ACCOUNTING AND AUDIT UPDATE

Tolley®CPD

March 2013

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TABLE OF CONTENTS

UPDATE ON POSSIBLE DEVELOPMENTS (LECTURE A408 – 10.29 MINUTES)............. 4

FRS 100: FINANCIAL REPORTING REQUIREMENTS (LECTURE A409 – 11.39 MINUTES) 5

The new framework 5
Application of SORPs 5
Transitional arrangements 6
Equivalence 7
For the purpose of Section 401 of the Companies Act 2006.............................. 7
For the purpose of FRS 101 and FRS 102 7

AMENDMENTS TO THE FRSSE (LECTURE A410 – 16.46 MINUTES)............................ 8

Introduction.. 8
Status of the FRSSE... 8
Changes in detailed requirements... 9
Fixed assets... 9
Related party transactions 11

FRS 101: REDUCED DISCLOSURE FRAMEWORK (LECTURE A411 – 5.58 MINUTES) 15

Introduction.. 15
Conditions.. 15
Disclosure exemptions.. 16
Transitional rules 17

DEBT INSTRUMENTS (LECTURE A412 – 6.37 MINUTES) 17

Loan at a rate of interest that is not market rate 17
Change in rate of loan following financial difficulties experienced by the borrower 19

FAQ: GROUP ACCOUNTS (LECTURE A413 – 3.27 MINUTES)..................................... 24

UPDATE ON CHARITY MATTERS (LECTURE A414 – 11.16 MINUTES)......................... 24

Impact of UK GAAP changes on charities.. 25
Impact of SI 2012/2301 on charities.. 25
Hodgson Review of the Charities Act 2006 25
Update on the Charitable Incorporated Organisation 26
Key points relating to CIOs – an overview.. 27
Proposed timetable... 27
Public benefit saga continues 28
Gift aid 28
Online Gift Aid due to start from April 2013 28
New rules for claiming Gift Aid on the proceeds of donors' goods sold by charity shops 29

Charity Commission "Back on Track" - November 2012 29
Key figures from Charities Back on Track 30
Themes from Charities Back on Track 30

AUDIT EXEMPTION FOR SUBSIDIARIES (LECTURE A415 – 24.43 MINUTES) 32

TRUSTEE SHAREHOLDINGS IN AUDIT CLIENTS (LECTURE A416 – 8.36 MINUTES).. 39

ANALYTICAL REVIEW (LECTURE A417 – 13.17 MINUTES) 41

Final analytical review 41
Extracts from ISA 520 41
Practical considerations 42
Final analytical review: Example working paper 43
Substantive analytical review example 43
Demonstrating what is needed 44
Example 44

ISQC (UK AND IRELAND) 1 QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF FINANCIAL STATEMENTS, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS (LECTURE A418 – 16.51 MINUTES) 45

Introduction 45
Objective and selected definitions 46
Applying, and complying with, relevant requirements 47
Elements of a system of quality control 47
Leadership responsibilities for quality within the firm 48
Relevant ethical requirements including independence 48
Acceptance and continuance of client relationships and specific engagements 49
Human resources and assignment of engagement teams 50
Engagement performance 50
Monitoring 52
Documentation of the system of quality control 54
Example documentation 54

WHAT IS THE DIFFERENCE BETWEEN A HOT FILE REVIEW AND AN ENGAGEMENT QUALITY CONTROL REVIEW? (LECTURE A419 – 9.44 MINUTES) 55

Engagement quality control review (EQCR) 56
Consultation 58
Other hot file reviews 58

SUMMARY OF DEVELOPMENTS 59

IFIAR releases first global survey of audit inspection findings 59
Consultation on implementation of Sharman Panel recommendations issued by FRC 60
FRC consults on proposals to improve the auditor's report 61
FRC to adopt improved auditing standards on using the work of internal audit 61

UPDATE ON POSSIBLE DEVELOPMENTS (LECTURE A408 – 10.29 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.	FRSs 100 and 101 were published in November 2012 and are covered below. FRS 102 was published on 14 March 2013 and will be covered in future updates.
Audit exemption Change of accounting framework	Proposal from BIS to exempt all small companies and some subsidiaries from audit. Proposal from BIS to allow companies to move more easily from IAS to UK GAAP.	SI published – applies to accounts for financial years ending on or after 1 October 2012. Questions are still arising on this topic and a number are included in the notes below.
Micro-companies	Proposal from Europe to permit limited exemptions for micro entities from the accounting requirements of the 4th and 7th Directives.	The government published a consultation paper at the end of February 2013. This will be covered in our next update.
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 and possibly increase the thresholds for small and medium-sized companies.	No further information is currently available on this topic.

It will be seen from the above that the first two issues have now been (or are about to be) resolved. As such they will be removed from this table in future update notes. The other topics will be covered as proposals develop.

FRS 100: FINANCIAL REPORTING REQUIREMENTS (LECTURE A409 – 11.39 MINUTES)

The new framework

FRS 100 was published in November 2012. It applies to entities in the United Kingdom and Republic of Ireland and is compulsory for accounting periods beginning on or after 1 January 2015. It may be adopted before then as long as early adoption is disclosed.

On application of FRS100, all existing SSAPs, FRSs and UITF Abstracts are withdrawn except for FRS 27: Life Assurance.

Financial statements (whether consolidated financial statements or individual financial statements) that are required by the IAS Regulation or other legislation or regulation to be prepared in accordance with EU-adopted IFRS, must continue to be prepared in accordance with those requirements. FRS 100 is not relevant to such financial statements.

FRS 100 is consistent with the previous exposure draft (FRED 46) in setting out the following framework for the preparation of financial statements intended to give a true and fair view:

An entity eligible to apply the FRSSE, may continue to do so;

An entity not eligible to apply the FRSSE (or an entity that is eligible to apply the FRSSE but chooses not to do so) must prepare financial statements in accordance with:

- FRS 102;
- EU-adopted IFRS; or
- if the financial statements are the individual financial statements of a qualifying entity, FRS 101.

The financial statements must contain a statement indicating compliance with one of FRS 101, FRS 102 or FRSSE.

Application of SORPs

If an entity's financial statements are prepared in accordance with the FRSSE or FRS 102, Statements of Recommended Practice (SORPs) will apply in the circumstances set out in those standards. It should be noted that it is planned that most SORPs will be updated to conform with FRS 102. If an entity adopts FRS 102

before the relevant SORP is updated then conflicts may arise between the FRS and the existing version of the SORP. In this case, it should be noted that provisions of a SORP cease to have effect to the extent that they conflict with a more recent financial standard.

When a SORP applies, the entity should state in its financial statements the title of the SORP and whether its financial statements have been prepared in accordance with the SORP's provisions that are currently in effect. In the event of a departure, the entity should give a brief description of how the financial statements depart from the recommended practice set out in the SORP. The effect of a departure from a SORP need not be quantified, except in those rare cases where such quantification is necessary for the entity's financial statements to give a true and fair view.

Transitional arrangements

As a result of the choices included in FRS 100, there are a number of possible transitions that may occur. These are summarised in the table below.

Existing framework:	**Transition to:**	**Transitional rules contained in:**
Existing UK GAAP	EU-adopted IFRS	IFRS 1 First-time Adoption of International Financial Reporting Standards as adopted by the EU
Existing UK GAAP	FRS 101	Paragraphs 6 to 33 of IFRS 1 as adopted by the EU including the relevant appendices. References to IFRSs in IFRS 1 are interpreted to mean EU-adopted IFRS as amended in accordance with paragraph 5(b) of FRS 101
EU-adopted IFRS	FRS 101	See notes later re FRS 101
Existing UK GAAP	FRS 102	FRS 102
Existing UK GAAP (not FRSSE)	FRSSE	FRSSE – see note below

The Financial Reporting Faculty of ICAEW has published a new factsheet on the new UK GAAP. One of the comments that is included refers to entities that are eligible to use the FRSSE but currently do not do so, preferring instead to use the full UK standards. The Faculty suggests that such entities may wish to consider adopting FRSSE now in order to avoid the more complicated new requirements of FRS 102. However, they go on to point out that this may not be a long-term option.

Equivalence

For the purpose of Section 401 of the Companies Act 2006

FRS 100 contains updated guidance on the subject of equivalence. The concept of equivalence arose when S228A was introduced into CA 1985. This section gave exemption to an intermediate parent undertaking from the requirement to prepare consolidated accounts where its parent entity was not established under the law of an EEA state. This exemption was subject to a number of conditions one of which was the need for the consolidated accounts of the larger group to be drawn up in accordance with the provisions of the Seventh Directive or in a manner equivalent to consolidated accounts and consolidated annual reports so drawn up.

UITF Abstract 43 was published to provide interpretation of "equivalence". When CA 2006 replaced CA 1985, S228A became the new S401 without any changes. UITF Abstract 43 was never updated for the new Act.

Now, FRS 100 contains Application Guidance on the subject of equivalence. This covers much the same ground as UITF Abstract 43 but includes more explicit comments on the GAAP of particular countries. The GAAP of the following countries are considered by the European Commission as equivalent to IFRS: United States, Japan, the People's Republic of China, Canada, the Republic of Korea and (for financial years starting before 1 January 2015) the Republic of India.

For GAAP of other countries, it is still necessary to follow the general principles laid down in FRS 100.

For the purpose of FRS 101 and FRS 102

FRSs 101 and 102 provide exemptions from disclosure in the individual accounts of companies that are part of a group. Some of these disclosure exemptions are dependant on the existence of equivalent disclosures in the consolidated financial statements of the group.

Equivalent disclosures are those that meet the basic disclosure requirements of the relevant standard. There is no need for strict conformity with each and every disclosure. The concept of 'equivalence' for the purpose of FRS 101 and FRS 102 is intended to be aligned to that described for section 401 of the Act.

Disclosure exemptions for subsidiaries are permitted where the relevant disclosure requirements are met in the consolidated financial statements, even where the disclosures are made in aggregate or in an abbreviated form. If, however, no disclosure is made in the consolidated financial statements on the grounds of materiality, the relevant disclosures should be made at the subsidiary level if material in those financial statements.

AMENDMENTS TO THE FRSSE (LECTURE A410 – 16.46 MINUTES)

Introduction

FRS 100 makes amendments to FRSSE. These are described as consequential amendments and are compulsory for accounting periods beginning on or after 1 January 2015. The revised FRSSE may be adopted early. As always, the accounting policies (and/or the statement at the foot of the balance sheet) will indicate what version of the FRSSE is being used and the amended FRSSE will be described as "The Financial Reporting Standard for Smaller Entities (effective January 2015)".

In the notes below, I shall refer to the Financial Reporting Standard for Smaller Entities (effective April 2008) as the existing FRSSE and the Financial Reporting Standard for Smaller Entities (effective January 2015) as the revised FRSSE.

Most commentators have highlighted three major impacts of the revised FRSSE namely those affecting the expected life of intangible assets, the need for an annual impairment review and the changes in definition affecting the disclosure of related party transactions. These three changes are considered below.

However, there are other, perhaps more subtle impacts and these are also dealt with today so that users of these notes can decide whether the revised FRSSE should be adopted early.

Status of the FRSSE

Entities that apply the FRSSE are exempt from complying with other Financial Reporting Standards. Unlike previous versions of the FRSSE, there is no longer a requirement for entities preparing consolidated financial statements to apply elements of the full standards as set out in the previous paragraph 16.2.

The revised paragraph 16.2 simply states that where the reporting entity is preparing consolidated financial statements, it should have regard to paragraph 5 (see below) of the Status of the FRSSE as a means of developing its policies and practices for the preparation of its consolidated financial statements.

Paragraph 5 in the existing FRSSE states that "for transactions or events not dealt with in the FRSSE, smaller entities should have regard to other accounting standards and UITF Abstracts, not as mandatory documents, but as a means of establishing current practice".

This is amended in the revised FRSSE to state “for transactions or events not dealt with in the FRSSE, smaller entities should first have regard to their own existing accounting policies. Where an entity applying the FRSSE undertakes a new transaction not dealt with in the FRSSE for which it has no existing policy, in developing a new policy it should have regard to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland not as a mandatory document, but as a means of establishing current practice”.

The above changes permit FRSSE entities to retain existing accounting policies (in both individual accounts and consolidated accounts) even where these are contrary to FRS 102. In fact, I might go so far as to say that this sentence encourages FRSSE entities to continue with existing accounting policies even where these are contrary to FRS 102.

Public benefit entities (PBEs), only, shall have regard to the requirements in FRS 102 that are specific to PBEs not as mandatory requirements, but as a means of establishing current practice.

Reporting entities that are entitled to adopt the FRSSE, but choose not to do so, are required by the revised FRSSE to apply EU-adopted IFRS, FRS 101 (if qualified to do so) or FRS 102 when preparing financial statements intended to give a true and fair view.

SORPs and other equivalent guidance may specify the circumstances, if any, in which entities in the industry or sector addressed in the SORP or equivalent guidance may adopt the current version of the FRSSE.

Financial statements prepared in accordance with the FRSSE cannot be said to comply with a SORP if the SORP has been drafted on the basis of the requirements of FRS 102. Since, as mentioned above, most SORPs are being updated to conform with FRS 102, this may make it difficult (or even impossible) for an entity to continue to use FRSSE if it is subject to the requirements of an updated SORP. We await comments from the experts as to whether my concerns are valid.

Changes in detailed requirements

Fixed assets

The revised FRSSE states explicitly that capitalised goodwill and intangible assets shall be considered to have a finite useful life. If the entity is unable to make a reliable estimate of the useful life of goodwill or intangible assets, the life shall be presumed not to exceed five years.

In the existing FRSSE, 20 years is an absolute maximum so the new requirement for useful life to be finite will have no impact. However, with good reasons, a longer period than 20 years could now be chosen. As before, the period chosen and the reasons for choosing it must be disclosed.

FRSSE has always contained a requirement that fixed assets and goodwill shall be carried in the balance sheet at no more than recoverable amount. Now the revised FRSSE contains new requirements similar to those in FRS 11.

Paragraph 6.45A requires an assessment at each reporting date of whether there is any indication that an asset should be written down to its recoverable amount. If any such indication exists, FRSSE requires the recoverable amount of the asset to be estimated.

FRSSE states explicitly that, if there is no indication that an asset should be written down, then it is not necessary to estimate the recoverable amount.

Indicators that might be considered as part of the annual assessment are listed in paragraph 6.45B as follows:

- During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.
- Significant changes with an adverse effect on an asset, or the entity, have taken place during the period, or will take place in the near future, (for example external factors such as technological, market, economic or legal changes or internal factors such as the asset becoming idle, or plans to dispose of an asset before the previously expected date).
- Market interest rates have increased during the period, and those increases are likely to affect materially the asset's recoverable amount.
- Evidence is available of obsolescence or physical damage of an asset.
- Evidence is available from internal reporting that indicates that operating results or cash flows from the use of the asset are, or will be, worse than expected.

The technically minded will observe some differences between this list and that provided in FRS 11. For example, FRS 11 refers to "a current period operating loss or net cash outflow" whereas FRSSE refers in e) above to results that are worse than expected. Other examples of differences are the references in FRS 11 to a "commitment to a significant reorganisation" or "a major loss of key employees". Neither of these indicators are included in the list in the revised FRSSE but perhaps the FRC would counter that these indicators are included in the revised FRSSE because they would probably lead to "the asset becoming idle, or plans to dispose of an asset before the previously expected date". In conclusion, it may be that the perceived differences between FRS 11 and the revised FRSSE may not be important.

The existence of one of the above indicators may also indicate that the entity should review (and if necessary adjust) the remaining useful economic life, the depreciation method or the residual value of the asset concerned. Paragraph 6.45C tells us that this adjustment may be necessary even if no loss is recognised for writing down the asset.

Related party transactions

Group exemption

Paragraph 16.2 in the existing FRSSE contains the comment "Where the reporting entity is part of a group that prepares publicly available consolidated financial statements, it is entitled to the exemptions given in FRS 8 paragraph 3(a)-(c)."

These paragraphs give exemption as follows:

- in consolidated financial statements, of any transactions or balances between group entities that have been eliminated on consolidation;
- of transactions entered into between two or more members of a group, provided that any subsidiary undertaking which is a party to the transaction is wholly owned by a member of that group.

Reporting entities taking advantage of the second exemption are required by FRS 8 to state that fact.

This part of paragraph 16.2 has been deleted in the revised FRSSE.

Instead we now have the following addition to the list in paragraph 15.7 of the situations where disclosure of related party transactions is not required

- related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member.

The practical implication of this is that the conditions for non-disclosure are relaxed such that:

- The exemption is not dependant on whether or not the group prepares publicly available consolidated financial statements; and
- there is no need to disclose that the subsidiary is taking advantage of the exemption.

Definitions

The definitions in the revised FRSSE have been amended to make them consistent with the current version of FRS 8. The changes are dramatic when compared with the definitions in the existing FRSSE which were based on an old version of FRS 8 dating from before CA 2006 came into force.

Existing FRSSE	Revised FRSSE
Related parties	*Related party*
Two or more parties are related parties when at any time during the financial period: (a) one party has direct or indirect control of the other party; or (b) the parties are subject to common control from the same source; or (c) one party has significant influence over the financial and operating policies of the other party. Significant influence would occur if that other party is inhibited from pursuing its own separate interests. For the avoidance of doubt, related parties of the reporting entity include the following: i. parent undertakings, subsidiary and fellow subsidiary undertakings; ii. associates and joint ventures; iii. investors with significant influence and their close families; and	A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity'). (a) A person or a close member of that person's family is related to a reporting entity if that person: (i) has control or joint control over the reporting entity; (ii) has significant influence over the reporting entity; or (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. (b) An entity is related to a reporting entity if any of the following conditions applies: (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others). (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member). (iii) Both entities are joint ventures of the same third party.

iv. directors of the reporting entity and of its parent undertakings and their close families.	(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity. (v) The entity is a retirement benefit scheme for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a scheme, the sponsoring employers are also related to the reporting entity. (vi) The entity is controlled or jointly controlled by a person identified in (a). (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).
Close family	*Close members of the family of a person*
Close members of the family of an individual are those family members, or members of the same household, who may be expected to influence, or be influenced by, that person in their dealings with the reporting entity.	Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include: a) that person's children and spouse or domestic partner b) children of that person's spouse or domestic partner; and c) dependants of that person or that person's spouse or domestic partner.

	Key management personnel
	Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Example

John is the owner and sole director of J Ltd. Are the following related parties?

a) *Pauline – John's domestic partner*
b) *Graham – Pauline's brother who lives with John and Pauline*
c) *Sarah –Pauline's daughter from a previous relationship. John has never met Sarah who lives in New Zealand*
d) *K Ltd - a company owned and controlled by John*
e) *L Ltd – a company in which John is one of five directors. John owns no shares in L Ltd*
f) *P Ltd – a company owned and controlled by Pauline*
g) *Claire – a member of key management personnel at J Ltd.*

Suggested answers

Party	Existing FRSSE	Revised FRSSE
Pauline	Yes – subject to influence	Yes
Graham	Yes – subject to influence	No – except in the circumstance where Graham is a dependant of Pauline or John.
Sarah	No	Yes
K Ltd	Yes	Yes
L Ltd	No	Yes
P Ltd	No	Yes
Claire	No	Yes

FRS 101: REDUCED DISCLOSURE FRAMEWORK (LECTURE A411 – 5.58 MINUTES)

Introduction

The starting point for FRS 101 is the definition of a qualifying entity:

"A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation."

A footnote refers to S474(1) of CA 2006 which indicates that inclusion must be by the method of full consolidation not proportional consolidation.

A charity may not be a qualifying entity.

FRS 101 sets out disclosure exemptions for the individual financial statements of qualifying entities.

The exemptions apply to subsidiaries, intermediate parents and ultimate parents in their individual financial statements. The exemptions are not available in consolidated financial statements be they the group accounts for the entire group or any sub-group even if these group accounts are prepared voluntarily.

Conditions

There are three conditions that apply to any entity wishing to take advantage of the reduced disclosures in FRS 101:

- Its shareholders must be notified in writing and do not object to the use of the disclosure exemptions.
- It otherwise applies as its financial reporting framework the recognition, measurement and disclosure requirements of EU-adopted IFRS.
- It discloses in the notes to its financial statements a brief narrative summary of the disclosure exemptions adopted and the name of the parent of the group in whose consolidated financial statements its financial statements are consolidated, and from where those financial statements may be obtained.

Notes on above conditions:

1. The immediate parent of the entity may object. Otherwise, objections may be made by a shareholder or shareholders holding in aggregate 5% or more of the total allotted shares in the entity or more than half of the allotted shares in the entity that are not held by the immediate parent.

2. The requirements of EU-adopted IFRS must be amended where necessary in order to comply with CA 2006 and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. This is necessary because the financial statements prepared by the company under FRS 101 are Companies Act accounts not IAS accounts. Application Guidance in FRS 101 sets out the necessary amendments.
3. A qualifying entity may apply the reduced disclosure framework regardless of whether the financial reporting framework applied in the consolidated financial statements of the group is based on IFRS.

Disclosure exemptions

Some disclosure exemptions (marked * below) are dependent on the inclusion of equivalent disclosures in the consolidated financial statements of the group in which the entity is consolidated. Guidance on 'equivalence' is detailed in the Application Guidance to FRS 100 and was outlined above.

On adoption of FRS 101, disclosure exemptions are available in the following areas (note 1):

(a) IFRS 2 Share-based Payment*

(b) IFRS 3 Business Combinations*

(c) IFRS 5 Non-current Assets Held for Sale and Discontinued Operations*

(d) IFRS 7 Financial Instruments: Disclosures*

(e) IFRS 13 Fair Value Measurement*

(f) IAS 1 Presentation of Financial Statements

(h) IAS 7 Statement of Cash Flows (Note 2)

(i) IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

(j) IAS 24 Related Party Disclosures (Note 3)

(l) IAS 36 Impairment of Assets*

Notes on the above list:

1. In most cases the exemptions apply to particular paragraphs of the IFRS/IAS as listed in FRS 101. The lists are generally long and detailed and are not reproduced here.
2. In the case of IAS 7, the qualifying entity is exempt from the requirements of IAS 7 and is therefore not required to present its own cash flow statement.
3. The disclosure exemptions from IAS 24 relate to (a) the disclosure of key management personnel compensation and (b) the disclosure of related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member.

Transitional rules

A qualifying entity transitioning from EU-adopted IFRS to FRS 101 does not reapply the transitional provisions of IFRS 1. However, the entity will then be preparing Companies Act individual accounts and must consider whether amendments are required to comply with paragraph 5(b) of FRS 101. As mentioned above, amendments may be necessary in order to comply with CA 2006 and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. Application Guidance in FRS 101 sets out the necessary amendments.

Where amendments in accordance with paragraph 5(b) of FRS 101 are required, the entity shall determine whether the amendments have a material effect on the first financial statements presented. Where there is no material effect, the qualifying entity discloses that it has undergone transition to FRS 101 and gives a brief narrative summary of the disclosure exemptions adopted, for all periods presented.

If the amendments have a material effect, then the qualifying entity's first financial statements shall include:

a) a description of the nature of each material change in accounting policy;
b) reconciliations of its equity determined in accordance with EU-adopted IFRS to its equity determined in accordance with FRS 101 for both the date of transition to FRS 101 and for the end of the latest period presented in the entity's most recent annual financial statements prepared in accordance with EU-adopted IFRS; and
c) a reconciliation of the profit or loss determined in accordance with EU-adopted IFRS to its profit or loss determined in accordance with FRS 101 for the latest period presented in the entity's most recent annual financial statements prepared in accordance with EU-adopted IFRS.

If there is a material effect but it is impracticable to apply the amendments retrospectively, a qualifying entity shall apply the amendments to the earliest period for which it is practicable to do so, and it shall identify the data presented for prior periods that are not comparable with data for the period in which it prepares its first financial statements that conform with the reduced disclosure framework set out in FRS 101.

DEBT INSTRUMENTS (LECTURE A412 – 6.37 MINUTES)

Bearing in mind the warning from the ASB that financial instruments are likely to prove an area of difficulty under FRS 102, we continue our series of examples.

Loan at a rate of interest that is not market rate

This example is based on an example provided on the FRC website that was originally produced by the ASB in their material known as Staff Guidance material.

On 1 January 20X1, an entity takes out a loan for £10,000. The lender has agreed a preferential rate of 5% per annum for the entity. The market rate of interest for similar loans is 10% per annum. Interest is paid annually in arrears and the loan must be repaid on 31 December 20X2.

The initial carrying amount should be calculated as the net present value of the cash flows discounted at a market rate of interest.

Year	Discount factor (10%)	Cash flow	Net present value
		£	£
20X1	0.9091	500.00	454.55
20X2	0.8264	10,500.00	8,677.68
NPV			9,132.23

Accounting entries required for initial recognition of the loan:

Dr	Cash	10,000	
Cr	Loans payable		9,132.23
Cr	Finance income		867.77

The annual interest payable and balance sheet amounts can then be calculated as follows:

Year	Carrying amount at start of the year	Interest payable	Cash flow	Carrying amount at end of the year
	£	£	£	£
20x1	9,132.23	913.22	(500.00)	9,545.45
20x2	9,545.45	954.55	(10,500.00)	0.00

Change in rate of loan following financial difficulties experienced by the borrower

The International Accounting Standards Board has issued Training Materials on the IFRS for SMEs and since (draft) FRS 102 is based on IFRS for SMEs, these examples are relevant to us in the UK. The examples below are based on examples 101 and 102 of the training material covering chapter 11 of the IFRS for SMEs. I have provided my own workings but I have not made any changes of principle and the final figures agree with those provided by the IASB. I acknowledge the copyright of the IFRS Foundation in the original material.

Note that the relevant sections from the IFRS for SMEs are included verbatim in (draft) FRS 102 as follows:

11.36 An entity shall derecognise a financial liability (or a part of a financial liability) only when it is extinguished — i.e. when the obligation specified in the contract is discharged, is cancelled or expires.

11.37 If an existing borrower and lender exchange financial instruments with substantially different terms, the entities shall account for the transaction as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, an entity shall account for a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) as an extinguishment of the original financial liability and the recognition of a new financial liability.

11.38 The entity shall recognise in profit or loss any difference between the carrying amount of the financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed.

Example 101:

On 1 January 20X1 a bank provides an entity with a four-year loan of £5,000 on normal market terms, including charging interest at a fixed rate of 8 per cent per year. Interest is payable at the end of each year. The figure of 8 per cent is the market rate for similar four-year fixed-interest loans with interest paid annually in arrears. Transaction costs of £100 are incurred on originating the loan.

Cash flows are as follows:

Year	Cash flow (£)
0	4,900.00
1	-400.00
2	-400.00
3	-400.00
4	-5,400.00

The effective interest rate is approximately 8.612% per annum (determined using the IRR function in excel).

Since the interest was initially set at the market rate, on 1 January 20X1 the entity must, on initial recognition, measure the loan at the transaction price, less transaction costs (i.e. £4,900).

The following was the original amortised cost calculation at 1 January 20X1.

Year	**Carrying amount at start of the year**	**Interest payable at 8.612%**	**Cash outflow**	**Carrying amount at end of the year**
	£	£	£	£
20x1	4,900.00	421.99	(400.00)	4,921.99
20x2	4,921.99	423.89	(400.00)	4,945.88
20x3	4,945.88	425.94	(400.00)	4,971.82
20x4	4,971.82	428.18	(5,400,00)	0.00

In 20X1 the entity experienced financial difficulties. On 31 December 20X1 the bank agreed to modify the terms of the loan. Under the new terms the interest payments in 20X2 to 20X4 will be reduced from 8 per cent to 5 per cent. The entity paid the bank a fee of £50 for paperwork relating to the modification.

At 31 December 20X1:

- the present value of the remaining cash flows of the original financial liability is £4,921.99 discounted at the original effective interest rate of 8.612 per cent.
- the present value of the cash flows under the new terms discounted using the original effective interest rate is £4,539.67 ($250*1/1.08612 + 250*1/(1.08612)^2 + 5{,}250*1/(1.08612)^3$). Including the £50 fee, the present value of the total cash flows is £4,589.67.

- the difference between £4,921.99 and £4,589.67 is £332.32 which is only 6.8 per cent of £4,921.99 (the present value of the remaining cash flows of the original financial liability).

As this difference is less than 10 per cent of the present value of the remaining cash flows of the original financial liability, the entity concluded that this modification should not be considered a substantial modification of the terms of the existing loan.

The IFRS training material explained this decision with the following comment:

"In considering whether the exchange of financial instruments must be accounted for as an extinguishment an entity must judge whether the terms (e.g. maturity date, interest rate, face value, collateral, loan covenants, currency etc) of the instruments exchanged are substantially different (see paragraph 11.37). However, the IFRS for SMEs does not provide guidance on how to make this judgement. In these circumstances the entity may (but is not required to) look to full IFRSs for guidance (see paragraph 10.6). Paragraph AG62 of IAS 39 provides guidance as follows - the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability."

Therefore the modification would not be accounted for as an extinguishment of the original financial liability.

The fees are recognised against the financial liability that continues to be recognised:

	Dr	Cr
Dr Loan (financial liability)	£50	
Cr Cash (financial asset)		£50

To recognise the fees against the financial liability.

Therefore the new carrying amount of the loan at 31 December 20X1 is £4,871.99 (i.e. £4,921.99 less £50).

We must now calculate a modified effective interest rate based on the revised cash flows. For this purpose, the new carrying amount of the loan at the end of 20x1 will be treated as the Year 0 cash flow. Cash flows are therefore as follows:

Year	Cash flow
0	4,871.99
1	-250.00
2	-250.00
3	-5,250.00

The modified effective interest rate is approximately 5.957% per annum (determined using the IRR function in excel).

The new amortised cost calculation at 1 January 20X2 is as follows:

Year	Carrying amount at start of the year	Interest payable at 5.957%	Cash outflow	Carrying amount at end of the year
	£	£	£	£
20x2	4,871.99	290.23	(250.00)	4,912.22
20x3	4,912.22	292.62	(250.00)	4,954.84
20x4	4,954.84	295.16	(5,250,00)	0.00

Example 102

The facts are the same as in example 101. However, in this example, the entity is not required to pay any interest under the revised terms of the loan. The entity needs to repay only the principal and this will be paid a year later than under the original terms (i.e. on 31 December 20X5).

At 31 December 20X1:

- the present value of the remaining cash flows of the original financial liability is £4,921.99 discounted at the original effective interest rate of 8.612 per cent.
- the present value of the cash flows under the new terms discounted using the original effective interest rate is £3,593.01 (i.e. £5,000*1/(1.08612)^4). Including the £50 fee, the present value of the total cash flows is £3,643.01.
- the difference between £4,921.99 and £3,643.01 is £1,278.98 which is 26 per cent of £4,921.99 (the present value of the remaining cash flows of the original financial liability).

The difference is more than 10 per cent of the present value of the remaining cash flows of the original financial liability so, using a similar argument as before (based on IAS 39), the entity concludes that the modification is a substantial modification of the terms of the existing loan. Therefore this debt restructuring would be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The new financial liability is an interest-free loan of £5,000 for four years. If we assume that 8% is still considered to be the market rate for similar four-year fixed interest loans with interest paid annually in arrears then the entity measures the new loan at the present value of the future payments discounted at a market rate of interest for a similar loan (i.e. £5,000*1/$(1.08)^4$). This gives a required balance for the new loan of £3,675.15.

The journal entry on extinguishment of the existing loan and replacement with the new loan is as follows:

Dr Loan (financial liability)	£4,921.99	
Cr New loan (financial liability)		£3,675.15
Cr Cash (financial asset)		£50.00
Cr Profit on derecognition of loan (balancing figure)		£1,196.84

To recognise the extinguishment of the loan.

The amortised cost calculation at 1 January 20X2 is as follows:

Year	Carrying amount at start of the year	Interest payable at 8%	Cash outflow	Carrying amount at end of the year
	£	£	£	£
20x2	3,675.15	294.01	(0.00)	3,969.16
20x3	3,969.16	317.53	(0.00)	4,286.69
20x4	4,286.69	342.94	(0.00)	4,629.63
20x5	4,629.63	370.37	(5000.00)	0.00

FAQ: GROUP ACCOUNTS (LECTURE A413 – 3.27 MINUTES)

Q: Our client P Ltd is a large company that has for many years prepared consolidated accounts. During the year to December 2012 the company disposed of all material subsidiaries. Is P Ltd required to prepare group accounts for the year ended 31 December 2012?

A: Section 399(2) of CA 2006 states: "If at the end of a financial year the company is a parent company the directors, as well as preparing individual accounts for the year, must prepare group accounts for the year unless the company is exempt from that requirement."

At 31 December 2012, the company is a parent company as it still has some subsidiaries at that point in time. It therefore has an obligation to prepare group accounts.

The only reason for not doing so would be if the impact was not material. It might be argued that the remaining subsidiaries are not material and therefore the subsidiaries have no material effect on the balance sheet. However, material subsidiaries have been disposed of and therefore there would be material transactions in the consolidated P&L and hence the materiality argument does not work.

Since group accounts must be prepared then paragraph 46 of FRS 2 is relevant:

"When an undertaking ceases to be a subsidiary undertaking during a period, the consolidated financial statements for that period should include the results of that subsidiary undertaking up to the date that it ceases to be a subsidiary undertaking and any gain or loss arising on that cessation, to the extent that these have not been already provided for in the consolidated financial statements."

UPDATE ON CHARITY MATTERS (LECTURE A414 – 11.16 MINUTES)

Most of the material in this section of the notes has been contributed by Jenny Reed of SWAT UK.

Impact of UK GAAP changes on charities

Nigel Davies, Technical Secretary to the SORP Committee, gave a brief update on progress so far on the next SORP in the September edition of the ICAEW's Charity and Voluntary Sector Group newsletter. He noted that the SORP Committee cannot complete its work until FRS 102 has been finalised (expected in early 2013). Then, provided the FRC approves the draft SORP, the intention is that the public consultation on the next charities SORP will be in late summer 2013. The Code of Practice requires that the consultation period be at least three months. Since the new SORP is being designed with a web based format principally in mind, the consultation will be mainly web based.

The Charity Commission and the Office of the Scottish Charity regulator also hope to work with professional and umbrella bodies to hold some regional events as part of the consultation process, the timing of which is yet to be determined.

Impact of SI 2012/2301 on charities

The government published SI 2012/2301 on 7 September 2012, which applies to accounting periods ending on or after 1 October 2012. The Statutory Instrument can be downloaded from www.legislation.gov.uk.

As noted in the previous Accounting and Auditing Update notes, the key change was the amendment of the Companies Act audit criteria. This in itself will have a minimal impact on charities as the Charities Act audit criteria are much lower.

One of the other changes was the ability to exempt subsidiaries with an EEA parent from audit if they meet certain criteria, principally that their parent company must guarantee their debts. This is unlikely to be viewed favourably by the Charity Commission, and is therefore not recommended for charities.

Hodgson Review of the Charities Act 2006

During its passage through Parliament, a commitment was formed to begin a review of the impact of the Charities Act 2006 within five years of it being granted Royal Assent, this commitment being enshrined in section 73 of the final Act. In November 2011 Nick Hurd, the Minister for Civil Society, appointed Conservative peer Lord Hodgson of Astley Abbotts to lead the review. His final report was published on 16 July 2012.

The main headline proposals are:

- Increasing the Charity Commission registration threshold from £5k to £25k income, with compulsory registration for all non-exempt charities (of any size) wanting to claim Gift Aid
- Charging for charity registration and annual return filing

- Introduction of late filing penalties
- Reduction of the registration threshold for excepted charities from £100k to £25k income
- Increasing the audit threshold from £500k to £1m income and abolition of the 'secondary' audit threshold (i.e. gross income more than £250,000 and total assets more than £3.26m)
- Large charities to be able to pay their trustees

Update on the Charitable Incorporated Organisation

The Charity Commission started accepting applications for registering charitable incorporated organisations (CIOs) from 10 December 2012. This is a welcome end to a saga that has gone on since the Charities Act 2006 received Royal Assent over six years ago.

The timetable for the opening of CIO applications from different sizes of charity has now been published by the Commission (see below). This confirms that the Commission has adopted the widely anticipated staggered approach to registration to avoid being swamped with applications. This is the same approach as that taken by OSCR in Scotland when registration commenced of Scottish CIOs.

At present the Commission are only registering new CIOs with an income of more than £5,000. It is anticipated that existing unincorporated charities wanting to transfer to CIO status will be able to do so from March 2013. There is no timetable yet for existing charitable companies limited by guarantee, but the head of legal services at the Charity Commission has suggested that it could be in 18 months. However, the Commission has stressed that this timetable is indicative only and may be subject to change. Charities considering applying for CIO status are advised to check the Charity Commission website for further updates and changes to the timetable.

This new legal form, designed exclusively for charities, will provide the same limited liability as companies without the need for dual registration with Companies House and the Commission.

A CIO will be able to own property, enter into contracts and sue and be sued in its own name. It is similar to (but not the same as) the Scottish Charitable Incorporated Organisation - which has been available since 2011. It remains to be seen how popular the new legal vehicle will be for both new and existing charities. In Scotland, 28% of new charity registrations were for CIO status in the first eight months of 2012.

Key points relating to CIOs – an overview

- Applications for registration must be made through the Commission's website (an exempt charity cannot apply) and all correspondence must be conducted electronically.
- A CIO comes into existence when entered on the Register of Charities. Similarly, it automatically ceases to exist when removed from the Register.
- There are two types of CIO – Federation (the trustees and members are the same persons) and Association (the trustees and members do not have to be the same persons).
- The CIO must have a constitution, which must include certain provisions to comply with the Charities Act 2011 and the CIO regulations. Models are available on the Charity Commission website and their use is recommended.
- There is a simple process to allow the property of an existing unincorporated charity (including permanent endowment) to be transferred to a CIO, by the completion of a vesting declaration.
- Permanent endowment will be held by the CIO as trustee on its original trusts - not as corporate property of the CIO. The CIO will have the powers of a trust corporation for that trust. (The trust does not need to register separately or produce separate accounts.)
- All CIOs must annually send their accounts and report to the Commission and complete an annual return. While CIOs are not currently fined for late filing, some breaches of the CIO Regulations are offences.
- CIOs must produce accounts under charity law, not company law. CIOs with an income below £250k can therefore opt to prepare simpler receipts and payments accounts.
- CIOs must keep a register of trustees, members and charges (mortgages etc) over CIO property. (The Commission will not maintain a register of charges.)
- The Insolvency Act 1986 applies to CIOs (with modification) so a CIO is subject to the same insolvency and dissolution procedures as a registered company. This means that a CIO can be subject to a voluntary arrangement, be placed in administration, or in receivership, or be wound up voluntarily or by the court.
- A CIO can apply to the Commission for voluntary dissolution. The Commission will then publish a notice (on its website) for three months of its intention to dissolve the CIO. The Commission can also dissolve a CIO itself where the CIO is not in operation, is no longer a charity or is being wound up.

Proposed timetable

- From late March 2013 - window opens for existing unincorporated charities (to set up a CIO and transfer assets into it) with incomes of over £250,000

- From May 2013 - window opens for existing unincorporated charities with incomes between £100,000 and £250,000
- From July 2013 - window opens for existing unincorporated charities with incomes between £25,000 and £100,000
- From October 2013 - window opens for existing unincorporated charities with incomes between £5,000 and £25,000
- From January 2014 - window opens for existing unincorporated charities with incomes less than £5,000 and for brand new charities with anticipated annual incomes of less than £5,000

Public benefit saga continues

If you thought that the issue of public benefit and schools had been settled by the Charity tribunal case and the Charity Commission rewriting its guidance, think again. The issue has now resurfaced, this time in Scotland where The Office of the Scottish Charity Regulator (OSCR) announced in January that 3 out of 13 schools assessed had failed the public benefit test.

Yet again, insufficient action on fees and a lack of access to the benefits provided were the key issues. The three schools in question have been given eighteen months to comply. This is in stark contrast to the five years given by the Charity Commission to the two schools that failed the public benefit test south of the border in 2009, albeit that neither of the two schools ended up needing that long.

The full public benefit assessment reports on all thirteen schools can be read on OSCR's website.

Gift aid

Online Gift Aid due to start from April 2013

HMRC has just announced that charities and Community Amateur Sports Clubs (CASCs) can sign up to make repayment claims electronically from 22 April 2013.

The new service, Charities Online, is being introduced in response to feedback from the charity sector. At present, although the Gift Aid claim form can be completed as an editable PDF on screen, the form has to be printed off and posted to HMRC. The new scheme will make repayment claims faster and easier. Under the transitional rules, paper forms will still be accepted until 30 September 2013. Guidance on the new scheme can be found at:

http://www.hmrc.gov.uk/charities/online/index.htm

New rules for claiming Gift Aid on the proceeds of donors' goods sold by charity shops

The new rules, recently announced by HMRC, allow donors to make a one-off Gift Aid declaration that covers donations of up to £100 (if the charity operates the shop directly), or £1,000 (if the goods are sold by a trading subsidiary) of future sale proceeds, in a tax year. The charity will need to write to the donor only when sale proceeds exceed the amount.

Current rules require a charity to write to a donor before the charity can claim Gift Aid on the proceeds from each sale, so that the donor can confirm that they are UK taxpayers.

Sajid Javid, Economic Secretary to the Treasury, said:

"I'm delighted that we've been able to work with the charity sector to make Gift Aid simpler and less costly for charity shops. Gift Aid income from these shops is important for many charities, and we want to reduce the associated administrative costs as much as possible."

The new procedures will apply from April 2013.

Charity Commission "Back on Track" - November 2012

The Charity Commission's website contains the following explanation:

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

The following comments are extracted from the Charity Commission's annual report for 2011/12.

Trustees are in charge of their charities – not the Commission, and not the courts. This is a fundamental principle of charity law and it is reflected both in the Commission's risk framework and in Lord Hodgson's recommendations following his review of the Charities Act 2006.

Most trustees understand this and take their resulting duties and responsibilities seriously. When problems do occur, trustees are usually able to take steps to limit any harm and prevent a repetition of the problem.

However, occasionally charities experience problems serious enough to require the Commission's involvement. This usually arises when trustees prove unable or unwilling to fulfil their legal duties. In the most serious cases, we can open a statutory inquiry to investigate what went wrong and help the charity get back on track.

Each year, we publish a report of our investigations and regulatory casework.

Charities Back on Track highlights themes, provides a statistical analysis, and identifies lessons emerging from case studies. The aim is not to "name and shame" charities, but to help other trustees prevent similar problems.

Key figures from Charities Back on Track

- 85 investigations closed, of which 9 were statutory inquiries
- 1,027 reports of serious incidents from charities
- 121 whistleblowing reports

Themes from Charities Back on Track

Failures of trusteeship

As in previous years, basic failures of trusteeship were again among the most common problems we saw in our investigations. These failures include:

- breaches of governing document (featured in 17 investigations)
- serious unmanaged conflicts of interest (featured in 16 investigations)
- concerns about fundraising governance (featured in 9 investigations).

Examples to illustrate failures in this area included the case of a charity run by a city council as corporate trustee. We found that the trustee had failed to act in the best interests of the charity by not ensuring its land was used for charitable purposes and by allowing someone to live in charity property rent-free.

Fraud and financial crime

Charities are no worse affected by fraud than other sectors of the economy. But our case work and research by the National Fraud Authority (NFA) show that financial crime continues to affect the work of too many charities.

These issues featured in 18 investigations concluded this year and in over a third (364) of the reports of serious incidents. Among trustees' core duties is ensuring their charity's funds are properly applied and that they manage the risk of abuse. Sound financial controls, and good management and oversight are key to preventing such problems arising in the first place.

Concerns about safeguarding vulnerable beneficiaries

The Commission does not regulate safeguarding issues or investigate child abuse, but we do have a regulatory interest in whether trustees have acted responsibly and complied with their charity law duties.

Trustees of charities working with children and vulnerable adults have a duty of care to their charity which will include taking steps to safeguard these beneficiaries. Our casework shows many trustees do not fulfil their duties in this regard; we continue to see cases where trustees have failed to put safeguarding policies and procedures in place and to then monitor their implementation. Concerns about safeguarding featured in 11 investigations this year.

Failures to monitor and verify the end use of funds

Charity trustees have a duty to ensure their charity's funds are used for legitimate purposes and are reaching the intended beneficiaries. Charities working in high-risk areas face particular risks in this regard and should put strong controls in place to protect the charity's assets and funds. This does not always happen. Concerns about accounting issues - including concerns about proper accounting records and due diligence - featured in 26 investigations, while concerns about alleged connections to terrorism featured in 5 investigations.

Concerns about "sham charities"

It is rare for the Commission's casework to uncover concerns that a charity has been deliberately set up for illegal or improper purposes - organisations that might be called "sham charities".

However, criminals do sometimes set up charities for the purpose of abusing them to generate private profit or gain. This is totally unacceptable, and, when there is evidence to suggest this is the case, we take firm and decisive action. Suspicions about charities set up for illegal or improper purposes featured in 4 of the 85 investigations closed this year.

Working with umbrella bodies

This year's report highlights the advantages of working with an umbrella body. We include the example of an almshouse charity which came to us for authorisation to enter into a contract with a local authority, before seeking and acting on the expert advice of the Almshouse Association. This umbrella body has experience of supporting charities facing similar situations. The approach taken by the almshouse charity created problems that could have been avoided. We recommend all trustees to consider how their charities might benefit from membership of an umbrella body.

AUDIT EXEMPTION FOR SUBSIDIARIES (LECTURE A415 – 24.43 MINUTES)

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 a number of detailed conditions. The most onerous of these conditions is that the parent undertaking must give a guarantee under section 479C in respect of the liabilities of the subsidiary.

The new legislation has given rise to a number of practical questions and some of these are included below.

Q1. My client is a subsidiary of a parent company based in Guernsey. Can they take advantage of audit exemption as a subsidiary company of an EEA parent?

No. See quote below from www.gov.gg

“Guernsey is neither a separate Member State nor an Associate Member of the European Union. The terms relating exclusively to the Channel Islands and the Isle of Man were subsequently embodied in Protocol No. 3 of the Treaty of Accession of the United Kingdom to the EEC, signed on 22 January 1972.”

Further extracts from that website are:

Protocol No. 3 placed the Channel Islands and the Isle of Man within the Common Customs territory of the Community and the Common External Tariff of the European Economic Community. Broadly speaking this means that no customs duties are applied to goods exported to members of the customs union but a common customs tariff applies to goods imported into the customs union from non-member countries.

Protocol 3 also provides that Guernsey is "within" the EU for most of the purposes of the free movement of goods but outside the EU for other purposes, in particular non-customs related fiscal matters and the free movement of persons and services. The Island is not eligible for assistance from the Union's structural funds or under the support measures for agricultural markets.

Ratification of the EEA Agreement by the United Kingdom had the effect of extending the Agreement to the Crown Dependencies from 1 January 1995, by virtue of the Community Treaties enshrined in the UK Treaty of Accession. However, the EEA Agreement applies to the Crown Dependencies only to the extent that is consistent with Protocol 3.

Q2: If one subsidiary in a group wishes to take advantage of audit exemption, is it necessary for all subsidiaries in the group to take advantage of audit exemption?

No.

Q3: X Ltd is a subsidiary of a parent company in Germany. The ultimate parent company is based in the USA. Can X Ltd take advantage of audit exemption under S479A and, if so, which parent needs to provide the guarantee?

X Ltd is entitled to audit exemption under S479A. The German parent will provide the guarantee.

One possible sticking point is that X Ltd must be included in accounts drawn up by the German parent and these must be filed in the UK with a translation into English or Welsh. It may be that the German company enjoys an exemption from preparing group accounts (similar to our exemption in S401 of CA 2006) and are not willing to prepare them for this purpose.

In passing, what would the situation be if the immediate parent was the US company and the ultimate parent was the company in Germany? In this case, X Ltd could still claim exemption. The German parent would provide the guarantee and include X Ltd in group accounts.

The reason why this is the case can be found in CA 2006 S1162. Sub section 2 gives the general definition of a parent, holding a majority of the shares etc. Sub section 3 then goes on to say: "For the purposes of subsection (2) an undertaking shall be treated as a member of another undertaking if any of its subsidiary undertakings is a member of that undertaking."

So where you have A owns B which owns C then Company A is the parent of C for the purposes of claiming exemption under s479A. A parent company can therefore be the ultimate parent or any intermediate parent in the chain.

Q4: My client is a UK company which is the parent of a UK group. It is keen to adopt audit exemption for all of its subsidiaries. They have asked whether the guarantee required under S479C can follow a standard form or whether they need to take their own legal advice.

Companies are required to confirm the guarantee for each year to Companies House. The guarantee statement should be prepared by a solicitor. Apparently, there are legal difficulties in having a standard guarantee that all companies could use.

This cost was envisaged by the government when BIS published the government response to consultation in September 2012. This included the following comments:

"The Impact Assessment anticipates there may be a one-off cost for external legal and accounting advice in the range of £2,000 to £5,000 per group holding company when the guarantee is first made and valued, and a subsequent ongoing annual cost for internal legal advice regarding the continued provision of the guarantee."

"However, in accordance with responses from consultees for more clarity as to the guarantee, the legislation implementing the policy provides that the parent guarantee is given under statute. This should make it more straightforward for parents and creditors, and reduce the legal advice necessary."

"In terms of ongoing costs, the Impact Assessment estimates that each group will require 4 to 10 hours of internal legal advice."

We wait to see developments in this area but, at the moment, the only advice you could give to a client is that they need to take legal advice. Sorry!

Q5. What debts are covered by the guarantee? Is it just the debts in the subsidiary's balance sheet or does it go further than that?

CA 2006 S479C(3) states:

"A guarantee given under this section 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 undertaking by any person to whom the subsidiary company is liable in respect of those liabilities."

The guarantee is in force for all liabilities that exist at the balance sheet date until they are satisfied. Notice that the above quote does not refer to liabilities recognised in the balance sheet therefore we need to consider other possible amounts as well.

The article "Every rose has its thorn" published in Audit and Beyond addresses this question somewhat. It says that, although the Regulations fail to define "all outstanding liabilities", the Consultation Report indicates that the wording of the guarantee is deemed to cover liabilities in tort and contingent liabilities.

Contingent liabilities will not be recognised in the balance sheet (if they were we would call them provisions) and may not even be disclosed (if they are remote). The contingent liability arising in 2012 could come back to haunt the parent company many years in the future.

What about obligations under operating leases as disclosed in the notes to the accounts? We know that they do not need to be recognised as liabilities in the balance sheet but are they "liabilities to which the subsidiary is subject at the end of the financial year"? If so, they are caught within the guarantee.

Liabilities with respect to finance leases are included in the balance sheet net of interest costs which are not yet due but are these future interest costs “liabilities to which the subsidiary is subject at the end of the financial year”?

Observe also that the guarantee could relate to liabilities arising in previous years since the guarantee covers all outstanding liabilities to which the subsidiary is subject at the end of the financial year not just the ones that arose during the financial year.

So, to quote the article again, “ the liabilities guaranteed can stretch endlessly into the past and the parent remains potentially liable for these liabilities infinitely into the future”.

And this indefinite future survives even the sale of the subsidiary – although presumably the sale agreement could arrange for the new owners to take over the guarantee from the previous owners.

This uncertainty over the scope of the guarantee is another reason why the parent should seek legal advice before going ahead.

Q6: If the client takes advantage of audit exemption does this mean that the auditor has ceased to hold office?

Probably yes – and note that this question is also relevant to the situation where a small company becomes audit exempt whether as a result of the recent change in the law or because of a reduction in size.

For private companies the appointment of an auditor is, subject to certain provisions, automatic under S485.

The auditor holds their appointment until the end of the next period for appointing auditors. Unless another auditor is appointed, or the directors decide not to appoint auditors, their re-appointment is automatic. The period for appointing auditors is 28 days after the earlier of the time allowed for sending out copies of the annual accounts under section 424 (9 months), or the date on which the accounts are sent out under section 423.

For example, a company with an accounting year ending 31 October 2011 would have reached the end of the period for appointing auditors by 28 August 2012 at the latest. Note this is just before the announcement was made by the Government concerning the changes to audit exemption and so, at that point in time, it was expected that an audit would be required for the year ending 31 October 2012. The auditors are automatically reappointed to perform the audit for the year ending 31 October 2012 and **must** perform that audit under S495 unless they are removed or resign from office. Their appointment finishes at the end of the next period for appointing auditors i.e. 28 days after the next set of audited accounts has been sent to the members.

On this basis, if the directors decide after 28 August 2012 to take advantage of audit exemption for the year ending 31 October 2012, then the auditor will need to resign or be removed. In this case, the auditor has ceased to hold office and therefore the requirements of the Companies Act will need to be complied with.

Q7. In the following example, what would be the effect on the quantity of audit work required in the audit of Q Ltd if all of the subsidiaries took advantage of audit exemption for the year ended 31 December 2012?

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	*£2m*	*£7m*	*£0.5m*	*£0.5m*
Balance sheet total	*£2.7m*	*£4.5m*	*£0.3m*	*£0.5m*
Number of employees	*10*	*40*	*10*	*10*

For simplicity, assume that there is no trading within the group and no balances with other members of the group.

The first and obvious impact is that the auditor will be expressing an opinion on the financial statements of Q Ltd but not giving a separate opinion on the accounts of the three subsidiaries.

However, the question is more concerned with the possible reduction in the audit work required and the consequent cost savings for the client.

ISA 600 requires the auditor to identify any significant components, defined as:

"A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements."

Guidance suggests that the group engagement team applies a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Benchmarks in our example might be group total assets (£8m) or group turnover (£10m). It is often suggested that components exceeding 15% of the chosen benchmark are significant components. Note the benchmarks should be applied in aggregate not on an individual basis.

In our example, A Ltd is clearly a significant component whereas B Ltd and C Ltd are probably not.

For a component that is significant, ISA 600 requires an audit of the financial information of the component using component materiality. Component materiality is the materiality for a component and is determined by the group engagement team. ISA 600 requires component materiality to be lower than materiality for the group financial statements as a whole in order to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole.

Notice that the words used to describe component materiality in ISA 600 (as shown above) are identical with the words used to describe performance materiality in ISA 320. The group auditor is therefore building a margin of safety into the audit of the significant component.

The component auditor must now determine a performance materiality for use in auditing the component. The group engagement team must evaluate whether the performance materiality determined at the component level is appropriate for the purpose of the group audit.

Let's calculate figures for these various materialities using the data for the Q group. We will assume that the auditor adopts the approach of setting materiality at 1% of turnover and performance materiality at approximately 75% of materiality – assuming there are no high risk considerations affecting this judgment.

When all members of the group are subject to statutory audit (as in 2011):

	Q Ltd	A Ltd	B Ltd	C Ltd	Group
Materiality	£20K	£70K	£5K	£5K	£100K
Performance materiality	£15K	£52K	£3.5K	£3.5k	£75K

In this situation, where all components are subject to audit by statute, the group engagement team would like to use the statutory audit of the components to provide audit evidence for the group audit. In this case, the group auditor needs to decide whether the materiality and performance materiality for each component are satisfactory from a group point of view. It is very likely, in this case, that sufficient work has been performed during the statutory audit of the components to satisfy the group auditor.

When the subsidiaries have taken advantage of audit exemption, we get:

	Q Ltd	Group
Materiality/ group materiality	£20K	£100K
Performance materiality/ group performance materiality	£15K	£75K
	A Ltd	
Component materiality	£75K	
Component performance materiality	£56K	

In setting, materiality and group materiality, I have, as before, used 1% of turnover. For component materiality, I have used 75% of group materiality and component performance materiality has then been set at approximately 75% of component materiality.

There is no need to set materiality/performance materiality for either B Ltd or C Ltd since it is not necessary to audit components that are not, in aggregate, significant components (assuming also that they are not likely to include significant risks of material misstatement of the group financial statements).

It can be seen that, with the figures in the Q group, the decision to claim audit exemption for A Ltd will make very little difference to the quantity of audit work performed in the audit of A Ltd.

The real saving in time for the auditor of the Q group will come with respect to the insignificant components for which the group engagement team is only required to perform analytical procedures at group level.

It is clear from the above that the saving in audit time across the entire group depends on the relative sizes of the subsidiaries compared with the totals for the group. Suppose that the P group consists of a parent company P Ltd with 5 subsidiaries. The parent and each of the subsidiaries has a turnover of £4m giving total group turnover of £24m.

If all 5 subsidiaries are subject to statutory audit then they will each be audited using materiality of £40K and performance materiality of £30K (assuming the same audit methodology as earlier). Suppose that in a particular audit area for subsidiary number 1 the auditor has calculated a sample size of 45 using a methodology based on the formula

n = (Population x risk factor)/performance materiality.

If all 5 subsidiaries claim exemption from audit, then they are all significant subsidiaries and will require audit with component materiality of £180K (based on 75% of group materiality of £240K). Component performance materiality will be £135K for each subsidiary. In the same audit area considered earlier for subsidiary number 1 the auditor will now calculate a sample size of 10.

In this example, assuming sample sizes are always based on performance materiality then all sample sizes will be reduced to 2/9th of their original size. However, not all work performed by the auditor is based on sampling and therefore we cannot jump to any quick conclusion about the saving in audit time. The point is that the client's directors need the auditor to provide an estimate of the saving on audit costs before they can decide whether subsidiary company audit exemption is likely to yield an overall saving.

Q8. The directors of our client Z Ltd have decided that all subsidiaries should take advantage of audit exemption. On this basis they say that they will not allow us to perform any audit work on the subsidiaries. Is this acceptable?

No. This is a limitation on the scope of your audit and it is imposed by the directors. If they will not change their mind then you will need to resign as auditor. See paragraphs 11 to 14 of ISA 705.

TRUSTEE SHAREHOLDINGS IN AUDIT CLIENTS (LECTURE A416 – 8.36 MINUTES)

Audit News 52 contains an article on the subject of trustee shareholdings in audit clients. The article points out that the threat to the auditor's independence may, in some cases, be too great to safeguard. Some firms have been given regulatory penalties for failing to deal with these situations appropriately.

Paragraphs 19 to 21 of ES 2 deal with this subject. The first step is to decide whether the person acting as a trustee (or an immediate family member of such a person) is in a position to influence the conduct and outcome of the audit.

There is a definition of "person in a position to influence the conduct and outcome of the audit" in the glossary of terms published with the ethical standards. The definition starts with the engagement team - including the audit team, professional personnel from other disciplines involved in the audit engagement and those who provide quality control or direct oversight of the audit engagement. However, parts (b) and (c) of the definition go on to include any person who forms part of the chain of command for the audit within the audit firm and any person within the audit firm who, due to any other circumstances, may be in a position to exert such influence.

Where the trustee (or their immediate family member) is in a position to influence the conduct and outcome of the audit then it is only possible to hold such a trustee interest where all of the following conditions are met:

- the relevant person is not an identified potential beneficiary of the trust; and
- the financial interest held by the trust in the audited entity is not material to the trust; and
- the trust is not able to exercise significant influence over the audited entity or an affiliate of the audited entity; and
- the relevant person does not have significant influence over the investment decisions made by the trust, in so far as they relate to the financial interest in the audited entity.

Any uncertainty concerning the fulfilment of these conditions is reported to the firm's Ethics Partner so that a decision can be made as to the steps that need to be taken. A common problem area is that in many cases, the shares in the audited entity are the only asset of the trust and, as such, are bound to be material to the trust whatever their value.

Recognising the difficulties involved in the above, audit firms might consider whether the trustee could be changed to a different partner in the firm who is not involved in the audit. The advantage of this is that most of the above conditions cease to apply. The only condition in this situation is that the trustee (or an immediate family member) must not be an identified potential beneficiary of the trust.

However, when trying to identify a partner who is not involved in the audit, particular care must be taken with parts (b) and (c) of the above definition.

Chain of command is defined by the glossary as:

"All persons who have a direct supervisory, management or other oversight responsibility over either any audit partner of the audit team or over the conduct of audit work in the audit firm. This includes all partners, principals and shareholders who may prepare, review or directly influence the performance appraisal of any audit partner of the audit team as a result of that partner's involvement with the audit engagement. It does not include any non-executive individuals on a supervisory or equivalent board."

In practice, particularly for smaller firms, it may be difficult to identify a partner in the firm who is not in a position to influence the conduct and outcome of the audit. Audit News points out that any senior principal in a firm is likely to be considered to have influence over a more junior principal unless the firm can demonstrate this isn't the case. Also, remember that the definition stretches to "an immediate family member" defined by the glossary as "A spouse (or equivalent) or dependent".

The final difficulty in finding a partner who is not in a position to influence the conduct and outcome of the audit is the perception of outsiders. Audit News points out that "someone outside the firm may perceive that any principal in the firm could exert influence over another. So, even if the firm considers that it has addressed any threat, it should also consider how the situation looks from the outside."

So we return to our starting point - the threat to the auditor's independence may, in some cases, be too great to safeguard. In this case, either the trustee must resign the trustee appointment or the firm must resign as auditor. Such action should be taken immediately.

ANALYTICAL REVIEW (LECTURE A417 – 13.17 MINUTES)

Final analytical review

Extracts from ISA 520

In our last update notes we considered what was required when performing preliminary analytical review. We ended with an example of a working paper that would be sufficient to meet the requirements of ISA 315. Today we try to answer the same question with respect to final analytical review.

Paragraph 6 of ISA 520: "The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity."

Auditors have always been uncertain as to what work should be recorded on file in order to satisfy this requirement. Unfortunately, the ISA offers little help. Indeed the ISA as prepared by the IAASB contained only three short guidance paragraphs:

- The conclusions drawn from the results of final analytical procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.
- The results of final analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, the auditor should revise the risk assessment and modify the planned audit procedures accordingly.

- Final analytical procedures may be similar to those that would be used as risk assessment procedures.

It is from a UK-plus (Paragraph A17-1) that we can develop the following list of questions to consider when carrying out final analytical procedures:

- Do the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of the audit?
- Do the procedures reveal any new factors which may affect the presentation of, or disclosures in, the financial statements?
- Do the final analytical procedures assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the entity's business?
- Has the presentation adopted in the financial statements been unduly influenced by the desire of those charged with governance to present matters in a favourable or unfavourable light?
- What is the potential impact of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit?

Practical considerations

It is sometimes suggested that the final analytical review should consist of a review of the final P&L account and balance sheet in the same way as was performed at the pre-planning stage. Indeed, the Application material reinforces this view. I have two comments to make about this:

- Do not repeat work which has already been performed. When the accounts were reviewed at the pre-planning stage, the auditor listed areas of risk to be followed up. As long as these risks have been resolved then the accounts should now make sense. Another possibility is that the draft accounts have been amended. If so, the auditor will need to reconsider any comparisons or ratios which have been affected by the amendments.
- We can document final review in the same way that we recorded pre-planning analytical review. This means recording work done, results and conclusions rather than recording long lists of ratios and explanations.

When documenting final review we need to ensure that the considerations listed in Paragraph A17-1 are dealt with on file.

Final analytical review: Example working paper

Work performed

The draft detailed P&L account and balance sheet were prepared and reviewed by AB at the pre-planning stage. This work is recorded on schedule x/x of the accounts file. Three areas were identified for examination during the audit and these issues have now been resolved (Schedule y/y).

In addition, there were post trial balance adjustments affecting stock and to correct errors identified during the audit. Schedule x/x has been annotated to reflect the impact of these changes on the ratios and analyses recorded. The ratios were reconsidered and no problems were identified.

The accounts were read for sense. It was also confirmed that there were no inconsistencies between the financial statements and the surround information.

Conclusion

The financial statements reflect the information and explanations obtained during the audit and are consistent with my understanding of the entity. The final review did not reveal any new factors affecting the financial statements nor did it reveal any bias in the presentation of information. The potential impact of any uncorrected misstatements is not material. The final review did not indicate any risk of material misstatement due to fraud.

Substantive analytical review example

The Clarity standard is very demanding when it comes to analytical review. Paragraph 5 requires that when designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures the auditor shall:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7.

Demonstrating what is needed

On a course recently, when trying to demonstrate what is required from auditors in terms of good analytical review, I remembered an old case study on analytical review which shows how it should be done. You can only solve the problem below if you form expectations before reviewing the ratios.

The example is over ten years old so you have to imagine how the businesses were back then, which adds to the fun. I have not provided the answers either, because they are lost in the mists of time, so this will add to the enjoyment even further, for everyone!

Example

Below are accounting ratios of six companies.

The companies fall into the following categories:

- Two Brewers
- Two Telephone Companies
- One Food Retailer and one Food Manufacturer

You are required in your groups to identify into which category each company falls.

Company	I	II	III	IV	V	VI
Gross profit %	36	33	31	9	N/A	N/A
Net profit %	7	7.5	5	2	22	21
Stock as % of turnover	8	10	9	4	19	5
Debtor Days	37	45	27	5	110	100

Fixed assets as % of turnover	23	196	138	37	117	132
Current ratio	1.22	0.85	0.46	0.44	0.77	1.00
Gearing ratio	0.21	0.11	-	0.31	28	30
Dividend cover	3	6	12	3.4	2.5	5
Investment as % of gross assets	0.5	17	4	-	7	7
Employee cost as % of turnover	21	20	19	10	35	20

ISQC (UK AND IRELAND) 1 QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF FINANCIAL STATEMENTS, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS (LECTURE A418 – 16.51 MINUTES)

Introduction

There are two reasons why we are including ISQC1 in this quarter's update notes. Firstly, ISQC1 is the only clarified standard that we have not yet covered in our update notes. Secondly, this is an area where the monitors from the professional bodies are frequently critical of audit firms - in particular the failure to produce an ISQC1 "manual". Note that, as usual, when I refer to ISQC 1, I mean ISQC (UK and Ireland) 1.

In the UK and Ireland, ISQC 1 applies to firms that perform audits of financial statements, report in connection with investment circulars and provide other assurance services where they relate to activities that are reported in the public domain and are therefore in the public interest.

Other pronouncements of the International Auditing and Assurance Standards Board set out additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements. ISA 220, for example, deals with quality control procedures for audits of financial statements.

A system of quality control consists of policies designed to achieve the objective set out below and the procedures necessary to implement and monitor compliance with those policies.

Objective and selected definitions

The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

Engagement partner - The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Engagement quality control review - A process designed to provide an objective evaluation, on or before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report. The engagement quality control review process is for audits of financial statements of listed entities, and those other engagements, if any, for which the firm has determined an engagement quality control review is required.

Engagement quality control reviewer - A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.

Inspection - In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

Monitoring - A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

Relevant ethical requirements - Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise Parts A and B of the International Federation of Accountants' Code of Ethics for Professional Accountants (IFAC Code) together with national requirements that are more restrictive.

Auditors in the UK and Ireland are subject to ethical requirements from two sources: the APB Ethical Standards for Auditors concerning the integrity, objectivity and independence of the auditor, and the ethical pronouncements established by the auditor's relevant professional body. The APB is not aware of any significant instances where the relevant parts of the IFAC Code of Ethics are more restrictive than the Ethical Standards for Auditors.

The APB Ethical Standard for Reporting Accountants applies to all engagements:

- that are subject to the requirements of the Standards for Investment Reporting (SIRs), and
- which are in connection with an investment circular in which a report from the reporting accountant is to be published.

Applying, and complying with, relevant requirements

Paragraph 13 requires that personnel within the firm responsible for establishing and maintaining the firm's system of quality control have an understanding of the entire text of this ISQC (UK and Ireland), including its application and other explanatory material, to understand its objective and to apply its requirements properly. Note that there is no general requirement for all auditors to understand the entire text of ISQC 1.

The firm must comply with all relevant requirements of ISQC 1. The requirements are designed to enable the firm to achieve the objective stated above. Therefore, the proper application of the requirements is expected to provide a sufficient basis for the achievement of the objective. However, because circumstances vary widely and all such circumstances cannot be anticipated, the firm is required to consider whether, in order to meet the objective, policies and procedures need to be established in addition to those required by this ISQC (UK and Ireland).

Elements of a system of quality control

The firm must establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:

(a) Leadership responsibilities for quality within the firm.

(b) Relevant ethical requirements.

(c) Acceptance and continuance of client relationships and specific engagements.

(d) Human resources.

(e) Engagement performance.

(f) Monitoring.

These elements are addressed in the requirements in ISQC 1 and are summarised below.

These policies and procedures must be documented and communicated to the firm's personnel.

Leadership responsibilities for quality within the firm

The firm is required to establish policies and procedures designed to promote an internal culture recognising that quality is essential in performing engagements. This requires the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent) to assume ultimate responsibility for the firm's system of quality control. Any person or persons assigned operational responsibility for the firm's system of quality control must have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.

Relevant ethical requirements including independence

The firm is required to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Paragraphs 21 to 25 set out requirements for policies and procedures concerning independence including:

(a) Communication of independence requirements to the firm’s personnel and others.

(b) Identification and evaluation of threats to independence. The elimination of those threats or reduction to an acceptable level by the application of safeguards. Alternatively, the need to withdraw from the engagement, where appropriate.

(c) The need for engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements.

(d) The requirement for personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.

(e) The accumulation and communication of relevant information to appropriate personnel so that the firm and its personnel can readily determine whether they satisfy independence requirements; the firm can maintain and update its records relating to independence; and the firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.

(f) Policies and procedures designed to provide the firm with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. These policies and procedures include requirements for:

- personnel to promptly notify the firm of independence breaches of which they become aware;
- the firm to promptly communicate identified breaches of these policies and procedures to the engagement partner who, with the firm, needs to address the breach; and other relevant personnel in the firm and, where appropriate, the network, and those subject to the independence requirements who need to take appropriate action; and
- prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to above of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

(g) Annual written confirmation of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant ethical requirements.

(h) Criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time. This includes compliance with any rotation requirements for audits of financial statements of listed entities.

Acceptance and continuance of client relationships and specific engagements

Paragraphs 26 to 28 contain requirements for the firm to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. These requirements cover:

(a) Competence to perform the engagement and the capabilities, including time and resources, to do so.

(b) Compliance with relevant ethical requirements.

(c) Consideration of the integrity of the client.

(d) The need for the firm to obtain such information as it considers necessary in the circumstances before accepting or continuing an engagement.

(e) Potential conflicts of interest.

(f) The documentation of how issues were resolved.

(g) The situation where the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures shall include consideration of the professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and the possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Human resources and assignment of engagement teams

Paragraphs 29 to 31 cover the issue of human resources.

The firm is required to establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles necessary to perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

An engagement partner should be assigned responsibility for each engagement. The identity and role of the engagement partner should be communicated to key members of client management and those charged with governance. The engagement partner must have the appropriate competence, capabilities, and authority to perform the role and the responsibilities of the engagement partner must be clearly defined and communicated to that partner.

The firm is also required to establish policies and procedures to assign appropriate personnel with the necessary competence, and capabilities to perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

Engagement performance

The firm shall establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances. Such policies and procedures shall include matters relevant to promoting consistency in the quality of engagement performance; supervision responsibilities; and review responsibilities.

The firm's policies and procedures for review should be based on the principal that work of less experienced team members is reviewed by more experienced engagement team members.

Consultation

Paragraph 34 requires the firm to establish policies and procedures concerning consultation. These should ensure that appropriate consultation takes place on difficult or contentious matters; sufficient resources are available to enable appropriate consultation to take place; the nature and scope of, and conclusions resulting from, such consultations are documented and are agreed by both the individual seeking consultation and the individual consulted; and conclusions resulting from consultations are implemented.

Appropriate recognition of consultation in the firm's policies and procedures helps to promote a culture in which consultation is recognised as a strength and encourages personnel to consult on difficult or contentious matters.

Engagement quality control review

Paragraphs 35 to 42 deal with the engagement quality control review (EQCR). These paragraphs require policies and procedures dealing with various issues. The requirements can be summarised as follows:

- An EQCR must be performed for all audits of listed entities and for other entities satisfying the criteria set by the firm;
- The policies must deal with the nature, timing and extent of an engagement quality control review. The auditor’s report must not be dated until the completion of the EQCR
- The EQCR must include a discussion of significant matters with the engagement partner; a review of the financial statements or other subject matter information and the proposed report; a review of selected engagement documentation relating to significant judgments the engagement team made and the conclusions it reached; and evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate.
- There are additional requirements for audits of listed entities (see Paragraph 38). These relate to independence, consultation and whether the documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.
- The firm’s policies must deal with the eligibility and objectivity of Engagement Quality Control Reviewers. Also the possible need for the replacement of the engagement quality control reviewer where the reviewer's ability to perform an objective review may be impaired.

- Documentation of the EQCR should indicate that the procedures required by the firm's policies on EQCR have been performed; the EQCR has been completed on or before the date of the report; and the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

We consider EQCR again later in these notes concentrating on the requirements of ISA 220.

Differences of opinion

Paragraph 43 requires the firm to establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Such policies and procedures must require that conclusions reached be documented and implemented. Further, the report must not be dated until the matter is resolved.

Engagement documentation

The firm is required to establish policies and procedures:

- For engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalised. The Application Material indicates that such a time limit would ordinarily not be more than 60 days after the date of the auditor's report.
- Designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.
- For the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.

Monitoring

48. The firm shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. This process shall:

(a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner;

(b) Require responsibility for the monitoring process to be assigned to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility; and

(c) Require that those performing the engagement or the engagement quality control review are not involved in inspecting the engagements.

Paragraphs 49 to 54 are concerned with the follow-up from the monitoring process. The following matters are covered:

- Consideration of whether the deficiencies identified are specific to individual assignments or whether there are weaknesses in the firm's systems which require prompt corrective action.
- The need for communication to relevant partners and staff.
- The requirement that the recommendations for appropriate remedial action include one or more of the following:

  (a) Appropriate remedial action in relation to an individual engagement or member of personnel;

  (b) Communication of the findings to those responsible for training and professional development;

  (c) Changes to the quality control policies and procedures; and

  (d) Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.
- The need for policies and procedures to address cases where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement.
- The requirement for the firm to communicate at least annually the results of the monitoring of its system of quality control to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing board of partners.
- Issues arising where firms operate as part of a network (See Paragraph 54).

Complaints and allegations

Paragraph 55 requires the firm to establish policies and procedures concerning complaints and allegations. This includes the requirement that the firm must establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

If deficiencies in the design or operation of the firm's quality control policies and procedures or non-compliance with the firm's system of quality control by an individual or individuals are identified, the firm is required to take appropriate actions as set out in paragraph 51.

Documentation of the system of quality control

Paragraphs 57 to 59 require the firm to establish policies and procedures:

- Requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.
- That require retention of documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.
- Requiring documentation of complaints and allegations and the responses to them.

Example documentation

ISQC 1 requires audit firms to document their quality control procedures. The following is an example of what this could look like in its most simplistic form.

Leadership Responsibilities

The firm's managing partner takes overall responsibility for audit quality and Mr J Angus is the audit compliance partner.

Ethics

Mrs J Robinson is the firm's ethics partner. Compliance with the APB Ethical Standards should be ensured by using the xxx audit pack for all audits and the appropriate checklist for appointment and reappointment.

The firm's staff manual sets out the rules on gifts from clients.

Training requirements on Ethics are being met thought the regular courses run by xxx Training.

Acceptance and continuance

See the firm's audit manual. Acceptance/reappointment checklists are used for all audits.

The Money Laundering compliance checklist should be used for all new appointments. The need for ongoing due-diligence work is considered as part of the reappointment checklist.

Queries should be addressed to the Money Laundering Compliance Officer, Mrs J Robinson.

Human resources

See the firm's staff manual. Procedures are in place to ensure that only staff and partners with the appropriate and relevant experience and knowledge undertake audit work. This is considered during the planning of every audit in the planning checklist.

Audit related training is provided by xxx Training and audit staff are expected to attend at least 3 out of the 4 quarterly update courses and any relevant topical courses.

All audit staff are expected to read Audit & Beyond which is available in the library.

Engagement performance

The audit approach set out in the audit manual and the standard working papers pack should be used for every audit.

All second partner reviews are carried out by Mr J Angus. Except his files will be reviewed by Mrs J Robinson. Where necessary external hot file reviews are carried out by xxx Training.

Monitoring

The Audit Compliance Review and the cold file reviews are carried out for the firm by the xxx Training Group.

Both ACCA and the Audit and Assurance Faculty of the ICAEW have issued guidance on ISQC1. You are also referred to an article in the September 2010 issue of Audit and Beyond.

WHAT IS THE DIFFERENCE BETWEEN A HOT FILE REVIEW AND AN ENGAGEMENT QUALITY CONTROL REVIEW? (LECTURE A419 – 9.44 MINUTES)

This question was posed by Andy Holton of SWAT UK in an article in Audit and Beyond published in November 2012. He went on to ask whether hot file reviews and second partner reviews are the same thing and when, and why, a formal consultation should be conducted.

In these notes, we go back to the requirements of ISA 220 incorporating relevant comments from the article.

Engagement quality control review (EQCR)

ISA 220 defines engagement quality control review as a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. The engagement quality control review process is only for audits of financial statements of listed entities and those other audit engagements, if any, for which the firm has determined an engagement quality control review is required.

The first thing to note is that EQCR is only required for listed audits and those other audits, if any, for which the firm has determined that an EQCR is required. As such, some firms may have no audits requiring EQCR. This does not mean that they will not require audits to be subject to second partner review or hot review.

Andy makes the point that, to avoid confusion, where a review is an EQCR, you should call it such rather than labelling it a hot file review. This will keep the reason and purpose of the review clear.

Where an EQCR is required, Paragraph 19 of ISA 220 places obligations on the engagement partner to:

- Ensure that an engagement quality control reviewer has been appointed.
- Discuss with the engagement quality control reviewer significant matters arising during the audit and the EQCR.
- Not date the auditor's report until the completion of the engagement quality control review. (Otherwise what was the point of it!)

Paragraph 20 of ISA 220 then requires the engagement quality control reviewer to perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This will require review of selected audit documentation and consideration of whether the proposed auditor's report is appropriate.

The EQCR also involves discussion of significant matters with the engagement partner (matching with the engagement partner’s responsibility above) and review of the financial statements and the proposed auditor's report.

Paragraph 21 lists additional requirements for an EQCR for audits of financial statements of listed entities. These relate to independence, consultation and the adequacy of audit documentation in relation to significant judgments.

It should be noted from the above that an EQCR is not a review of the complete audit file.

Paragraph A28 of the Application Material lists other matters that may be considered in an engagement quality control review as follows:

- Significant risks identified during the engagement and the responses to those risks including the engagement team's assessment of, and response to, the risk of fraud
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters are listed in ISA 220 as being applicable to listed entities but it goes on to say that, depending on the circumstances, these matters may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

Note that the EQCR must be completed before the date of the auditor’s report but the documentation of the EQCR may be completed after the date of the auditor's report as part of the assembly of the final audit file.

My comment on this is that I sometimes get asked to perform cold file reviews of audits where the job is finished in the sense that the auditor’s report has been signed. My review then reveals that the paperwork is not complete. Invariably the excuse is made that ISA 230 gives 60 days for this task.

Not so!

Paragraph 14 of ISA 230 states “The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.”

No limit is given. It is in Paragraph A21 of the Application material that we find “An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.”

In other words 60 days is an absolute limit but firms should aim for a shorter period and might consider setting a policy for a shorter period.

Note also that paragraph 14 refers to the assembly of the audit file as an administrative process. The Application material stresses that this does not involve the performance of new audit procedures or the drawing of new conclusions.

Changes of an administrative nature may be made during the final assembly process. The Application Material gives as examples:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists **relating to the file assembly process**.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

I have added the bold print above in order to emphasise that the only completion checklists that can be completed at final assembly stage are those that relate to the final assembly process. Any other checklists used by the firm should be completed before signing the auditor's report.

Consultation

Consultation is dealt with in paragraph 18 of ISA 220. Here the responsibility is placed on the engagement partner to ensure that appropriate consultation occurs and that the resulting conclusions have been agreed with the party consulted and implemented.

Consultation may occur within the engagement team or with others at the appropriate level within or outside the firm.

Consultation should occur in any audit where there are difficult or contentious matters. The need for consultation is independent of the need for an EQCR.

However, Andy Holton points out that, if an EQCR is needed, then ideally the consultation should be with somebody other than the EQCR reviewer.

Other hot file reviews

The fundamental difference between EQCR and other hot reviews is that an EQCR is performed in response to the requirements of ISA 220. Other hot file reviews (sometimes known as second partner reviews) are performed for various reasons such as:

- Specific factors in the audit may lead the engagement partner to want a second opinion on all or part of the file. For example, in my file reviews, I sometimes suggest that a second partner review is performed as a safeguard against threats to the firm's independence – particularly arising from longevity issues.
- The auditor's supervisory body may require hot reviews to be undertaken as a condition of retaining audit registration. These reviews may apply to some or all of the firm's audits. Sometimes the supervisory body will insist that these reviews are performed by a reviewer from outside the audit firm.

- The firm may wish to monitor the work of a newly appointed audit engagement partner during a probationary period.

As with EQCR, the hot review must be completed before the date of the auditor's report. It should be documented and retained on the audit file. All points arising from the review must be properly cleared such that no unresolved matters or differences of opinion remain. The reviewer must confirm that all review points raised have been dealt with satisfactorily.

Andy comments:

"Where a hot review is undertaken at the request of the ARC then obviously any additional requirements they impose must also be followed. This usually includes submission of the review to the ARC, but may also include formal agreement by the reviewer that any points raised were properly cleared before the audit report was completed."

SUMMARY OF DEVELOPMENTS

The following are extracts from press releases issued by the FRC over the last three months.

IFIAR releases first global survey of audit inspection findings

IFIAR, the International Forum of Independent Audit Regulators, has released the findings of the first global survey of audit inspections. The inspections covered audit engagements for 961 public companies at 98 audit firms.

The survey identifies common audit findings among Members in a number of areas. For example, the survey results indicate that the largest number of inspection findings in audits of public companies occurred in the following areas: fair value measurements; internal control testing; and engagement quality control reviews.

Additionally, inspections of audits of major financial institutions revealed that the largest number of common inspection findings occurred in the following areas: internal control testing; valuation of investments and securities; and audit of allowance for loan losses and loan impairments.

The survey results also include four areas that have been discussed by IFIAR with representatives from the six largest audit firm networks since 2010: professional scepticism, group audits, revenue recognition, and the role of the engagement quality control reviewer.

The information in this report may be of use to audit firms, audit regulators, other regulators, policy makers and standard-setters in their efforts to improve audit quality. It also may be of use to investors and audit committees as an indicator of the current status of inspections of auditors of public companies, including financial institutions in jurisdictions around the world.

19 December 2012

Consultation on implementation of Sharman Panel recommendations issued by FRC

The Financial Reporting Council issues for consultation, guidance for directors, and related standards for auditors, to implement the recommendations of the Sharman Panel of Inquiry into Going Concern and Liquidity Risks.

The Panel was commissioned in March 2011 to identify lessons from the financial crisis and recessionary environment for companies and auditors, addressing going concern and liquidity risks; and to recommend measures, if any, which are necessary to improve the existing reporting regime and related guidance in relation to these matters.

The inquiry highlighted the importance of the identification, analysis and management of risk. It raised questions about the quality of information provided on companies' financial health and their ability to withstand economic and financial stresses in the short, medium and longer term.

The inquiry recommended, and the FRC has concluded, that to improve the robustness and reporting of the going concern assessment, the boards of companies complying with the FRC's Corporate Governance Code should:

- consider the threats to the company's business model and capital adequacy, over a period longer than twelve months, looking through the economic cycle and the company's own business cycle;
- develop a high level of confidence that solvency and liquidity risks can be managed effectively during the period of at least twelve months from approval of the financial statements;
- always disclose the significant risks to the company's solvency and liquidity and how they are being managed, as part of its discussion of principal risks in the business review; and
- confirm that it has undertaken a robust going concern assessment.

In addition, auditors should consider the board's report on the robustness of its assessment and the resulting disclosures in the annual report and confirm in their report that they have nothing to add or to draw attention to.

30 Jan 2013

FRC consults on proposals to improve the auditor's report

The FRC responds to criticism that auditors' reports are uninformative by issuing a Consultation Paper: Revision to ISA 700. This proposes requiring auditors' reports to:

a) Describe the risks of material misstatement that were identified and assessed by the auditor and which had the greatest effect on the audit strategy;
b) Explain how the auditor applied the concept of materiality; and
c) Summarise the audit scope and in particular how the scope responded to the matters set out in (a) and (b).

The FRC believes these changes will better meet the needs of investors and thus enhance the value of audit.

We hope the findings from this consultation will influence the work of others seeking to enhance the communicative value of the auditor's report; such as The European Union and the International Auditing and Assurance Standards Board (IAASB).

The proposed changes build on changes made by the FRC to board and auditor reporting last Autumn, requiring: the auditor to communicate information to the audit committee about significant audit judgments; audit committees to report on their activities to the board (including on their communication with auditors); boards to describe the work of the audit committee in the annual report; and the auditor, in turn, to report by exception if the board's disclosures do not, in its view appropriately address the matters it communicated.

04 Feb 2013

Editor's note: The proposed changes apply only to auditor's reports of those entities that report on how they have applied the UK Corporate Governance Code.

FRC to adopt improved auditing standards on using the work of internal audit

The FRC today confirms it will adopt the proposed international improvements to the auditing standards on the external auditor using the work of internal audit. In doing so, subject to consulting on the timing of implementation, it will rule out the direct use of internal audit staff as members of audit engagement teams, with the aim of preserving auditor independence.

The improvements reflect changes to the IAASB's International Standards on Auditing, the aim of which was to:

- enable better use, in making the external auditor's risk assessments, of the knowledge and findings of the internal audit function;

- strengthen the external auditor's evaluation of the work of the internal audit function in obtaining audit evidence; and
- resolve the ambiguity as to whether the ISAs permit the use of internal audit staff as members of the external audit engagement team to perform audit procedures (referred to as 'direct assistance').

Prior to these revisions, the IAASB's standards were not explicit about whether or not direct assistance by internal audit staff was permitted. The FRC's own standards included additional guidance that allowed direct assistance in certain circumstances, subject to appropriate safeguards. The IAASB's proposed revised ISAs are expected to take a similar approach. The FRC Board concluded that, because using internal audit staff as members of the audit engagement team is contrary to the principle of independence, this should no longer be permitted. This was also the advice of the Audit and Assurance Council.

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

"Direct assistance involves some of the audit being undertaken by individuals that are not independent of the audited entity. Shareholders generally expect that external auditors should be seen to be free from threats to their independence. Permitting the direct use of internal auditors involves agreeing lower independence standards for some members of the audit engagement team, which leans against this expectation. Accordingly, the FRC has concluded that this should no longer be allowed."

11 Feb 2013