ACCOUNTING AND AUDIT UPDATE

Tolley®CPD

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UPDATE ON POSSIBLE DEVELOPMENTS (Lecture A387 – 15.12 minutes)

In the previous quarterly update notes, I included a table showing the state of play of a number of pending developments which might affect the practising accountant. I said that I would repeat this table in future update notes until the issues began 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 30th April. Final standard is expected by about the end of 2012.
Audit exemption	Proposal from BIS to exempt all small companies and some subsidiaries from audit.	SI published – applies to accounts for financial years ending on or after 1 October 2012. See below.
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.
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.	This project has been delayed. It is now expected that deliberations will continue into 2013 and possibly beyond. It is not clear how this will affect the date of implementation – originally planned to be mid 2014.
Increased thresholds for small companies	The legislative proposal referred to above suggest 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	It had been thought that the UK government would seek to accelerate this aspect of the proposed changes. However, presumably, progress in this area will now be delayed.

SI 2012 No 2301

These regulations have just been published. They apply to accounts for financial years ending on or after 1 October 2012. The SI covers four areas:

1. Small companies – will be entitled to audit exemption if they meet the general small company criteria for accounts exemptions
2. Companies which are subsidiaries of EEA parents – will be entitled to audit exemption subject to the fulfilment of a number of detailed conditions
3. Dormant subsidiaries – will be exempt from the requirement to prepare and file accounts subject to the same detailed conditions as in 2 above
4. Companies preparing accounts in accordance with International Accounting Standards – will find it easier to switch to UK GAAP

The same exemptions will also apply to LLPs from the same date.

We will consider these new regulations in detail in the next update notes but have included some case study examples in the section below.

SMALL COMPANY ELIGIBILITY (Lecture A388 – 17.53 minutes)

There have been no changes to the eligibility rules for small companies since CA 2006. However, this continues to be a problem area in practice so I am including some worked examples in our course today.

Qualifying conditions for companies and groups

For periods commencing on or after 6 April 2008, the qualifying conditions to be small are met by a company (or group) in a year if it satisfies two or more of the following requirements:

	Turnover not more than	Balance Sheet total not more than	Average Employees not more than
Company	£6.5m	£3.26m	50
Group - net	£6.5m	£3.26m	50
Group - gross	£7.8m	£3.9m	50

For a period that is a company's financial year but not in fact a year the maximum figures for turnover must be proportionately adjusted.

The balance sheet total means the aggregate of the amounts shown as assets in the company's balance sheet.

The number of employees means the average number of persons employed by the company in the year, determined as follows-

a) find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not),

b) add together the monthly totals, and

c) divide by the number of months in the financial year.

A company qualifies as small in relation to its first financial year if the qualifying conditions are met in that year.

In order to qualify as small in any financial year (other than its first) it must:

a) Meet the qualifying conditions in the current year and the previous year; or,

b) Meet the conditions in the current year and qualify as small in the previous year; or

c) Meet the conditions in the previous year and qualify as small in the previous year.

Note that, in the case of c), it does not have to satisfy the requirements in the current period.

The above is often referred to as the “years rule” and has the effect of delaying changes in size by one year. Therefore companies which fail to meet the qualifying conditions in any year, having satisfied them in previous periods continue to qualify as small in the first year that the conditions are not met. This can be beneficial for a company which is increasing in size but has a counter effect for companies going in the opposite direction.

For a group, the limits shown above are applied to the aggregate turnover and aggregate balance sheet total which are obtained by adding together the separate figures for each member of the group.

"Net" means after set-offs and other adjustments made to eliminate group transactions whereas "gross" means without those set-offs and adjustments. A company may satisfy any relevant requirement on the basis of either the net or gross figure.

A parent company qualifies as a small company in relation to a financial year only if the group headed by it qualifies as a small group.

Application of the qualifying conditions to companies

X Ltd was incorporated on 1 October 2009. The following data applies for the four financial years ending on 31 March:

	2010	2011	2012	2013
Turnover	£3.5m	£7m	£6m	£10m
Balance sheet total	£2.5m	£4m	£3m	£5m
No. of employees	40	40	55	80

<u>Did X Ltd qualify as a small company for 2010?</u>

Yes, the company satisfied two out of the three requirements and therefore satisfied the qualifying conditions to be small. Since this is the company's first financial year it qualified as small.

<u>Was the company entitled to audit exemption for 2010?</u>

No. The company qualified as small but it failed the turnover test - the financial year is only 6 months long so the turnover limit must be adjusted to £3.25m. The company was not entitled to audit exemption.

<u>Did X Ltd qualify as a small company for 2011?</u>

X Ltd satisfied only one of the three requirements in 2011. However, it still qualified to be a small company on the grounds that it met the conditions in 2010 and qualified as small in 2010 therefore it continued to qualify as a small company in 2011 under part (c) of the year's rule.

<u>Was the company entitled to audit exemption for 2011?</u>

No. The company qualified as small but it failed both the turnover and balance sheet total requirements for audit exemption.

<u>Did X Ltd qualify as a small company for 2012?</u>

Yes. The company satisfied two out of three conditions in 2012. It qualified as small in 2011. Therefore the company is still small for 2012 under part (b) of the years rule.

<u>Was the company entitled to audit exemption for 2012?</u>

Yes. The company qualified as small and met both the turnover and balance sheet total tests for audit exemption. Failure of the test for number of employees does not affect this decision.

Does X Ltd qualify as a small company for 2013?

X Ltd satisfies none of the three requirements in 2013. However, it still qualifies to be a small company on the grounds that it met the conditions in 2012 and qualified as small in 2012 therefore it continues to qualify as a small company in 2013 under part (c) of the year's rule.

Is the company entitled to audit exemption for 2013?

Yes. It is a small company and therefore it qualifies for audit exemption.

Application of the qualifying conditions to groups

Example 1

The following data applies to P group Ltd for the year ended 31 December 2011:

		net	gross
Turnover		£7m	£7m
Balance sheet total		£3m	£4m
Number of employees in group	60		

Does P Ltd satisfy the qualifying conditions to be a small group in 2011?

Yes, the P group does satisfy the qualifying conditions to be a small group. The turnover condition is satisfied on a gross basis and the balance sheet condition is satisfied on a net basis. It is acceptable to "mix and match" the net/gross limits.

Example 2

The following data applies to the Q group for the years ended 31 December 2011 and 31 December 2012. The group consists of Q Ltd (parent) and three wholly owned subsidiaries – A Ltd, B Ltd and C Ltd.

	Q Ltd	A Ltd	B Ltd	C Ltd
Turnover	£1m	£7m	£1m	£1m
Balance sheet total	£2m	£4m	£1m	£1m
Number of employees	10	40	10	10

The figures for the years 31 December 2009 and 31 December 2010 were the same as those shown above. There is no trading within the group and no balances with other members of the group.

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

B Ltd and C Ltd are small companies.

A Ltd is not since it fails two out of the three requirements. Q Ltd is also not a small company because the group it heads up is not a small group.

None of the companies are audit exempt because the group is not small.

Which of the companies qualify as a small company in 2012 and which of them qualify for audit exemption?

B Ltd and C Ltd are small companies.

A Ltd is not since it fails two out of the three requirements. Q Ltd is also not a small company because the group it heads up is not a small group.

If the directors of the companies are prepared to meet the conditions in S479A(2) of CA 2006 then A Ltd, B Ltd and C Ltd are all exempt from the requirement to have their accounts audited. The conditions are:

(a) all members of the company must agree to the exemption in respect of the financial year in question,

(b) the parent undertaking must give a guarantee under section 479C in respect of that year,

(c) the company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with—

(i) the provisions of the Seventh Directive (83/349/EEC)(d), or

(ii) international accounting standards,

(d) the parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirements of this Act relating to the audit of individual accounts by virtue of this section, and

(e) the directors of the company must deliver to the registrar on or before the date that they file the accounts for that year—

(i) a written notice of the agreement referred to in subsection (2)(a),

(ii) the statement referred to in section 479C(1),

(iii) a copy of the consolidated accounts referred to in subsection (2)(c),

(iv) a copy of the auditor’s report on those accounts, and

(v) a copy of the consolidated annual report drawn up by the parent undertaking.

ACCOUNTING FOR DEBT INSTRUMENTS WITH VARIABLE INTEREST RATES (Lecture A389 – 7.14 minutes)

In the notes issued last quarter we looked at the method for dealing with loans and other financial instruments where the interest rate was fixed throughout the period of the loan. The examples were based on the principles of FRS 4 but the point was made that the methodology would continue to be relevant in the new UK GAAP – (Draft) FRS 102. In these notes we continue to look at debt instruments but now we are moving on to consider variable interest rates.

The International Accounting Standards Board has issued Training Materials on the IFRS for SMEs and since (draft) FRS 102 is based on IFRS for SMEs, these examples are relevant to us in the UK. The examples below are based on examples 77 to 80 of the training material covering chapter 11 of the IFRS for SMEs. I have provided my own workings but I have not made any changes of principle and the final figures agree with those provided by the IASB. I acknowledge the copyright of the IFRS Foundation in the original material.

Example 1: Changing interest rate

On 1 January 2012 entity A issues a debt instrument for a price of £1,250.

The principal amount is £1,250 and the debt instrument is repayable on 31 December 2016. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6 per cent in 2012 (ie £75), 8 per cent in 2013 (ie £100), 10 per cent in 2014 (ie £125), 12 per cent in 2015 (ie £150), and 16.4 per cent in 2016 (ie £205). The entity structured the payments in this manner to manage its cash flows. If it had borrowed at a fixed rate for the five years, the market rate of interest would have been 10 per cent.

On initial recognition the loan is measured at £1,250 (net proceeds).

Cash flows are as follows:

Year	Cash flow
0	1,250
1	-75
2	-100
3	-125
4	-150
5	-1,455

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

The effective interest rate is approximately 10.013% per annum (determined using the IRR function in excel). This is consistent with the information in the question.

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× 10.013%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2012	1,250.00	125.16	75.00	1,300.16
2013	1,300.16	130.19	100.00	1,330.35
2014	1,330.35	133.21	125.00	1,338.56
2015	1,338.56	134.03	150.00	1,322.59
2016	1,322.59	132.41	1,455.00	0.00

The small rounding error has been included in the finance cost for 2016.

Example 2: Variable interest rate based on LIBOR

On 1 January 2012 a bank provides an entity with a four-year loan for £5,000 under normal market terms for that type of loan, including charging interest at a variable rate of interest specified as LIBOR plus 250 basis points (1 basis point is 1/100th of 1 per cent), with interest payable annually in arrears. On 1 January 2012 LIBOR is 1.1 per cent and on 31 December 2012 LIBOR is 1.5 per cent.

Since interest is payable at the market rate for that type of loan, the loan is recorded by the entity at the transaction price of £5,000, because the transaction price will approximate the present value of the future payments discounted at the market rate.

Since there are no transaction costs on the loan and the loan is recognised at transaction price, the effective interest rate on 1 January 2012 is 3.6 per cent (1.1 per cent plus 250 basis points).

The transaction price at which the loan is recognised is equal to the principal payable on maturity. Therefore, re-estimating the future interest payments will have no significant effect on the carrying amount of the loan (see paragraph 11.19 of (draft) FRS 102). Cash flows over the life of the loan will constantly vary as LIBOR varies. However, because interest is charged at the market rate for this type of loan, if the effective interest rate is set to LIBOR plus 250 basis points it will at any time always exactly discount estimated future cash payments over the remaining loan term to £5,000. Hence the carrying amount of the loan throughout the four years will be £5,000.

Example 3: Variable interest rate with an arrangement fee

The facts are the same as in example 2. However, in this example, the entity incurred transaction costs of £50 on setting up the loan.

For simplicity, for variable rate loans it is better to consider transaction costs separately from the interest payments when determining the effective interest rate. This avoids having a different effective interest rate from the market rate (as the effective rate will need to take into account that the £4,950 (net of £50 transaction costs) needs to accrete to £5,000). For fixed rate loans it is easier to include the transaction costs in the calculation as cash flows over the period of the loan are known.

The £50 should be amortised over the four-year period using the effective interest method as follows:

Cash flows are as follows:

Year	Cash flow
0	4,950
4	-5,000

The effective interest rate is approximately 0.252% 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× 0.252%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2012	4,950.00	12.45	0.00	4,962.45
2013	4,962.45	12.48	0.00	4,974.93
2014	4,974.93	12.52	0.00	4,987.45
2015	4,987.45	12.55	5,000.00	0.00

Example 4: Fixed rate loan with changes in expected cash flows

On 1 January 2012 a bank provides an entity with a four-year loan of £5,000 under normal market terms, including charging interest at a fixed rate of 8 per cent.

Interest is payable at the end of each year. The figure of 8 per cent is considered the market rate for similar four-year fixed-interest loans with interest paid at the end of each year (ie annually in arrears). Transaction costs of £100 are incurred on originating the loan.

On 31 December 2012 the entity decides that it would like to repay half the loan on 31 December 2013 and half on 31 December 2014, instead of the full amount on 31 December 2015. This will reduce the interest payments by £200 in 2014 and mean no interest is payable in 2015. The contract allows for early repayment at the option of the entity and so this is not a change in the terms of the loan.

Since the interest is at market rate, on 1 January 2012 the entity will have initially recorded the loan at the transaction price, less transaction costs (ie £4,900).

The following is the original calculation of cash flows at 1 January 2012:

Cash flows are as follows:

Year	Cash flow
0	4,900
1	-400
2	-400
3	-400
4	-5,400

The year 4 payment is made up of the repayment plus interest.

The effective interest rate is approximately 8.612% 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× 8.612%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2012	4,900.00	421.99	400.00	4,921.99

Following the decision to repay the loan early, we now get the following cash flows:

31 December 2013 Interest £400 + repayment £2,500 = £2,900

31 December 2014 Interest £200 + repayment £2,500 = £2,700

These need to be discounted to 1 January 2013 as follows:

Present value at 1/1/13 $= £2{,}900/1.08612 + £2{,}700/(1.08612)^2$

$= £2{,}670.05 + £2{,}288.80 = £4{,}958.85$

The balance sheet liability is adjusted to this figure by the following journal:

Dr Profit or loss expense £36.86

Cr Loan (financial liability) £36.86

To recognise the adjustment to the carrying amount of a financial liability due to changes in estimated cash flows.

The IASB do not tell us where this expense is analysed but presumably it is a finance expense.

We can now complete the calculation of the P&L and balance sheet figures for the remaining two years of the loan:

Year ending 31 December	Opening balance	P&L – finance cost (op bal× 8.612%)	Cash paid	Balance sheet liability at end of year
	£	£	£	£
2013	4,958.85	427.06	2,900.00	2,485.91
2014	2,485.91	214.09	2,700.00	0.00

ADVANCES TO DIRECTORS (Lecture A390 – 18.41 minutes)

What progress is BIS making in amending CA 2006 so that the requirements in Section 413 are more sensible? What progress is the profession making in reaching agreement on the best way to deal with this section? Since we have not considered this topic in our update notes for some time, I thought we should look again at this area

[Note that the answers to the above questions concerning progress on S413 are shown below (marked *) after the case study and FAQs.]

Case study

Janet is the sole shareholder and a director of J Ltd, a company entitled to follow the small companies regime. The following information refers to the year ended 31 December 2011:

1. On 3 March, the company makes a loan to Janet of £9,500. This is charged to her current account which had a zero balance before this transaction.
2. On 10 April, the company makes a loan of £25,000 to John, Janet's husband. John is not involved with the company in any way.
3. On 4 May, Janet finds herself short of cash and draws £2,500 from petty cash. This is debited to her current account.
4. On 30 June, the company pays a shareholder-approved dividend of £16,000. Janet's dividend is credited to her current account.
5. On 8 August, Janet again finds herself short of cash and draws another £2,500 from petty cash. This is debited to her current account.
6. On 9 September, the company delivers goods to Janet and sends her an invoice for £14,400. She pays it in full on 30 September.
7. On 8 December, Janet again finds herself short of cash and draws another £2,500 from petty cash. This is debited to her current account.
8. On 15 December the company signs a guarantee to guarantee Janet's borrowing of £70,000 from ABC Bank plc for a term of five years.
9. At 31 December, the balance on Janet's current account is £1,000.

Case study questions:

a) Which of the above transactions require approval by members?

b) Which require disclosure in the annual accounts presented to shareholders?

c) Which require disclosure in the abbreviated accounts?

d) How would the answers to questions a) and b) change if the company was a plc?

e) Draft disclosure suitable for the abbreviated accounts of J Ltd.

Comments on case study

Approval and disclosure of transactions with J Ltd

Transaction with J Ltd	**Approval**	**Disclosure in annual a/cs**	**Disclosure in abbreviated a/cs**
Loan to Janet	No since the loan is below £10,000	Yes	Yes
Loan to John	No – there is no need to obtain approval when the loan is to a connected person	Yes (under FRSSE) – if material	No – S 413 only covers loans to directors
Cash advance to Janet in May	Yes because the cumulative total of all advances to Janet now exceeds £10,000	Yes	Yes
Total dividend	Note 1	Yes – aggregate dividends require disclosure under the small company regulations	No
Dividend to Janet	Note 1	Yes (as a related party transaction under FRSSE) – if material	No
Cash advance to Janet in August	No – Janet's current account is in credit	No since Janet's current account is in credit	No
Credit transaction in September	No – since J Ltd is not a plc.	Yes	Yes
Cash advance to Janet in December	No – the amount advanced is less than £10,000	Yes	Yes
Guarantee in December	Yes	Yes	Yes

Balance on Janet's current account	N/A	No – see note 2	No – see note 2

Note 1: The details of the dividend payment indicated that the dividend was shareholder approved (often referred to as a "final" dividend). The directors could simply have declared an interim dividend without the need for shareholder approval. The act of writing a cheque to the shareholder would make the dividend legally binding. However, in this case, the dividend is to be credited to Janet's current account resulting in a credit balance. To avoid any possible uncertainty, the directors decided it was best for the shareholder to approve a written resolution to pay the dividend.

Note 2: There is no legal requirement, as such, to disclose the balance - although section 413 does require disclosure of the aggregate advances and the aggregate repayments. The balance would be disclosed under FRSSE if it was material.

Approval and disclosure of transactions with J plc

The table below shows only those transactions where the treatment would be different for J Ltd. (I have not reproduced the answers where the only difference is that the reference to FRSSE should be replaced by a reference to FRS 8.)

Transaction with J plc	**Approval**	**Disclosure in annual a/cs**
Loan to John	Yes – for a plc, it is necessary to obtain approval when the loan is to a connected person	Yes (under FRS 8) – if material
Credit transaction	No – since the total amount outstanding is £12,900 – below the threshold of £15,000.	Yes

Disclosures suitable for the abbreviated accounts

Although CA 2006 is not explicit, most technical experts consider that the abbreviated accounts of a small company should contain the disclosures required by S 413. Despite widespread acceptance that S 413 requires amendment, no changes have been made since CA 2006 came into force. The following extracts from S413 indicate the disclosures required:

(3) The details required of an advance or credit are:

(a) its amount,

(b) an indication of the interest rate,

(c) its main conditions, and

(d) any amounts repaid.

(4) The details required of a guarantee are:

(a) its main terms,

(b) the amount of the maximum liability that may be incurred by the company (or its subsidiary), and

(c) any amount paid and any liability incurred by the company (or its subsidiary) for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

(5) There must also be stated in the notes to the accounts the totals:

(a) of amounts stated under subsection (3)(a),

(b) of amounts stated under subsection (3)(d),

(c) of amounts stated under subsection (4)(b), and

(d) of amounts stated under subsection (4)(c).

These requirements of S413 result in the following disclosures for our case study:

Advances and credits granted to directors

During the year, the following advances were made to a director:

3 March	Advance	£9,500
4 May	Advance	£2,500

These advances were interest free and repayable on demand. The advances were repaid on 30 June.

8 December	Advance	£1,000

This advance was interest free and repayable on demand. The amount was still outstanding at 31 December.

During the year, the following credit transaction occurred with a director as a result of the sale of goods to the director in the normal course of business:

9 September	Credit	£14,400

This transaction was subject to the normal terms and conditions applying to all customers and the amount was payable within 30 days. This amount was paid to the company by the director on 30 September.

The total amount of advances or credits during the year was £27,400. The total amount repaid was £26,400.

Guarantees entered into by the company on behalf of its directors

On 15 December, the company entered into a guarantee on behalf of one of its directors. The purpose of the guarantee was to secure a five year term loan for that director. The company's maximum exposure under the guarantee is £70,000 for a period of five years. This was the only guarantee entered into by the company during the year and the company has not yet incurred any liability as a result of entering into this guarantee.

Note that there is no requirement under CA 2006 to disclose the name of the director to whom the advances etc, were made. However, this disclosure would be required in the annual (shareholder) accounts by FRS 8/FRSSE if material.

Note also that the wording of the act requires all advances and credits to be disclosed separately. As can be seen from the above, this could result in voluminous disclosure of very small transactions.

The ICAEW have responded to this with the following quote taken from the Factsheet: UK Regulation for Company Accounts Published by the Financial Reporting Faculty on 10 November 2010, last updated 3 March 2011:

'However, a common sense interpretation of the requirement is that it will be adequate to give summarised details such as the amounts drawn down and repaid during the period, together with the balance at the end of the year and the maximum outstanding during the period.'

If we adopted the ICAEW suggestion, the disclosure concerning advances and credits would look like this:

Advances and credits granted to directors

During the year, interest free advances were made to a director. These were repayable on demand. In addition, a credit transaction occurred with a director as a result of the sale of goods to the director in the normal course of business. This transaction was subject to the normal terms and conditions applying to all customers and the amount was payable within 30 days.

Total advances and credits during the year	£27,400
Amounts repaid	£26,400
Balance at 31 December	£1,000
The maximum amount outstanding during the period was	£12,900.

Are the ICAEW correct to suggest this common-sense approach or should we follow the letter of the law?

FAQs: Transactions with directors

Q. All amounts owed to the company by directors are cleared before the year end. Is it still necessary to disclose advances and credits granted to directors?

A. Yes. Regardless of the year-end balances, CA 2006 requires that the company must disclose the amounts advanced, an indication of the interest rate, the main conditions and amounts repaid during the year.

Q. The directors' current accounts have remained in credit during the year and therefore no advances to the directors were made. Are any disclosures required in the shareholder or abbreviated accounts?

There is no requirement under the companies act to disclose credit balances on directors' accounts. Therefore there will be no disclosure in the abbreviated accounts.

However, amounts advanced to the company by directors are related party transactions. Subject to materiality, FRS 8 and FRSSE require disclosure in the annual (shareholder) accounts of related party transactions and balances.

*Answer to earlier questions: none!

THE LOST ART OF PREPARING A CASH FLOW STATEMENT

As a file reviewer, one area of financial statements that I find particularly susceptible to errors is the cash flow statement and associated notes. The cash flow statement is often considered of secondary importance to the profit and loss account and balance sheet. However, it is a primary statement, and errors here have a nasty habit of being material.

When such errors are pointed out at file review closing meetings, the response from the practitioner is usually one of disbelief and amazement, swiftly followed by the response, "But we use accounts production software, so how has this happened?"

We all know the perils of over-reliance on accounts production software, and all software is only as good as the information given to it. One of the most common omissions from accounts is the operating lease commitments note, simply because this information has to be input manually as it is not contained within the trial balance.

Cash flow statements are especially prone to errors going unnoticed because it is quite possible for a cash flow statement to balance yet still contain errors. It is clear that there have been many benefits to the standard of accounts disclosure from the use of accounts production software, but accuracy of cash flow statements is not one of them. The majority of cash flow statements I review contain some sort of error, often material, which is a frightening statistic given that only entities that do not qualify as small companies are required to prepare a cash flow statement.

In my experience, accountants tend to ensure that the cash flow balances, but do not perform any further checks on the figures. I cannot recall a single audit file I have reviewed in recent years where the cash flow statement has been audited as such.

Back in the days of yore when I still worked in practice, we still prepared accounts in Word, and so the cash flow statement was usually prepared manually in Excel before the figures could be inserted. I used a fantastic spreadsheet with a number of built-in checks to try to ensure that errors were not made. However, the best lines of defence were familiarity and good old-fashioned checking, and this is something that has been lost in recent years.

So in a bid to reduce the number of errors noted in cash flow statements during file reviews, here are some of the most common errors I find:

a) Treatment of debt

Debt includes items such as invoice discounting and debt factoring borrowings. However, these balances are rarely analysed under "Bank loans and overdrafts" in the creditors note, but usually within "Other creditors". As a result, the movement on the debt becomes wrapped up in the movement in creditors figure in the operating profit reconciliation note, rather than shown separately on the face of the cash flow statement.

The potentially more serious impact is that the balance is not classified as debt within the net debt note, and therefore a misleading picture is painted of the indebtedness of the company, which may be a key focus of users of the accounts.

The same issue can arise with intercompany balances as intercompany loans and intercompany trading balances are rarely distinguished in the notes of creditors. The same comment often applies to directors' loans and indeed loans from any other parties.

b) Liquidity of "cash" balances

FRS 1 defines cash as, "cash in hand and cash deposits repayable on demand…" where a deposit is repayable on demand if the client can access it within 24 hours. Clients who are fortunate enough to have enough funds available to warrant the use of notice accounts or money market accounts tend to think of these funds as cash, whereas in fact they may not meet the definition. Again, the misleading picture painted is one of greater liquidity than is actually the case.

c) Payment of dividends

Due to the impact a few years ago of the change in accounting for dividends, well-organised clients who wish to accrue a final dividend in the year end accounts will ensure that the dividend is voted in before the year end. However, such dividends are often incorrectly shown as being paid in the cash flow statement.

d) Movements on hire purchase contracts and finance leases

Any new finance leases or hire purchase contracts taken out during the year are a non-cash movement that should be shown in the movement in net debt note, but these are often netted off the capital element of finance lease repayments on the face of the cash flow statement.

e) Fixed asset purchases

If a fixed asset has been purchased close to the year end, the purchase invoice may still be within trade creditors at the year end. This means that no cash has yet changed hands for the purchase of the asset, but the additions figure in the fixed asset note is invariably the same as the figure shown for "Payments to acquire tangible fixed assets", with the other half of the transaction lost within the year on year movement in creditors within the operating profit reconciliation note.

It is also not uncommon to see assets bought under finance leases and hire purchase contracts shown as cash additions in the year, when they should be shown as a non-cash movement on debt within the movement in net debt note.

Written by Jenny Reed and published on SWATUK website in May 2012

QUALITY ASSURANCE (Lecture A391 – 8.37 minutes)

The ACCA recently published an article highlighting the common weaknesses they find on their Quality Checked visits.

Many of the points they mention agree with our own findings from conducting practice compliance visits to both ACCA and ICAEW firms. The following is a brief list of these common weaknesses together with recommended procedures.

WEAKNESS	RECOMMENDED PROCEDURE
Planning of workload	
No forward planning or scheduling of workload leading to unnecessary time pressure, missing client expectations and increasing the risk of errors.	Have regular, preferably weekly, meetings with client service managers to review client lists and workload. Use a spreadsheet or practice management software to monitor deadlines and work progress for each client.
Client engagement	
Lack of new client procedures.	Use a new client checklist to ensure that client identity is confirmed, professional clearance is requested and received, engagement letter is sent and returned by the client and any relevant ethical matters are considered.
Acting for the client prior to obtaining the professional clearance response from the previous adviser.	Ensure that all staff and principals are aware that this should not happen.
Engagement letters that are out of date and/or do not cover all the services being provided by the firm; and Failing to monitor whether the engagement letter has been agreed by the client.	Check/review engagement letters each time work is carried out for the client. Work completion checklists used to prompt and record that this has been done. Consider having a rolling cycle of engagement letter renewals every 3 years.
Accounts preparation	
Treating a client's approval of the tax return as approval of the non-statutory accounts.	Include a client approval statement in non-statutory accounts so that a client specifically acknowledges their responsibility for the

	information they gave the firm and its completeness.
Over reliance on accounts software leading to missed or inaccurate disclosures in company accounts.	Use a disclosure checklist. For audit clients this should be done every year. For audit exempt clients use one in the first year and then every three years after that.
Failing to assess whether audit exemption can be claimed by the client.	Use a checklist on each client to assess audit exemption risk.
Tax returns	
Failing to confirm tax liabilities in writing.	Use a standard letter to be produced when each return (personal, company, payroll, CIS, VAT etc) is to be sent/given to the client for approval. Include space in the standard letter for amounts of tax due and dates of payment. Ensure that the client is provided with this even if the return is signed at a meeting.
Not informing clients that the return will be filed online.	Include this information in the standard letter above.
Not obtaining client approval for the tax return	Always obtain client approval before submitting a return. In some cases, such as VAT and CIS, prepare the firm's own approval template for the client to sign.
Management accounts, projections and income references	
Failing to include disclaimers or restrictions on use in documents that may be relied on by third parties to make decisions.	Have standard disclaimer wording available and ensure that all staff and principals are aware that it must ALWAYS be used.

Written by Daniel Hurst and published on SWATUK website in May 2012.

ENFORCEABILITY OF ENGAGEMENT LETTERS (Lecture A392 – 10.52 minutes)

Relevant regulations

Recently the professional bodies formed a collaborative working party to meet and discuss the subject of enforceability of engagement letters. In part this was prompted by two pieces of legislation that impose conditions on traders (including service providers) when contracts are formed with consumers in certain situations. The regulations in question are:

- The Cancellation of Contracts made in a Consumer's Home or Place of Work etc. Regulations 2008 ("Cancellable Contracts")
- The Consumer Protection (Distance Selling) Regulations 2000 ("Distance Selling Contracts")

Guidance has been issued by the various professional bodies and links are provided below.

What is the impact of these regulations on accountancy firms?

The regulations are designed to provide protection to consumers in contracts made in certain circumstances. Both sets of regulations define consumers in the same way – "a natural person who … is acting for purposes which can be regarded as outside his trade or profession."

Many clients will not fall within this definition. However the regulations could apply where the firm is acting for an individual in relation to their personal affairs. Typically this would include personal tax work.

Where a contract is caught by the regulations then the firm is required to provide the client with a written notice of their right to cancel.

Failure to provide the written notice may mean that the entire contract is unenforceable by the practice. This would include any limitation of liability clauses. However the client may still be able to enforce their side of the contract. In addition there are possible consequences set out in the regulations. For example, failing to comply with the Cancellable Contracts regulations is a criminal offence, bringing the possibility of a fine or imprisonment.

Contracts caught by the Cancellable Contracts regulations

The focus of these regulations is on contracts that are made:

a) During a visit by the accountant to the client's home or place of work, or the home of another individual;

b) During an excursion organised by the accountant away from his business premises; or

c) After an offer made by the client during such a visit or excursion.

Some types of contracts are excepted from the requirements and these are set out in the regulations. In most cases these exceptions would seem unlikely to apply to the usual work carried out by an accountancy firm.

Contracts caught by the Distance Selling regulations

The focus of these regulations is on distance contracts. Essentially these are contracts that are concluded with the exclusive use of any communication method that means that the accountant and the client are not simultaneously physically present.

Again some types of contracts are excepted from the requirements and these are set out in the regulations.

What is a 'contract'?

The definition of a contract is not set out in the regulations and therefore its general meaning in law applies. This is a vast area of its own and we are not able to provide guidance on this subject in these notes. However, broadly speaking, a contract comes into being when an offer is made and accepted.

Therefore a contract does not have to be made in writing. This could occur, for example, at a meeting, over the telephone or internet. It is pointed out in the professional body guidance that while the engagement letter provides evidence of the terms of the contract, it is not necessarily the contract itself.

How do I determine if the regulations apply?

We can break this down into two main steps, as follows:

1. Consider if the client falls within the definition of a consumer as set out in these regulations (note the definition above).

2. If they are, then determine where and how the contract was made to see if either of the regulations apply.

Step 1:

Remember a client is only a consumer if they are a natural person (i.e. an individual) and they are acting for purposes that would be regarded as outside their trade or profession. Where the client is a limited company, a partnership, a charity, an association, a trust and so on, it is easy to see that they are not consumers.

However a director of a limited company who instructs the firm to do his personal tax return would be considered a consumer. This is confirmed by the professional body guidance.

Less clear might be a sole trader since they are an individual and this is a situation that the professional body guidance does not specifically address. Where a sole trader employs a firm to carry out bookkeeping, payroll, annual accounts and VAT services (i.e. services for their business) they would seem to be making the contract as part of their trade or profession. So our view is that they are unlikely to be considered a consumer for the purposes of making that contract.

However if they are instructing the firm to also complete their personal tax return, does that then make them a consumer for at least the personal tax element of the contract? Our view would be yes.

Step 2:

Determining where and how the contract was made could be quite difficult depending on the circumstances. If there is any doubt or possibility that the regulations might apply then our recommendation would be to play it safe and assume that the regulations do apply. In some situations it may be advisable to seek legal advice.

Examples

An ‘official’ example …

The professional body guidance gives the example of a potential client who telephones to arrange a meeting to discuss their personal tax affairs. The guidance states that if there is a fee for the meeting then the Distance Selling regulations may apply. However if the meeting is free and the potential client is free to choose whether or not they want to instruct the firm at the meeting, then the Distance Selling regulations will not apply because no contract was made prior to the meeting.

Some other examples

Example 1: A manager from the firm visits one of the partners at ABC & Co at the client’s premises to discuss taking over the partnership accounts. During the meeting is it agreed that the firm will prepare the accounts of ABC & Co and deal with the partnership tax return. Once back at the office the manager prepares the engagement letter and sends it to the client.

Conclusion: Neither set of regulations applies because ABC & Co is not a consumer.

Example 2: A director of XYZ Ltd arranges by email a meeting with a principal because the board of directors want the firm to prepare a cashflow. The meeting is held at XYZ Ltd’s premises and is charged for. Following the meeting the principal prepares the engagement letter setting out the detailed terms and calls in at XYZ Ltd on the way home from work to deliver it. The principal sees the director again and during the ensuing conversation the director asks the principal to deal with his personal tax return. The principal accepts.

Conclusion: XYZ Ltd is not a consumer so the Distance Selling regulations do not apply to the meeting or the work to be carried out for the company. For the same reason the Cancellable Contracts regulations do not apply to the company work. However the director is a consumer in relation to his personal affairs and the contract is made at his workplace. Therefore the Cancellable Contracts regulations apply to the contract for personal tax work.

Example 3: The firm organises a drinks evening at a local hotel which includes a presentation on cash flow management and invites existing as well as prospective clients. One of the attendees discusses his personal tax affairs with one of the principals attending and asks the principal to do his tax return. The principal agrees.

Conclusion: The attendee is a consumer and makes an offer while on an ‘excursion’ organised by the firm. The Cancellable Contracts regulations therefore apply.

Actions required if the regulations apply

If the regulations apply then a written notice of their right to cancel must be provided to the client. The regulations set out what must be included in the written notice. You will not be surprised to find that the requirements differ between the 2 sets of regulations, as does the cancellation period.

For the Distance Selling regulations, the notice period depends on when the client is provided with the notice.

- If it is provided on or before the day on which the contract is concluded, then the cancellation period is 7 working days beginning with the day after the day on which the contract is concluded.
- If it is provided within 3 months of the contract being concluded, then the cancellation period is 7 working days beginning with the day after the day on which the consumer receives the information.
- If it is not provided then the cancellation period ends after 3 months plus 7 working days beginning with the day after the day on which the contract is concluded.

For the Cancellable Contracts regulations, the client has to be given a period of 7 (calendar) days starting with the date they receive the notice. In addition this notice must be given at the time the contract is made. The only exception is where the consumer makes an offer when the trader visits them at home or work, or on an excursion organised by the trader (the situation in part (c) above). In that case the consumer must be provided with the notice at the time they make the offer.

Admittedly a client making the offer may be an unlikely scenario. However if a prospective client did make an offer for the firm to do work on his personal affairs at a function organised by the firm, the firm would need to be prepared with a written notice to give immediately to the client!

Until the cancellation period expires the client can cancel the contract, and unless they have made a written request for the contract to begin in the meantime they may not be required to pay any fees for work carried out by the firm during the cancellation period.

Clearly then, it is not in the firm's interests to begin work for the client during the cancellation period. In the case of rush work it is absolutely vital that the firm obtains a written request from the client to begin earlier.

Adjustments to general procedures

The professional body guidance suggests that firms consider including a checklist in their file opening forms to establish whether a client is a consumer and whether the Cancellable Contracts or Distance Selling Contracts regulations apply.

Their guidance also includes some template forms for dealing with Distance Selling requirements and an example written notice for use where the Cancellable Contracts regulations apply.

Contracts already in place

Both sets of regulations have been in place for some years. To be fair it seems unlikely that the regulations were intended to catch professional firms. The regulations were mainly drafted to provide consumer protection against doorstep sellers and buying from telesales and the internet.

However it seems highly likely that firms will have entered into contracts that the regulations apply to without advising the client of their right to cancel, and this could cause an issue. Unfortunately the professional body guidance does not address this scenario at all, which we have to say is pretty unhelpful.

To some degree the risk is lower where a client has paid the fees (particularly where they do not pay upfront) as this indicates their acceptance and satisfaction with the contract. However where fees remain outstanding there is a potential issue. In addition where a limitation of liability clause is being relied upon for the work done, this may not be enforceable if the firm should have given notice to cancel, but did not.

Bearing in mind that the regulations relate to consumers, where it is probable that work is more likely to be lower value and risk, this may not be a particular issue. However where a firm is concerned about its exposure, whether to fees or a limitation of liability, then our recommendation is to seek legal advice.

We have reviewed guidance provided by the Law Society to solicitors on the Cancellable Contracts regulations as they do include a section on possible ways of dealing with current contracts that those regulations apply to. They point out that it is an area that is not free of doubt and that this is not likely to change until cases start to be tried in court.

One suggestion they make where fees are outstanding is to consider advising the client of their right to cancel now. Depending on the amount of fees and work done we think this action could cause a sleepless 7 days!

An alternative they suggest is to consider entering a new agreement that does meet the requirements. This would ensure the firm can enforce its terms for fees in relation to future work. However recovering fees for work already done may be difficult.

The Law Society guidance also suggests an alternative option of varying the terms of the agreement where this is a possibility and is appropriate in the circumstances. However we note that the Cancellable Contracts regulations state that "a term contained in a contract is void if, and to the extent that, it is inconsistent with a provision for the protection of the consumer contained in these Regulations." Therefore if a firm is looking to vary the terms of an ongoing agreement we would recommend seeking legal advice before doing so.

On an encouraging note, although the regulations have been around for a number of years there has been little indication that 'consumer' clients are seeking protection from their accountant through these regulations! Therefore if the firm is not heavily exposed, it may feel it best to let sleeping dogs lie so to speak and put procedures in place from now on for new clients and new work/renewals with existing clients. However if a firm has any concerns we would recommend seeking specific legal advice.

Further guidance

We recommend obtaining a copy of the full regulations, which can be found at:

Cancellable Contracts - www.legislation.gov.uk/uksi/2008/1816/contents/made

Distance Selling Contracts - www.legislation.gov.uk/uksi/2000/2334/contents/made

The guidance issued by each professional body is identical and has been approved by Leading Counsel. Copies can be obtained as follows:

ACCA: Technical Factsheet 174 - http://www2.accaglobal.com/pubs/members/publications/technical_factsheets/downloads/174.pdf

ICAEW: Technical Release TECH 02/12 - http://www.icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-312-tech-212-tax-enforceability-of-engagement-letters.ashx

CIOT and ATT - http://www.tax.org.uk/Standards/General+Guidance

<u>FLOWCHART TO HELP DETERMINE WHETHER THE CANCELLABLE CONTRACTS REGULATIONS APPLY</u>

[Step 1: *Consider whether the client is a consumer*]

Is the client “a natural person”? — No ⇒ Regulations do not apply

⇓ Yes ⇓

Are they “acting for purposes which can be regarded as outside their trade or profession”? — No ⇒ Regulations do not apply

⇓ Yes ⇓

[Step 2: *If the client is a consumer, determine where the contract was made*]

Was the contract made during a visit to the client’s home or place of work, or the home of another individual? — Yes ⇒ Cancellable Contracts regulations apply

⇓ No ⇓

Was the contract made during an excursion organised by the firm away from business premises? — Yes ⇒ Cancellable Contracts regulations apply

⇓ No ⇓

Was the contract made following an offer made by the client during such a visit or — Yes ⇒ Cancellable Contracts regulations apply excursion?

No

Cancellable Contracts regulations do not apply

<u>FLOWCHART TO HELP DETERMINE WHETHER THE DISTANCE SELLING REGULATIONS APPLY</u>

[Step 1: *Consider whether the client is a consumer*]

Is the client "a natural person"? — No → Regulations do not apply

Yes

Are they "acting for purposes which can be regarded as outside their trade or profession"? — No → Regulations do not apply

Yes

[Step 2: *If the client is a consumer, determine how the contract was made*]

Was the contract made *exclusively* by the use of distance communication (such as telephone or email) without you and the client being physically present at the same time? — Yes → Distance selling regulations apply

No

Distance selling regulations do not apply

Written by Daniel Hurst and published on SWATUK website in May 2012.

MORTGAGE REFERENCES (Lecture A393 – 10.35 Minutes)

Audit and Assurance Faculty guidance - Audit 2/01 - Requests for References on Client's Financial Status and their Ability to Service Loans

There are many organisations that may seek references from accountants regarding the financial status of clients. This might include banks, building societies, insurance companies, letting agents and others. This is an area that often causes practical problems for accountants and is something we have not covered in our update notes for a number of years. It is therefore worthwhile giving practitioners a reminder of ICAEW guidance as contained in the Technical Release Audit 2/01.

The issues addressed in the Technical Release relate to requests for reference where no special procedures are required and the response expected from the accountant is fairly general. If the request is more specific then technical release Audit 1/01 'Reporting to Third Parties' should be consulted.

The principal considerations involved

Third parties often ask for information regarding future income and expenditure and the present solvency of a client. The former is inherently uncertain and it is impossible for the accountant to make positive representations in this matter. Reporting on present solvency would require extensive procedures to be carried out and the cost of such procedures is likely to be out of proportion to the assurance being sought.

The technical release refers to the use of audited accounts to assess a client's approach to the fulfilment of past obligations but it points out that the audited accounts do not give any certainty in relation to going concern.

It is also important that auditors do not find themselves owing a duty of care in respect of their auditor's report to anyone other than the members of the client company. Generally auditors do not send audited accounts to third parties.

Returning to the question of requests for references, the accountant does not carry out any special procedures in order to provide such a reference. This should be stated clearly in the reference. Accountants should not charge additional fees for the preparation of such references. This will make it clear that no work has been undertaken to back up any assertions made in the reference. The ICAEW advice that no fee should be charged is explored further below.

If the accountant considers that particular procedures are required, then TR 2/01 is no longer the appropriate guidance. Rather, the accountant should consult Technical Release 1/01.

It should be remembered that the accountant is at liberty to refuse to provide a reference if the risks are judged to be unreasonably high. This might not be an easy answer for commercial reasons but it is an option to be borne in mind.

Meeting lender's needs for individual and other small borrowers

Lenders will usually wish to seek assurance on the potential borrower's financial status. In many cases there will be insufficient financial data to do this.

Nevertheless for individuals and other small borrowers there is likely to be information that accountants can supply that might be useful to a lender, for example:

a) The length of time during which the accountants have acted on behalf of the client.

b) The net income or profits of the clients as declared by the client to the tax authorities in the latest tax return.

c) Based on the reporting accountant's experience and having exercised judgment, a statement that the accountants have no reason to suppose the client would be likely to enter into a commitment such as that proposed that the client did not expect to be able to fulfil.

a) and b) above will often provide all the information that the lender requires. However, sometimes the lender will require the information in c) because they consider that they will receive a significant benefit from the accountant's judgment on this matter. If the accountant does not feel able to express a view, then they may and should decline to express a view due to their limited amount of experience. They may also decline to comment where there is any doubt regarding a judgment or where the client asks the accountant to give information selected and provided by the client. It should be noted that accountants are not obliged to express a view.

It should also be noted that the accountant's knowledge of the client is not always up to date and this fact should be stated in the written report.

Forms of reporting

The accountant should not be overly constrained by the lender's or third party's prescribed formats. If the prescribed formats do not reflect the considerations referred to in the statement the accountant may, if necessary, amend the wording on the report or provide explanatory wording so as to reflect the limited view they are in a position to provide.

Sometimes it may be more appropriate for the client to provide information directly to the lender if the accountant cannot add anything to that information.

Accountants should avoid the possibility of misinterpretation arising from the use of technical terms. Therefore accountants are encouraged to define the terms used such as income which could mean either net income or gross income.

In circumstances where accountants are uncertain about whether they are able to provide either the requested report or a modified version of it they should not do so.

Risk management and mortgage references

The following is adapted from an article "No fee charged - why give something for nothing?" published in Audit & Beyond, December 2011/January 2012. The article was written by Christopher Arnull who is a solicitor at KPMG and chaired the ICAEW working group on TR 02/11 'Managing the professional liability of accountants'.

Clients and others will sometimes make demands for information from accountants. For example, auditors may be asked to make their working papers available to prospective purchasers of their audit clients or to successor auditors.

Landlords or providers of finance may ask for confirmations or references from accountants before making a tenancy, or funds, available to a client. The financial standing of the client will be a key consideration for the lender, and accountants will frequently be asked to provide a reference.

The article tells us that responding to these requests can be a risky activity, especially where the accountant is expected to make statements regarding a client's future financial resources. The article went on to consider the guidance in AAF 2/01 that where an accountant does provide a reference, 'no fee should be charged'. Can it ever be right to do something for nothing? Is the ICAEW's guidance appropriate?

Charging fees for references

Recommending that a fee is not charged may seem contrary to commercial logic but declining to charge a fee is a sensible precaution to safeguard against risk. This is consistent with the approach recommended in Audit 4/03 'Access to working papers by investigating accountants' (see paragraph 46) and AAF 01/08 'Access to information by successor auditors' (see paragraph 62).

It is important to be clear about the implications of charging a fee to a lender requesting a reference (or to the client who is the subject of a reference). Where a party pays for a reference, it expects to get something in return namely the right to rely on what is provided. If a fee is charged to the lender, a duty to the lender is likely to arise. The reference may contain a denial of responsibility but, because of the fee, a court will find that the denial was not reasonable and is not enforceable.

If no fee is charged then the denial should be reasonable and enforceable. However, the accountant should beware of other actions inconsistent with the denial of any duty such as entering into discussions with the lender or providing oral assurances.

If it is not appropriate to charge a fee to the lender, then is it acceptable to charge a fee to the client? The article says that it is not appropriate to charge any client for any activity unless there is a product or service provided. In line with Tech 02/11 'Managing the professional liability of accountants', all engagement activity should be documented in an agreed engagement contract. If there is no engagement but the accountant charges a fee to the client in respect of a reference sent to a lender, a duty of care to the client will arise in respect of the reference provided. If the reference does not meet the lender's needs, then the lender might refuse to go ahead and the client might suffer loss. In this case the client might claim that the accountant owed the client a duty to provide a reference that met the lender's needs. The accountant will then be exposed.

Performing work for a reference

If substantive work is necessary in order to enable a reference to be provided then the accountant will manage risk more effectively by issuing an engagement letter. This will set out the scope of work to be performed which may take the form of agreed-upon procedures with a factual report on findings only. A fee will then be payable.

The engagement letter might also deal with the basis on which the report can be disclosed to the lender assuming the lender is not the engaging party. In this case the guidance in AAF 04/06 'Assurance engagements: management of risk' and liability should be followed. The article indicates that this would probably be unusual. More commonly the client will ask the accountant to provide a reference and to send it to the lender. Audit 2/01 recognises that the accountant might decline to provide a reference as mentioned earlier in these notes.

Charging actual costs incurred

The accountant providing a reference might incur costs in retrieving stored information or making photocopies. Is it reasonable to charge such costs?

This subject is dealt with in paragraphs 60 to 63 of AAF 01/08 'Access to information by successor auditors'. This document indicates that it may be possible to raise a charge, at the same time as denying a duty, if the charge relates to actual costs incurred in providing information. The same principles can be applied to an accountant providing a reference.

The accountant wishing to recover costs must not include a profit element or time costs. Any invoice recovering costs should make it clear that the payer is paying for actual costs incurred so that the accountant does not have to incur costs. If a 'fee' is charged that includes a time or profit element, this implies a service, a duty of care, and a right to rely and bring a claim.

In some cases, the costs actually incurred may be minimal and it may not be worth preparing an invoice. But that is a separate issue.

Caveats and denials

A reference to any third party should always contain caveats and a denial of responsibility, in line with Audit 2/01. This may not meet the needs of the lender and so the accountant might consider an engagement with the third party to perform work on matters of special interest to the lender. The engagement letter will then define the scope of the engagement and the form of the report as well as setting a fee and providing contractual protections.

Finally

The article concludes with the following advice: 'References should always be treated with caution. They can give rise to unexpected liabilities for the provider. Charging a fee for a reference increases the accountant's risk in a way that is beyond management: it leaves the accountant exposed. Providing guidance to this effect does not mean that ICAEW is not being commercial. On the contrary, such guidance demonstrates a proactive and sophisticated approach to managing risk and informs accountants of matters that might not otherwise occur to them. Accountants will have their eyes wide open to the possibility of pitfalls if they decide not to follow the guidance.'

ICAEW – Example mortgage reference

An example reference is included in the ICAEW guidance. This needs to be adapted to reflect the particular situation.

DOCUMENTATION OF GROUP AUDITS (Lecture A394 – 12.51 Minutes)

Background

In recent update notes we have concentrated on the new requirements of the revised and clarified ISA (UK and Ireland) 600 'Special considerations – audits of group financial statements (including the work of component auditors)'. No doubt we shall be looking at this subject again in the future.

However, today we are not looking at ISA 600. Instead we are considering how the auditor documents their work when auditing a group of UK companies where the components of the group are similar.

This issue was addressed by ICAEW Audit & Assurance Faculty in the Spring 2012 road shows and has been seen to be an issue on recent cold file reviews.

In the UK and in many other jurisdictions the individual members of the group require an audit in their own right, in addition to the audit of the consolidated financial statements. This means that audit evidence must be obtained to meet the relevant audit assertions for each member of the group, at entity level, as well as at group level. Therefore, the group auditor cannot merely audit the group and on the strength of that alone, express opinions on the accounts of the subsidiaries and parent.

This section looks at the practical considerations of performing and, just as importantly, documenting audit work in these circumstances.

The big question: three case studies

Can you document a group audit on one file or do you need a separate file for each opinion expressed?

The answer is rather predictably – it depends!

Note: the question is not: Can you form one single audit opinion on the group and then sign a number of audit reports for the various components of the group? The answer to this question is - No!

It is worth reminding ourselves what the Clarity ISAs require in terms of audit documentation. ISA (UK and Ireland) 230 'Audit documentation' does not have anything specific to say on group audits and so we must return to the objectives of the standard as set out in paragraph 5:

"The objective of the auditor is to prepare documentation that provides:

a) A sufficient and appropriate record of the basis for the auditor's report; and

b) Evidence that the audit was planned and performed in accordance with ISAs (UK and Ireland) and applicable legal and regulatory requirements."

The ICAEW, in the Spring AAF road show, looked at three scenarios in the form of case studies. These are summarised below.

Case Study 1 – A very large group with 1,200 identical subsidiaries.

The business was operated and managed as a single entity and there was a single system for maintaining the business systems and accounting records of the business. The financial statements of each of the subsidiaries looked virtually identical.

Producing 1,202 audit files (don't forget the holding company and group) is clearly onerous but is it necessary?

The case study made the point that there are many tasks that the auditor needs to complete (and document) only once:

- If the auditor understands the workings of one subsidiary then they understand all of the subsidiaries. Thus one permanent file (or note re knowledge of the business) will cover all of the subsidiaries. Further information may be required for the parent.

- As part of the knowledge of the business, the accounting systems and internal control activities will also be identical for all of the subsidiaries.

- A compliance test that provides evidence of the operating effectiveness of a control can be relied upon across the whole group (known as group-wide controls in ISA 600)

It is only factors which are peculiar to an individual entity or a number of entities that will need to be considered separately

Case study 2 – a non-trading holding company with twelve wholly owned trading subsidiaries

The twelve subsidiaries each run a single retail shop. The shops are identical in the way they operate and what they sell. The shops are effectively run as a single business.

Planning and completion processes and documentation might be combined for this assignment, provided that any entity specific items are addressed separately.

A particular issue that arises in this case study is how much audit evidence needs to be obtained. For example, the auditor wishes to perform a test of completeness of income. Is it appropriate to determine the sample size by looking at each entity in isolation or can a group approach be adopted? Suppose that the auditor's normal sample size formula suggests a sample size of, say, 30 per entity which results in a group sample size of 360. Some auditors might argue that this is excessive when, in essence, it is a single population that is being sampled. Can the sample sizes for the subsidiary audits be reduced on the grounds that it is the same system that is being used group-wide and systemic failings would be identified with a smaller sample?

The AAF case study suggests that sample sizes should be determined on an entity by entity basis. The auditor cannot meet an audit assertion at entity level by using a sample size based on group materiality and risk.

This answer is based on the assumption that all evidence concerning completeness of income is obtained from the substantive samples, If, on the other hand, the auditor is adopting a systems based approach then, as in case study 1, group-wide controls can be tested with a single compliance test. If this indicates that group-wide controls are operating effectively then the auditor can reduce substantive sample sizes in all companies within the group.

Case study 3 – a non-trading holding company with a single trading subsidiary.

As there is virtually nothing in the holding company the case study suggested that much of the work documenting an understanding of the entity/group might be duplicated and therefore a single file might be used in some circumstances.

Practical problems using PCAS or similar systems

If you use the PCAS audit methodology or a similar system the challenge is to use it in the ways discussed above. It is not for the faint hearted, because at all times it needs to be clear whether the documentation is covering all group companies, a select number of group companies or just one company. However, the alternative is to set up a separate file for every company being audited, which might involve so much repetition of documentation that the audit team might start to question why they are doing it!

With some careful tailoring PCAS and other similar systems can be used to audit several companies at the same time but thought will need to be given to ensuring that the audit documentation is adequate for each entity being audited. Audit teams giving extra thought to what they are documenting is always a good thing!

AUDIT MONITORING 2011 (Lecture A395 – 14.49 Minutes)

Introduction

The QAD visited 716 audit firms in 2011 and found the majority of audits to be satisfactory. They provided the following overview of results:

Visits closed without follow-up action	496	(69%)
Some further follow-up action	149	(21%)
Detailed report to Audit Registration Committee	71	(10%)
Total	716	(100%)

The notes in the report explain that a visit closed without follow-up action is a visit where the firm produces good quality audit work. If areas for improvement are identified then the QAD is confident the firm can address them easily.

Follow-up action may involve a request for further information on a firm's audit procedures. The firm may be asked to submit the results of subsequent audit compliance reviews or a plan for future training courses.

A report to the ARC may be prompted by poor audit work. Alternatively, there may be issues relating to the firm's eligibility to be a registered auditor or to the control of the audit firm. The ARC may impose conditions and restrictions on the firm's audit registration for example a requirement for external hot reviews of all audits and for the firm to submit the results. If the ARC has doubts about the firm's progress, it may ask the firm to pay for the cost of a follow-up visit. Another possibility is that the firm may be restricted from taking on new audit clients.

The ARC gives firms a chance to improve and wants them to do so, but if conditions and restrictions do not work, it may ultimately withdraw a firm's audit registration.

Returning to the introduction to the report, the QAD states that firms have invested significantly in training, have updated their procedures for clarified ISAs and, increasingly, smaller firms are engaging training organisations and other specialists to supplement their own audit compliance resources.

Nevertheless, some firms need to make significant improvements to their audit work.

Clarified ISAs

The report confirms that firms and the major training providers were well prepared for the change to clarified ISAs. Whilst many firms need to make minor improvements to comply with clarified ISAs, the QAD does not usually have any doubts over the quality of otherwise sound audit work.

The report lists the common points raised on clarified ISA audit files. This list contains no surprises for regular users of these update notes. Indeed, elsewhere in these notes, you will find an article written by Adrian Gibbons of SWATUK which includes all of the points raised by the QAD (plus plenty of others!). The QAD refer to:

- Accounting estimates: failure to identify at the planning stage; lack of review of the outcome of prior year estimates; failure to assess estimation uncertainty.
- Related parties: incomplete documentation particularly the failure to identify other businesses where trustees or directors and their close families may be involved.
- Failure to address the presumed significant risks: fraud in revenue recognition and management override of controls.
- Failure to use performance materiality to support the scope of audit procedures.

The QAD comments that, whilst the new requirements for audit of accounting estimates and related parties are significant, they generally reflect previous best practice. Firms need to have more discussion with their clients to better understand the impact of these areas on the financial statements.

Group audits

The QAD reports that there are significant group audit issues in a small number of files reviewed. Problems are often related to communication and administration of the audit rather than to technical audit issues.

The report gives a brief comment on this area but I shall not repeat that here since we have considered this topic extensively in recent update notes.

Challenging audits

It is interesting that the QAD does not provide a full list of the weaknesses identified during their visits. Most of their detailed comments are presented under this heading based on the common theme of the need for professional scepticism.

Challenging audits, they say, are those where the most important areas are not clear-cut and which involve considerable judgment. A good auditor will quickly identify these risks to their audit opinion, dealing with them through detailed audit work and robust challenge of their client. This is where professional scepticism is key. The auditor must challenge the assumptions and circumstances encountered during the audit.

Professional scepticism has always been a pre-requisite for a good auditor but recently there has been an increased emphasis on this subject as reflected in comments and publications from the Professional Oversight Board and the APB. The report from the QAD reflects the current interest in this subject by relating a number of disparate audit weaknesses back to the need for scepticism.

Auditors will respond that scepticism is part of their very being but how can it be demonstrated on the audit file? The QAD reports that they do see good examples, where firms identify and conclude on alternative views thus setting a strong framework for the audit judgments. The QAD are reassured by this evidence of challenge and scepticism.

Conversely, they report examples where the audit file suggests a lack of scepticism - unchallenged assumptions and acceptance of management judgments without consideration of alternative and possibly conflicting audit evidence.

The report goes on to list areas where professional scepticism is particularly important:

- Fraud risk: lack of thoughtful consideration at the engagement team meeting – possibly due to over-familiarity with the client; failure to document assessments; tendency to dismiss risk of management override.

- Substantive analytical review: tendency to accept explanations from management at face value without doing further work to corroborate them. Whilst on the subject of substantive analytical review, the QAD comments that this is difficult to do well; sometimes because it's not the most appropriate strategy.

- Provisions: tendency to assess as reasonable because basis is unchanged from previous periods – need to consider impact of factors such as the deterioration in the economic climate; tendency to overlook necessary provisions, for example warranties.

- Going concern: typically there is a lack of detailed management information (such as cash flow forecasts) so considerations will be broadly based. Documentation could be improved in this area although the QAD reports that they do not often think firms have reached an inappropriate conclusion when they discuss the circumstances with them.

The ICAEW and the POB have produced web-based videos on the subject of professional scepticism and other key audit issues. Go to: icaew.com/professionalscepticism

Ethical standards

The QAD reports that firms generally act in accordance with the spirit of the Ethical Standards but sometimes fail to identify or adequately safeguard potential threats to their independence. They say that firms should continue to focus on documenting their consideration of threats and safeguards in respect of non-audit work and other potential threats to independence.

Cold file reviews - the first line of defence

Finally the QAD says that cold file reviews continue to play a key role in effective self-regulation leading to improvements in audit work on a timely basis.

Under the UK audit regulations, cold file reviews are required every year. These reviews can be carried out in-house or externally, as long as they are effective.

If smaller audit firms do not have enough experienced staff to conduct independent cold file reviews then the QAD says that they should engage an external cold file reviewer at least every third year to comply with the requirements of ISQC1.

The QAD recommends that all firms consider whether external reviews would strengthen their quality control procedures. External reviews that include face-to-face discussion provide the greatest benefits to audit quality.

SIGNING THE AUDITOR'S REPORT

Audit News 51 contains a brief article on the subject of signing the auditor's report in order to comply with Sections 503 to 505 of CA 2006. The article refers to the frequency of questions on this subject despite earlier guidance in editions 44 and 45 of Audit News.

The details of the registered auditor and responsible individual that are typed into the auditor's report must be identical to those contained in the national audit registers of the UK and Ireland. These can be checked at www.auditregister.org.uk and www.cro.ie/auditors.

The responsible individual can sign freehand with their usual signature – even if this does not match the name in the register. Therefore William Smith may sign freehand as Bill Smith. The typed version of his name will be William Smith to match the register.

If Mr Smith wishes to have Bill Smith as his formal name on the register, he can email regulatory.support@icaew.com asking for the change to be made, but he needs to do this personally and not through third parties. In addition, he needs to note that this change will be reflected on ICAEW's member record so all his ICAEW correspondence will, in future, be addressed to Bill Smith.

The article goes on to consider the location of the registered auditor in the situation where the responsible individual is based in more than one office. CA 2006 is silent on the subject of location and Paragraph 25 of ISA 700 seems to leave the matter open to discretion.

However, the ICAEW warn that registered individuals can only be registered (in the audit register) in one location. Therefore, they suggest that the location on the auditor's report should be the same as the registered location of the registered individual regardless of the client location or the location of the underlying staff that may perform the work. Nevertheless, they say, the auditor does have the discretion to vary this if they consider it necessary.

PROFESSIONAL SCEPTICISM (Lecture A396 – 12.34 Minutes)

Introduction

The APB has published a paper giving its views on the nature of auditor scepticism and its role in the audit. This follows responses to their earlier Discussion Paper 'Auditor Scepticism: Raising the Bar' which suggested a lack of consensus about the nature of professional scepticism and its role in the conduct of an audit.

The APB explains that the paper draws analogies from a diverse group of areas. There are two reasons for this approach. Firstly, they believe that what is meant by scepticism needs to be more broadly understood and that drawing these analogies will assist in broadening that understanding. Secondly, they wish to stimulate and provide input to an international debate on the issue of scepticism. The APB provides the following description:

'Section 2 considers the philosophical origins of scepticism in ancient Greece and how it later influenced scepticism in the scientific method that began to flourish in the 17th Century. The relationship between scepticism and the disposition to believe or disbelieve is explored as well as the influences of evidence and behaviours on that disposition.

Section 3 seeks to provide insight into the mind-set required to develop the audit strategy and plan and to evaluate the audit evidence obtained, by demonstrating how another learning – science – has developed a sceptical approach that now commands respect.

Section 4 seeks to provide further insight into the mindset of the auditor by considering the nature of the agency relationships, and the resultant need for assurance, that gave rise to early auditing traditions in manorial households from the 14th Century.'

The above sections provide an interesting background to the subject and users of these notes are encouraged to read the full paper. However, we will not consider these sections any further but in these notes will move on to consider:

- The APB's conclusions in Section 5 as to what a sceptical audit looks like;
- Section 6, in which the APB sets out its views about the conditions that are necessary for auditors to demonstrate the appropriate degree of professional scepticism; and finally
- Section 7 setting out how the APB proposes to take these matters forward.

Conclusions about professional scepticism in the audit

The analysis provided in the APB's paper suggests that 'the appropriate application of professional scepticism in the audit requires a mindset which rigorously questions and challenges management's assertions with a degree of doubt that reflects the expectations of shareholders (and other stakeholders) for whose benefit it is performed'.

The APB concludes that an appropriately sceptical audit will include:

- A risk assessment process involving a critical appraisal of management's assertions. This will look actively for risks of material misstatement.

- A high degree of knowledge of the business and its environment. This should be sufficient for the auditor to make a fresh and independent assessment rather than through the eyes of management. The APB goes on to say that the challenges in acquiring sufficient knowledge and experience should not be underestimated, especially in relation to complex business models. They say that the traditional pyramid structure of the audit team may not always be appropriate - consideration should be given to including experienced business people on the team.

- Audit procedures designed to give active consideration to evidence that contradicts management assertions. In many cases, audits are the opposite of sceptical in that the auditor merely rationalises and documents management's assertions.

- Considered judgments based on evidence. Judgment about whether the financial statements do or do not give a true and fair view should be suspended until the auditor is satisfied that there has been sufficient inquiry and challenge and sufficient testing of management's assertions. This requires a critical appraisal of the evidence so that the auditor can judge whether it is sufficiently persuasive. Where there are plausible alternative treatments of an item in the financial statements then the auditor must be satisfied that an assessment has been made as to whether one is superior and whether sufficient disclosure of the alternatives has been given, in order to give a true and fair view.

- Documentation of audit judgments and review processes in a manner that facilitates challenge and demonstrates the rigour of that challenge.

- Documentation of audit judgments that is conclusive rather than conclusionary.

I use the APB's own words in the final bullet point and I confess that neither I nor the Concise Oxford English Dictionary (nor my spell-checker) have ever heard the word conclusionary. However, conclusionary is what we must not be in our documentation so perhaps we don't need to know what it means. Conclusive, on the other hand, means that the auditor's argument is decisive or convincing and this is a sensible objective. Returning to the APB's document, they explain that the auditor should set out not only a conclusion but also their rationale for the conclusion. This will indicate the nature of the challenges raised in the underlying work and reviews, the strength of the evidence obtained and the perspective of shareholders (and other stakeholders). The APB finishes this section by saying that the auditor needs strong skills in logical argument to do this effectively.

Fostering conditions necessary for auditors to demonstrate the appropriate degree of professional scepticism

The application of an appropriate degree of professional scepticism is a crucial skill for auditors. Auditors must be prepared to challenge management's assertions. The APB believes that the auditor should perform a sceptical audit and evidence the exercise of appropriate scepticism in the audit documentation.

The challenge for firms is to identify, develop and retain people with the necessary skills and to deploy them appropriately. Firms should nurture the conditions that allow professional scepticism to flourish. The environment in which the auditor operates should recognise and support the important role that scepticism plays in the audit.

If auditors are to demonstrate the appropriate degree of professional scepticism then individual auditors should have:

- a good understanding of the entity and its business.

- a questioning mind and a willingness to challenge management assertions.
- the ability to assess critically the information and explanations obtained in the course of their work and to corroborate them.
- an understanding of management motivations for possible misstatement of the financial statements.
- an investigative approach - not jumping to conclusions.
- an eye for inconsistency.
- the confidence to challenge management and the persistence to follow things through to a conclusion – even if predisposed to agree with management's assertion, the auditor should actively consider the alternative views and challenge management to demonstrate that they are not more appropriate.

The APB provides a similar list for engagement teams but (perhaps not surprisingly) this overlaps somewhat with the comments above concerning the individual members of the team. The conditions identified include the need for:

- experience within the team as well as good business knowledge
- information to be shared on a regular basis.
- partners and managers to be actively involved in assessing risk, planning the audit procedures and leading and participating in audit team planning meetings particularly relating to fraud and related parties. Accessibility of partners and managers is also important.
- key audit judgments and conclusions to be documented in a way that clearly demonstrates an appropriate degree of challenge to management and the exercise of professional scepticism. The reasons why the audit team concurs with management's assertions should be clearly articulated in a way that, where appropriate, discusses the appropriateness of reasonably credible alternative views and the reasons why they have not been adopted.
- face to face review by partners and managers of the audit work performed, and the adequacy of the documentation prepared, by other members of the engagement team.

It is for the audit firm to develop a culture that emphasises the importance of professional scepticism. As well as the obvious areas of coaching and training the APB mentions the need to share experiences about difficult audit judgments within the firm; the need to consult with others about difficult audit judgments; and the need to support audit partners in taking and communicating difficult audit judgments.

Scepticism, they say, should be embedded in the firm's training and competency frameworks used for evaluating and rewarding partner and staff performance. Engagement quality control reviews should challenge engagement teams' judgments and conclusions.

The final part of this section of the paper deals with the role of Audit Committees and management

Taking these matters forward

The APB says that the immediate emphasis should be on encouraging auditors and others to deliver a step change in behaviours that will achieve consistency in the manner in which professional scepticism is exercised in the conduct of their audits.

Firms should consider their business models, culture and their approach to audits and implement such changes as are necessary to respond to the challenges they identify.

The APB also concludes that it is possible for an auditor to follow the ‘letter’ of the ISAs without conducting a truly sceptical audit. Therefore these standards may need to be improved so as to be clearer about the performance, documentation and communication of professional scepticism.

WHAT THE FILE REVIEWER FOUND – SOME CURRENT ISSUES

Overview of a file review

The main aim of a cold audit file review is to assess the quality of audit work when judged against the clarity ISAs and the audit regulations. This involves many detailed requirements but, in summary the main purpose of a cold file review is to answer two questions:

- Has the audit team identified the key risks that may have an impact on the true and fair view of the accounts?
- Does the audit file have a suitable response to these key risks?

It is often the case that audit files identify risks but do not contain sufficient documentation of the response to the risks highlighted at the planning stage. The two questions above are brought into sharp focus when something goes wrong - for example if the client goes bankrupt after the year end. The risk is clear once the problem has occurred but did the audit team recognise the risk at the planning stage and if they did was the audit response robust enough to support the opinion they reached?

A cold file review asks the question 'Does the file add up and is it consistent?' If a problem is highlighted, has it been dealt with and are the conclusions on the detailed audit work in line with the main conclusion in the auditor's report? I have seen files where the audit work suggests that the accounts do not give a true and fair view but the auditor's report says that they do. Sometimes it looks as if the auditor's report was written before the audit work was carried out!

At the completion stage a reviewer is looking for evidence as to how key issues highlighted by the audit work have been dealt with. Does the file have evidence of review by the Senior Statutory Auditor (SSA) or does it look as if the file has been signed off in haste with little consideration of the notes or conclusions reached by the audit team? Has the review by the SSA acted as a quality control exercise?

Does the completion of the audit work show that safeguards recommended for independence issues have been implemented? This should include appropriate notes to show second partner review if necessary.

It is important to understand the focus of a cold file review as this should be reflected in the detailed reviews that the firm's audit team have carried out on the file.

Acceptance and independence

The acceptance procedures are important as they should incorporate the firm's money laundering procedures. The audit file should demonstrate that you have checked that the Customer Due Diligence information that has been used to generate a risk assessment of the client for money laundering purposes is still up to date. Has the client engaged in any activities that are new and may change the risk assessment that you have? Is the ID information still up to date and appropriate for the risk level of the client?

The assessment of independence risks should identify all non-audit services that are provided to the client with some commentary on the impact that these services have on your ability to act as an independent auditor. The assessment should identify who within the client's management team are considered to be informed management for the non-audit services that you provide. Some non-audit services may need special consideration for example do you provide just the tax compliance work or are you giving proactive tax planning advice? The second service may have a greater level of threat to your independence than the first.

Non-audit services such as providing the client with cash flow forecasts or budgets for the year ahead may create a higher level of self review threat if this information is also being relied on to assess going concern.

The QAD and the ACCA monitoring teams often comment on the lack of evidence of communication with the client at the planning stage. It should be remembered that the audit team must communicate independence issues and safeguards to those charged with governance. Evidence of this communication must be on the audit file.

Ongoing restrictions on the audit imposed by the client

The acceptance procedures need to highlight any ongoing restriction that the client has placed on the audit approach. The starting point at the acceptance stage is to ask the client to remove the restriction. If this is not likely then the acceptance notes should evidence that the audit team has considered alternative audit procedures to overcome the restriction placed on them by the client. If there are no alternative procedures then the acceptance notes should consider if the likely outcome of the restriction is going to be material but not pervasive or if it is going to be material and pervasive. If it is the later then the auditor should not accept the audit appointment.

Background information

It makes no difference how the background information is held (electronically or on paper) the purpose of background information is to create a risk profile for the client. ISA 315 sets out very clearly the information that we need to create a risk profile of the audit client. This information is required to be assessed as part of the audit planning and the impact that it has on your risk assessment should be clear by attaching a risk conclusion to the information.

Understanding the client's business

To create a meaningful risk profile the audit team needs to demonstrate that they have understood the client's business. The background information should set out what information has been made available to the audit team to help them understand the client's business and industry. This should include consideration of industry specific text books and websites as well as competitors to the client and any current press comment on the industry.

Systems notes

Systems notes should be 'cradle to grave' and should highlight the key control activities operated by the client. There should be a clear link between the key controls on the systems notes and the implementation checking carried out by the audit team.

The systems notes should consider areas that may be a risk as far as the audit is concerned. For example, how is a sales event recognised and does this link to the audit work for completeness of income? The current clarity ISAs also require you to update your systems notes to document controls established by management to identify related parties and ensure appropriate accounting and disclosure of related party transactions.

The systems notes should also express a conclusion on the adequacy of the systems as you have recorded them. This conclusion should highlight any weaknesses that you have identified in the systems and procedures and link to an appropriate audit response in this area.

If the implementation testing of key controls is carried out after the planning has been signed off it should be clear that the planning has been signed off subject to the implementation testing showing that key controls are operational. The audit staff should be briefed that if the implementation testing does not show that key controls are operational then the risk assessments reached at the planning stage should be reviewed.

Related parties

A lot has been said about related parties over the last few updates. It is important to ensure that your notes on related parties are reviewed and updated. The background information must have some evidence that you have communicated with the client on the issue of related parties.

Audit planning

Risk assessments

The main focus of the planning should be to review the risk profile for the audit client and identify those risks that may have an impact on the accounts. The result of the audit planning should be an audit strategy that is responsive to the risk profile that has been identified.

It should be noted that the definition of 'The risk that the accounts may contain a material misstatement' is a combination of inherent risk and control risk. The review of the systems and implementation checking of key controls should have given us an indication of those areas where the controls are weak and those areas where the controls are good. If you have weak controls within an area that has a high or medium inherent risk of an error then the overall risk is likely to be high.

If the controls over an area are good, they can only be relied on to reduce the risk assessment if you intend to carry out some form of compliance testing. The level of inherent risk for an area must be assessed ignoring the existence of any controls (try to imagine a client with no controls). If you have a specific area that has a high inherent risk but a low control risk (i.e. the controls are very good), the overall risk can only be low if you intend to compliance test the controls as these are being relied on to reduce the risk assessment. If you do not intend to compliance test the controls then the best you can get on the control risk is neutral. Thus a high inherent risk combined with a neutral control risk results in a high risk.

Specific risk areas identified by the clarity ISAs

The clarity ISAs identify the following areas of risk that must be addressed by the audit planning documentation:

- The risk of fraud in revenue recognition is a presumed significant risk. It can only be a low risk if you have an argument to rebut the presumed risk. In this case, the rebuttal must be recorded on the audit file. In the absence of a rebuttal, the presumed significant risk means that the audit file should consider what controls the client operates over this area.

- Management override of controls is a deemed significant risk on all audit files. As a minimum the audit strategy must include the following audit work:

    - Inquiry as to the existence of inappropriate or unusual activity in the processing of journals.

    - A test of journal entries made at the end of the reporting period. This review should pay particular attention to any journals that manipulate the main control accounts.

    - Consideration of the need to test journal entries throughout the period.

    - A review of all transactions outside the normal course of business.

    - A review of any other unusual transactions.

- Transactions outside the normal course of business are automatically high risk areas for the audit. This should include overdrawn directors' current accounts unless the client is a bank or a money lender.

- The risk associated with all related party transactions should be considered as these have an inherent high risk element through the nature of the transaction.

Audit strategy

The result of the audit planning should be an audit strategy. This should show clearly how the audit team are going to respond to the risk issues identified as part of the planning process. The strategy should include consideration of the approach to low risk areas as well as the approach to high risk areas. As a reviewer I should be able to tell the difference on the audit file between a low risk area and a high risk area.

There should be evidence on the planning section that the audit team have discussed the risk issues and are clear on the audit approach. The audit team should be briefed that the risk assessments are like speed limits on the audit file. A low risk area is a 70 mile an hour dual carriageway and the audit team should get quick and dirty audit evidence and move on. A high risk area is a 20 mile an hour road with speed bumps and the audit team need to slow down and ensure that they get good quality audit evidence.

Other planning issues

Materiality

The ISAs require materiality to be set on the audit file at two levels. Headline materiality (materiality for the accounts as whole) is the materiality used to make judgments about the true and fair view of the accounts. Performance materiality must also be set and is required to be lower than materiality for the accounts as a whole. How much lower is a matter of judgment for the audit team.

Performance level materiality should be used for all audit testing.

The materiality assessment should also include some notes on external interest in the figures. Are there any external parties that might be interested in a specific area of the accounts? For example an indentified external investor may be specifically interested in turnover or the bank may have a specific interest in the level of debtors. If a specific external interest is identified in part of the accounts the audit team should consider if a section specific level of materiality is needed to respond to this external interest. If a section specific materiality level is set then this should have its own (lower) performance materiality. The planning section should comment on this consideration.

Service organisations and experts

The audit strategy should consider the impact of service organisations or experts on the audit approach. A service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting. For example, if payroll is outsourced to the audit/accounting firm then the firm is a service organisation as the payroll department is maintaining part of the client's records for them. The audit plan should consider how the client controls the service organisation and what information is available for the audit team to review.

An expert can be an auditor's expert or a client expert. The expert's qualifications should be considered and the audit plan should indicate the level of reliance you intend to place on the expert. If the expert is a client expert then you should consider if there is any evidence that the scope of the expert's work has been limited by the client.

Some care is needed on this area for certain types of audits. For example a charity will often have an investment portfolio that is managed by investment managers on their behalf. If the investment managers have discretionary powers over the investments then they are acting as a service organisation. Any confirmation they may give of the investments is merely confirming the accounts records of the entity and is not very good audit evidence. The audit strategy should ensure that dividends are agreed to an external source (hence giving some confirmation of existence of the holding) and that you write to the third party custodian of the title documents to confirm that they are held on behalf of the charity.

Specific audit issues

Goodwill

Goodwill is an intangible asset and as such the audit team should consider if the asset value is still justifiable. Many audit files that I review simply have the amortisation calculation and conclude that because the maths adds up the remaining figure for goodwill is fairly stated.

The audit work should consider if there is any evidence that the goodwill may have been impaired. This should be done even if the write off period is in line with current guidance. You may be writing your goodwill off over 10 years but if in year 5 the company is experiencing losses the balance of the goodwill may be worthless.

Substantive analytical review

The audit file must have planning analytical review as a risk assessment exercise. The conclusion to planning analytical review should be risk based i.e. these movements are unexpected and hence represent a risk that will be followed up as part of the audit approach.

The audit file is required to have some evidence of final or completion analytical review as part of the process of reaching a true and fair view conclusion.

The use of analytical review as a substantive audit test is at the option of the audit team. If, as part of the audit strategy, analytical review is to be used in this way the working paper must show the following information:

- A justification that the assertions being tested are suitable for analytical review.
- Comments on the reliability of the data used for the analytical review.
- A statement of your expectations before the analytical review is carried out.
- If the analytical review movement is outside of your expectations this represents a failure of the audit test. The working paper should make clear what follow-on audit work was carried out in the circumstances of the test being a failure.

The requirement to set out analytical review used as a substantive test in this way means that it needs to be approached with some consideration at the planning stage of the audit so that the audit team understands what they are required to produce.

Going concern

This is a risk area for most clients in the current economic climate. The audit strategy should be clear on the approach. The audit team are required to assess the information considered by the directors in forming an opinion on using the going concern principle. If the directors have not considered any information or refuse to discuss the future of the business this may represent a limitation on the scope of the audit evidence available to the audit team and an appropriate modification to the auditor's report should be considered.

The audit working paper on the file should start with the phrase 'The directors have considered the following documentation.....' The audit file should then go on to consider the adequacy of the information considered and thus the justifiability of the conclusion reached by the directors to use (or not to use) the going concern principle.

The audit file should also consider if any of the information used represents a material uncertainty with regard to going concern as this will have an impact on the disclosures in the accounts and the auditor's report.

Accounting estimates

Many audit files are still ignoring the issue of accounting estimates. Nearly all accounts have accounting estimates. Depreciation (estimated useful life and estimated residual value) and bad debts are the most common accounting estimates that appear on most audit files. The information at the planning stage should identify what estimates are used in the client's accounts and indicate an audit approach. If the estimate is not material then the background information should make this point so that a reviewer can see that the estimate has been considered. If the estimate is material then the audit strategy should consider the following:

Opening estimate audit work

The opening estimate audit work is focused on how the estimate has performed against the actual experience of the business. The purpose of this is to form an opinion on the estimation process or technique that has been used. This work should be done before the closing estimate audit work as the results of the assessment may affect the approach to the audit of the closing estimate.

Example – depreciation

The opening estimate work should consider if any of the assets have been sold at a large loss or a large profit and if so, whether this indicates that the process of setting the estimated residual value of the asset should be reviewed. The audit work should also consider if the client has any assets that have been fully depreciated but are still in use as this may indicate that the process of estimating the useful economic life should be reviewed.

Example – bad debts

The opening estimate work on bad debts should consider whether the actual bad debts in the following year are matched to the bad debt provision. The conclusion should indicate if the bad debt provision has been set too pessimistically, too optimistically or about right. If the provision has been set pessimistically or optimistically then this should be taken into account when auditing the closing bad debt provision from the client. If the opening provision is about right then the audit work might be reduced on the closing provision.

Closing accounting estimates

The audit file should have suitable substantive testing for the closing estimate. As indicated above, this may be influenced by the results of the work on the opening estimate and the estimation process.

Audit completion

Evidence of review

The SSA is responsible for the overall quality of the audit work. The audit file should have sufficient evidence that the SSA has reviewed the audit file and considered the quality of the audit work carried out.

Notes on the audit file should either be cleared or removed from the audit file. Technically only those notes that relate to the exercise of professional judgment should be left on the audit file and it should be clear how that professional judgment has been exercised. These notes create a link between the detailed conclusions on the audit file and the final conclusion expressed in the auditor's report.

The review notes should have clear comments on the high risk issues identified at the planning stage. It should also be clear that the planning risk levels have been re-considered in light of the audit results to ensure that no added or unexpected risks have been identified. If they have, the audit plan should be adjusted to reflect this.

Disclosure checklists

The completion section should illustrate how disclosures have been reviewed. This might not mean a full disclosure checklist every year but perhaps sections of the disclosure checklist might be used to review risk areas.

Letters of representation

The audit file must contain the letter of representation from the client. The auditing standards state that if the directors refuse to provide a letter of representation the audit team should disclaim an opinion. The QAD and the ACCA thus consider the letter of representation to be important audit evidence - if it is not on the file they will consider the file to be a failure.

The audit team needs to be careful that they do not place too much reliance on the letter of representation. If they could reasonably expect audit evidence to be available to support an area and that evidence is not available then this cannot be remedied by a letter of representation. The audit team should consider qualifying on limitation of scope in this situation.

Conclusion

The QAD and the ACCA have recently been criticised by the Professional Oversight Board. The core of the criticism seems to be that the regulators do not do enough to ensure that firms follow up on the weaknesses that are identified from the control visits. Subsequent visits often find similar problems and weaknesses. It seems likely that in response to this the regulators will require more commitment from firms to deal with the weaknesses identified than they have done in the past and may be tougher with firms that are seen as repeat offenders.

All firms should create and track an action plan following on from any type of quality control review. This will enable them to demonstrate to the regulators that they have taken on board recommendations from cold file reviews and implemented changes within the firm.

Firms should remember that both the QAD and the ACCA take the view that a file is a 'fail' at cold review if any material area is not supported with adequate audit evidence to justify the conclusion reached in the auditor's report.

SUMMARY OF DEVELOPMENTS

APB consults on revisions to auditing standards addressing the use of internal audit

The Auditing Practices Board (APB) of the Financial Reporting Council (FRC) today issues a consultation on proposed revisions to International Standards on Auditing (ISAs) (UK and Ireland) addressing the use of internal audit to adopt changes to the corresponding ISAs issued by the International Auditing and Assurance Standards Board (IAASB).

The proposed changes are designed to:

- Enhance the auditor's risk assessment procedures for entities with an internal audit function, and
- Provide a more robust framework for evaluating and using the work of an internal audit function including in appropriate, limited, circumstances obtaining direct assistance from internal audit staff under the supervision and control of the external auditor.

A copy of the APB consultation paper may be downloaded free of charge from the Publications/Exposure Drafts and Consultations section of the APB's website (www.frc.org.uk/apb/publications/exposure.cfm).

Nick Land, a director of the FRC and chairman of the APB, said:

"In appropriate circumstances external auditors may be able to improve the efficiency or effectiveness of the audit of financial statements by using the work of an internal audit function as part of the evidence obtained. These proposals are designed to adopt changes to International Standards on Auditing that the APB has considered and believes will enhance the relevant auditing standards applied in the UK and Ireland. The APB would welcome responses not just from auditors but also other parties with an interest in the audit including audit committees and users of financial statements."

30 May 2012

Sharman panel publishes final report and recommendations

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

The Panel's key recommendations are that:-

- The primary purpose of the going concern assessment and reporting should be to reinforce responsible behaviour in the management of going concern risks; and
- The going concern considerations made by directors and reviewed by auditors should cover both solvency and liquidity and that these should be considered over the cycle, taking an appropriately prudent view of future prospects.

and that the FRC should:

- Seek to clarify and harmonise the differing definitions of going concern and related risks in accounting, auditing and governance requirements, working with the international bodies.

- Review its Guidance for Directors to ensure that the going concern assessment is integrated with business planning and risk management; focusses as appropriate on both solvency and liquidity risks (including risks to the entity's business model or capital adequacy) that could threaten the entity's survival through the cycle; and includes stress tests of liquidity and solvency.

- Integrate going concern reporting with its Effective Company Stewardship proposals, to present a fuller picture of the principal risks the entity is taking and facing in pursuit of its business model and strategy rather than only highlighting going concern risks when there are significant doubts about the entity's survival.

- Enhance the role of the auditor by seeking an explicit statement in the auditor's report about whether the auditor has anything to add to or emphasise in relation to the narrative disclosures made by the directors about the robustness of the process of assessing going concern and its outcome.

The Panel also recommended that the FRC should take a more systematic approach to learning lessons when significant companies fail or suffer significant financial or economic distress but nonetheless survive.

The Panel also looked at whether a special going concern disclosure regime is required for banks and concluded that this should not be necessary. However, the Panel considers it is critical to that conclusion that, in taking forward the recommendation to clarify and harmonise the differing definitions of going concern and related risks, the FRC should clarify that a conclusion that a bank is or would be reliant, in stressed circumstances, on access to liquidity support from central banks that is reasonably assured does not necessarily mean that the bank is not a going concern or that material uncertainty disclosures or an auditor's emphasis of matter paragraph are required.

Lord Sharman, Chairman of the Panel, said:

"Our final recommendations aim to refocus the going concern process, in light of lessons learnt from the financial crisis, so as to support better risk decision-taking, ensure that investors and other stakeholders are well-protected and informed about those risks and sustain an environment in which directors recognise, acknowledge and respond to economic and financial distress sooner rather than later."

"The aim of the directors' assessment and reporting of going concern is not primarily to inform outsiders of distress. Rather, it is to ensure that the company is managed to avoid such distress while still taking well-judged risks. That judgment must rest with the directors and our aim should be to encourage them to discharge their duties in that regard with skill and in good faith."

"In reaching our recommendations, and in keeping with the responses we have received, our primary purpose has therefore been to reinforce responsible behaviour in the management of going concern risks for companies."

"Our report addresses in some detail the special considerations for going concern reporting that flow from the unique business model of banks. A key question which we raised in our preliminary report was whether the public interest objective of financial stability should ever override the public interest objective of transparency in capital markets. We have set out in our report our vision of how these may be reconciled."

“The success of this vision depends critically on: there being adequate central bank liquidity support to address systemic crises; close dialogue between directors, auditors, supervisors and the Bank of England; directors and auditors each being able to reach their own conclusions about the bank’s ability to withstand anticipated stresses, including whether access to central bank liquidity support would be available where necessary; and acceptance that, where such support is expected to be available and relied upon, market transparency does not demand disclosure of that fact to the markets."

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

“The FRC welcomes the Panel’s report and thanks Lord Sharman and his fellow Panel members for their insights and recommendations. We will now embark on a careful consideration of the most effective way to take these forward so as to improve the quality of corporate reporting and dialogue between investors and company boards and to reinforce the effective management of going concern risks for companies. The FRC reform has been designed partly to enable us to respond positively to the Panel’s recommendation that we take a more systematic approach to learning lessons when significant companies fail."

"The final report has made significant ground in exploring the implications of the Panel’s preliminary recommendations and how these may be taken forward. In doing so, it provides much further analysis of the issues identified and this should assist the FRC in developing these recommendations in the UK and in promoting them on the international stage.”

“We will explore the matters relating to banks with the Government, the Bank of England and other stakeholders.”

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

13 June 2012

Further Update for Directors of Listed Companies in the UK

The Financial Reporting Council (FRC), the United Kingdom’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment, is publishing a further Update for Directors of Listed Companies in the UK to assist them in responding to continued economic uncertainties facing a number of countries around the world.

The Update is being published today with the aim of drawing together a number of the more significant issues directors may considers in preparing interim reports, given the heightened country and currency risk.

Commenting on the Update, Stephen Haddrill, Chief Executive of the FRC, said:

“This second Update for Directors draws attention to the importance of interim reports giving a balanced and understandable assessment of a company’s position and prospects in the current uncertain economic conditions. Directors need to focus disclosures on the strategic, operational and financial risks facing their companies and clearly identify the nature and scope of direct, and where possible indirect, exposures to currency and other current risks.”

15 June 2012

FRC to consult on executive remuneration

The Financial Reporting Council has announced that it will consult on whether to amend the UK Corporate Governance Code to address a number of issues relating to executive remuneration. The consultation will be carried out after the Government's legislation on voting and reporting on executive remuneration has been finalised.

The FRC will consult on two proposals that the Government has asked it to consider: to extend the Code's existing provisions on claw-back arrangements, and to limit the practice of executive directors sitting on the remuneration committees of other companies. It will also seek views on whether companies should engage with shareholders and report to the market in the event that they fail to obtain at least a substantial majority in support of a resolution on remuneration.

Announcing the decision to consult, FRC Chairman Baroness Hogg commented:

"The FRC will reflect on the case for changes to the Code once the legal requirements on companies are clear. We will undertake a full consultation, and there is no presumption on the FRC's part as to the outcome of that consultation. All interested parties will have an opportunity to make their views known before we reach a final decision, which will also take into account any developments in company and shareholder practice, including the use made by shareholders of their right annually to vote on the election of directors."

The FRC is currently consulting on changes to the UK Corporate Governance Code which would require FTSE 350 companies to put the external audit contract out to tender at least every ten years and encourage more meaningful reporting by audit committees. If implemented these changes would come into effect in October 2012. Any further changes following the consultation on remuneration issues would be incorporated into the next edition of the Code, which is normally updated every two years.

20 June 2012

Financial Reporting Council publishes report on 'A single figure for remuneration'

The Financial Reporting Council (FRC) has today released the Financial Reporting Lab's (Lab) project report on 'A single figure for remuneration', which was undertaken at the request of the Department of Business Innovation and Skills (BIS) in connection with their policy decisions around executive remuneration.

The Lab worked closely with a wide range of leading companies and investors in preparing the proposals contained in the project report, and the Lab is grateful to them for their contribution.

The proposals describe the components of remuneration that the investors involved in the project believe should be contained within total remuneration, as well as how these components should be measured and the related disclosure. Investors also want companies to report separately the most recent awards relating to long term incentives, including performance shares and options, which may vest in the future.

Executive Director of Codes and Standards, Melanie McLaren, said

'We are pleased at the consensus that it has been possible to achieve. It is of course up to BIS to take the final decision, but we believe that one important additional benefit of the proposals should be the simplification of remuneration disclosure, which many now consider to be overly complex. It was to address precisely this sort of issue that we created the Lab.'

21 June 2012

Decline in percentage of fee income for non-audit work for audit clients

The Professional Oversight Board (POB), part of the Financial Reporting Council (FRC), has published today the tenth edition of Key Facts and Trends in the Accountancy Profession. The information illustrates the size and shape of the accountancy profession and shows how it has evolved over recent years. It brings together information about the major audit firms and seven accountancy bodies including both those who offer audit qualifications and those who register and supervise audit firms.

The overall number of members in the UK continues to increase, though those accountancy bodies that have a substantial proportion of their membership outside the United Kingdom have shown the strongest growth in the overall number of members and students over recent years. Both total fee income and audit fee income for the largest registered audit firms show some recovery after last year's declines.

John Grewe, Director of Oversight said:

"The analysis of fee income for the major audit firms shows that the percentage of fee income from non-audit clients has been rising, from 51% in 2006 to 55% in 2011, mirrored by a decline in the percentage of fee income from non-audit work for audit clients, from 18% in 2006 to 14% in 2011."

Key Facts and Trends was first published in 2002, though its contents and presentation have developed since that date.

The tenth edition includes information up to 31 December 2011. We are anxious to encourage feedback from readers about any aspects of Key Facts and Trends where they think the publication might be changed and improved. A short questionnaire will be going out to FRC subscribers.

The Professional Oversight Board would welcome comments on Key Facts and Trends in the Accountancy Profession and would be grateful if users would complete their short questionnaire at:

https://www.surveymonkey.com/s/KeyFactsandTrends

25 June 2012