ACCOUNTING AND AUDIT UPDATE

Tolley®CPD

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UPDATE ON POSSIBLE DEVELOPMENTS (Lecture A397 – 7.29 minutes)

In previous update notes, I have 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 FRC finalised FRSs 100 and 101 recently, enabling subsidiaries and parent entities to take advantage of the reduced disclosure framework for 31 December 2012 year ends should they choose to do so. We will consider this topic in detail in our next update notes. An Exposure Draft has been issued proposing minor amendments to (draft) FRS 102. The limited scope proposed amendments relate to the accounting for multi-employer pensions and service concession arrangements, and are only likely to affect a small proportion of entities applying UK accounting standards. The FRC anticipates finalising the draft FRS in early 2013 and for it to be effective for accounting periods beginning on or after 1 January 2015.
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 EC to permit limited exemptions from the accounting requirements of the 4th and 7th Directives.	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. Some comments on this subject are provided later in these notes.
Increased thresholds for small companies	There has been speculation that there may be 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 introduce an SI to this effect during 2012. There is no progress as at today's date.

AUDIT EXEMPTION (Lectures A398 – 18.10 minutes; A399 – 16.15 minutes)

We introduced this topic briefly in last time's notes. Today I want to give it fuller attention.

Eligibility

Before looking at the new developments, let's remind ourselves of the rules on eligibility. Section 384 of CA 2006 tells us that the small companies regime does not apply to a company that is, or was at any time within the financial year to which the accounts relate

a) a public company,

b) a company that is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or carries on insurance market activity,

c) a member of an ineligible group.

A group is ineligible if any of its members is:

a) a public company,

b) a body corporate (other than a company) whose shares are admitted to trading on a regulated market in an EEA State,

c) a person (other than a small company) who has permission under Part 4 of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity,

d) a small company that is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or

e) a person who carries on insurance market activity.

The eligibility rules for audit exemption for a small company are dealt with in S478. The list of ineligible companies includes all of those listed above with the addition of:

- a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 (c. 52) or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (S.I. 1992/807 (N.I. 5)).

All of the above rules are unchanged.

Previous requirement for audit exemption

Having assessed eligibility as described above, there was then a two stage process in order to decide whether a company was audit exempt:

- Determine whether the company was small in accordance with the requirements in the Companies Act 2006;
- If small, did it satisfy the turnover and balance sheet total requirements?

In a group situation there was a requirement to apply the above to both the group and the company.

The result of the above was that there were a number of small companies that could not take advantage of audit exemption. Companies which are asset driven, for example property investment companies, often had no problem in satisfying the small requirement but with the property being shown at market value they did not satisfy the balance sheet total requirement for audit exemption.

Changes – individual companies

The second stage above has been removed. The turnover and the balance sheet total requirements have been removed for accounting periods ending on or after 1 October 2012. Therefore, from this date, if the company satisfies the conditions of section 382 to be small it will be entitled to take advantage of audit exemption.

This also applies to companies who are small on the basis of the "years rule", even though they might not be able to satisfy two out of the three conditions in the current year.

This change also applies to small LLPs.

Example showing the application of the new SI to individual 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

We considered this example in the notes for last quarter. We drew the following conclusions:

	2010	2011	2012	2013
Small company	Yes	Yes	Yes	Yes
Audit exempt	No	No	Yes	Yes

Further comment: Had the new SI applied throughout the four year period then X Ltd would have been audit exempt in all four periods.

Changes – small groups

The same principle applies to small groups. If the group qualifies as small then all members of the group that are small companies can take advantage of audit exemption.

This change also applies to small LLPs that are part of small groups.

Changes - companies that are subsidiaries of EEA parents

A new section 479A has been added to CA 2006. This applies to companies that are subsidiaries of EEA parents. Similar changes apply to LLPs.

For accounting periods ending on or after 1 October 2012, companies that are subsidiaries of EEA parents will, irrespective of size, be entitled to audit exemption subject to fulfilment of the following conditions:

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 the provisions of the Seventh Directive or 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 (a) above,

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

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

    (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.

Notes:

The balance sheet should include the statements required by S475(2) (Statement by the directors that the company is entitled to audit exemption – remember to change the section reference!) and S475(3) (Statements that the members have not required the company to obtain an audit and that the directors acknowledge their responsibilities for complying with the requirements of the Act with respect to accounting records and the preparation of accounts).

Companies House has now issued form AA06 – Statement of guarantee by a parent undertaking of a subsidiary company. This must be completed and filed with the documents listed in e) above.

If the parent's consolidated accounts and report are prepared in a language other than English or Welsh then they must be accompanied by a certified translation into English or Welsh.

Subsidiary companies excluded from audit exemption

A company is not entitled to the exemption conferred by section 479A (subsidiary companies) if it was at any time within the financial year in question:

a) a quoted company as defined in section 385(2) of CA 2006,

b) a company that is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or that carries on insurance market activity, or

c) a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 (c 52)(a) or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (S.I. 1992/807) (NI 5).

Note that a) above differs from the normal exclusions in that a subsidiary that is a plc is entitled to the subsidiary company audit exemption as long as it is not quoted.

Note also that the eligibility restrictions only apply to the subsidiary seeking audit exemption not to other members of the group. For example, the parent company may be quoted and the group may contain an FSA entity – this would not preclude another subsidiary from audit exemption under S479A.

Parent company guarantee

The guarantee to be given by the parent and delivered to the registrar by the subsidiary must be authenticated by the parent and must contain:

a) The name of the parent.

b) If the parent is incorporated in the UK, its registered number.

c) If the parent is incorporated outside the UK and registered in the country in which it is incorporated, the identity of the register on which it is registered and the number with which it is registered.

d) The name and registered number of the subsidiary in respect of which the guarantee is being given.

e) The date of the statement, and

f) The financial year to which the guarantee relates.

The guarantee has the effect that:

(a) The parent guarantees all outstanding liabilities to which the subsidiary is subject at the end of the financial year to which the guarantee relates, until they are satisfied in full, and

(b) The guarantee is enforceable against the parent by any person to whom the subsidiary is liable in respect of those liabilities.

Example showing the application of the new SI to groups

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?

We answered this question last quarter and concluded:

- 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 shown above.

FAQ: Change of accounting reference date

Q. I have a number of property company clients all of which are small. The directors wish to take advantage of audit exemption ASAP. When can they do so?

A Ltd: Year end 31 December 2012

B Ltd: Year end 30 September 2012

C Ltd: Year end 30 June 2012

D Ltd: Year end 31 March 2012

E Ltd: Year end 31 December 2011

Answer:

A Ltd: 31 December 2012

B Ltd: I assume the Accounting Reference Date (ARD) is 30 September. The financial year is permitted to be any date up to 7 days each side of that therefore they can prepare accounts for the year ended 1 October and take advantage of audit exemption.

C Ltd: Extend the ARD to any date from 1 October to 31 December (or even 30 September) and take advantage of audit exemption.

D Ltd: Extend the ARD to 30 September and then prepare accounts for the period ended 1 October. They will be audit exempt.

E Ltd: Stop wasting time! The accounts are overdue for filing. Get on and do the audit and get it filed ASAP!

SI 2012 NO 2301: OTHER MATTERS

Dormant subsidiaries

Two new sections are introduced into CA 2006 with effect for accounting periods ending on or after 1 October 2012. Under S394A, a company is exempt from the requirement to prepare individual accounts for a financial year if it is itself a subsidiary undertaking, it has been dormant throughout the whole of that year, and its parent undertaking is established under the law of an EEA State.

Similarly, under S448A, the directors of such a company are not required to deliver a copy of the company's individual accounts to the registrar in respect of that financial year.

These exemptions are subject to detailed conditions and exclusions identical to those shown above for subsidiary companies exemption from audit.

Before moving on, it is worth reminding ourselves of all other references to dormant companies in CA 2006:

- S479(3) which says that a company that is a member of a group is not excluded from audit exemption as a member of a group if, throughout the whole of the period or periods during the financial year when it was a group company, it was both a subsidiary undertaking and dormant.
- S480 which contains the conditions for dormant companies to be exempt from audit and S481 which lists companies excluded from the dormant companies exemption (see below).
- S1169 which defines the term "dormant company"

For the purposes of the Companies Acts a company is "dormant" during any period in which it has no significant accounting transaction. A "significant accounting transaction" means a transaction that is required by section 386 to be entered in the company's accounting records.

For this purpose, the following transactions are disregarded:

- any transaction arising from the taking of shares in the company by a subscriber to the memorandum as a result of an undertaking of his in connection with the formation of the company
- any transaction consisting of the payment of a fee to the registrar on a change of the company's name, a fee to the registrar on the re-registration of the company, a penalty under section 453 (penalty for failure to file accounts), or a fee to the registrar for the registration of an annual return.

Under S480, a company is exempt from the requirements of CA 2006 relating to the audit of accounts in respect of a financial year if it has been dormant since its formation, or if it has been dormant since the end of the previous financial year and the following conditions are met:

- the company is entitled to prepare accounts in accordance with the small companies regime (see sections 381 to 384), or would be so entitled but for having been a public company or a member of an ineligible group, and
- is not required to prepare group accounts for that year.

Notes:

The balance sheet should include the usual statements required by S475(2) and S475(3)

Audit exemption for dormant companies is subject to the right of members to require an audit.

S481 states that a company is not entitled to the exemption conferred by section 480 if it was at any time within the financial year in question a company that is an authorised insurance company, a banking company, an e-money issuer, an ISD investment firm or a UCITS management company, or that carries on insurance market activity. That is, a dormant plc or a dormant member of an ineligible group can still take advantage of audit exemption.

FAQ: Dormant company audit exemption

Q. For many years X Ltd was a medium sized company. During September 2011, the company was purchased by a newly formed plc and the trade was hived up to the parent. The accounts of X Ltd for the year ended 30 September 2011 showed turnover of about £10m and average number of employees as 65. The company was not struck off and the balance sheet at 30 September 2011 showed net assets (inter-company balance) of £10,000 to match the share capital of the company.

Is the company entitled to audit exemption for the year ended 30 September 2012 since it is now a dormant company?

A: X Ltd was not a small company for the year ended 30 September 2011 and did not satisfy the qualifying conditions to be a small company in that year. Therefore, the company is not a small company for the year ended 30 September 2012.

Accordingly, X Ltd is not entitled to audit exemption as a dormant company since it does not satisfy the condition in S480(2)(a). Try again next year!

Q2: What is the point of dormant company exemption? By next year, the company would qualify as small and be entitled to audit exemption as a small company. What is the benefit of claiming audit exemption as a dormant company rather than as a small company?

A: In fact, X Ltd would not qualify as a small company for the year ended 30 September 2013 because it is a member of an ineligible group on the grounds that its parent company is a plc. Therefore, small company audit exemption is not available whereas dormant company audit exemption is available. This is the point of dormant company exemption.

Q3: So, is it necessary to perform an audit for the year ended 30 September 2012?

A: There are two possible approaches which would avoid the need for an audit. The first is to prepare accounts to 1 October 2012 and claim audit exemption as a subsidiary. As indicated earlier in these notes, this exemption is subject to a number of conditions.

The alternative is to extend the company's year by six months; reduce the capital under S641 of CA 2006; pay a dividend to clear the inter-company balance; X can then be struck off before the new accounting reference date. However, since this was not done in September 2011 this may not be acceptable to the client.

FAQ: Filing of accounts for a dormant company not part of a group

Q: Companies House makes a distinction between companies that have been dormant since incorporation and companies that become dormant. Is this distinction important?

A: This distinction is not important if you are filing paper accounts. The distinction is important if you wish to file accounts using WebFiling or form AA02. These methods are only available for companies that have been dormant since incorporation. Also form AA02 is not suitable for all dormant companies - for example dormant subsidiaries cannot file a Form AA02.

In other words, the distinction is important for administrative purposes but it has no significance in CA 2006.

Change of accounting framework

As a result of this final change brought in by the SI, companies previously preparing accounts in accordance with International Accounting Standards will find it easier to switch to UK GAAP.

CA 2006 S395(3) states:

"After the first financial year in which the directors of a company prepare IAS individual accounts ("the first IAS year"), all subsequent individual accounts of the company must be prepared in accordance with international accounting standards unless there is a relevant change of circumstance.

The phrase 'a relevant change of circumstance' is defined in S395(4) as occurring when, at any time during or after the first IAS year, the company becomes a subsidiary undertaking of another undertaking that does not prepare IAS individual accounts, or the company ceases to be a company with securities admitted to trading on a regulated market in an EEA State, or a parent undertaking of the company ceases to be an undertaking with securities admitted to trading on a regulated market in an EEA State.

S395(3) is now subject to subsection (4A):

'After a financial year in which the directors of a company prepare IAS individual accounts for the company, the directors may change to preparing Companies Act individual accounts for a reason other than a relevant change of circumstance provided they have not changed to Companies Act individual accounts in the period of five years preceding the first day of that financial year.'

In calculating the five year period for the purpose of subsection (4A), no account should be taken of a change due to a relevant change of circumstance.

A similar change has occurred in S403 dealing with the applicable accounting framework for group accounts.

The importance of this change is that UK companies that had previously adopted IAS may now opt back into UK GAAP and follow the reduced disclosure framework introduced by FRS 101.

THOUGHTS ON THE FUTURE OF SMALL COMPANY UK GAAP

Introduction

This section of the notes has been submitted by one of our contributors based on his informal discussions with a number of people. It consists of his personal thoughts on the possible future of small company UK GAAP and should not be relied upon as very little of a concrete nature has come out of the FRC Accounting Council (or the ASB before it) on the future of small company accounting.

We are still waiting for a new draft FRSSE, FRS 102-lite or whatever they decide to call it (interestingly within the FRC they still refer to FRSSE when talking about the future). I expect that we will still be waiting in a few months time because the deliberations on small company accounting within the EU continue and the FRC will not do anything until they are concluded.

This section looks at the possible pitfalls for small companies. It is included in order to raise awareness among accountants of the key issues as I understand them today.

Conformity between FRS 102 and the FRSSE

FRS 102 and the FRSSE may be less alike than the FRSSE and current UK GAAP. The ASB Exposure Drafts included a list of consequential amendments needed to the FRSSE resulting from FRS 102.

Not every major change in FRS 102 is there. For example the FRSSE will still require investment property revaluations to go to reserves rather than the profit and loss account, as required by FRS 102. There are other areas of divergence such as deferred tax and employee costs.

If this is not changed, accountants will need to be more vigilant than before in ensuring that the right accounting rules are followed for the right sized company. Also, the accounting consequences of losing small company exemptions become more significant.

Convergence and change of accounting policy

When UK GAAP changes in 2015 it is still intended that the FRSSE will refer the user of FRSSE to FRS 102 when there are transactions or balances not addressed in the FRSSE. This will operate as it does now i.e. not mandatory but an indication of current practice.

If an entity already has an accounting policy in an area not covered by the FRSSE but that policy does not conform to FRS 102, it has been suggested that the non-compliant policy could be retained for as long as that entity applies the FRSSE!

First time adoption of FRS 102

Small companies sometimes grow and what happens when they are no longer small? They adopt FRS 102 and they are required to go through the first time adoption process covered by Section 35 of FRS 102 which, in summary, requires:

- The preparation of the accounts on the basis that the company has always adopted FRS 102, this includes the reassessment of all assets and liabilities. Comparatives may need restating.
- The presentation of various reconciliations of assets and liabilities on the different basis, including one at the transition date.
- The consideration of the accounting exemptions (optional but often desirable) and exceptions (mandatory) on first time adoption.

This process is very similar to the first time adoption of IFRS.

Is anyone still keen to kill the FRSSE?

There remains a body of opinion that FRS 102 is suitable for application to small entities and that the continued adoption of FRSSE is superfluous and unnecessarily complex.

This view seems to ignore the role that the FRSSE will play in implementing EU small company accounting deregulation. Nevertheless the FRC has not discounted it!

What is happening on micro companies?

We do not know yet! BIS seems less than impressed with the EU limitations on deregulating the accounts of micro entities. Does this mean that they will not bother?

A final thought

All of the above points are based upon draft proposals that can change at any time!

HOW WELL DO YOU KNOW FRS 12? (Lecture A400 – 21.27 minutes)

Case studies

Example 1: An entity A has been operating for many years in a country which has no environmental legislation. At 31 December 2011 it is virtually certain that a draft law will be enacted shortly after the year-end which will require entities to clean-up land they have already contaminated. Should A make provision for the estimated cost of cleaning up past contamination?

Example 2: An entity B has just begun operating in a country which has no environmental legislation. However, B has published its environmental policy in which it undertakes to clean up all contamination that it causes. B has honoured this pledge in other countries in the past. Should B make provision for the estimated cost of cleaning up contamination in this country?

Example 3: An entity C operates a quarry where its licensing agreement requires it to restore the site at the end of extraction – estimated to be in twenty years' time. Should C make provision for the estimated cost of restoring the site?

Example 4a: Under new legislation, an entity D is required to fit smoke filters to its factories by 30 June 2012. D has not fitted the smoke filters at the balance sheet date of 31 December 2011. Should D make provision at that date for the estimated cost of fitting the smoke filters?

Example 4b: Under recent legislation, an entity D is required to fit smoke filters to its factories by 30 June 2012. D has not fitted the smoke filters at the balance sheet date of 31 December 2012. Should D make provision at that date for the estimated cost of fitting the smoke filters?

Example 5a: During December 2011, an entity E gives a guarantee of certain borrowings of a director, whose financial condition at that time is sound. Should a

provision be made in the accounts for the year ended 31 December 2011 when they are approved by the directors in March 2012?

Example 5b: During December 2011, an entity E gave a guarantee of certain borrowings of a director, whose financial condition at that time was sound. In June 2012 the director concerned went bankrupt and ceased to be a director. Should a provision be made in the accounts for the year ended 31 December 2011 when they are approved by the directors in August 2012?

Example 5c: During December 2011, an entity E gave a guarantee of certain borrowings of a director, whose financial condition at that time was sound. In June 2012 the director concerned went bankrupt and ceased to be a director. Should a provision be made in the accounts for the year ended 31 December 2012?

Example 6A: Entity F operates a venue for conferences and other functions. During a conference in October 2011, several people became ill possibly as a result of food poisoning. Later, two of them died. Legal proceedings seeking damages have been started against F but F disputes liability. On 30 March 2012, the entity's lawyers advise that it is probable that the entity will not be found liable. Should a provision be made in the accounts for the year ended 31 December 2011 when they are approved by the directors on 31 March 2012?

Example 6B: Entity F operates a venue for conferences and other functions. During a conference in October 2011, several people became ill possibly as a result of food poisoning. Later, two of them died. Legal proceedings seeking damages have been started against F but F disputes liability. On 30 March 2012, the entity's lawyers advise that it is probable that the entity will not be found liable.

There is then a delay in signing off the accounts and, during June 2012, the lawyers are asked again for their view. The lawyers advise that, owing to developments in the case, it is now probable that the entity will be found liable. Should a provision be made in the accounts for the year ended 31 December 2011 when they are approved by the directors on 30 June 2012?

Example 7A: Entity G owns a furnace. The lining of the furnace needs to be replaced approximately every five years. Should a provision be built up over the five year period to cover the cost of the relining?

Example 7B: Entity H owns an aircraft. They are required by law to overhaul the aircraft once every three years. Should a provision be built up over the three year period to cover the cost of the overhaul?

Background material: Extracts from FRS 12

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

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

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

A provision should be recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable (i.e. more likely than not) that a transfer of economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met, no provision should be recognised.

The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date. Where an entity can avoid future expenditure by its future actions, for example by changing its method of operation, it has no present liability for that future expenditure and no provision is recognised.

An entity should not recognise a contingent liability. A contingent liability is disclosed unless the possibility of a transfer of economic benefits is remote.

Contingent assets are not recognised in financial statements because this could result in the recognition of profit that may never be realised. However, when the realisation of the profit is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is disclosed where an inflow of economic benefits is probable.

Comments on case studies

All of these examples are based on the application notes included in FRS 12

Example 1: The obligating event is the contamination of the land. Transfer of economic benefits in settlement is probable because of the virtual certainty of legislation requiring cleaning up.

Therefore A should make a provision for the best estimate of the costs of cleaning up past contamination.

Example 2: The obligating event is the contamination of the land. There is a constructive obligation because of B's past action.

Therefore B should make a provision for the best estimate of the costs of cleaning up contamination in this country.

Example 3: There is an obligation under the terms of the licence to restore the site. The obligating event is the extraction of the materials from the quarry. As the extraction continues, the cost of re-instatement will increase. A provision will be made and this will be increased each year to reflect the increase in the costs of re-instatement.

Note that the journal required is:

Dr: Fixed assets

Cr Provisions

And that the fixed asset will be depreciated over the remaining expected life of the quarry.

Example 4a: There is no obligation because there is no obligating event. D is not permitted to make a provision for the cost of fitting the smoke filters.

Example 4b: There is still no obligation because there is no obligating event. D is not permitted to make a provision for the cost of fitting the smoke filters.

However, there might be an obligation to pay fines under the legislation. Therefore a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

Example 5a: There is an obligating event namely the giving of the guarantee. This gives rise to a legal obligation. However, no provision is recognised because the probability of a transfer of benefits at 31 December 2011 is less than 50%. The guarantee is disclosed as a contingent liability unless the probability of any transfer is regarded as remote. The guarantee is also disclosed under S 413 of CA 2006.

Example 5b: There is an obligating event namely the giving of the guarantee. This gives rise to a legal obligation. However, no provision is recognised because the probability of a transfer of benefits at 31 December 2011 is less than 50%. The event after the balance sheet date is non-adjusting. The guarantee is disclosed as a contingent liability with a note indicating the impact of the events after the balance sheet date. The guarantee is also disclosed under S 413 of CA 2006.

Example 5c: There is an obligating event namely the giving of the guarantee. This gives rise to a legal obligation. A transfer of benefits is probable at 31 December 2012 so a provision is recognised for the best estimate of the obligation. Despite the fact that the director has ceased to be a member of the board, the guarantee will still be disclosed under S 413(6) of CA 2006 which says "References in this section to

the directors of a company are to the persons who were a director at any time in the financial year to which the accounts relate."

Example 6A: On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events. Therefore no provision is recognised. The matter is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

Example 6B: We now have to be more careful in our use of words. In fact, a re-consideration of the answer to 6A reveals that the way the answer was expressed (by the ASB) is not entirely appropriate. Despite the availability of new information from the lawyers, this information is not necessarily relevant in making the decision as to whether a provision is required. Why did the lawyers change their mind? Was it that they discovered more information about the true state of affairs at the balance sheet date? If this is the case then the possession of the new information is an adjusting event and provision will be made.

Example 7A: There is no present obligation so no provision is recognised.

Note that the linings should have been capitalised separately from the furnace and depreciated over their separate useful life of five years. If this was not done then the correct accounting treatment should be introduced by way of a prior period adjustment.

Example 7B: There is no present obligation so no provision is recognised.

In other words the answers to Examples 7A and 7B are the same. Some might think that the legal requirement to overhaul would make a difference but the ASB points out that the legal requirement does not make the costs of overhaul a liability because no obligation exists to overhaul the aircraft independently of the entity's future actions. The entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Just as in the case of the furnace, an amount equivalent to the expected maintenance costs is depreciated over three years.

FRRP ANNUAL REPORT 2012 (Lecture A401 – 10.00 minutes)

Introduction

This annual report focuses on particular aspects of non-compliance that the Panel identified in the course of its reviews of company reports and accounts in the year to 31 March 2012. During that year, the panel reviewed 326 sets of reports and accounts of which 25 were unlisted public and private companies.

As a consequence of the population of companies reviewed, many of the comments raised by the Panel are only relevant to entities which are preparing accounts under international accounting standards.

It is interesting to note that many of the criticisms in the report arise from IAS requirements that have no equivalent in current UK GAAP. This implies to me that, perhaps, UK accountants and auditors are still developing their understanding of IAS and would do well to concentrate on the continuing differences between IAS and UK GAAP as a means of reducing the incidence of disclosure errors. Users of these notes with listed and/or other IAS clients are urged to read the full report. In these notes, I will only refer to matters that may be of interest to UK GAAP reporters.

One final point of introduction. As part of the reform and restructuring of the Financial Reporting Council ('FRC') that took effect in July 2012, statutory responsibility for the application to court to rectify corporate reports and accounts passed from the Financial Reporting Review Panel to the Conduct Committee of the FRC.

Directors' reports

The business review

There is a long section dealing with the contents of the directors' report – specifically business reviews. The Companies Act 2006 requires all business reviews to contain a fair review of the company's business and a description of the principal risks and uncertainties facing the company (S417(3)).

The Panel reported a significant improvement this year in the overall quality of reporting in relation to all aspects of principal risks and uncertainties. However some disclosures fell short of what shareholders might expect given that the purpose of the business review is to help them assess how the directors have performed their duty to promote the success of the company.

In particular, the Panel criticised companies which only provided a list of bullet point headings rather than a clear description of the principal risks they faced. Another criticism is that there was a long list of potential risks rather than a clear identification of principal risks and uncertainties. The business review should also provide an explanation of actions taken or processes adopted to mitigate the likelihood and impact of the principal risks and uncertainties.

The Panel states in the report that it 'takes the view that the law requires an account of the management of risk and will continue to encourage boards of all sizes of company which publish a business review to refer to their actions and proposals to reduce the likelihood of risks crystallising'.

The business review should be balanced and comprehensive (S417(4)). This, says the Panel, would include an explanation of significant events or items, including any described by the company as exceptional. This might include significant impairment charges, the financial effect of acquisitions and significant redundancy and re-organisation charges.

The Panel continued to seek further information where there were references to significant items in the business review but these items were not separately disclosed in the accounts.

In addition, the Panel asked some companies to explain in the business review material variations in the current period compared to the previous year. Examples include significant variations in the tax charge, such as a material prior year adjustment and significant movements in provisions for doubtful debts.

S417(6(a)) requires an analysis using financial key performance indicators (KPIs) to the extent necessary for an understanding of the development, performance or position of a company's business. The Panel continued to find examples where KPIs were disclosed as a bullet point list in the business review but were not explained or referred to in the discussion of the company's performance.

Where financial statistics, including non-GAAP measures, were used in the business review without further expansion, the Panel sought to understand the relationship between them and amounts appearing in the accounts. Where KPI measures are referred to as 'adjusted' from figures in the accounts then the nature or amount of the adjustments should be explained. The Panel gives as an example "adjusted operating profit", where operating profit is a sub-total in the income statement. In such cases, the nature and amount of the adjustments should be clearly explained and the measures referred to consistently.

Other disclosures

The Act requires a statement to be made on behalf of each director regarding disclosure of information to the company's auditor. The Panel encountered circumstances where that statement was missing.

The report refers to the omission of disclosures required by Schedule 7 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 ("the Regulations"). Part 6 of Schedule 7 of the Regulations requires a number of disclosures to be given, where relevant, in the directors' reports of companies which have securities admitted to trading on a regulated market. Paragraph 2 of that part contains 11 additional requirements for such companies. I will not list those in these notes but will simply bring them to the attention of interested readers.

Finally, this part of the panel's report refers to Corporate Governance statements. Again, I will give no further attention to this topic.

Annual financial statements - introduction

The Panel introduces this part of the report by including a reference to unnecessary disclosures. They use the following words:

‘The Panel discourages companies from including unnecessary disclosures in their accounts. The Panel is aware that some companies prefer to err on the side of caution and include in their accounts all disclosures raised by the Panel in their letters whether or not they are material. The Panel encourages boards to interpret these reminders from the Panel in the helpful spirit in which they are intended and to have the confidence to make judgements about those disclosures which are material and those which are not.’

After referring to a list of IAS common disclosure errors given in Appendix 1 of the report, the Panel continues:

‘The Panel’s 2011 Report drew attention to points raised in the FRC’s Discussion Paper ‘Cutting Clutter’ and emphasised the need for companies to avoid immaterial detail and to focus on key messages in corporate reports. During the year, the Panel sought to reinforce this message when writing to companies by stating explicitly that it discourages boards from including unnecessary information in their accounts. Such an approach requires a careful assessment of materiality, in both its qualitative and quantitative aspects, in relation to a company’s specific facts and circumstances. The test of materiality lies in the value of the information, not from the disclosure requirement in the Standard - what is material for one company will not be material for another; what may be material for a specific company one year may not be the next.’

Clutter is a very important issue for the standard setters – who, some might say, are mainly responsible for the existence of clutter. I can understand the need to reduce the length of annual reports which are consistently running to over 100 pages. However, when we try to apply this principle to the small or medium-sized company then the case for cutting clutter is not so strong. At the risk of being labelled a reactionary, I would prefer to advise my readers to continue to err on the side of caution and to provide disclosures required by regulations or standards even where the materiality of such disclosures may be challenged. I think it is better to be criticised for over-disclosure in SME accounts rather than running the risk that reviewers and monitors may think we are unaware of the disclosure requirements.

Accounting policies

The panel’s report refers to the requirements of IAS 1. The equivalent standard in UK GAAP is FRS 18. Paragraph 55 contains the following requirement:

‘The following information should be disclosed in the financial statements:

a) a description of each of the accounting policies that is material in the context of the entity's financial statements.

b) a description of those estimation techniques adopted that are significant, as explained in paragraph 57.'

The Panel's report indicates that they continue to challenge the omission of policies which it judged to be significant in view of the nature and complexity of a company's business. Note the word 'significant' is the word used in IAS 1 and may differ in meaning from the word 'material' used in FRS 18. The panel suggests the removal of policies that relate only to immaterial amounts as they detract from the substantive policies underlying key areas of reporting. Examples mentioned in the report are descriptions of leasing and hedging policies.

Most substantive questions about accounting policies related to aspects of revenue recognition, often triggered by policy descriptions in the accounts that were generic and repeated terms and phrases directly from the relevant standards without reference to the company's particular business and transactions. Revenue is addressed in a separate section in the Panel's report and we look at this area in more detail below.

The report refers to the requirement in IAS 1 to disclose separately those management judgements that have the most significant impact on the carrying amounts in the accounts. IAS 1 also requires disclosure of information about the assumptions that management makes in preparing their accounts and other major sources of estimation uncertainty that could result in a material adjustment to the reported amounts of assets and liabilities within the next twelve months.

The equivalent requirement in FRS 18 is in paragraph 55(b) to provide a description of the significant estimation techniques. Paragraph 57 explains that 'an estimation technique is significant for the purposes of paragraph 55(b) only if the range of reasonable monetary amounts is so large that the use of a different amount from within that range could materially affect the view shown by the entity's financial statements. To judge whether disclosures are required in respect of a particular estimation technique, an entity will consider the impact of varying the assumptions underlying that technique. The description of a significant estimation technique will include details of those underlying assumptions to which the monetary amount is particularly sensitive.'

The Panel challenged companies that either failed to make any such disclosure or that were not sufficiently specific as to the precise nature of the judgements they make, sometimes merely cross referring to the broader descriptions of the accounting policies and, in other cases, stating that the judgmental aspects of specific amounts were further explained in the relevant notes to the accounts when in fact no such explanations were provided.

The Panel expects boards to explain the nature of the judgements applied to significant items in the accounts such that users can better appreciate the importance of the area and its sensitivity to management opinion. Where the financial statement item concerned is significant and the judgement applied has a material impact on the recognition or measurement of the item, the board should consider discussing the impact on the financial statements of reasonably possible alternative judgements that it has rejected.

In view of the uncertain economic environment, the Panel said that it might have expected greater disclosure of the sensitivity of the carrying amounts to the methods, assumptions and estimates underlying their calculation but in most cases detected no evidence of this. Directors are encouraged to be specific in these disclosures and to refer to the actual issues they face, consistent with disclosures in the business review.

Disaggregation and netting off

Initially it might appear that this heading is only relevant to IAS preparers since it refers to the format of accounts laid down in IAS1. However, the issue is also important for those companies following the formats of CA 2006. It relates to the standard line item: “Prepayments and accrued income”. The Panel’s report makes the point, quite reasonably in my view, that it may be appropriate to disclose the amounts separately in the notes as the assets are different in nature and liquidity. The same comment applies to “Accruals and deferred income” where the liabilities are different in nature and timing. For some companies, for example those which engage in significant outsourcing, the Panel says that the separation of the amounts provides useful information to users about the pattern of operations.

Paragraph 29 of FRS 5 states that ‘Assets and liabilities should not be offset’. The Panel referred in its report to a number of instances where companies were netting-off amounts either in the income statement or the balance sheet. If this approach is adopted then the accounts should disclose reasons for adopting it and the amounts offset.

Taxation

Both current and deferred tax should be recognised in the profit and loss account except where they relate to items recognised in the statement of total recognised gains and losses. The Panel reported a number of cases where companies’ disclosures appeared inconsistent with this requirement

There were a number of cases where the reconciliation of profit before tax to the tax charge was unclear or appeared inaccurate, for example where deferred tax movements were shown as reconciling items.

Recall that this reconciliation is only one element of Paragraph 64 of FRS 19 which requires the notes to the financial statements to highlight circumstances that affect the current and total tax charges or credits for the current period or may affect the current and total tax charges or credits in future periods. This disclosure is also required by Paragraph 9.3 of FRSSE.

Several companies had to be reminded that current and deferred tax liabilities and assets are to be measured using the tax rates that have been enacted or substantively enacted by the end of the reporting period as they had not reflected the reduction in the corporation tax rate. Some companies included an incorrect amount for tax paid and received in the cash flow statement and misclassified current tax assets and liabilities.

Paragraph 62 of FRS 19 requires the disclosure of the evidence supporting the recognition of a deferred tax asset if the recoverability of the deferred tax asset is dependent on future taxable profits in excess of those arising from the reversal of deferred tax liabilities; and the reporting entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

Tangible fixed assets

In some cases, accounting policies in respect of highly material tangible fixed assets were unclear as to whether a cost or revaluation model had been adopted.

The Panel also asked a number of companies to explain the basis on which they had grouped material amounts of different assets which did not appear to meet the test for aggregation.

Leases

The matter drawn most frequently to boards' attention was the failure to disclose the total of future minimum lease and sub-lease payments under non-cancellable operating leases in the periods specified by the standard. This is of particular importance to users when reviewing the accounts of companies who are experiencing funding difficulties. Whilst this arose from non compliance with IAS 17, Paragraph 56 of SSAP 21 (Paragraph 7.17 of FRSSE) contains equivalent requirements.

The Panel also sought further information from several issuers that reported sale and leaseback transactions as operating leases but where, from the descriptions provided, there was a question whether the risks and rewards of ownership had been substantially transferred, indicating that the leasebacks may be finance leases.

Revenue

As in previous years, most of the Panel's substantive questions of companies about accounting policies related to revenue recognition, where the reported descriptions did not clearly explain the basis for recognition.

Policies were often drafted in broad generic terms or simply repeated text from the standard which did not enable users to understand the transactions entered into or the point at which revenue would be reflected in the income statement. The Panel often had to ask for additional information to help it understand the basis on which management satisfied itself that:

- The significant risks and rewards of ownership had been transferred to the customer or the stage of completion could be determined reliably;
- The amount of revenue could be measured reliably; and
- It was probable that the company would benefit economically from the transaction.

Boards are encouraged to consider the following when assessing the appropriateness and adequacy of their disclosure of revenue recognition policies.

- Categories of revenue – there should be a description for revenue recognition in respect of each significant category of revenue recognised during the period. This omission could sometimes be identified when the business review referred to different categories of business which did not appear to be reflected in the disclosures in the financial statements.
- Stage of completion – IAS requires that companies that derive revenue from the provision of services are required to disclose the methods they use to assess the stage of completion and the amount of revenue to be recognised at each stage. There is no equivalent requirement in UK GAAP so we are thrown back on the more general requirement of Paragraph 55 of FRS 18. The principle is the same – if the estimation techniques adopted for revenue recognition are significant then a description must be provided.
- Complex arrangements - particular attention needs to be paid to the policy description where there may be other parties with an interest in the financial outcome of a sales transaction. The Panel quotes the example of companies with franchise-type arrangements or that trade through an agent or distributor. It is necessary to make it clear in the accounting policies at what point the transfer of the risks and rewards of ownership occurs. Other complex transaction types listed in the report include extended credit sales, long term projects where discounting may be appropriate or transactions involving the provision of both goods and services where it should be clear, from the description, how the various components are accounted for.

Related party disclosures

The only relevant point here for UK GAAP preparers is the failure of some companies to recognise that all directors, including non-executives, are considered by the standard to be key management personnel and, therefore, must be included in the disclosures required by the standard.

Financial Instruments: Presentation

FRS 25 establishes the principles to apply to the presentation of financial instruments as liabilities or equity.

Enquiries were made of companies where it was not clear that the principles had been applied as required by the standard. Several were asked to demonstrate that the method used to allocate amounts paid to extinguish convertible loan stock, either through redemption or purchase, was consistent with that used in the original allocation to the separate liability and equity components of the proceeds when the instrument was issued.

One company had failed to present the liability and equity components of a convertible debt instrument separately on the grounds that, on the date of issue, the company's share price was significantly lower than the conversion price. A pricing anomaly does not negate the requirement to recognise both the financial liability and the right to convert to a fixed number of shares.

Impairment of fixed assets

FRS 10 requires an annual impairment review for goodwill and intangible assets that have an expected useful life exceeding 20 years from the date of acquisition. Otherwise all intangible and tangible fixed assets should be reviewed for impairment if events or changes in circumstances indicate that the carrying amount may not be recoverable.

Impairment tests require the exercise of significant judgements and are therefore accounting estimates. Accordingly, disclosures should be given in line with FRS 18.

Where the company's income generating units have disparate activities then the Panel will generally query the application of a single discount rate to the testing for impairment of all units. FRS 11 requires the pre-tax discount rate used to reflect the risks specific to the individual units.

Recoverable amount is the higher of net realisable value and value in use. The Panel continued to observe confusion concerning the different considerations that apply to each basis.

For example:

- Cash inflows or outflows expected to arise from future restructurings or from improving the asset's or IGU's performance should not be included in the calculation of value in use. On the contrary, in determining fair value it would be reasonable to expect market price to reflect potential improvements.

- In calculating value in use, cash flows are to be estimated in the currency in which they will be generated and then discounted using a rate appropriate for that currency. The present value is to be translated using the spot exchange rate at the date of the value in use calculation. On occasion, the Panel asked companies why, in the light of these requirements, they had estimated future exchange rates in order to determine value in use.

- The Panel identified potential double counting for example where the benefit of prior year tax losses had been recognised as an asset within deferred tax and then also included within the recoverable amount for testing purposes.

- The discount rate should be a risk adjusted pre-tax rate. Where this rate is not directly available from the market then it should be an estimate reflecting the return required by an investor. The Panel reported that, in some accounts reviewed, it was evident that little thought had been given to how to determine 'an investor's return' and rates proposed were, on occasion, unrealistically low. If the company's weighted average cost of capital is used then this must be adjusted for the market's assessment of the risks attaching to the particular asset's cash flows. Some companies appeared to have decided the rate to apply without regard to any of these considerations. Others selected out of date rates which did not reflect either current circumstances or market conditions and some used rates that were based on the company's borrowing rates that, inevitably, were lower than the company's cost of equity. Some companies claimed to have what seemed to the Panel an unrealistically low weighted average cost of capital, suggesting that their understanding of the concept was poor. Companies may be challenged where there is no evidence of the basis on which they determined the rates to apply, particularly where headroom is slim.

Provisions, contingent liabilities and contingent assets

Questions asked of companies focussed on the apparent absence of provisions when other disclosures indicated their existence, for example, why there was no provision for rehabilitation in the accounts of a mining company whose development costs were stated to comprise amounts incurred to rehabilitate production facilities.

Other companies were challenged where items that are generally accepted to be provisions were treated as accruals with no disclosure of their nature or of the expected timing and any uncertainties regarding the amount or timing of the outflows.

For example, onerous lease liabilities and restructuring costs were, on occasion, presented as accruals rather than provisions in circumstances, however, which indicated that there was still uncertainty regarding their timing or amount. Similarly, aggregation of provisions was questioned where it appeared that the aggregation might include amounts that differ significantly in their nature and/or timing, such that the disclosure requirements of IAS 37/FRS 12 were not met.

RELATED PARTY DISCLOSURE (Lecture A402 – 5.09 minutes)

A consent order published in September's Economia has been sending shock waves through the profession. The case relates to a partner in a two partner firm who failed to ensure that adequate disclosure of a related party transaction was made in a set of company accounts that his firm produced. The facts of the case as published in the consent order are:

> Mr A on the 4 May 2005 and the 23 June 2006, on behalf of his firm, prepared the financial statements, and issued an accountant's report, for X Ltd for the years ending 31 December 2004 and 2005 when the financial statements failed to include details of related party transactions, in particular between X Ltd and entities in which a Mr Y, a director of X Ltd, had an interest, contrary to the requirements of section 15 of the Financial Reporting Standard for Smaller Entities (effective June 2002).
>
> With Mr A's agreement the Investigation Committee made an order that he be reprimanded, fined £1,000 and ordered to pay costs of £3,500.

What is interesting about this case is that the accounts prepared were for a small company being prepared under the FRSSE and they were not subject to audit. As the consent order clearly indicates, Mr A issued an accountant's report. Many practitioners find this a worrying development. After all, when you prepare accounts you do so from the information and explanations provided by the client. For an audit exempt limited company do the directors not take responsibility for the accounts, the disclosure and the fact that they need to give a true and fair view?

This case clearly indicates the ICAEW view (a view also held by the ACCA) that as practitioners you take some responsibility for the disclosure in a set of company accounts regardless of the report that you issue. So what can you do to avoid a reprimand and fine/costs of £4,500? I would suggest that the following procedures should be standard for non-audit limited company accounts:

- The firm should always issue a non-audit letter of representation getting the directors to confirm that they have made available to you all relevant information necessary for the purposes of preparing the accounts of the company.

- The firm should run some form of disclosure checklist over the accounts to ensure that the information that you are aware of has been disclosed properly. All staff involved with company accounts should be familiar with the disclosure requirements of the FRSSE and FRS 8.

- Finally, at the completion meeting with the client, you should discuss related parties and get the client to confirm that all transactions with related parties have been disclosed.

The last point above should be recorded on the closing meeting agenda/notes and it should be clear that you have explained to the client what a related party is. For some transactions you will have no way of knowing that it is a related party transaction unless the directors tell you. Hence the issue should always be discussed.

I am currently dealing with an issue for a firm that is similar to the above. However in my case we have evidence that the client lied to the practitioner about the existence of the related party (in my case a partnership between the two directors). As this was not an audit we see no reason for the practitioner to have investigated this issue any further. He was entitled to rely on the information and explanations given to him by the client. It will be interesting to see if the authorities agree with our viewpoint.

Article contributed by Adrian Gibbons of SWATUK.

RESIDENTIAL MANAGEMENT COMPANIES (Lecture A403 – 10.29 minutes)

Recognition of service charges

Q: After an exceptionally long (but very interesting!) presentation on the subject of RMCs, the lecturer suggested that the best advice (for the moment) was to do what we did last year even if it was wrong. We have a client A Ltd which is an RMC. It does not own the freehold of the property and therefore its only source of income is from service charges. We have always credited service charges to turnover on receipt of the money from tenants. Do I understand that we can go on doing this?

A: There is a difference between continuing with policies that may be wrong and continuing with policies that are known to be wrong.

In your case, the policy of crediting service charges to turnover on receipt of the money is clearly wrong under the principles of FRS 5 Application Note G. Paragraph G4 states:

‘A seller recognises revenue under an exchange transaction with a customer, when, and to the extent that, it obtains the right to consideration in exchange for its performance.’

The RMC will typically receive service charges from tenants in accordance with a set timetable. This is not linked to the timing of the performance by the RMC of services for the tenants. We are in the area covered by Paragraph G5:

'When a seller receives payment from a customer in advance of performance, it recognises a liability equal to the amount received, representing its obligation under the contract.'

In normal commercial circumstances this liability is described as deferred income.

We will consider the issues peculiar to RMCs in more detail below.

No separate trust bank account

Q: We have a client B Ltd (Company limited by guarantee) which is an RMC. It does not own the freehold of the property and therefore its only source of income is from service charges. All costs incurred by B Ltd are refundable from the service charges. B Ltd does not have a separate trust bank account and all money received is paid into the company's bank account. Recognising that this money does not belong to B Ltd until it provides services, we have set up a liability account – amounts due to tenants. This will indicate, at any time, the cash which is held by B Ltd on behalf of tenants. At the year-end the bank balance and the liability account are included in the company balance sheet. The balance on both accounts must always be equal and opposite.

I know that counsel's opinion is that this money does not belong to the company but I think that the tenants would be very confused if the company's balance sheet did not include a bank account since they would expect the company to be holding money on behalf of the tenants.

Is this approach acceptable?

A: The approach you describe is very common in practice. Let's first of all deal with the money held on trust for the tenants. RICS recommend that this money should be held in a separate bank account but this is not a requirement of the legislation. However, even if the bank account is not nominally a trust account the money received from service charges is still held on a statutory trust for the tenants until it is used to meet service charge costs.

Since the company does not have access to the benefits of this money then this money is not an asset of the company and shouldn't be in the balance sheet. The correct approach is therefore to remove the bank balance from the company's balance sheet. The confusion felt by the tenants is an unfortunate by-product of this decision but the confusion would probably be short lived. One way to reduce the confusion would be to add a note in the accounts explaining the existence of the bank account and the reason why the money held on trust is not included in the balance sheet.

The balance on the account could also be disclosed with an explanation of any factors that may be important to the tenants – for example the reasons for holding large amounts of cash. See the question below dealing with sinking funds.

The directors of B Ltd may wish to continue with their current method of accounting citing the possible change in the rules included in draft UITF Abstract 49 and the desire not to change accounting policies twice in a short period. In this case, it would be helpful if a note to the accounts could be included which would explain the position concerning the money held on trust. I have to say however that I don't think that this approach is strictly correct since the uncertainty dealt with by (draft) UITF 49 concerns the treatment of transactions not the trust bank account. The UITF did not challenge counsel's opinion that the bank balance is not an asset of the company and therefore should not be in the balance sheet.

Journal entries for service charge income

Q: We have a client B Ltd which is an RMC. It does not own the freehold of the property and therefore its only source of income is from service charges. All costs incurred by B Ltd are refundable from the service charges. B Ltd does not have a separate trust bank account and all money received is paid into the company's bank account. I don't understand how the book-keeping works if the bank account is not part of the company's accounting records.

A: The company should not recognise service charge income when it is invoiced to the tenants. Similarly, no entries are made in the accounting records on receipt of cash from the tenants.

The company has a right to reimbursement by the trust, it has no right to service charge monies if they are not spent. When the RMC incurs a liability for any service charge costs then the following entries occur:

Dr	Amounts expended on service charge costs	xx	
Cr	Purchase ledger control		xx

Being the recognition of the service charge costs

Note that, for the purposes of the company's statutory accounts, there would be no need to distinguish between different categories of expenditure. However, more detail is required in order to prepare service charge accounts and so, in practice, the entries in the nominal ledger of B Ltd may well distinguish the various types of expenditure.

Dr	Amounts due from tenants	xx	
Cr	Amounts recoverable from service charges		xx

Being the recognition of the income from the recharging of service charge costs
In other words, for every occasion that B Ltd incurs costs on behalf of the tenants, matching journal entries will be made such that, at any time, the profit and loss account of B Ltd will always show zero profit.

Once the supplier has been paid direct from the trust bank account, we can then make the journal entry:

Dr	Purchase ledger control	xx	
Cr	Amounts due from tenants		xx

Being the payment of the supplier
Note that there is no need for there to be two bank accounts.

Sinking funds

Q: I am currently completing accounts for a residential management company. The company has received £2,000 from each tenant towards a major repair fund. How should these receipts be shown in the accounts? I have put them as miscellaneous income and then transferred them to a separate reserve on the balance sheet, and vice versa with cost of repairs. Also should this fund be restricted?

A: It is clear from the answer to the first question above that this money cannot be treated as income since there has not yet been any performance and therefore no right to consideration.

The money will not be recognised as an asset of the company and therefore no accounting entries are required on receipt of that money. The journal entries shown above for service charge income are applicable to the sinking fund monies in exactly the same way. As noted in the second question above, disclosure in the RMC's accounts of the balance on the trust bank account could include a note of the amounts built up for future major expenditure.

In the past, sinking funds presented major problems when preparing accounts for an RMC. The directors would want to recognise the cash received in the balance sheet but, recognising that this was not income, a common approach was to credit the amounts received direct to reserves. This is misleading since it implies that the reserves belong to the company. An alternative approach used in the past was to credit the amounts received to a provision account. FRS 12 made this method of accounting unacceptable since there was no past event that gave the RMC an obligation at the balance sheet date. Some directors formed the erroneous conclusion that it was no longer possible to build up a sinking fund since no method of book-keeping could be found which would deal appropriately with the credit side of the journal entry.

The removal of the trust bank balance from the company's balance sheet has solved this problem. A sinking fund is built up outside of the company's accounting records. The tenant that can't understand where the money has gone if it's not in the balance sheet needs to be educated in order to understand the peculiarities of 21st Century accounting.

FAQS: COMPANIES ACT MATTERS (Lecture A404 – 10.40 minutes)

Change of company name

Q: I have just completed a set of company accounts however the company has now changed its name, where in the accounts must I disclose this name change?

A: The accounts should be in the name of the company as it is at the date they are filed. The change of name should then be presented as follows:

1. The cover should be NEW NAME LIMITED (formerly Old Name Limited).
2. The directors' report (even if it is a small company) should state the change of name and the date.
3. If there is an auditor's report, this should be address to the members of New Name Limited (formerly Old Name Limited).

I have seen some firms show the old and new names on every page. This seems over the top to me and I think what I have suggested above is fine.

Dismissal of directors

Q: The shareholders of a company want one of the directors to resign. What is the process in order to achieve this? Do the shareholders arrange a meeting to demand resignation?

A: This is permitted by Companies Act 2006, the relevant legislation being as follows:

S168: An ordinary resolution is required **at a meeting** and special notice is required of the resolution. S312 requires 28 days notice to be given of the resolution.

S288(2): Note that removal of a director is one of only two things that cannot be done by written resolution. The other is the removal of the auditor.

S303: This section gives the members the power to require directors to call a general meeting. The directors are required to call a general meeting once the company has received requests to do so from members representing at least 10% of the paid-up capital of the company as carries the right of voting at general meetings of the company (excluding any paid-up capital held as treasury shares).

This percentage is reduced to 5% in the case of a private company if more than twelve months has elapsed since the end of the last general meeting.

For a company limited by guarantee, then the required percentage is members who represent at least 10% of the total voting rights of all members having a right to vote at general meetings.

The request must state the general nature of the business to be dealt with at the meeting, and may include the text of a resolution that may properly be moved and is intended to be moved at the meeting.

S304: The directors have a duty to call meetings required by members within 21 days from the date on which they become subject to the requirement. The meeting is to be held on a date not more than 28 days after the date of the notice convening the meeting. In this case, the need for special notice means that the meeting will be held exactly 28 days after the date of the notice.

S305: If the directors fail to call the meeting, then the members who requested the meeting, or any of them representing more than one half of the total voting rights of all of them, may themselves call a general meeting. Any reasonable expenses incurred by the members requesting the meeting by reason of the failure of the directors duly to call a meeting must be reimbursed by the company.

Any sum so reimbursed shall be retained by the company out of any sums due or to become due from the company by way of fees or other remuneration in respect of the services of such of the directors as were in default.

S169 requires the company to send a copy of the resolution to the director who then has the right to send written representations to the company. A copy of the representations should be sent to the members. The director has a right to be heard on the resolution at the meeting.

The resignation or removal of directors must be notified to Companies House using form TM01 within 14 days of the meeting.

Issue of shares

Q: We have a client who wishes to issue some more shares.

The current shareholding is as follows:

Person 1	*75 shares*
Person 2	*15 shares*
Person 3	*10 shares*

Person 1 is the sole director and majority shareholder. He wants to issue 100 more shares selectively at par.

Is this allowable and, if so, how should it be done?

A: Additional capital can be raised from existing shareholders by way of a rights issue. The number of shares each shareholder is entitled to apply for will be proportionate to that shareholder's existing shareholding. This cannot be selective in who this is offered to. If a member does not exercise his right to the shares he may renounce them in favour of someone else.

There must be a period of not less than 21 days in which to accept the offer, after which the company may utilise any shares not accepted either by issue to outsiders or in different proportions between members.

If the director does not want to use a rights issue but simply to allot new shares under s555 of CA 2006 it will be necessary to check whether, under the Articles, the existing shareholders have the right to have allotted to them a proportionate part of a new issue of shares.

CHANGES TO AUDITING STANDARDS (Lecture A405 – 5.20 Minutes)

Introduction

The FRC has released amendments to a number of ISAs (UK & Ireland). The purpose of these amendments was explained in the FRC press release as follows:

"The revisions primarily give effect to proposals in Effective Company Stewardship: Next Steps published by the FRC in September 2011 and support changes to the UK Corporate Governance Code and Guidance for Audit Committees that have also been issued by the FRC today. The changes in the standards are mainly directed at:

- Enhancing auditor communications by requiring the auditor to communicate to the audit committee information that the auditor believes the audit committee will need to understand the significant professional judgments made in the audit;
- Extending auditor reporting by requiring the auditor to report, by exception, if the board's statement that the annual report is fair, balanced and understandable is inconsistent with the knowledge acquired by the auditor in the course of performing the audit, or if the matters disclosed in the report from the audit committee do not appropriately address matters communicated by the auditor to the committee.

Revisions to the auditor reporting standards have also been made to enable those standards to be used by auditors in the Republic of Ireland; and also more fully align the requirements of ISAs (UK and Ireland) 705 and 706 with those of ISA (UK and Ireland) 700.

All changes are effective for audits of financial statements for periods commencing on or after 1 October 2012."

ISA (UK & Ireland) 260: Communication with those charged with governance (Revised October 2012)

New requirement

Paragraph 16-1 requires the auditor to communicate various matters to the audit committee. This requirement only applies where the audited entity is required (or chooses voluntarily) to report on how they have applied the UK corporate governance code. Guidance is provided in the Application Material in paragraphs A20-1 to A20-5.

Other new application material

Paragraph A6-1 has been introduced into the section dealing with communication to a sub-group of those charged with governance. It provides guidance as to whether it is necessary for the auditor to communicate with the full board (or members of it) rather than just with the audit committee.

ISA (UK & Ireland) 700: The auditor's report on financial statements (Revised October 2012)

New requirement

Paragraph 22A:

'In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code or to explain why they have not, the auditor shall report by exception if, when reading the other financial and non-financial information included in the annual report, the auditor has identified information that is materially inconsistent with the information in the audited financial statements or is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit or that is otherwise misleading.'

Paragraph 22B includes a list of matters that the auditor shall report on by exception in accordance with paragraph 22A. Guidance on Paragraph 22A is provided in the Application Material in paragraph A18A.

Other new application material

One of the main objectives of the revision is to apply ISA 700 in Ireland. To this end, the ISA refers to the new Compendium of Illustrative Auditor's Reports on Irish Financial Statements. New guidance material is introduced relating to the auditor's signature under Irish law.

ISA (UK & Ireland) 705: Modifications to the opinion in the independent auditor's report (Revised October 2012)

Changed requirements

Paragraph 16 has been amended by the addition of the words shown in bold below:

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by ISA (UK and Ireland) 700, include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor shall place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified Opinion **on Financial Statements**", "Basis for Adverse Opinion **on Financial Statements**", or "Basis for Disclaimer of Opinion **on Financial Statements**", as appropriate.

Prior to the revision of ISA 700, Bulletin 2010/2 already used these headings.

Paragraph 22 has been amended similarly:

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion **on Financial Statements**", "Adverse Opinion **on Financial Statements**", or "Disclaimer of Opinion **on Financial Statements**", as appropriate, for the opinion paragraph.

Once again, Bulletin 2010/2 was ahead of the game and already uses these headings.

There are consequential amendments in ISA 705 which follow from the changes in Paragraphs 16 and 22 above.

Part of Paragraph 24 has been deleted as shown:

When the auditor expresses an adverse opinion, the auditor shall state in the Qualified Opinion on Financial Statements paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph:

(a) The financial statements do not present fairly (or give a true and fair view) ~~in accordance with the applicable financial reporting framework~~ when reporting in accordance with a fair presentation framework; or

(b) The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

You will not be surprised to hear that Bulletin 2010/2 was again ahead of the game.

It would appear from the above that the FRC has got a little confused in referring to the “Qualified Opinion on Financial Statements” paragraph when surely they meant the “Adverse Opinion on Financial Statements” paragraph.

Paragraph 26 of the revised standard is now described as “deliberately left blank”. This draws attention to the fact that the previous paragraph 26 has been deleted. It said:

‘When the auditor expresses a qualified or adverse opinion, the auditor shall amend the description of the auditor’s responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor’s modified audit opinion.’

This requirement was removed in the interests of reducing clutter in the auditor’s report. You guessed it, Bulletin 2010/2 already ignored this requirement.

In conclusion, if you had never read these notes but just followed the examples in Bulletin 2010/2 then you would meet all of the new requirements.

New application material

Guidance is added in A15-2 for auditors of Irish companies that cease to hold office.

ISA (UK & Ireland) 706: Emphasis of matter paragraphs and other matter paragraphs in the independent auditor’s report (Revised October 2012)

The only changes in ISA 706 are consequential amendments following on from the changes to headings in ISA 705 as described above.

ISA (UK & Ireland) 720 part A: The auditor’s responsibilities relating to other information in documents containing audited financial statements (Revised October 2012)

Change of definition

The previous definition of ‘misstatement of fact’ was ‘Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.’

To this has been added the following new paragraph:

‘In the context of an audit conducted in accordance with ISAs (UK & Ireland), other information that is incorrectly stated or presented includes other information that is apparently incorrect based on, or inconsistent with, the knowledge acquired by the auditor in the course of performing the audit or that is otherwise misleading.’

New requirements

Paragraph 6-1:

'The auditor shall also read the other information to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit.'

Paragraph 14-1:

'If, on reading the other information for the purpose of identifying any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit, the auditor becomes aware of an apparent misstatement of fact, the auditor shall discuss the matter with management.'

New application material

Paragraph A4-2 is extended to refer to entities that report on how they have applied the UK Corporate Governance Code. The auditors of such entities are referred to the requirements and guidance in ISA 700 to report on matters by exception.

AUDIT QUALITY INSPECTIONS 2011/12 (Lecture A406 – 10.04 Minutes)

Introduction

The Audit Inspection Unit has reported a continued improvement in overall inspection results as indicated by a further reduction in the audits assessed as requiring significant improvements. These now account for less than 10% of the audits reviewed.

However, there is evidence that audit efficiency is becoming progressively more important to audit firms, as a consequence of pressure on fees and costs. Audit committees need to be aware of the potential effect of fee reductions on audit quality.

The report indicated that the AIU has not yet identified any improvements in the application of professional scepticism by audit firms despite action taken by firms. Audit committees should consider how they might encourage the application of professional scepticism

Section 2 of the report gives on overview of the findings of the AIU and discusses matters arising from the 2011/12 inspections that are significant or which are common to a number of firms and where action is required to improve overall audit quality. Most of these topics are covered in the notes below.

The AIU highlights a number of areas where they believe firms have made significant progress in addressing issues and note some examples of good practice.

The full AIU report contains matters pertaining to the financial services sector but these are not included in these update notes.

Focus on audit quality

In response to fee pressures firms have sought efficiencies and a reduction of overall audit hours. The report tells us a number of ways that firms have acted in order to achieve these efficiencies including raising materiality (including group materiality such that the number of business components subject to full audit procedures is reduced); "off-shoring" strategies; changes to the provision of staff training; greater delegation of work to junior staff; and an increased use of checklists.

The AIU are concerned that audit efficiency is becoming progressively more important to firms and firms should ensure that they maintain appropriate controls centrally to ensure audit efficiencies are not achieved at the expense of audit quality.

Professional scepticism

Good initiatives include additional training; specific communications to staff from key management personnel; the demonstration of professional scepticism within staff development and promotion processes; and the requirement by one firm that audit teams demonstrate how professional scepticism is applied on high profile audits – an approach recommended to other firms.

Professional scepticism is not a procedure or process; it is an approach to be adopted, and demonstrated, throughout the conduct of the audit. Despite the initiatives listed above, improvements in behaviour have not yet been fully achieved and in certain areas (eg impairment of goodwill and other intangibles) the AIU has yet to see any significant impact. Further action is required to embed the application of professional scepticism within the audit.

Impairment of goodwill and other intangibles

This was an area of focus this year. A significant number of issues were identified in this area, including insufficient evidence of challenge to the key assumptions, and concerns regarding the adequacy of the related disclosures.

Challenge of key assumptions was less robust than appropriate given the current economic environment. Sensitivity analysis of key assumptions should be performed but, even where this did occur, the analysis was often performed on individual assumptions and the combined effect of changes to a number of key assumptions was not considered. More rigorous assessments are needed.

The AIU suggests that audit teams do not always fully understand the accounting and reporting requirements in this area thus demonstrating that firms need to provide further training to staff covering these types of issues.

Examples of areas of weakness were: not identifying the mixing of pre and post-tax cash flows used to calculate value in use; accepting impairment reviews based on profit forecasts rather than cash-flows; failing to identify incorrect or incomplete calculations of the carrying value of the assets being tested for impairment; and failing to understand the calculation and determination of appropriate discount rates.

Going concern

Problems included the extent of work performed on financial projections; the adequacy of disclosures relating to going concern uncertainties; the sufficiency of evidence of parental support; and inadequate emphasis given to the status of negotiations with respect to renewal of banking facilities, which expired 13 months from the date of the audit report – the audit team had concluded that this was not central to their assessment of going concern.

Group audit considerations

The most common issue was insufficient involvement of the group audit team at the planning stage of the audit when the business component auditor's risk assessments and planned audit procedures were to be considered.

Other specific issues included insufficient justification of the scoping and materiality of business component audit procedures; a lack of clarity in respect of the objectives and outcome of visits to component auditors; and the adequacy of the review of the business component auditor's work by the group audit team.

The AIU points out that the requirements of ISA 600 apply to business components audited in the UK by other teams independent of the group audit team in the same way as they do to business components located overseas.

Revenue recognition

Issues included insufficient testing despite revenue recognition being identified as a significant risk; insufficient consideration of the risk of overstatement; and insufficient corroboration and challenge in respect of contract revenue.

Audit procedures should be more focused on the risks associated with revenue recognition.

Determination of materiality

A major concern for the AIU is that auditors may set materiality with an eye on cost reduction. For example, in a group situation, the materiality level for business components within a group must be set at a level lower than that for the group audit as a whole.

Another example identified at one firm was the possibility of setting materiality for individual account balances, classes of transactions and disclosures at a level higher than overall materiality. The result of this was that, if assessed as low risk, such items could be inappropriately scoped out for audit testing purposes.

The AIU also referred to the situation at one firm where overall materiality was set at too high a level but members of the audit team were instructed to use the lower performance materiality measure in all circumstances. The AIU's view was that such guidance could lead to confusion

Use of experts and specialists

A key issue for the AIU was insufficient challenge of the assumptions used by the expert. Further, issues arose in relation to the consideration of the objectivity and independence of the proposed expert and the adequacy of their work for audit purposes.

The use of internal specialists (eg for tax or pensions calculations) is common. The following issues arose: the demonstration of professional scepticism; documentation of the specialist's work to enable review by the audit team; consideration of issues identified by the specialists and evidence that these had been appropriately resolved.

External confirmations

The areas highlighted by the AIU were cash and investment assets. Audit evidence is more reliable when obtained from third parties. A common error arose when audit teams obtained copies of investment reports from the audited entity, rather than direct confirmations from investment managers. This was a particular issue in relation to the audit of pension scheme assets.

Testing the effectiveness of controls

The AIU include the following statement "We believe that there is scope for firms to improve the efficiency and effectiveness of their audit approaches by reviewing the extent to which audit evidence is obtained through their testing of the effectiveness of internal controls."

The report says that the testing of the effectiveness of controls tends to be limited to the largest listed entities, large retailers and financial institutions where sufficient audit evidence cannot be obtained on a timely basis from substantive testing alone.

Auditor independence

Ethical Standards are clear in requiring the assessment of threats and the application of safeguards.

The AIU identified a number of instances where they said that audit teams did not appear to understand or appreciate the importance of this approach. They reported concern that, more than seven years after the introduction of the Ethical Standards, they were not able to report any improvement in this area. This indicated a need for improved training and a greater focus on this area in internal quality reviews.

Reporting to the client

In the AIU report this section was described as reporting to audit committees but I do not want users of these notes to think that this section is irrelevant to auditors of smaller entities

Ethical standards require the auditor to report threats and safeguards to those charged with governance. Other deficiencies identified by the AIU included inadequate reporting of audit findings, and inconsistencies and omissions in the reporting of significant risks.

Engagement quality control review

Firms are required to have policies in place specifying what audits require an engagement quality control review. The AIU are concerned at the effectiveness of these reviews in practice.

They reported two positive developments:

1. At one firm, all reviews were undertaken by a small group of senior audit partners. These partners had periodic meetings to share best practice, to promote consistency and awareness of issues arising. This improved the quality of the review process by ensuring a more consistent approach.

2. At another firm, reviewers were required to document the procedures that they performed in relation to key areas of the audit. This emphasised the importance this firm places on the role of the EQCR and ensured that appropriate evidence exists of the review procedures performed.

However, the AIU expressed concerns about:

- Lack of evidence of appropriate challenge of key judgments made by the engagement team including the exercise of professional scepticism.
- Limited evidence that underlying work papers had been reviewed and appropriate review points raised and cleared.
- Over-reliance on checklists.
- Whether reviews are performed by individuals with appropriate experience and authority and, therefore, whether the review process is effective.

Financial statement review processes

Under this heading, the AIU are referring to a technical review performed separately from the audit team. Such a review would not be a standard element of the work performed on audits of entities that are not listed. However, for all audit clients it is important that senior members of the team, such as the partner and/or manager, should perform their own review of the financial statements as well as that performed by the senior. Evidence of such reviews should be retained, together with details of how significant points arising have been cleared.

Performance evaluation

Audit quality objectives should be set and performance monitored. Partner and staff appraisals should emphasise audit quality. The AIU says that firms should ensure that there is a direct and proportionate impact on remuneration arising from adverse audit quality assessments.

AUDIT FACULTY ROADSHOW (Lecture A407 – 19.07 Minutes)

The recent roadshow presented by the audit faculty of the ICAEW dealt with the subject of efficient and effective auditing for smaller entities. This contained a lot of interesting information and we will return to it in future update notes. Today I want to consider two issues – proportionality and preliminary analytical review.

Proportionality

A new audit buzz word that you might have heard is proportionality.

This refers to the proportional interpretation and application of the Clarified ISAs on smaller, less complex audits. The clarification of the ISAs has intensified the debate that they are not entirely appropriate for the smallest of audits and consideration of the principle of proportionality is thought to be helpful in the solution to this problem.

This consideration of the principle of proportionality can look dry and academic but there are some useful practical points that come out of it, that are covered later.

What proportionality is not

Auditing standard setters have indicated that they would not accept two tiers of auditing standards. This might be appropriate for accounting standards such as the Financial Reporting Standard for Small Entities (FRSSE) but there is no chance of there being such a thing as ISA-lite. It is frequently said that “an audit is an audit” regardless of size and complexity. Any attempt to scale down the requirements of the ISAs for smaller entities devalues the audit.

Taking these ideas a step further the principle of proportionality does not require a two tier approach when applying the ISAs.

What proportionality is

The approach to auditing different entities changes according to the complexity of the entity rather than just its size. Considering the range of audits from a risk and complexity perspective, they represent a continuum rather than two separate tiers. There is no step-change between simple and complex audits. Rather, in practice, there is a wide variety of issues within each audit that place it on the continuum of complexity. The idea of audits varying in complexity on a continuum is an important one because as an entity gets smaller and simpler the way an auditor applies the ISAs changes. It is important because:

- Auditors only need to comply with relevant standards – less complex audits mean that auditors will not need to apply specific standards that are not relevant to the circumstances. For instance if there is no internal audit function ISA 610 will not apply; if group accounts are not prepared ISA 600 will not apply. The standards which are or are not applicable will, of course, vary from audit to audit.

- Conditional requirements – many ISAs contain conditional requirements which only apply in certain situations. For instance in ISA 501, if there is no stock, then that section of the ISA will not apply; if there is no segmental reporting disclosure then that section will not apply; the requirements relating to litigation and claims will always be applicable.

- Less formal procedures – a number of factors negate the need for a formal approach to certain audit procedures. Factors such as small audit teams, the provision of non-audit services and frequent communication with the client mean that auditors of small, less complex entities often need to do very little to understand their client and assess risk. The requirements of the ISAs still need to be met and documented but a different, less formal, approach is appropriate.

- Documentation – where an entity is not complex the audit documentation can be reduced. The extent of documentation required under ISA 230 shall be sufficient to enable an experienced (third) auditor to understand the audit procedures performed, the audit evidence obtained and any significant professional judgment applied. Where the entity is less complex, less documentation is needed to achieve this. In this situation it is usually comparatively easy for an experienced auditor to understand the audit procedures performed and the significance of any audit evidence obtained. Therefore, it is less likely that there is a need to explicitly document a basis for the individual conclusions drawn by the auditor or the professional judgment applied by the auditor

Applying the concept of proportionality in practice

What can auditors do to progress a more proportionate approach to the Clarity ISAs?

- "More documentation is not better documentation" – this is a quote taken from the front cover of the ICAEW AAF publication Audit & Beyond. Whilst it would appear to be an obvious statement, cold file reviewers report that firms do not behave in a way that suggests that they believe this. Clichés such as "more is less" and "cannot see the wood for the trees" also spring to mind. Moving towards leaner, more effective documentation is not easy but following the points below should help.

- ISA Book club – If an auditor is to apply the ISAs proportionally then they need to know what the standards require. Understanding the standards better gives an auditor more confidence when documenting audit work. One way to better appreciate the requirements of the standards is to implement an ISA book club, as mentioned in Adrian Gibbons' Audit & Beyond article – "Each month pick one ISA and ask everybody involved to take it away and read it. At the end of the month, meet to discuss the impact that this ISA may have on your audit clients. Ask individuals to come up with strategies for dealing with the requirements of the ISA."

- Better use of audit methodologies (e.g. PCAS) – standard working paper packs and their automated equivalent are designed to be adapted to the specific circumstances of the audit. This often does not happen. An audit methodology needs to be equipped with standard checklists and audit programs that cope with the most complex of audits. This does not mean that they have to be applied all of the time. On the contrary, on a simple audit many checklists and programmes will be superfluous and others should be replaced with simple narrative notes. However, this approach requires audit teams with a thorough knowledge of the requirements of the standards. See the above point on the ISA book club.

- Reducing superfluous schedules and detail on tests – The golden rule of audit documentation is that it needs to be sufficient to enable an experienced auditor to understand the audit procedures performed, the audit evidence obtained and any significant professional judgement applied. Any more is superfluous and is inefficient to produce and results in wasted review time.

- Every audit is unique - there is no special approach for small and simple audits. Instead the audit teams approach must be scalable and flex according to the individual circumstances. There is no single approach to simpler audits.

- Automate the audit process – automated (computerised) methodologies allow easier personalisation of audit tests and checklists which can be easily rolled forward. Automated methodologies can work well for smaller audits. This tends to be more of a benefit in the second year once the personalisation has been done in the first.

Analytical procedures at the risk assessment stage

I have been encouraged to look at this subject because of the inclusion in the Faculty's roadshow of an example working paper for analytical procedures at the risk assessment stage. We do not have permission to reproduce this working paper but I have produced my own example later in these notes.

Paragraph 6 of ISA 315 requires risk assessment procedures to include:

a) Inquiries of management, and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.

b) Analytical procedures.

c) Observation and inspection.

The first thing that should be observed is that the above extract is taken from ISA (UK & Ireland) 315: Identifying and assessing the risks of material misstatement through understanding the entity and its environment. Analytical procedures at the risk-assessment stage are no longer included in ISA 520. My use of the term "risk-assessment stage" reflects my preference not to refer to this stage of the audit as the planning stage. The risk-assessment procedures should take place before planning starts so perhaps the best way to describe this stage is as the pre-planning stage.

The next thing to be aware of is that there are no compulsory requirements concerning analytical procedures at the pre-planning stage other than as indicated in paragraph 6 above. Paragraph A5 of the application material tells us that, although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity, the auditor is not required to perform all of them for each aspect of that understanding. In other words, as long as some analytical procedures are performed at the pre-planning stage then that is sufficient.

A7 of the Application Material tells us that analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

And in A8: Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Notice the emphasis on the use of analytical procedures to identify risk. That is, the purpose of the analytical review at the pre-planning stage is to pose questions not to answer them. Many auditors confuse pre-planning analytical review with what I call the accounts review.

The accountant for an audit-exempt company is usually preparing accounts both for the approval of the directors and, in due course, for submission to HMRC. Both the directors and the tax authorities are likely to raise questions on the accounts concerning fluctuations from the previous year's accounts and the accountant wants to be prepared for those questions. Therefore, the accountant will ask staff to consider the obvious questions that might arise and to provide answers to them. I call this review the accounts review.

Similar work is performed for the audit client but it is, in my opinion, performed for the same reasons as for the non-audit client – that is, as a client service and as part of the tax work. As such, this sort of review has nothing (or very little) to do with the audit.

Some of you may consider that the accounts review performed for the audit client could double as the pre-planning analytical review for the audit. I accept that both reviews may use the same inputs (the draft accounts) but the output of the reviews is fundamentally different. The output of the accounts review is explanations for significant fluctuations whereas the output of the pre-planning analytical review is the identification of risk areas for further examination. In other words, for audit purposes, explanations are not required at the planning stage.

Others may say that the accounts review might provide substantive evidence for the auditor but the substantive analytical review is now subject to detailed requirements in ISA 520 that make it completely different from the accounts review.

For the audit client, the work performed on the accounts review should provide the information needed for the pre-planning analytical review. The accounts review should be documented in the accounts file; the pre-planning analytical review would be documented in the audit file. This documentation could be brief (see below).

It is useful to involve the client in the pre-planning analytical review since this will help the auditor to make a better assessment of which fluctuations are worthy of further examination. Problem areas should be recorded in the pre-planning analytical review on the audit file. This would ensure that all risks identified are included on the risk action plan so as to identify appropriate responses to risk.

The pre-planning analytical review does not constitute substantive audit evidence and, therefore, sample sizes for substantive tests cannot be reduced based on this review. The pre-planning analytical review will identify areas where additional work is required because of an assessed risk.

In the absence of any assessed risks then the conclusion from the pre-planning analytical review is that no risks have been identified in the review.

Pre-planning analytical review: Example working paper

Work performed

The draft detailed P&L account and balance sheet were reviewed by AB. This work is recorded on schedule x/x of the accounts file. Fluctuations were discussed with John Smith on 14 July 20xx. As a result of the review and discussion, the following have been identified as areas requiring further examination:

Trade debtors: Debtors days have increased considerably from 52 days to 64 days. This may indicate cut-off errors, weaknesses in controls over debt collection or other problems.

Revenue: The amount recoverable on contracts is considerably lower than last year (£180K:£352K) but John said that he expected work in progress to be roughly the same.

Rent and rates: John told us that they moved into new premises during the year which were cheaper than the old premises. Also, a rent-free period was enjoyed. Despite this, the expenditure on rent and rates has increased by £57K when compared with last year.

Conclusion

These three issues have been recorded on the planning memo (See schedule C1) as risk areas. Responses to risks are recorded there.

The use of analytical procedures as risk assessment procedures did not identify any other risks for investigation.

Notice that the above working paper provides sufficient evidence of the work performed and the results of that work. There is no need to include the accounts review in the audit file.

SUMMARY OF DEVELOPMENTS

FRC updates to Corporate Governance Code + Stewardship Code

Following consultation in April, the Financial Reporting Council (FRC) has today announced limited changes to the UK Corporate Governance Code and Stewardship Code intended to increase accountability and engagement through the investment chain. Both Codes will continue to apply on a "comply or explain" basis.

Changes to the UK Corporate Governance Code include:

- FTSE 350 companies are to put the external audit contract out to tender at least every ten years with the aim of ensuring a high quality and effective audit, whether from the incumbent auditor or from a different firm. The FRC will be holding discussions with companies, auditors and investors to consider whether guidance on tendering would be useful;
- Audit Committees are to provide to shareholders information on how they have carried out their responsibilities, including how they have assessed the effectiveness of the external audit process;
- Boards are to confirm that the annual report and accounts taken as a whole are fair, balanced and understandable, to ensure that the narrative sections of the report are consistent with the financial statements and accurately reflect the company's performance;
- Companies are to explain, and report on progress with, their policies on boardroom diversity. This change was first announced in October 2011, but its implementation was deferred to avoid piecemeal changes to the Code
- Companies are to provide fuller explanations to shareholders as to why they choose not to follow a provision of the Code.

Changes to the Stewardship Code include:

- Clarification of the respective responsibilities of asset managers and asset owners for stewardship, and for stewardship activities that they have chosen to outsource;
- Investors are to explain more clearly how they manage conflicts of interest, the circumstances in which they will take part in collective engagement, and the use they make of proxy voting agencies;
- Asset managers are encouraged to have the processes that support their stewardship activities independently verified, to provide greater assurance to their clients.

Announcing the changes to the Codes, chairman of the FRC Baroness Hogg explained,

"The changes to the UK Corporate Governance Code are designed to give investors greater insight into what company boards and audit committees are doing to promote their interests, and to provide them with a better basis for engagement. The changes to the Stewardship Code are designed to give companies and savers a better understanding of how signatories to the Code are exercising their stewardship responsibilities.

We have aimed to keep these revisions to a minimum and change only those elements of the codes where consultation indicated real improvements could be made".

The updated codes will apply from 1 October 2012.

The FRC has also published an updated edition of its Guidance on Audit Committees to reflect the changes to the UK Corporate Governance Code, and set out on its website transitional arrangements with respect to the introduction of ten year retendering, to ensure it can be introduced without significant disruption.

The UK Corporate Governance Code, which celebrates its twentieth anniversary in November, sets out good practice for UK listed companies on issues such as board composition and effectiveness, risk management, audit committees and relations with shareholders. It is normally reviewed every two years.

The FRC will carry out further consultation on whether changes are needed to those parts of the UK Corporate Governance Code dealing with remuneration when the Government's legislation on remuneration reporting and voting has been finalised. Any changes following this consultation will be effected in the next edition of the Code.

The Stewardship Code, first published in 2010, sets out good practice for institutional investors on monitoring and engaging with investee companies and reporting to clients and beneficiaries.

28 Sep 2012

Financial Reporting Council publishes its Annual Report for 2011/12

The Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment, today publishes its Annual Report for 2011/12.

The Annual Report describes the ways in which the FRC, working closely with its stakeholders, has contributed to promoting high quality confidence in corporate reporting and governance during 2011/12.

Baroness Hogg, Chairman of the FRC, said:

"In the past year, we have published our first assessment of the implementation of the UK Corporate Governance Code and Stewardship Code, proposed improvements in the way companies report on the key strategic risks facing their businesses, and supported Lord Sharman's Panel of Inquiry to consider going concern and liquidity risks.

Within Europe, we have continued to engage in the debates on corporate governance and auditing.

The recent passage of legislation to reform the FRC empowers the Board to set both our strategic direction and standards. We have created two Board Committees, on Codes & Standards and Conduct, to co-ordinate the work of the different parts of the organisation, drive forward our international work and take a number of supervisory decisions. We have also created three expert Councils to advise on accounting, audit & assurance and actuarial issues. These Councils will have a crucial role in ensuring that the FRC remains an accountable and transparent standard-setter.

We believe that these reforms mark the beginning of a deeper and wider relationship between the FRC and its stakeholders. Our key challenge will be to work with investors, business, the professions and other regulators and other interests to identify and help address the challenges facing those responsible for corporate governance and reporting in the UK.

Looking to the year ahead, we will focus on the improvement of our codes and standards; our international influence; and the strengthening of our conduct work, including the enhancement and overhaul of the disciplinary scheme."

02 Oct 2012

FRC consults on updated guidance for financial instruments

The FRC has today issued a consultation on the proposed update of the guidance to auditors on the audit of financial instruments; an update to Practice Note 23 (Revised).

The proposed update reflects both the clarified International Standards on Auditing (ISAs) (UK and Ireland) and updated guidance issued by the International Auditing and Assurance Standards Board (IAASB) in its International Auditing Practice Note (IAPN) 1000, Special Considerations in Auditing Financial Instruments.

The FRC has supplemented IAPN 1000 with guidance that is currently set out in Practice Note 23 (Revised) that is still believed relevant and with a small amount of new guidance in relation to matters not covered in either IAPN 1000 or Practice Note 23 (Revised).

The consultation period closes on 4 January 2013.

Nick Land, FRC Board member and chairman of the Audit and Assurance Council, said,

"The proposed updated guidance is intended to be relevant to audits of entities of all sizes that may be subject to the risks associated with using financial instruments. The guidance reflects lessons learnt in the financial crisis. The FRC invites comments from auditors and other stakeholders with an interest in audit."

04 Oct 2012

FRC publishes paper to enhance disclosure in financial reporting

The FRC is today publishing a discussion paper 'Thinking about financial reporting disclosures in a broader context'. The paper aims to improve the quality of financial reporting disclosures.

The paper sets out a road map for a disclosure framework for financial reporting aimed at improving the quality of disclosures and their value to users. In particular, the paper covers the reduction of clutter in financial reports by avoiding duplication in disclosures and using tests of materiality more rigorously.

The consultation period closes on 31 January 2013.

The publication of this paper builds on the FRC's work with the Autorité des normes Comptables and the European Financial Reporting Advisory Group (EFRAG) to develop a disclosure framework for the notes to the financial statements.

Roger Marshall, Director of the FRC, said,

"We believe that there is a need to curtail the piecemeal approach to disclosures and develop a coherent framework for disclosures in the financial report. We anticipate that this will lead to disclosures in financial reports being more relevant to the needs of the users of those financial reports whilst at the same time cutting clutter".

This paper contributes to the FRC's work on influencing the development of International Financial Reporting Standards.

15 Oct 2012

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