-financial fixed assets that do not have physical substance but are identifiable and are controlled by the entity through custody or legal rights. It then goes on to explain that an identifiable asset is (defined by companies legislation as) one that can be disposed of separately without disposing of a business of the entity. If an asset can be disposed of only as part of the revenue-earning activity to which it contributes, it is regarded as indistinguishable from the goodwill relating to that activity and is accounted for as such.

Paragraph 18.2 of (draft) FRS 102 includes the idea of separately identifiable assets above but then goes on to a second possibility. An asset is also identifiable when it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Again, there is no comment in the Faculty's document on this conflict with CA 2006.

Under FRS 10, goodwill and other intangible assets may have an indefinite life. Otherwise, it is presumed that useful economic life will not exceed 20 years - although this presumption can be rebutted.

(Draft) FRS 102 states that, where no reliable estimate can be made, the useful life is presumed to be five years.

Deferred tax

The current approach under FRS 19 is referred to as a timing difference approach. The approach envisaged by (draft) FRS 102 is referred to as ‘timing differences plus’. Deferred tax will also be recognised on revaluations of property, plant and equipment and fair value adjustments arising on business combinations.

(Draft) FRS 102 forbids discounting of current or deferred tax liabilities or deferred tax assets.

Employee benefits

(Draft) FRS 102 refers to short-term compensated absences - for example holiday pay and sick leave. In some circumstances these can be carried forward and used in future periods if the employee does not use the current period’s entitlement in full.

The draft FRS requires an entity to recognise the expected cost of accumulating compensated absences when the employees render service that increases their entitlement to future compensated absences.

This section of (draft) FRS 102 also deals with post-employment benefits. There are a lot of changes affecting defined benefit pension schemes. For example, FRS 17 requires the current service cost, the interest cost and expected return on plan assets to be recognised in the P&L account. By contrast, (draft) FRS 102 follows the revised IAS 19 in requiring the service cost and net interest cost to be recognised in profit or loss. It is expected that this will lead to a reduction in reported profits compared with FRS 17. This is because the interest on the plan assets under (draft) FRS 102 is likely to be lower than the expected return on plan assets under FRS 17.

There is also a change affecting group schemes. At present, group entities may use FRS 17’s multi-employer exemption to avoid recognising their share of the group plan in their individual financial statements. Under (draft) FRS 102, the defined benefit surplus or deficit will either be recognised on the sponsoring entity’s balance sheet or on the balance sheet of the group entities depending on the circumstances.

Disclaimers

The above differences are based on the differences identified to date by the Financial Reporting Faculty and others. It is unlikely that this is a full list of changes and as the technical experts examine (draft) FRS 102, other differences will emerge.

Secondly, as stressed throughout the above text, FRS 102 is still in draft form and further amendments may occur during the exposure period.

MICRO ENTITY ACCOUNTING EXEMPTIONS

(LECTURE A377 – 9.20 MINUTES)

On 21 February 2012 the European Council formally approved a set of limited exemptions for micro entities from the accounting requirements of the 4th and 7th Directives.

These FAQs are quoted from a document published by the Financial reporting faculty of ICAEW on 24 February 2012. The copyright of ICAEW is acknowledged and the title of the document is “Micro-entity accounting exemptions”.

Q. Are these exemptions now EU law?

Not quite; before they formally become law they will need to be published in the Official Journal of the European Union. However, this is merely a formality and is expected to be completed shortly.

Q. What happens now?

The exemptions are a Member State option, so it’s up to the UK government to decide whether, when and how to bring the exemptions into UK company law.

Q. Can the UK now establish a ‘light touch’ regime for micro companies?

The UK can now go ahead and establish a differential regime for micros. However, only limited exemptions are available from the directive. Apart from the items specifically de-regulated, all other provisions of the directive will still apply. Significantly, micro companies will still be obliged to file an abridged balance sheet with Companies House.

Q. How is a micro-company defined?

During the discussion process in Brussels, a number of different definitions of ‘micro’ were considered. In the final text the thresholds were agreed as follows: micro companies are those not exceeding two out of three of:

Turnover: €700,000;

Gross assets: €350,000;

Employees: 10.

Q. What exemptions are offered?

Micro-companies would only need to prepare an abridged balance sheet and abridged profit or loss account. The profit or loss account would not need to be filed with Companies House. Where a company has acquired its own shares, has outstanding commitments or has advanced loans to directors these would need to be appropriately disclosed. No other note disclosures would be required.

Micro companies would also be allowed not to recognise accruals or prepayments as long as these relate to 'charges other than the cost of raw materials and consumables, value adjustments, staff costs and tax'. Apart from this limited exemption, normal accruals accounting would still apply.

Q. How does this vary from current UK practice?

At present, qualifying small companies are permitted to file 'abbreviated accounts'. As micro companies would still be required to file their balance sheets at Companies House, in substance the level of information on the public record may not radically alter for companies that took advantage of this exemption. However, the 'full accounts' that companies have to prepare for their members will be significantly simplified. In addition, if the relevant exemptions are adopted as expressed in EU law, companies will be able to omit certain accruals or prepayment balances. For many companies this is unlikely to have a material effect on the financial statements, but in some cases it could make a significant difference.

Q. Will these accounts be 'true and fair'?

The directive states 'annual accounts drawn up in accordance with (these exemptions) shall be regarded as giving the true and fair view required'.

Q. Does this mean that BIS can press ahead with its 2011 proposals for cash accounting by UK micro companies?

No. Cash accounting would not be permitted under the limited exemptions now available.

Q. When can we expect to see these exemptions being made available?

BIS have been enthusiastic to simplify micro-entity accounting and are likely to wish to move quickly to take advantage of the exemptions. However, they will need to consult before taking any further action. The separate proposed revisions to the accounting directive, currently under discussion in Brussels, could mean accounting simplification for all small companies in the fairly near future. Nevertheless, given their enthusiasm for these exemptions, the UK government may well act to introduce them without waiting for the wider revision of the directive to be completed.

Q. What about unincorporated entities?

Unincorporated entities are not covered by the Companies Act requirements for the preparation of accounts and therefore are not within the remit of the directives. However, they will often be required to prepare accounts for tax purposes. The basis of the tax calculation is currently UK GAAP and therefore to the extent that accounting practice changes in the UK there are likely to be implications for HMRC to consider.

Q. How do these exemptions relate to the ASB's work to replace UK GAAP?

The ASB is currently consulting on proposals to replace current UK GAAP, for medium and large entities, in its entirety, with a new regime. At its core this envisages a comprehensive new standard based around the IFRS for SMEs. For small companies the intention was, at least initially, for the FRSSE to remain in place. However, it now seems likely that the FRSSE will need to be replaced more quickly than anticipated as it will need to be adapted to accommodate the micro entity exemptions and the proposed simplified regime for all small companies. The ASB is thus considering the implications of developments in Brussels for the future of the FRSSE.

Q. What are ICAEW's initial views on the micro-entity exemptions now available to the UK?

ICAEW is strongly supportive of government efforts to remove disproportionate regulatory requirements and to cut 'red tape' for business. However, the responses to the recent UK BIS/FRC consultation: simpler reporting for the smallest businesses have shown that this is a more complex issue than might otherwise be expected, for example there are tax and distribution issues that need to be addressed. The non-recognition of accruals and prepayments is, moreover, likely to lead to a reduction in the usefulness of micro company financial statements without any significant reduction in costs. In any case, the rationale for a reduced regulatory regime for micros has been weakened by the proposed disclosure reductions for all small companies contained in the proposed new directive.

We have not yet seen BIS' proposals for the implementation of the micro exemptions in the UK. When these are released for public scrutiny ICAEW will consult extensively with members to gauge the implications.

What is ICAEW doing to influence how the exemptions are implemented in the UK?

ICAEW has formed a working party which has been examining the issue of small and micro company accounting simplification in more detail. The working party comprises SME representatives from business and practice as well as leading company law experts. ICAEW commented in detail on BIS paper: simpler reporting for the smallest businesses and since the close of this consultation has been engaged with key policy makers in an effort to influence government thinking in this area.

Will any resources be available to help me deal with the new requirements?

The Financial Reporting Faculty is developing a range of resources to help members to implement the new UK reporting requirements related to both these company law changes and from the imminent replacement of UK GAAP.

PROPOSALS FOR A MODERNISED TAX SYSTEM

(LECTURE A 378 – 3.36 MINUTES)

It is not usual for me to cover tax matters but I thought it was worth referring to the developments in and just after the budget since they are relevant to the topic of Micro-entities covered above.

The notes below are based on two articles written by Rebecca Benneyworth on 21 March and 30 March 2012 and published on Accounting Web.

The new proposals are based on the ideas put forward by the Office of Tax Simplification and covered in previous update notes. If you recall, OTS was hesitant about pushing too far with their new ideas suggesting a turnover limit of £20,000 or £40,000 or, at most, the VAT registration threshold. The Chancellor has opted for the highest of these levels.

There will be a new optional basis for accounts for tax purposes. Small businesses will be permitted to choose either a full accounting basis for tax purposes, or a simple cash receipts and payments basis instead. In her first article, Rebecca suggested that companies would also be eligible for the new regime but, by the date of her second article, the consultation paper had been issued and it had become clear that companies would be excluded from this new regime. Companies must continue to prepare accounts for tax purposes using UK GAAP.

There are rules for eligibility for the new regime including:

- The new rules fall into two areas, voluntary cash accounting and simplified expenses. Entities which choose to use the voluntary cash basis must also use the simplified expenses rules. The reverse is not true.

- There are a number of businesses excluded from the cash accounting scheme including LLPs.

- VAT registered businesses wishing to use cash accounting must also use the VAT cash accounting scheme.

- Any business other than companies will be permitted to use the simplified expenses rules.

- If a person (or a partner) has control over more than one unincorporated business, then the cash basis is only available if all of them together are below the threshold. If any of the businesses adopt normal accounting rules then all of the businesses must move over to normal accruals accounting.

The consultation paper provides details of the cash basis. These include:

- The cash basis must be operated on a fiscal year basis – that is from 6 April to 5 April.

- The taxable profit is the amount of receipts, less the allowable business payments, less the simplified expenses calculated. A negative result for a period is carried forward to set against future income. If a business wishes to claim loss relief it will have to move to a GAAP basis.

- Allowable business expenses include purchased assets such as plant and machinery and interest on purchases provided the purchase is allowable.

- Disallowed items include investments in land, property and shares; costs allowed by the simplified expenses rules; entertaining and expenses for private purposes; interest on cash borrowings, such as a bank loan; and drawings.

Other matters re cash accounting:

- Further guidance will be provided by HMRC on the transition to and from the cash basis.

- The cash basis will operate on VAT inclusive figures, so that any VAT paid to HMRC is treated as an expense, and any VAT repaid to the business is treated as income.

The simplified expenses rules cover the use of a standard mileage rate for business use of cars or motorcycles (which could also be used for other vehicles such as vans); flat rate expenses for business use of home and/or flat rate adjustment for personal use of business premises. Other simplifications include a proposal that telephone and internet costs should normally be allowed in full. HMRC will also review and update current guidance on subsistence costs for small businesses travelling away from base.

UITF DRAFT ABSTRACT 49: RMC FINANCIAL STATEMENTS

(LECTURE A 379 – 11.47 MINUTES)

Background

The UITF received a request from the ICAEW to consider the treatment of transactions relating to residential service charges in the financial statements of residential management companies (RMCs).

The ICAEW had received legal counsel opinion that, irrespective of whether a RMC is acting as principal or agent, the cash balance representing contributions received from lessees in accordance with the terms of their leases and held by a RMC under S.42, Landlord & Tenant Act 1987 is held on statutory trust and is not an asset of the company.

This led to confusion as to whether the lack of beneficial ownership of the cash balance meant that none of the relevant transactions should be recorded in the RMC financial statements and the ICAEW identified variations in practice. In some cases the RMC apparently regarded itself as acting as an agent and, accordingly, did not record the transactions which often meant, for the purposes of company law, that it was dormant. In other cases the RMC apparently regarded itself as acting as a principal or as an undisclosed agent and, hence, recorded the transactions in its financial statements. It was not clear which treatment was correct and whether or not this was dependent on the RMC acting as principal or agent.

The UITF considered the request by reviewing various forms of arrangements for providing residential services by RMCs. The UITF concluded that various forms of arrangement were in place and that it could usefully assist preparers and users by

providing guidance on determining the transactions to be entered into the financial statements of the RMC.

Scope

The [draft] Abstract shall be applied by residential management companies. A residential management company is an entity which may be referred to in the lease, which is responsible for the provision of services, and manages and arranges maintenance of the property, but which does not necessarily have any legal interest in the property.

Consensus

The UITF considers that:

1. to determine the transactions to be included in its financial statements, a RMC must first determine whether, in its dealings with third parties, it is acting as an agent or as principal (or undisclosed agent). A RMC should consider the guidance in FRS 5 ‘Reporting the Substance of Transactions’ Application Note G. Paragraphs G62 to G66 provide principles for determining whether a seller is acting as agent or principal and this guidance should be applied by analogy to transactions to purchase goods and services. The guidance also notes, inter alia, that where the seller has not disclosed that it is acting as agent, there is a rebuttable presumption that it is acting as principal;

2. where the RMC determines it is acting as principal (or undisclosed agent), it shall record the relevant service charge transactions arising from contracts to purchase goods and services in the profit and loss account and concurrently recognises income by drawing from the service charge cash balances;

3. where the RMC determines it is acting as an agent (and has disclosed this fact), it should not record the relevant service charge transactions in its financial statements;

4. where a RMC determines it is acting as an agent and has no relevant service charge transactions, it may be dormant if it also meets all the requirements of company law for dormant companies; and

5. where a RMC discloses it is an agent, the financial statements should refer to where tenants can obtain information regarding residential service charges transactions.

It is expected that the accounting treatment required by the [draft] Abstract should be adopted for periods ending after 31 December 2012. Early adoption will be permitted once the abstract is released.

Other matters

There is an extensive section in the information sheet dealing with the development of the draft abstract. Some of those comments are listed here but interested readers are referred to the full document for more details.

The UITF noted that paragraph G64 of FRS 5 provides a rebuttable presumption that, where a seller has not disclosed that it is acting as agent, it is acting as principal. The UITF noted that this should apply equally to RMCs. An RMC which has not disclosed that it is acting as agent, and not rebutted the presumption that it is a principal, shall be deemed to be exposed to legal rights and obligations under the contracts it has entered into and should prepare financial statements which record service charge transactions. Notwithstanding this, the law of agency is complex and, where there is sufficient doubt as to the status of the RMC as principal or agent, legal advice should be obtained.

Note that, if the RMC is acting as an agent and produces dormant company financial statements, the UITF noted that residents may have unlimited liability.

Once the RMC has determined whether it is acting as principal or agent, the appropriate accounting can be determined. A principal should recognise the relevant transactions in its profit and loss account and concurrently recognise income by drawing from the service charge cash balances. An agent should not recognise the relevant transactions in its financial statements.

OTHER POSSIBLE DEVELOPMENTS (LECTURE A380 – 6.33 MINUTES)

Update on progress

In recent update notes we have reported many developments and potential developments. These have come thick and fast and, in some cases, disappeared just as quickly. My readers can be forgiven for being confused as to the current state of play therefore I thought I would present the table below to help you get a handle on what’s happening and what might happen next. If it seems worthwhile, I shall repeat this table in future update notes until the issues begin to clarify.

Development	What's it about?	Where are we now?
UK GAAP	The proposal by the ASB to replace all existing standards with new FRS 102 based on the IFRS for SMEs.	The comment period closed on 30th April. Final standard is expected by the end of 2012.
Audit exemption	Proposal from BIS to exempt all small companies and some subsidiaries from audit.	The summary of responses has been published. The government is expected to give their response and publish draft legislation (if any) "in the Spring".
Change of accounting framework	Proposal from BIS to allow companies to move more easily from IAS to UK GAAP.	
Micro-companies	Proposal from Europe to permit limited exemptions for micro entities from the accounting requirements of the 4th and 7th Directives. (See earlier in these notes)	Up to the UK government to produce consultation paper, if they wish to proceed.
Simplified accounting for micro-entities	Discussion paper from BIS and FRC seeking views on possible approaches to the accounting requirements for micro-entities.	Dead! Overtaken by developments from Europe as shown above.
Reduced disclosures for small companies	Legislative proposal from Europe for changes to the accounting directives. This will greatly reduce disclosures in the accounts of small companies. The most interesting proposal is the 'maximum harmonisation provision' such that the UK could not require additional disclosures.	Committee vote expected in July with a plenary vote in the European parliament in September. It is planned that a new Accounting Directive should be made effective by Member States by 1 July 2014 but the exact contents and date are subject to change.

Increased thresholds for small companies	The legislative proposal referred to above suggests an increase in the thresholds to: Turnover: €10 million Gross assets: €5 million to be translated into sterling at the official rate on the date of enactment	As above but the UK government may decide to accelerate this aspect of the proposed changes. It has even been suggested that a statutory instrument could be released in 2012 for almost immediate implementation.

FRS 4: DOES IT STILL EXIST? (LECTURE A 381 – 15.51 MINUTES)

FRS 4 was substantially amended by FRS 25, with effect for accounting periods beginning on or after 1 January 2005. In fact the vast majority of FRS 4 was deleted leaving only those paragraphs (27 to 32) which deal with the carrying amount of debt and the allocation of finance costs.

Those parts of FRS 4 which remain do not apply to companies which are complying with FRS 26.

One feature of the current economic climate is that loans (be they from banks or others) may come with a variety of unusual terms and conditions. We have received a number of technical enquiries concerning the accounting treatment of loans, debentures and preference shares. Bank loans may involve arrangement fees or renewal fees. Other issue costs might also be involved. Interest rates may be fixed or floating. Repayments may be spread throughout the period of a loan or may be concentrated at the end of a loan where a premium is frequently payable.

FRS 4 simplifies all of these complications by concentrating on the key issues of net proceeds and total finance costs. The definitions are as follows:

Net proceeds: The fair value of the consideration received on the issue of a capital instrument after deduction of issue costs.

Issue costs: The costs that are incurred directly in connection with the issue of a capital instrument, that is, those costs that would not have been incurred had the specific instrument in question not been issued.

A bank arrangement fee would be an issue cost, but a report setting out financing options and suggesting which route to take would not be. We have had a couple of technical queries on this point as, in the current climate, there is sometimes a desire to try and spread such costs forward rather than taking the hit in one year.

Finance costs: The difference between the net proceeds of an instrument and the total amount of the payments (or other transfers of economic benefits) that the issuer may be required to make in respect of the instrument.

Armed with these definitions we can then comply with the requirements of paragraphs 27 and 28:

- Immediately after issue, debt should be stated at the amount of the net proceeds.

- The finance costs of debt should be allocated to periods over the term of the debt at a constant rate on the carrying amount. All finance costs should be charged in the profit and loss account.

This will require the calculation of an appropriate interest rate using IRR calculations. Some accountants will claim that this is unnecessarily complicated and that, based on materiality, it is unlikely that sophisticated methods are necessary. My view is that IRR calculations no longer involve any great difficulty and should always be performed to establish the correct amount of the annual finance costs. As to materiality, we would usually need to perform the calculations to demonstrate immateriality so, once the figures have been established then why not use them in the accounts.

The balance sheet treatment is dealt with in paragraph 29 which requires the carrying amount of debt to be increased by the finance cost in respect of the reporting period and reduced by payments made in respect of the debt in that period.

Example 1: Loans

A loan of £1,000,000 is taken out on 1 January 2012. Annual interest of £42,000 is payable at the end of each year. The loan is repayable on 31 December 2016 at a premium of £100,000.

Net proceeds equal £1,000,000; total finance costs are £310,000.

Cash flows are as follows:

Year	Cash flow
0	1,000,000
1-4	-42,000
5	-1,142,000

The year 5 payment is made up of the repayment plus premium plus interest.

The effective interest rate is approximately 6% per annum (determined using the IRR function in excel).

The relevant balance sheet and profit and loss account figures are as follows:

Year ending 31 December	Opening balance	P&L – finance cost (op bal× 6%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2012	1,000,000	60,000	42,000	1,018,000
2013	1,018,000	61,080	42,000	1,037,080
2014	1,037,080	62,225	42,000	1,057,305
2015	1,057,305	63,438	42,000	1,078,743
2016	1,078,743	64,724	1,142,000	1,467

Note that there is a final balance in 2016 as a result of rounding errors. This should be written off to the P&L account and will reduce the finance cost in 2016 to £63,257.

Example 2: Debentures

On 1 January 2012, a company issues 5% debentures having a nominal value £200,000 at a discount of 10%. Debt issue costs amounted to £10,000 and interest is payable annually in arrears. The debentures are repayable in five years' time at a premium of 20%.

Net proceeds can be calculated as:

Nominal value (£200,000) less discount on issue (£20,000) less issue costs (£10,000) = £170,000

Total amount payable is:

Interest @ 5% for 5 years = £10,000 per annum

Redemption payment is nominal value (£200,000) plus premium (£40,000) = £240,000

Total finance costs of £120,000 (made up of interest £50,000, issue costs £10,000, discount on issue £20,000 and redemption premium £40,000) need to be recognised over the term of the debentures.

Although we have introduced several complications, this is, in essence, no different from the loan problem above.

Cash flows are as follows:

Year	Cash flow
0	170,000
1-4	-10,000
5	-250,000

The year 5 payment is made up of the repayment plus premium plus interest.

The effective interest rate is approximately 12.3% per annum (determined using the IRR function in excel).

The relevant balance sheet and profit and loss account figures are as follows:

Year ending 31 December	Opening balance	P&L – finance cost (op bal× 12.3%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2012	170,000	20,910	10,000	180,910
2013	180,910	22,252	10,000	193,162
2014	193,162	23,759	10,000	206,921
2015	206,921	25,451	10,000	222,372
2016	222,372	27,352	250,000	-276

Note in this example that the opening balance of the debentures is not the nominal value of £200,000. Paragraph 27 of FRS 4 states that, Immediately after issue, debt should be stated at the amount of the net proceeds ie: £170,000.

The rounding difference will increase the finance cost in 2016 to £27,628.

Example 3: Preference shares

How do preference shares differ from debentures?

If redemption is mandatory and dividend payments obligatory, then preference shares are, in substance, no different from debentures. The same calculations will be performed as shown above.

However, there are differences that arise because of the legal nature of preference shares. Let us consider the above example with preference shares rather than debentures.

On 1 January 2012, a company issues cumulative, redeemable 5% preference shares having a nominal value £200,000 at a discount of 10%. Issue costs amounted to £10,000 and dividends are payable annually in arrears. The preference shares must be redeemed in five years' time at a premium of 20%.

The first problem we have is that, under Section 552 of CA 2006, shares cannot be issued at a discount. However, Section 553 permits (subject to authorisation by the company's articles) the payment of commission of up to 10% of the nominal value. The entries in the nominal ledger will need to be true to the requirements of the Companies Act:

Dr	Cash	180,000	
	Commission	20,000	
Cr	Preference share capital		200,000

Being the proceeds of issue of preference shares.

Dr	Issue costs	10,000	
Cr	Cash		10,000

Being the issue costs in connection with the issue of £200,000 preference shares.

Note that the commission and issue costs are not expensed in 2012 since they are prepayments of finance costs.

The numerical calculations can now proceed as before. The balance in the financial statements at the end of 2012 is £180,910. This is included in liabilities due beyond one year. The analysis of these liabilities will disclose the amount which relates to the preference shares.

The share capital note will indicate that cumulative, redeemable 5% preference shares are in issue with a nominal value of £200,000. The share capital note should indicate that the amounts outstanding to preference shareholders have been included within liabilities due beyond one year and an analysis should be given as follows:

Nominal value of preference shares	£200,000
Less: prepaid finance costs	£19,090
Liability (see note xx)	£180,910

The finance cost note to the profit and loss account should distinguish between dividends on shares (£10,000) and the other elements of the finance charge (£10,910 in 2012).

Another problem which may arise is that there may be insufficient distributable reserves to enable the payment of the dividend. In this case, the dividend should still be charged as a finance cost and the unpaid dividend included in creditors. This situation may continue for a number of years, in which case the unpaid dividends would accumulate in creditors.

There is no problem with accruing unpaid dividends; the Companies Act would only be breached if a payment were to be made.

Let us return to the lifecycle of the preference shares. Assuming now that all amounts are paid on schedule, the following journal entries will be required on redemption (CA 2006, sections 687 and 733).

Dr	Preference shares	200,000	
	Accrued interest costs	40,000	
Cr	Cash		240,000

Being the repayment of the preference shares at a premium of £40,000.

Note that this reduces the balance on the preference shares account to zero.

Dr	Profit and loss reserves	200,000	
Cr	Capital redemption reserve		200,000

Being the statutory transfer required by CA 2006, s 733 on the redemption of shares.

Example 4: Options for early redemption

A company has a 10 year £1m redeemable fixed rate 5% bond. Issue costs £20,000. Premium on redemption 10%

The company has an option to redeem the bond at the end of 5 years with a 15% premium.

To deal with this example we need to quote two sources. Firstly, paragraph 16 in the definitions section of FRS 4 defines the term (of a capital instrument) to be the period from the date of issue of the capital instrument to the date at which it will expire, be redeemed, or be cancelled.

The definition goes on to say that, if either party has the option to require the instrument to be redeemed or cancelled and, under the terms of the instrument, it is uncertain whether such an option will be exercised, the term should be taken to end on the earliest date at which the instrument would be redeemed or cancelled on exercise of such an option. Further, paragraph 73 of FRS 4 says that, if there is an option for early redemption, the term should be taken to end on the earliest date the option could be exercised, unless there is no genuine commercial possibility that the option will be exercised.

In our example, there is a genuine commercial possibility that the option will be exercised for example, falling interest rates may make it worthwhile to redeem the loan early despite the penalty.

Therefore FRS 4 requires us to take the term as 5 years.

Our second source is UITF Abstract 11 which deals with the appropriate accounting for an issuer call option under FRS 4.

In the section explaining the issue, the Abstract says that FRS 4 ‘could be construed as requiring the accounting to be based on the assumption that the call option will be exercised and hence that the premium will be paid.’ Nevertheless, say the UITF, ‘the amount payable under an issuer call option is not usually a payment “that the issuer may be required to make in respect of the instrument” (part of the definition of “finance costs” quoted above).’ In current terminology, we would express this by saying that the issuer has no obligation to pay a premium to exercise an option that they are not required to exercise.

Therefore, under UITF Abstract 11, the correct premium to use in the calculation is 10%.

We can now proceed to answer the question.

Net proceeds of the bond are £1 million less issue costs of £20,000 = £980,000.

When we try to determine the finance costs, we hit a problem. The definition referred to the total amount of the payments that the issuer **may** be required to make in respect of the instrument.

We have already remarked (based on UITF 11) that the issuer cannot be required to pay the premium of 15% but that is not the problem that we face now. It could be said that the issuer **may** be required to pay interest over the full ten years of the loan if they don't exercise the option but surely it would be nonsense to use a 5 year term with ten years' worth of interest!

Notice that the addition to the definition of finance costs of the words "over the term of the loan" would solve this problem and I'm sure that many accountants will assume that this is the only construction that makes sense.

So let's assume that the finance costs amount to 5 years' worth of interest payments at £50,000 per annum plus a redemption premium of 10% ie £100,000 plus issue costs of £20,000 to give total finance costs of £370,000.

So the cash flows are as follows:

Year	Cash flow
0	980,000
1-4	-50,000
5	-1,150,000

The year 5 payment is made up of the repayment plus premium plus interest.

The effective interest rate is approximately 7.22% per annum (determined using the IRR function in excel).

The relevant balance sheet and profit and loss account figures are as follows:

Year ending 31 December	Opening balance	P&L – finance cost (op bal× 7.22%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2012	980,000	70,756	50,000	1,000,756
2013	1,000,756	72,255	50,000	1,023,011
2014	1,023,011	73,861	50,000	1,046,872
2015	1,046,872	75,584	50,000	1,072,456
2016	1,072,456	77,431	*50,000	1,099,887

*The cash paid is merely the interest amount since redemption will only take place if the issuer so decides.

The balance sheet figure at the end of 2016 is (allowing for roundings) £1.1 million. This figure is the capital amount of the bond plus the 10% premium. However, as my readers will have realised already, this is a figure that cannot possibly be equal to the amount actually paid at the end of 2016.

One possibility is that the issuer will choose to redeem early in which case the amount to pay is £1,150,000. UITF Abstract 11 sees no problem with this. It quotes paragraph 32 of FRS 4:

‘Gains and losses arising on the repurchase or early settlement of debt should be recognised in the profit and loss account in the period during which the repurchase or early settlement is made.’

So, in the event of early redemption, the entire extra premium of £50,000 will hit the P&L in the year to December 2016.

The alternative outcome is that the option to redeem early is not taken. Now, the issuer will need to recalculate the interest rate to use for the next five years. For a new five year term, the balance sheet figure (which I have corrected to remove the impact of the rounding error) is taken as the year 0 cash flow:

Year	Cash flow
0	1,100,000
1-4	-50,000
5	-1,150,000

The year 5 payment is made up of the repayment plus premium plus interest.

The effective interest rate is approximately 4.545454....% per annum (determined using the IRR function in excel). Note that this is now below the "nominal" rate of 5% reflecting the over-accrual of the redemption premium. I have expressed this as a more accurate percentage because this will then give us the intuitively obvious result shown below:

Year ending 31 December	Opening balance	P&L – finance cost (op bal× 4.55%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2017	1,100,000	50,000	50,000	1,100,000
2018	1,100,000	50,000	50,000	1,100,000
2019	1,100,000	50,000	50,000	1,100,000
2020	1,100,000	50,000	50,000	1,100,000
2021	1,100,000	50,000	1,150,000	0

Comparison with (draft) FRS 102

All of the financial instruments in the examples above fall into the category of basic financial instruments as defined in (draft) FRS 102. Paragraph 11.14(a) of that standard states:

'Debt instruments that meet the conditions in paragraph 11.8(b) shall be measured at amortised cost using the effective interest method. Paragraphs 11.15 – 11.20 provide guidance on determining amortised cost using the effective interest method.'

Paragraphs 11.15 – 11.20 (and the worked example in paragraph 11.20) describe a method identical to that required by FRS 4. Therefore the methods of FRS 4 will continue to be appropriate under the new UK GAAP.

FAQS ON RECENT COURSES /FILE REVIEWS

(LECTURE A382 – 10.52 MINUTES)

Small group rules

We have a client with the following group structure. The parent P Ltd has very little in the way of turnover or assets other than an investment in the wholly-owned subsidiary S Ltd.

The following is the relevant information for the first financial year which was the year ended 31 December 2011.

	P Ltd	*S Ltd*
Turnover	*£0.1m*	*£7m*
Balance sheet total	*£0.1m*	*£3.7m*
Number of employees	*2*	*60*

Which of the companies qualify as a small company in 2011 and which of them qualify for audit exemption?

S Ltd is not a small company. It exceeds all three of the qualifying limits. S Ltd is not audit exempt.

Normally it would be obvious that P Ltd could not be a small company because you would think that the group it heads up is not a small group.

However, the group turnover is £7.1m (on a gross basis) and the group balance sheet total amounts to £3.8m (on a gross basis). Therefore the group is a small group and the parent is a small company. It is not necessary to prepare group accounts.

This result may be surprising enough but the fact that P Ltd is audit exempt is even more surprising.

Let's turn the above example the other way round. What if the group is set up so that it is the subsidiary that has very little turnover? The following would then be the relevant information for the first financial year ended 31 December 2011.

	P Ltd	*S Ltd*
Turnover	*£7m*	*£0.1m*
Balance sheet total	*£3.7m*	*£0.1m*
Number of employees	*60*	*2*

Which of the companies qualify as a small company in 2011 and which of them qualify for audit exemption?

P Ltd is not a small company. It must prepare group accounts and it must be audited.

S Ltd is a small company. It meets all three of the qualifying conditions.

The group turnover is £7.1m (on a gross basis) and the group balance sheet total amounts to £3.8m (on a gross basis). Therefore the group is a small group.

Accordingly S Ltd is audit exempt.

These two examples give the lie to the oft-quoted comment that either all of the companies in a group are audit exempt or none of them.

Investment property

Q. A company owns a property which it lets mainly to its parent company for the parent's business activities. Over 80% of the rent comes from the parent. There are 5 small residential tenants living upstairs. Is the property an investment property?

In an ideal world you would split the property in the accounts and account for the 80% let to a group company as a fixed asset at cost and for the 20% let to residential tenants as investment properties. If the properties are assessed separately for rates and energy then this should be possible. Reasonable estimates for the value of residential properties are also relatively easy to obtain.

However, if it is too complicated to do this then you could treat the property as a fixed asset as this is the majority usage and add a note to this effect to the accounting policy.

Revenue recognition

Q. A company's business is carpet dealer and fitter. The company's main customers tend to work on reasonably large projects. It can take six months from date of order to final fitting, and for larger projects, the actual fitting itself can be a lengthy exercise.

The company receives a 50% deposit upfront from the customer which covers the cost of purchasing the carpet.

The company prepares accounts in accordance with FRSSE. How should they account for the revenue?

In line with FRS 5, Application Note G, FRSSE requires the seller to recognise revenue when, and to the extent that, it obtains the right to consideration in exchange for its performance. Where a seller has partially performed its contractual obligations, it recognises revenue to the extent that it has obtained the right to consideration through its performance.

FRSSE (consistently with UITF 40) requires revenue on a service contract to be recognised as contract activity progresses to reflect the seller's partial performance of its contractual obligations. The amount of revenue should reflect the accrual of the right to consideration as contract activity progresses by reference to value of the work performed.

The analysis depends on the actual facts of the case. For example, the use of the term “carpet dealer” might imply that there is a great deal of effort involved in sourcing the carpet and, in this case, the contract price might include a significant charge for this service. In that case, the revenue related to the search activity will be recognised once that activity is complete.

However, it is much more likely that there is little work performed ahead of the actual fitting of the carpet. If this is the case, then revenue is recognised as the carpet is fitted.

The deposit is irrelevant in this analysis. It will be recognised as a liability until the carpet supplier obtains the right to consideration through its performance. Once the carpet has been obtained by the supplier and is held in stock then the deposit can be reclassified as a deduction from the cost of the carpet (in accordance with the principles of SSAP 9).

Negative revaluation reserves

Q. Recently I attended a course where the presenter said that FRS 15 permits the existence of a negative revaluation reserve. I am aware that negative revaluation reserves can exist under SSAP 19 but I thought that any reduction in the value of a tangible fixed asset below its depreciated historical cost should be charged directly in the P&L account. Would you care to comment?

You are exactly right that SSAP 19 permits a negative revaluation reserve:

‘... changes in the market value of investment properties should not be taken to the profit and loss account but should be taken to the statement of total recognised gains

and losses (being a movement on an investment revaluation reserve), unless a deficit (or its reversal) on an individual investment property is expected to be permanent, in which case it should be charged (or credited) in the profit and loss account of the period.'

Therefore reductions in the market value of an investment property caused by a temporary downturn in the market do not hit the P&L account. If there are no previous upward revaluations against which the current downward revaluation can be set, then a negative revaluation reserve will arise.

FRS 15 contains the following in paragraph 65:

'All revaluation losses that are caused by a clear consumption of economic benefits should be recognised in the profit and loss account. Other revaluation losses should be recognised:

(a) in the statement of total recognised gains and losses until the carrying amount reaches its depreciated historical cost; and

(b) thereafter, in the profit and loss account unless it can be demonstrated that the recoverable amount of the asset is greater than its revalued amount, in which case the loss should be recognised in the statement of total recognised gains and losses to the extent that the recoverable amount of the asset is greater than its revalued amount.'

Paragraph 70 reiterates this point when it states that: 'where it can be demonstrated that recoverable amount is greater than the revalued amount, the difference between recoverable amount and the revalued amount is clearly not an impairment and should therefore be recognised in the statement of total recognised gains and losses as a valuation adjustment, rather than the profit and loss account.'

Recognising that this result may surprise, FRS 15 goes on to provide an example:

A non-specialised property costs £1 million. It is depreciated on a straight-line basis over its useful life of 10 years with a residual value of zero. The property is revalued annually and therefore the depreciation charge (based on the opening book amount of the year) is recalculated every year. Further information is shown in the table below.

Accounting treatment under modified historical cost

	Year 1	Year 2
	£000	£000
Opening book amount	1,000	1,080
Depreciation	(100)	(120)
Adjusted book amount	900	960
Revaluation gain (loss)		
- recognised in the STRGL	180	(220)
- recognised in the P&L account	–	(40)
Closing book amount (Existing use value)	1,080	700
Further information:		
Depreciated historical cost	900	800
Recoverable amount	N/A	760

Year 1 is straightforward with the revaluation gain of £180,000 being recognised in the statement of total recognised gains and losses.

In year 2, the revaluation loss on the property is £260,000. This will be recognised in the statement of total recognised gains and losses until the carrying amount reaches its depreciated historical cost. Therefore, the first £160,000 is recognised in the statement of total recognised gains and losses.

The remaining £100,000 revaluation loss is usually recognised in the profit and loss account. However, in this example, recoverable amount exceeds the revalued amount by £60,000. Therefore a further £60,000 of the revaluation loss is recognised in the statement of total recognised gains and losses (giving £220,000 in total) leaving only £40,000 to be recognised in the profit and loss account.

Returning to the source of this question, probably the reason that the presenter talked about negative revaluation reserves is that these will no longer arise if (draft) FRS 102 is adopted unchanged.

Revaluation reserves will not arise on revaluation of investment properties because changes in the fair value of investment properties will go to profit or loss. With respect to property, plant and equipment, the “exception to the rule” in paragraph 65 of FRS 15 (quoted above) is not included in (draft) FRS 102.

DISCLOSURE ERRORS ON RECENT FILE REVIEWS

(LECTURE A 16.15 MINUTES)

Directors' report

Small companies do not need to include a business review in the directors' report. For medium-sized and larger companies, the review should include an analysis disclosing key performance indicators. This should include figures. The risks addressed in the business review should include the risks arising from the economic environment.

One directors' report included a note referring to the re-appointment of the auditor at the AGM. This may be appropriate if it is a requirement of the company's articles but it is not the way that private company auditors are appointed under S 485 of CA 2006. I suggest that this note is best omitted in future since this avoids the possibility of getting it wrong.

Accounting policies

If a parent company is not preparing consolidated accounts, then the reasons for that should be included in the accounting policies section of the financial statements.

The accounting policy for turnover should be extended to explain how revenue is recognised. This is an area where the professional bodies are currently active in trying to make accounts more useful to users.

Freehold buildings must be depreciated. An accounting policy of non-depreciation cannot be deemed to be reasonable.

Depreciation rates (or expected lives) should be disclosed for all classes of assets.

If there is a change in the expected useful life of fixed assets and this change has a material impact on the accounts then Paragraph 100d of FRS 15 requires the accounts to disclose the financial effect of such a change.

One of the companies reviewed owned investment property. The accounting policy referred to SSAP 19 which was inappropriate because the company had adopted the FRSSE. There was also a reference to SSAP 12 which was a very bad error because SSAP 12 no longer exists.

Investment property should be revalued every year. There is no need for a professional valuation and so the directors can perform the valuation themselves. In an audit situation, failure to revalue would lead to a modified auditor's report. However, if the client is audit exempt then failure to follow an accounting standard means that the accounts are misleading. In this situation, the accountant should refuse to be associated with the accounts and should withdraw from the engagement.

There were some situations where an accounting policy was included but the amounts involved were zero. I can understand that a policy may be helpful even if the company has no current transactions which fall within the policy. However, in this case, it might be helpful if the policy note indicated that the current balance is zero – and either a reason can be given or the policy note could indicate the purpose for including a policy which is apparently irrelevant. What should be avoided is the inclusion of accounting policies as boiler plate information.

In particular, it is common to include a policy for deferred tax but present no balance in the accounts on the grounds of immateriality. In this circumstance, my preferred method is to include the immaterial amount in either debtors or creditors and then disclose in the notes to the accounts that this has occurred and that there is no further disclosure required on the grounds of immateriality.

In one case, a note stated that the deferred tax asset had not been recognised as there was no certainty that there would be suitable taxable profits in the foreseeable future. Certainty is not required. FRS 19 says that deferred tax assets should be recognised if it is more likely than not that suitable taxable profits will be earned.

In one set of accounts, there was a reference to going concern in the accounting policies section of the financial statements. This referred to the renewal of the bank facility in November 2013. Since this was over two years from the balance sheet date I would probably not consider it to be a material uncertainty and would not include it in the policies section of the accounts. This is because the inclusion of a reference to going concern in the accounting policies implies a material uncertainty. If this comment was intended to meet the FRC requirement (see below) then I would position it elsewhere in the notes to the accounts.

Notes to the accounts

Under SSAP 21, the total of operating lease rentals charged as an expense in the profit and loss account should be disclosed, analysed between amounts payable in respect of hire of plant and machinery and in respect of other operating leases. This disclosure is not required under FRSSE.

Under SSAP 21, for operating leases, there should be disclosure of payments which the company is committed to make during the next year, analysed between those in

which the commitment expires within that year, in the second to fifth years inclusive and over five years from the balance sheet date. This should show separately the commitments in respect of leases of land and buildings and other operating leases.

FRSSE contains a similar disclosure requirement re obligations but does not require the analysis between different types of operating lease. Note that a property lease is an operating lease.

The number of directors who are members of pension schemes should be disclosed.

Amounts recoverable under contracts should be included in debtors and should not appear as part of stock.

In one job, the analysis of the bank loan between current liabilities and liabilities beyond one year was performed incorrectly. The liability due within one year was calculated as 12 times the monthly repayment which included interest.

There is no need to disclose authorised share capital.

All material related party transactions during the period must be disclosed. This includes loans to or from related parties. Balances with related parties at the year-end should also be disclosed.

There should be disclosure of dividends paid to related parties.

Under FRS 8, the exemption from disclosure of a transaction between two or more members of a group is only available if all subsidiary companies involved in the transaction are wholly owned by a member of the group. If advantage is taken of this exemption then there should be disclosure of that fact in the notes to the accounts. This exemption is also available to companies that use the FRSSE as long as the group prepares publicly available consolidated financial statements.

In the accounts of a subsidiary, it is a companies act requirement that the ultimate parent company should be identified. Therefore, if there is a note referring to the controlling party (under FRS 8 or FRSSE) then that note should make it clear that the controlling party is also the ultimate parent company (if that is the case). Notice that the ultimate controlling party may well be different from the ultimate parent company and the ultimate controlling party should also be disclosed. So there may need to be disclosure of three different individuals or entities – the controlling party, the ultimate parent company and the ultimate controlling party.

FRC guidance indicates that every set of accounts should contain a note concerning the impact of the current economic environment. If this has already been covered in the directors' report, then the note in the accounts could refer to the directors' report.

ISA 706 EMPHASIS OF MATTER + OTHER MATTER PARAGRAPHS

(LECTURE A384 – 10.19 MINUTES)

This section of the course completes our study of the revisions to the auditor's report as a result of the clarity ISAs. Since the most common example of an emphasis of matter paragraph is one related to going concern, we are also looking at that subject today.

Later on in these notes, I refer to a consultation paper of amendments to ISAs 700, 705 and 706. If the amendments are made to ISA 706 as proposed, they will have no effect on the notes below.

Objective

'The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.' (ISA 705.4)

Emphasis of matter paragraphs

The key thing to note about Emphasis of Matter is that the matter is appropriately presented or disclosed in the financial statements and the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements.

The Application Material stresses the point that including more information in an Emphasis of Matter paragraph than is presented or disclosed in the financial statements may imply that the matter has not been appropriately presented or disclosed. This should therefore be avoided.

Emphasis of Matter paragraphs cannot be used to provide disclosures which should have been included in the financial statements. They cannot be used as a substitute for a modified opinion and cannot refer to information which is not disclosed in the financial statements.

A footnote in ISA 706 refers to the requirement in Paragraph 19 of ISA 570 that the auditor always includes an Emphasis of Matter paragraph in the auditor's report to highlight the existence of a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.

An Emphasis of Matter paragraph is included in the auditor's report immediately after the Opinion on Financial Statements with a heading "Emphasis of Matter", or other appropriate heading.

The paragraph contains a clear reference to the matter being emphasised and to where the relevant disclosures can be found in the financial statements. The paragraph must indicate that the auditor's opinion is not modified in respect of the matter emphasised.

Bulletin 2010/2 contains two examples of Emphasis of Matter paragraphs. Example 12 which is an emphasis of matter relating to going concern is included later in these notes in an extended section covering going concern and the auditor's report. Example 13 is shown here.

Example 13: Emphasis of matter – uncertain outcome of a lawsuit

In forming our opinion on the financial statements, which is not modified, we have considered the adequacy of the disclosures made in note [x] to the financial statements concerning the uncertain outcome of a lawsuit, alleging infringement of certain patent rights and claiming royalties and punitive damages, where the company is the defendant. The company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

Other matter paragraphs in the auditor's report

'Other Matter' paragraphs will always be concerned solely with information about audit matters. Appendix 2 of ISA 706 refers to other ISAs which might require Other Matter paragraphs in certain circumstances. These include:

- ISA 560: when information comes to the auditor's attention after the date of the auditor's report

- ISA 710: where prior period financial statements were not audited

- ISA 720A: where there is a need to amend the other information issued with the financial statements and those charged with governance refuse to make the amendment.

However, probably the best example of an Other Matter paragraph in the UK is the 'Bannerman disclaimer'.

An Other Matter paragraph is usually placed immediately after the Opinion on Financial Statements paragraph and any Emphasis of Matter paragraph. However, the Other Matter paragraph may appear elsewhere in the auditor's report if the content of the Other matter paragraph is relevant to the Other Reporting Responsibilities section. There are no examples of Other Matter paragraphs in Bulletin 2010/2.

Communication with those charged with governance

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, then Paragraph 9 of ISA 706 requires the auditor to communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph.

GOING CONCERN + THE AUDITOR'S REPORT

(LECTURE A 385 – 11.56 MINUTES)

The auditor's approach to going concern has varied over the years. A quick summary of current thinking is found in the table shown below. This has been adapted from the guidance published by the FRC in October 2009 in the document 'Going concern & liquidity risk: guidance for directors of UK companies'.

Conclusions	Resulting disclosures	Consequences for the auditor's report
The directors have not identified any material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern.	The accounts should use the going concern principle and make disclosures as necessary to give a true and fair view. See note 1(a) below.	If the auditor concurs with the directors' assessment and the disclosures in the financial statements then an unmodified auditor's report will be given with no Emphasis of Matter paragraph. See note 1(b) below.

There are material uncertainties but the directors consider that the use of the going concern basis is appropriate.	The accounts should be prepared on the going concern basis. There should be disclosure of the material uncertainties that may give rise to significant doubt about the going concern principle. This disclosure should be made in the accounting policy section so that it is included in the abbreviated accounts. See note 2(a) below	If the auditor concurs with the directors' assessment and supporting disclosures then the auditor's report should include an emphasis of matter paragraph highlighting the existence of material uncertainties that may cast significant doubt. See note 2(b) below. .
The going concern basis is not appropriate.	Disclosures explaining the basis of the conclusion and the accounting policies applied in preparing the financial statements. Disclosure also of any uncertainties about the carrying amounts of assets and liabilities. See note 3 below	Unmodified opinion provided that the financial statements contain the necessary disclosures and the auditor considers the basis to be appropriate to the specific facts and circumstances. The auditor may include an emphasis of matter paragraph. If the decision and its implications are not adequately explained the auditor may determine it necessary to modify its opinion. See note 3 below

Note 1a

It is in this area that the FRC has extended disclosures beyond those required in FRS 18 or FRSSE. The accounting standards only require disclosure where there are material uncertainties that may cast significant doubt on the entity's ability to continue as a going concern. Paragraph 17 of the FRC guidance says "Whatever the economic circumstances, it is important that .... financial statements contain balanced, proportionate and clear disclosures of going concern uncertainties and liquidity risk as necessary to give a true and fair view."

Example 1 in Appendix 1 is disclosure for a company where 'No material uncertainties that may cast significant doubt about the ability of the company to

continue as a going concern have been identified by the directors'. Nevertheless the FRC go on to give example disclosure:

> **Example 1 – A small company that has adopted the FRSSE and anticipates reduced sales next year**
>
> There has been a significant reduction in requests for estimates for new decorating work and the directors expect sales to reduce significantly next year. However, costs are expected to reduce accordingly and the company should be able to operate within its overdraft. The directors are not aware of any reason why the overdraft facility might be withdrawn. As a result they have adopted the going concern basis of accounting.

The impact of the text and the example above is that the FRC have redefined 'True and Fair' to mean that there must be disclosure of the impact of the current economic environment in all accounts which intend to show a true and fair view.

Example 1a in Appendix 2 makes this point even more clearly:

> **Example 1(a) – A company with a significant positive bank balance, uncomplicated circumstances and little or no exposure to economic difficulties that may impact the going concern assumption**
>
> The company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the company, its cash flows, liquidity position and borrowing facilities are described in the Finance Director's Review on pages P to Q. In addition, notes A-D to the financial statements include the company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.
>
> The company has considerable financial resources together with long-term contracts with a number of customers and suppliers across different geographic areas and industries. As a consequence, the directors believe that the company is well placed to manage its business risks successfully despite the current uncertain economic outlook.
>
> The directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

Note 1b

If the auditor does not agree with the disclosures included in the financial statements then the auditor must modify the auditor's report. This may appear obvious but further research tells us that ISA 570 only requires a modification to the auditor's report if there is a material uncertainty. The FRC has therefore extended the requirements relating to going concern beyond the requirements of the ISA in that a modified auditor's report is required if the directors refuse to include appropriate disclosure in circumstances of no material uncertainties .

Note 2a

Example disclosure is provided by the FRC in Example 2 of Appendix 1:

Example 2 – A small company that has adopted the FRSSE and has experienced difficulties in securing future work

The company has orders for work for the next two months. However, despite significant efforts, it has so far proved impossible to obtain additional sales orders. If new orders are not forthcoming, the directors will need to close the factory and make the employees redundant. The directors have concluded that a material uncertainty exists that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realise its assets and discharge its liabilities in the normal course of business. However, given the continuing efforts to secure new orders, the directors continue to adopt the going concern basis of accounting.

Note 2b

If the disclosures are adequate then the auditor will include an emphasis of matter paragraph in the auditor's report. Bulletin 2010/2 provides the following example:

Example 12: Emphasis of matter – Going concern

In forming our opinion on the financial statements, which is not modified, we have considered the adequacy of the disclosure made in note [x] to the financial statements concerning the company's ability to continue as a going concern. The company incurred a net loss of £X during the year ended 31 December 201X and, at that date, the company's current liabilities exceeded its total assets by £Y and it had net current liabilities of £Z. These conditions, along with the other matters explained in note [x] to the financial statements, indicate the existence of a material uncertainty which may cast significant doubt about the company's ability to continue as a going

concern. The financial statements do not include the adjustments that would result if the company was unable to continue as a going concern.

If the disclosures are not adequate then the auditor will produce a modified report – including either a qualified or an adverse opinion. Bulletin 2010/2 provides examples of both of these:

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

- Example 43 – Adverse opinion: Significant level of concern about going concern status that is not disclosed in the financial statements.

The final reason for a modified report is that the directors have not looked sufficiently far ahead to satisfy the requirements of FRS 18/FRSSE. Both of these standards require the directors to consider a period of at least 12 months from the date of their approval of the financial statements. Example 41 of Bulletin 2010/2 covers this situation.

Note 3

Neither the FRC nor the APB provide example wording in this situation.

Going concern FAQs

The following FAQs are based on questions answered by John Selwood in the April 2012 edition of Audit & Beyond, magazine of the ICAEW Audit and Assurance Faculty.

Q. I am the auditor of a large property development company. Last year my auditor's report included an emphasis of matter paragraph relating to going concern but the situation has since deteriorated:

- *The property portfolio has been revalued downward at the year end. Largely due to this, there is little equity left in the company.*

- *The bank has become concerned about the company's position and has sent in reporting accountants (who are yet to report). The company's overdraft facility expires in five months time.*

- *The directors are hoping to recover compensation on an interest rate hedging arrangement which they believe was mis-sold. This is disclosed in the accounts as a contingent asset on the grounds that the directors consider it more likely than not that compensation will be received; and*

- *A large claim has been received from a tenant for breach of contract. The bank is particularly concerned about this development and has said that a negative outcome would be a significant setback to refinancing the company.*

The financial statements include extensive disclosure of the company's financial position and this includes the comment that the directors are confident that the company will be able to continue in business.

Is it still satisfactory to use an emphasis of matter paragraph in the auditor's report or is some sort of modified report required?

A. Usually, as long as the disclosures in the financial statements are adequate, it is satisfactory for the auditor's report to be unmodified with the addition of an emphasis of matter paragraph.

However, John went on to question whether the auditor was in that "extremely rare circumstance" envisaged by ISA 705 paragraph 10:

"The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, 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."

If the auditor concludes that a disclaimer is needed then example wording can be found in Example 45 of Bulletin 2010/2.

I have discussed this Q&A with other technical experts and some are uncertain whether a multiple uncertainty disclaimer should be used when faced with a material uncertainty relating to going concern.

I quote the second objective of the auditor under ISA 570:

"To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern".

It is usually the case that where there are doubts about the company's ability to continue as a going concern, these doubts are cast by "events or conditions" in the plural. The question the auditor needs to answer is whether there are indeed multiple uncertainties or whether there is a single material uncertainty related to (multiple) events or conditions.

For example, take the write down of the property portfolio. This is an event which has left the company with depleted equity but it does not seem, of itself, to be an uncertainty.

The questioner does not mention how the claim against the company has been accounted for. If a provision has been made for the best estimate of the expected loss then the accounts already include the worst outcome. Any uncertainty can only be positive. Alternatively, if the accounts disclose a contingent liability (on the grounds that the company expects to win the case) then no provision has been made and an uncertainty exists.

Again the financial position of the company will be better than the position shown in the financial statements if the mis-selling claim goes in the company's favour.

So, our conclusion is that there may be circumstances where a disclaimer on the grounds of multiple uncertainties is appropriate but this route should be approached with caution. In many cases, there will be multiple conditions with only one material uncertainty. In this case, emphasis of matter is the correct route.

At the end of his answer, John declined to make the decision for the questioner ending with the words "Ultimately, the opinion that you reach and the report you give will be based upon your judgment of the situation." I can't say better than that.

Q. In my opinion, there is a material uncertainty which may cast significant doubt about the company's ability to continue as a going concern. (Details from original question omitted).

The directors refuse to make what I consider to be the necessary disclosures in their financial statements. When I pushed the matter, the directors became aggressive and told me that they will prepare their accounts how they want.

A. This question has been covered in the notes above. If the directors refuse to make the appropriate disclosures then the auditor will modify the opinion on the financial statements on the grounds of disagreement see Examples 38 and 43 of Bulletin 2010/2 referred to above.

The reason I have included this FAQ is to draw your attention to the rest of John's reply. He comments that the directors' attitude is not uncommon in these situations and their intimidation may threaten the auditor's independence. A safeguard such as a second partner review is essential.

The directors, faced with the possibility of a modified opinion, may remove the auditor from office before the completion of the auditor's term of office. They should be warned that, in this case, the auditor will mention the circumstances in the statement required by CA 2006 S 519 and in the notice to the appropriate audit authority required by S522. The auditor might also inform the directors of the duty of the company to notify the appropriate audit authority under S523.

IMPROVING THE QUALITY OF YOUR AUDITS

(LECTURE A386 – 22.25 MINUTES)

The April edition of Audit & Beyond contained an article providing hints on how auditors might improve the quality of their audits. This article was entitled "Good, Better, Best" and was written by Michael Scott from PCP.

Starting with Michael's list of areas that may repay attention, I have adapted his comments and included my own ideas and extensions. Readers of these notes are encouraged to read Michael's article since the notes below bear little resemblance to the original.

Engagement letters

These must be up to date and accurately reflect the services being provided. A copy of the letter signed by one of the directors of the company should be on file.

How does your firm handle the required communications at the planning stage? If you use an audit arrangements letter then it would be natural to attach **every year** a revised engagement letter.

The engagement letter is your friend. Without it, or if it is not up to date, you are taking a great risk.

Understanding the business

The permanent file should contain sufficient background information on the client to satisfy ISA 315. The only way to know for certain what is required is to use ISA 315 as your aide memoire. For example, it is often said that you must consider the nature and history of the business but ISA 315 does not actually say this.

Paragraph 11(b) requires the auditor to obtain an understanding of the nature of the entity, including:

- its operations;
- its ownership and governance structures;
- the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
- the way that the entity is structured and how it is financed

Why is this understanding required? Paragraph 11(b) continues – "to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements."

There is nothing here about writing up a history of the client – however interesting that may be.

Paragraph 18 of Practice Note 26 has a different take on the same subject:

'To comply with the ISAs (UK and Ireland), it is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor has based the assessment of the risks of material misstatement in the financial statements.'

I know that it is tempting to bring forward last year's notes about the business and add to them rather than subtract. The problem is that superfluous material soaks up audit time as the new senior tries to get to grips with the forest of information provided. Further, while we are on the subject of forests, superfluous information may mean that you cannot see the wood for the trees.

Laws and regulations

ISA 250A identifies two sorts of laws and regulations in which the auditor is interested. Firstly, there are those which 'have a direct effect on the determination of material amounts and disclosures in the financial statements.' These laws and regulations include such matters as disclosure requirements and the measurement and recognition requirements of accounting standards. This first sort of laws and regulations is generally dealt with effectively by auditors.

The second sort of laws and regulations are those that 'do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties'. The auditor's second objective stated in ISA 250A is:

'To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements.'

When obtaining the auditor's general understanding of the legal and regulatory framework (as required by paragraph 12 of ISA 250A), it seems logical to me that the notes on the auditor's files should be restricted to those laws and regulations which may have a material effect on the financial statements.

Paragraph 14 of ISA 250A requires the auditor to perform particular procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. These procedures are:

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

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

Finally, the auditor is required to remain alert during the audit to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

Assessment of accounting systems and policies

ISA 315 regards the accounting system as just one of five elements in the entire system of internal control. We cover the subject of internal control in the next section of these notes.

The accounting system merits a separate heading here because of its interaction with the subject of accounting policies. Paragraph 11(c) of ISA 315 requires the auditor to obtain an understanding of the entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor is also required to evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

In my view, this means that the notes on file concerning accounting policies should include a comparison with other similar entities.

But how does this interact with the accounting system? One of the fundamental issues for many clients is the policy for recognition of revenue. This should be clearly documented as part of the notes detailing the accounting system for income. Whilst revenue recognition is the usual area of difficulty, there may also be other areas where the policy needs to be spelled out.

As an example of this, it is now quite common for goods to be despatched directly from suppliers in countries such as India or Sri Lanka to customers anywhere in the world. When should purchases and revenue be recognised by the seller based in the UK?

Internal controls

The accounting system should be documented “from cradle to grave”. Within this documentation, it is easy to highlight the existence of control activities.

Paragraph 13 of ISA 315 requires the auditor to evaluate the design of the controls relevant to the audit and determine whether they have been implemented. Recall that ISA 315 includes the accounting system and the control activities within the heading of internal control.

Paragraph 13 goes on to say that the evaluation of the design and implementation of controls requires the auditor to perform procedures in addition to inquiry of the entity's personnel. The best way to satisfy this requirement is usually to perform a walk-through test which will confirm that the accounting system and the control activities are operating properly in accordance with the notes on the auditor’s file.

Independence

Firms frequently use audit documentation which leads them to identify threats to their independence. In this case, the audit documentation will usually take the auditor to the next step which is to identify appropriate safeguards to mitigate the threats to an acceptable level.

Unfortunately, many firms fail to implement the safeguards (particularly second partner or external hot review) or notify the client, as required.

Materiality

Michael Scott's article made the brief comment 'ISA 320 now requires performance materiality to be considered. So it is important to appreciate why, and to link the concept to the audit sample selection process'.

I agree that this is important and it reminded me of an earlier article in Audit & Beyond written by David Gallagher and published in November 2011. This article contains a lot of useful and interesting information and I consider some of that information here.

Some auditors liken the term "performance materiality" to the term "working materiality". This indicates the use of performance materiality at the planning stage in determining when no work is necessary in an audit area or, alternatively, where audit evidence is required, the extent of that evidence. Similarly, at the planning stage, performance/working materiality is used in the selection of items for testing.

Other auditors have swapped their old term "tolerable error" and replaced it with the new term "performance materiality. Tolerable error highlights the use of performance materiality in evaluating the results of audit work.

I am going to concentrate on the setting of performance materiality and its use in the selection of items for testing.

David's article is underpinned by a fundamental assumption that performance materiality depends on risk. I am not convinced that this assumption is correct and, in fact, I think that the assumption may lead to overauditing.

He gives an example of two identical companies in size, industry, customers etc. Overall materiality should be the same for each company. He goes on to suggest that Company A has extremely good accounting systems and controls whereas Company B does not. As such, the audit firm has always found several misstatements during the course of their audit of Company B. David concludes that 'performance materiality will be lower (and hence more evidence will be needed) on the audit of Company B'.

I have placed this last part in quote marks to indicate that it is reproduced exactly from the article. I agree, absolutely that more evidence is needed in auditing Company B but I do not agree that the way to achieve this is by a lower performance materiality. For me, the reason that a different quantity of work is required is because of the risk assessment.

Most audit systems set sample sizes based on a combination of risk and materiality. In assessing risk in an audit area, it is usual to consider both overall risks and assertion based risks. Risk is then represented by a number which is incorporated into the sample size formula. If the materiality factor also takes account of risk (as the article suggests) then risk is double counted and sample sizes can be too high. Consider the following example where the auditor determines the required quantity of audit evidence by first selecting all items over performance materiality and then setting a sample size for the residual population (i.e. that which remains after the removal of the items above performance materiality) based on the formulae:

(Residual population value/Performance Materiality) * Risk factor

Performance materiality = Materiality/Risk factor

Example: The auditor is testing debtors. Materiality is £100,000. What testing will be performed if: a) there is a (low) risk factor of 1.2 or b) there is a (high) risk factor of 2.5.

In situation a) Performance materiality = £100,000/1.2 = £83,333

In situation b) Performance materiality = £100,000/2.5 = £40,000

Suppose the population can be stratified as follows:

Balances	Number of balances	Total value of balances
Over £83k	3	440,000
£40k - £83k	8	480,000
Under £40k	89	680,000
Total	100	1,600,000

We can then calculate sample sizes as follows:

	Situation (a)		Situation (b)	
	Number	*Value*	*Number*	*Value*
High value items	3	440,000	11	920,000
Residual population	97	1,160,000	89	680,000
Sample size for residual population	1,160,000* 1.2/83,333 = 17		680,000*2.5/40,000 = 43	
Total number of items examined	3 + 17 = 20		11 + 43 = 54	

It is interesting to observe that, whilst the PCAS audit system calculates performance materiality as above, it avoids the problem of double counting by using the formula for sample size in the residual population of:

(Residual population value/Materiality) * Risk factor

That is, the denominator is materiality not performance materiality.

This would change the sample sizes above to:

Sample size for residual population	1,160,000* 1.2/100,000 = 14	680,000*2.5/100,000 = 17
Total number of items examined	3 + 14 = 17	11 + 17 = 28

Notice that, in the PCAS approach, there is relatively little difference between the size of the random samples. However, in the case of the higher risk population, more evidence is being sought from the testing of higher value items. For those of you who like to measure the success of your audit tests by coverage, PCAS will usually achieve greater coverage in higher risk situations.

To my mind, this is a perfectly adequate way to deal with performance materiality without falling into the trap of double counting the effect of risk.

But let us go back to the original assumption and ask "should performance materiality be dependent on risk?"

ISA 320 helps us in two ways. First, the definition:

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

Then we have paragraph A12 of the Application Material:

'Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole.'

Based on this part of A12, my preference is to regard performance materiality as a way of achieving a "margin of safety". This recognises that sampling is an inaccurate process and builds in a bit of "slack". I do not believe that the level of slack need necessarily be higher in a higher risk situation since we have already compensated for the extra risk by the use of our risk factor.

Returning to A12, the paragraph ends with:

'The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.'

Does this mean that performance materiality must take account of risk? If this paragraph is demanding that then I would suggest that it may be saying that the calculation of performance materiality in any audit area should depend on the overall risk assessment not the individual area risk assessment. The amount would only vary from area to area if there were individual area materialities. It would not vary because of individual area risk assessments.

So what conclusion can we reach? Firstly, you need to make sure that you set and use performance materiality in your audits. Secondly, you need to make sure that you are not overauditing by double counting risk.

Going concern

The original article states that ISA 570 requires the auditor to provide positive confirmation in the working papers that the company is likely to continue as a going concern for the foreseeable future. In my view, this is not quite correct. I may be accused of pedantry but I think it is important to be very careful with our use of words when dealing with the subject of going concern.

The article is suggesting that auditors record on file their view as to the continuance of the entity as a going concern. This is not what ISA 570 requires.

The objectives of the auditor in paragraph 9 of ISA 570 are:

(a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To determine the implications for the auditor's report.

The auditor is not required to form a conclusion on whether the entity is a going concern. Part (a) of the objectives above make it clear that the auditor must obtain sufficient appropriate audit evidence about the appropriateness of **management's** use of the going concern **assumption**.

The going concern assumption is a default position adopted by management until it becomes clear that this is no longer appropriate. Paragraph 21 of FRS 18 says

An entity should prepare its financial statements on a going concern basis, unless

- the entity is being liquidated or has ceased trading, or
- the directors either intend to liquidate the entity or to cease trading, or have no realistic alternative but to do so,

in which circumstances the entity should prepare its financial statements on a basis other than that of a going concern.

It is therefore appropriate for management to continue to use the going concern presumption until such time as they intend to liquidate the entity (or have already done so) or there is no realistic alternative but to cease trading.

For the auditor to say that it is appropriate for management to use the going concern presumption is very different from the auditor making a positive statement that the company is likely to continue as a going concern for the foreseeable future.

If we, who are professional auditors, are confused about what we can and can't conclude then there is no wonder that users of the accounts do not understand what we are saying.

The final comment on this first objective of the auditor comes from paragraph 7 of ISA 570:

'....the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.'

Most of ISA 570 is directed at the second objective above. At the risk assessment stage of the audit, the auditor is required by paragraph 10 to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. During the audit, the auditor remains alert for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (per paragraph 11).

Paragraphs 12 to 15 are concerned with the auditor's evaluation of management's assessment of the entity's ability to continue as a going concern. The auditor ensures that:

- management's assessment covers a period of at least 12 months from the date of approval of the financial statements; and

- it takes into account all relevant information of which the auditor is aware as a result of the audit.

In addition, the auditor inquires of management as to its knowledge of events or conditions beyond the period of their assessment that may cast significant doubt on the entity's ability to continue as a going concern.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, paragraph 16 of ISA 570 requires the

auditor to obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors.

So the purpose of identifying the "events or conditions" is merely to lead the auditor to consider whether there might be a material uncertainty. This is the second objective above.

Note that it is only at this stage that the auditor will perform procedures such as the evaluation of management plans, the detailed analysis of the cash flow forecast and the request for management representations.

The purpose of this step is to establish whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for the financial statements to give a true and fair view.

If a material uncertainty does exist then paragraph 18 requires the auditor to determine whether the financial statements:

- adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

- disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

Note that this second bullet point requires disclosure in the financial statements that goes beyond the requirements of FRS 18.

Turning to the third objective of determining the implications for the auditor's report, this topic has been covered earlier in these notes.

Fraud and error

ISA 240 requires the auditor to document conversations with management and those charged with governance. Who did you talk to, when and what was said? Remember to document your response to the presumed significant risks of revenue recognition

and the risk of management override. Don't forget to keep a meaningful record of discussions at staff briefings.

Risk and key areas

Risk assessment is not a matter of ticking boxes in checklists. Risk assessment requires the exercise of professional judgment. Significant risks should be identified as should other key areas. A response to risk should be documented and adequately addressed in the subsequent work. Audit programmes should be prepared or standard programmes tailored so as to achieve an appropriate response to risk. Additional tests may need to be devised

Audit evidence

Documentation

Paragraph 8 of ISA 230 requires the auditor to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the extent and the results of procedures, the significant matters arising, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

This is the benchmark for audit documentation. It is not a matter of whether you or your colleagues understand it; put yourself in the shoes of the unconnected experienced reviewer.

Substantive tests should indicate the purpose of the test; how any sample or selection of items was chosen; which direction the test was performed in; and the results. Compile a summary and evaluation of the work and a conclusion showing that the audit evidence obtained was sufficient and appropriate.

Analytical review

Substantive analytical review requires considerably more than comparing this year's figures with last year's figures. Recall the requirements of paragraph 5 of ISA 520 in particular the need to:

- evaluate the reliability of data used in the analytical procedure

- develop an expectation of recorded amounts or ratios

- evaluate whether the expectation is sufficiently precise for the purpose

- determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

If substantive analytical review is not going to provide you with reliable evidence in a cost-effective manner then don't do it!

Fixed assets

Ensure that tests include both additions in the year and items brought forward from previous years.

Give consideration to potential impairment of property values.

Stock

If material stock is held the count should be attended, unless this is impracticable. ISA 501 contains compulsory requirements which should be complied with.

Work in progress

This is not a matter of attaching photocopies to the file. Record the work performed to support the valuation of work in progress. Remember that, in almost all cases, work in progress will need to be audited for both under and overstatement.

Debtors

There are essentially two elements – cut-off and recoverability. Obtain evidence to support both.

Select samples so as to properly cover the population including both major debtors and a sample of smaller balances.

Creditors

Audit completeness of trade creditors by performing supplier statement reconciliations, post year-end review of invoices and payments, cut-off work and a review of debit balances. Remember that agreeing year-end creditor balances to

their subsequent payment supports only the existence of the balance and not necessarily its completeness.

Profit and loss

The emphasis will usually be on completeness of income. Ideally, tests should start from a point in the transactions cycle before the invoice is raised since testing from the invoice itself will not usually provide sufficient evidence of completeness.

When cash income is involved, perform till roll reconciliations.

When testing expenditure, do not perform irrelevant tests that add nothing to the file.

Representation letter

This is usually dated on the same date as the accounts are approved by the directors. In every case, make sure that the representation letter is dated before the date of the auditor’s report.

Make sure it covers all of the “standard” matters plus any additional representations required in the particular circumstances of the case.

Disclosure review

A review should try to ensure that the accounts comply with current legislation and professional standards. It is advisable to use a disclosure checklist for this purpose.

Audit management

The engagement partner should perform an adequate review of the work performed and this should be evidenced on file. Review points should be raised and cleared. There is no requirement to keep these points on file after clearance and indeed it is usually recommended that they should be destroyed.

Subsequent events review

This is not a matter of ticking boxes in checklists Record exactly what work has been performed. Try to avoid a gap between the date the work was performed and the date of the auditor’s report. If there is a gap, then record on file the further work that has been performed.

SUMMARY OF DEVELOPMENTS

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

Accounting Standards Board (ASB)

Urgent Issues Task Force (UITF)

Financial Reporting Review Panel (FRRP)

Auditing Practices Board (APB)

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

FRC publishes paper on its 'comply or explain' approach to Corporate Governance

The Financial Reporting Council has taken steps to promote a better understanding of explanations under its 'comply or explain' approach to corporate governance in a paper published today.

The paper, which is based on discussions between senior company and investor representatives facilitated for the FRC by the London Business School, notes a very high level of compliance with the UK Corporate Governance Code. It says that a large majority of companies who do not comply with one or more provisions of the Code provide a full explanation of their reasons. However, a minority do not and the paper is intended to help address this by setting out clearly what practitioners expect.

Key elements of an explanation identified in the discussion are that it should;

- set out the background,
- provide a clear rationale which is specific to the company,
- indicate whether the deviation from the Code’s provisions is limited in time,

- state what alternative measures the company is taking to deliver on the principles set out in the Code and mitigate any additional risk.

Participants in the discussion also felt that the starting point should be an improvement in the general quality of disclosure around corporate governance and a clear articulation by each company of how its governance arrangements support its business model.

Baroness Sarah Hogg, Chairman of the FRC, commented:

“The 'comply or explain' approach to corporate governance has given us flexibility and enabled us to raise the standards of UK corporate governance over the years in ways that regulation cannot always achieve.“

“This exercise is designed to reinforce our approach at a time when Europe has shown signs of driving towards more prescriptive regulation with a consequent diminution of shareholder rights. It should also make shareholders better equipped to push for full explanations on the relatively rare occasions when these are not forthcoming.”

“We will now consider whether to incorporate the conclusions of this paper into our forthcoming consultation on revisions to the Governance Code. In the meantime we are very grateful to the London Business School for their help in facilitating the discussions and to all who participated.”

15 February 2012

APB publishes exposure draft of revisions to its reporting ISAs (UK and Ireland) 700, 705 and 706

The Auditing Practices Board (APB) of the FRC today issues a Consultation Paper proposing revisions to ISAs (UK and Ireland):

- 700 “The auditor’s report on financial statements (revised)”;
- 705 “Modifications to the opinion in the independent auditor’s report”;
- 706 “Emphasis of matter paragraphs and other matter paragraphs in the independent auditor’s report”.

The consultation period ends on 31 May 2012.

The APB's primary objective in proposing these revisions is to enable its clarified reporting ISAs (UK and Ireland) to be used by auditors in the Republic of Ireland. An earlier version of ISA (UK and Ireland) 700 currently applies in Ireland and ISAs (UK and Ireland) 705 and 706 are not in effect in Ireland. The APB is also proposing changes to ISAs (UK and Ireland) 705 and 706 to more fully align their requirements with those of ISA (UK and Ireland) 700 and with the illustrative example auditor's reports that it has previously published.

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

"The APB, on the advice of its Irish Consultative Committee, believes that the time is now right for Irish auditors to adopt the clarified reporting ISAs (UK and Ireland). The principal benefit of making this change will be to enable Irish auditor's reports to be more concise, with less boilerplate. In particular, ISA (UK and Ireland) 700 permits cross reference to a 'Statement of the Scope of an Audit' maintained on a separate web-site rather than inclusion of a description within the auditor's report".

An illustrative example of an Irish auditor's report, which follows the requirements of ISA (UK and Ireland) 700, is set out on page 17 of the Consultation Paper. The APB will issue a compendium bulletin of Irish auditor's reports at the same time as it issues final versions of the ISAs (UK and Ireland).

The proposed changes should not affect auditor's reports issued by UK auditors that follow the APB's illustrative examples in Bulletin 2010/2 (Revised).

23 February 2012

APB updates guidance for Charities Act 2011

The Auditing Practices Board (APB) of the FRC today publishes an update to Practice Note 11 (Revised): The Audit of Charities in the UK and a related update to the illustrative charity auditor reports in Bulletin 2010/2 (Revised): Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements ended on or after 15 December 2010.

These updates have primarily been made to incorporate new legislative references to the Charities Act 2011 which becomes effective on 14 March 2012. The amendments do not require any changes to audit processes and procedures and a formal consultation was not considered necessary.

In addition to changes for the Charities Act 2011, the following amendments have been made:

- The Practice Note reflects changes in respect of revised charity audit thresholds in Scotland and other legislative changes in Northern Ireland.

- The Bulletin includes amendments to:

    - Change the wording in the illustrative charity auditor reports in respect of reporting on the small company exemption from preparing a Directors' Report;

    - Reflect the issuance of the "Annotated UK Corporate Governance Code" by the Association of Financial Mutuals in the illustrative friendly society auditor reports.

A copy of the updated Practice Note may be downloaded from the publications section of the APB's web site at: http://www.frc.org.uk/apb/publications/practice.cfm and the updated Bulletin is available at: http://www.frc.org.uk/apb/publications/bulletins.cfm. Previous versions of these documents have been moved to the section of the APB web-site that contains superseded documents.

12 March 2012

The Financial Reporting Review Panel publishes revised operating procedures

The Financial Reporting Review Panel today published revised operating procedures which incorporate changes on sharing information with the Audit Inspection Unit (AIU) and on the circumstances in which the Panel may make an announcement about a company's report and accounts under review.

The Panel works for as much mutual agreement as possible with companies in seeking improvements to their financial reporting. The amendments to the operating procedures do not affect this. The Panel is pleased that a more efficient approach will be possible through greater cooperation with the AIU. It is also pleased that the revised procedures will allow more transparency about the Panel's work in specific circumstances.

Following public consultation and approval by the Department for Business ('BIS'), the key changes, as proposed in the consultation document:

- enable the Panel to share voluntary information received by the Panel with the AIU

- reserve the right of the Panel to make an announcement where, following its intervention, a company makes a significant change, whether corrective or clarificatory, to its financial or corporate reporting

- enable the Panel to release its own press announcement if the fact of a Panel enquiry has become public other than as a result of a Panel press notice.

The feedback paper on the responses to the consultation paper provides further information on the practical considerations the Panel will apply.

The reforms of the FRC's structure will necessitate amendments to operating procedures. These consequential amendments will be announced and published following approval by BIS.

The revised operating procedures apply to all cases where the Panel's initial letter is sent to the company on or after 1 April 2012.

14 March 2012

The Professional Oversight Board announces the scope of the Audit Inspection Unit's work for 2012/13

The Professional Oversight Board of the Financial Reporting Council (FRC) today publishes a description of those entities whose audits will be deemed to be "major audits" for the purposes of audit inspections in the year from 1 April 2012 to 31 March 2013. Such audits will fall within the scope of the work of its Audit Inspection Unit ("the AIU"). The AIU selects the audits it reviews from this population, using a risk-based approach.

The FRC consulted on the scope of its activities as part of its Reform Programme. Further discussions are being held with stakeholders before substantive decisions are taken. In the meantime, therefore the Board has decided that no change should be made to the scope of the AIU's work for 2012/13.

The AIU reviews the focus of its inspections annually to ensure that account is taken of risks arising from the current economic climate and other relevant developments. In 2012/13 the AIU will continue to give particular consideration to the exercise of appropriate professional scepticism by audit partners and staff in key areas of judgment. It will expect to see evidence that initiatives taken by firms to improve

performance in this area, including additional training and communications from senior management, are leading to changes in behaviour in practice.

The AIU will also continue to place emphasis on the quality of auditing in the financial sector, in particular banks and building societies, liaising as appropriate with the Financial Services Authority.

Areas of particular focus for 2012/13 will include the audit of revenue recognition, fair value measurements and disclosures, the impairment of goodwill and other intangible assets, the recoverability of deferred tax assets, going concern and related party relationships and transactions. The AIU will also continue to place emphasis on group audit considerations and the quality of reporting to Audit Committees.

John Kellas, Interim Chair of the Board, said:

"The current economic environment continues to pose challenges to auditors. At the same time, there is pressure on audit fees. The AIU will review how auditors are responding to these challenges to maintain audit quality."

21 March 2012

FRC welcomes Government statement on its reform

The FRC welcomes the Government's intention to bring forward proposals to provide it with a reformed set of statutory powers following the joint consultation on FRC reform.

Commenting on this decision, Chairman of the FRC Baroness Hogg said

"We are pleased that the Government has decided to proceed with the proposals to reform the FRC and the appointments we have announced today will help to take them forward. The reforms will simplify the FRC's over-complicated structure and enable it to mobilise all the expertise in its operating bodies to strengthen the UK voice in international debates on corporate governance and reporting."

Following the decision to bring forward proposals to reform the FRC, Business Minister Norman Lamb said,

"The FRC is already well-regarded both in the UK and internationally for the crucial role it plays in supporting high quality and transparent financial reporting. But by tightening its focus and streamlining its governance and structure, we believe the FRC can be even more effective.

"Government and the FRC reflected on all responses to the consultation and held further discussions with industry and investors on the detail of the proposals. The FRC will continue this dialogue with stakeholders as the changes are implemented."

Some aspects of the reforms do not require legislative change, in particular the FRC's intention to group its activities around Codes & Standards and Conduct. The FRC has today announced a number of senior appointments to reflect this aspect of the reforms.

(Details omitted from these notes.)

27 March 2012

APB publishes paper on professional scepticism in the audit

The Auditing Practices Board (APB) of the Financial Reporting Council (FRC) today issues a paper that sets out its views on the nature of professional scepticism and its role in auditing.

The paper builds on the APB Discussion Paper published in 2010 Auditor Scepticism: Raising the Bar and the subsequent Feedback Paper, published in March 2011, which summarised the comments received and outlined the actions that the APB, and other parts of the FRC, intended to take. The paper is designed to provoke new thinking and broaden the understanding of the need for and meaning of scepticism in the context of auditing.

A copy of the paper may be downloaded free of charge from the Publications/Other section of the APB's website (www.frc.org.uk/apb/publications/other.cfm).

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

"The critical importance of professional scepticism to audit quality is widely recognised but, as we previously found, there is a lack of consensus as to its nature and its role in the audit. This paper addresses that lack of consensus and ensures that there is a consistent understanding of the nature of professional scepticism and its role in the conduct of an audit.

I hope that this paper will be an important point of reference for auditors, companies and those who use audited financial statements and that it will be considered carefully and contribute to confidence in financial reporting."

The APB is also taking steps to promote the conclusions drawn in this paper by:

- Encouraging the auditing profession and the audit firms to consider the implications of these conclusions for their business models and culture;

- Encouraging Audit Committee members and management to recognise and act on the important contribution that they can make to support the appropriate exercise of professional scepticism in considering the key judgments involved in preparing the financial statements and in responding to the challenges raised in the audit; and

- In due course, identifying ways in which the International Standards on Auditing (ISAs) might be further developed in response to these conclusions, as part of the post Clarity ISA implementation review being conducted by the International Auditing and Assurance Standards Board (IAASB).

30 March 2012

APB announces withdrawal of various documents

The Auditing Practices Board (APB) of the FRC today announces the withdrawal of the following documents.

Practice Notes

- PN 14 “The Audit of Registered Social Landlords in the United Kingdom (Revised)” issued in March 2006 (The APB has recently formed a working party to develop a completely updated Practice Note on this subject).

- PN 27 “The Audit of Credit Unions in the United Kingdom” issued in January 2009 (This Practice Note has been superseded by PN 27 (Revised) “The Audit of Credit Unions in the United Kingdom” issued in May 2011).

Statement of Standards for Reporting Accountants

- “APB Statement of Standards for Reporting Accountants Applicable to Small (Charitable) Companies” issued in February 2009 (The legislation giving rise to this Statement has been repealed and the reports that the Standards gave rise to are no longer required)

Bulletins

- Bulletin 1997/3 “The FRSSE: Guidance for auditors”
- Bulletin 2000/3 “Departures from Statements of Recommended Practice for the Preparation of Financial Statements: Guidance for auditors”
- Bulletin 2001/1 “The Electronic Publication of Auditor’s Reports”
- Bulletin 2002/2 “The United Kingdom Directors’ Remuneration Report Regulations 2002”
- Bulletin 2002/3 “Guidance for Reporting Accountants of Stakeholder Pension Schemes in the United Kingdom”
- Bulletin 2005/3 “Guidance for Auditors on First-time Application of IFRSs in the United Kingdom”

The documents referred to in this Press Notice are retained in the Superseded Documents Section of the APB web-site http://www.frc.org.uk/apb/publications/superceded.cfm.

The Bulletins have been withdrawn because the references to auditing standards, law and regulations are outdated. However, the substantive guidance may still be useful to an auditor if used in the knowledge that the detailed references are likely to be out of date.

30 March 2012

FRC publishes Audit Inspection reports on Baker Tilly, Crowe Clark Whitehill, Mazars and PKF

The Professional Oversight Board, part of the Financial Reporting Council, has today published the findings of the Audit Inspection Unit’s inspections of the following firms:

- Baker Tilly UK Audit LLP
- Crowe Clark Whitehill LLP

- Mazars LLP
- PKF (UK) LLP

These reports include the inspection findings and key messages specific to each firm and set out the AIU's views on audit quality based on the 2011/12 inspections

These reports are available on the website at:
http://www.frc.org.uk/pob/audit/publications/.

The FRC's Annual Report on Audit Quality Inspections 2011/12 will be published in June 2012.

10 May 2012

Editor's comment: It is not my style to report on the weaknesses of individual firms. Once the summary is available, we will include relevant learning points in future update notes.