
small company reporting

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Auditing matters affecting the smaller company

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twenty years on

Small company reporting was first published in Spring 1992, so this edition of the Bulletin marks our twentieth birthday. At the time, the ASB had just been created and had only issued one FRS, that on cash flow statements. Over the next eight years the Board issued 18 major standards. Since then it has issued another 11 but none of the recent ones have had a significant effect on the accounts of typical private companies and several have only replaced the UK standard with the international equivalent.

For some time it has been clear that the ASB has ceased to have a major role in the process. Indeed, once it implements its plan for UK GGAP to be based on the IFRS SME standard, its only role would appear to be to lobby for the UK view on IASB proposals. This now appears to have been recognised by the proposals to transfer responsibility for setting UK standards to the Financial Reporting Council, and to downgrade the ASB to an advisory body to the new FRC Codes and Standards Committee. It is, ironic that our twentieth birthday should coincide with the demise of the ASB.

Many of our subscribers will no doubt be delighted to see the back of the ASB. However, we were mostly happy with its approach, particularly the use of a statement of principles to provide the foundations for accounting standards. Our favourite standard has always been FRS12 on provisions which clearly states that if there is an obligation which will result in an outflow of funds you should recognise a liability, and makes this clear on page one, so that the rest of the requirements can almost be guessed without reading the standard. Conversely, under the ASB approach, if an entity has control over a flow of economic resources it should be recognised as an asset. Moreover, if a debit or credit does not meet the criteria for recognition in the balance sheet, the only option is to treat them as profit and loss account items, or occasionally, to take them to reserves. Armed with this approach, we have, for many years, fielded questions from subscribers with some confidence. Now things are much less clear, and we have begun to say: "Well, at one time I would have said....."

The big change has, of course, been the switch to international standards. It was not inevitable that we should choose to abandon UK GAAP and certainly not the case that, by doing so, we should end up with a better set of rules. However, there is a good case for having a single set of standards for use around the world. Moreover, once major UK companies began to use IAS, we always felt that the rules for smaller companies should be part of the same system, and that a standard based on the IFRS for SMEs was the only sensible option. Fortunately, this will enable most UK companies to operate under a rule book similar in size to the current FRSSSE, which should eventually be based on the new rules, or be discontinued. Before any of this can happen, the EU is planning to issue a new accounting directive, and its provisions will have to be incorporated in the FRS for UK accounts and the FRSSSE.

Since implementation of the 2006 Companies Act, **small company reporting** has had little to address. This will remain the case this year. However, beyond that we expect to become more active, with major revisions to the content to checklists and summaries to reflect adoption of FREDs 46-48 and revision of the FRSSSE. There should be sufficient work to enable us to reach our twenty fifth birthday (at least). It would be nice to think that during this period, standards will once again come to be based on a clear set of principles. However, it is probably unrealistic to expect that the rule makers of the EU, USA, Japan, and BRIC countries will agree on a set of principles to underpin all IAS standards. Indeed it will be something of a triumph if they can secure agreement on what the standards should say, even if that means the logic behind the rules is no longer made clear!

audit file reviews – page 2

notebook – page 4

points arising – page 5

update instructions – page 6

points from audit file reviews

The clarity ISAs have now been applicable for 18 months so firms should have mastered the key features and be applying the new rules effectively. Set out below are typical comments made on audit files that we have reviewed over the past few months. Firms may find it useful to see the mistakes being made by other practitioners.

permanent information

- 1. Systems and controls.** The notes on the system are very comprehensive but I could not see that you had specifically addressed several aspects specifically required by ISA 315 including:
 - evaluation of whether management has created and maintained a culture of honesty and ethical behavior and whether the control environment provides an appropriate foundation for the internal controls
 - how related party transactions and relationships are identified, authorised, accounted for and disclosed, including those outside the normal course of business;
 - how control is exercised over journal entries;
 - how, in preparing the financial statements, necessary estimates are made, subsequent events identified and necessary disclosures determined;
 - how business risks affecting the financial statements are identified, their significance estimated, the likelihood of occurrence assessed and the risks addressed and where there is no documented process, its absence is appropriate in the circumstances;
 - measurement and review of the entity's financial performance?

I suggest that you add a very basic note on these points with a heading covering each one.

- 2. Confirming accounting procedures.** ISA 315.13 stipulates that "when obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel". This requirement applies even where you do no control tests and rely on substantive procedures. I suggest that you augment the system notes in the permanent file with an explanation of how you confirmed the procedures described. This could include observing procedures and inspecting documents – it may include walk through tests, where suitable. I see no need to repeat the procedure every year unless the system changes.
- 3. Related Parties.** The register of related parties included only some of the companies listed as subsidiaries in the notes to the accounts and no directors or shareholders. It is now a requirement of ISA 550.28 to document all related party relationships. Ideally, the register should list and explain all parties for which disclosures might be required in the accounts.

- 4. Engagement letter.** Although you have issued a new engagement letter, paragraph 6 differs, in some respects from the ICAEW Help Sheet 13 example, in not dealing with the access to information and persons having audit evidence. In addition the ICAEW example includes notification to the client of your audit regulator and PI cover under the Provision of Service Regulations 2009, although this can be done separately.

planning

- 5. Team meeting.** The Clarity ISAs are more specific about the topics to be covered at the team meeting. ISA 240.26 requires a discussion of the risk of fraud related to revenue recognition as required by ISA 240.26 and ISA 550.12 states that the engagement team discussion must include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. ISA 240.47 requires you to document the reasons where concluding that there is no risk of material misstatement related to revenue recognition. I suggest that you create a basic agenda for team meetings and adapt it for each assignment.
- 6. Fraud enquiries.** It is not clear from C8.3 when and of whom the enquiries about fraud took place. ISA 230.10 appear to require you to make a specific record of all significant matters discussed with management and directors, including the nature of the matters discussed and when and with whom the discussions took place. A tick in the programme is rarely sufficient.
- 7. Materiality.** ISA 320.14 requires an auditor to set and record the levels of performance materiality, in addition to financial statement materiality. Under UK GAAP an item is material if its non-disclosure or omission would prevent the accounts showing a true and fair view and being misleading. Performance materiality is the level at which things need to be tested, which could together be material to the financial statements. The figures thrown up by the formula in your system do not seem to me to give a sensible figure for the financial statements or a sensible relationship with the performance figure. It is arguable that, for substantive tests, you should test all items over performance materiality and only use samples to test the items below.
- 8. Triviality.** ISA 450 15 requires you to determine the level at which items would be regarded as clearly trivial, that is to say, the level at which you would not consider it necessary to inform the client about a misstatement. Your system deals with this in the misstatements summary – but it needs to be filled in at the planning stage.
- 9. Risk assessment and audit strategy.** I question whether it was necessary to complete a multipage assessment of risk and your planned response in this assignment. Moreover, I cannot see that the process made any difference to the way in which

you approached the audit. Whilst a risk assessment and an explanation of your response is always required, in this case a single page showing your analysis and the response would be much more useful. The audit strategy should show which are the key balances, classes of transactions and disclosures; how you are going to cover the key assertions; how you intend to confirm that controls are operating as assessed, and which need testing, and what procedures are to be performed, including sample sizes.

audit evidence

10. Programme for debtors. Do you really need 13 pages of programme to verify two debtors? There are some sections of the programme which always need completing. However, it is often better to devise your own approach for dealing with the balance sheet and profit and loss account. In this case an ad hoc programme could set out the assertions, strategy, procedures, results and conclusion on a single page.

11. Transactions testing. The work on transactions work referred to “walk through tests”. Such tests are really only appropriate when the client has satisfactory controls and you are confirming that these are operating as assessed. Even then it is always necessary to perform some substantive procedures and you can never rely entirely upon control tests. (ISA330.49). Substantive procedures can be analytical but need to be more extensive than the procedures performed at the planning or conclusions stage and cannot always provide sufficient assurance that the figures are not materially misstated. Where controls are weak it is usually necessary to do some tests of detail on the occurrence and amount of expenditure and on completeness and amount of sales.

12. Specific coverage. I could not see how you had covered several specific areas where there are now requirements in ISAs including:

- Accounting estimates used in preparing the accounts including reviewing those made in the prior period (ISA 540.10-21);
- Journal entries and adjustments – including management authorisation (ISA 240.32);

13. Accumulated Misstatements. ISA 450.15(b) requires an auditor to document all non-trivial misstatements accumulated during the audit and whether they have been corrected, not just the unadjusted ones. In addition, under ISA 450.8, an auditor must communicate these misstatements with the appropriate level of management and request that they be corrected. It is not sufficient to note only unadjusted errors and the heading of C6 is misleading. Material errors must be notified in writing and, if no adjustment is considered necessary, explained in the letter of representation. However, there is no need to record errors that are put right in preparing the accounts before the audit starts. Under ISA 260.23 where matters are communicated orally, the auditor must include them in the audit documentation, and when and to whom they were communicated. Where communicated in writing, the auditor must retain a copy of the communication as part of the audit documentation.

14. Letter of Representation. ISA 580 and other ISAs requires representations to be obtained on some matters not covered in your letter.

- **Information and access** Confirmation of provision of all relevant information and access as agreed in the terms of the audit engagement. (This includes access to individuals holding information).
- **Litigation and claims.** Completeness of disclosure of all known actual or possible litigation and claims whose effect should be considered when preparing the financial statements. Although the letter covers contingencies it does not specifically refer to litigation.
- **Accounting estimates** The view that significant assumptions used in making accounting estimates are reasonable.

In addition you should note:

- **Uncorrected misstatements.** Under ISA 450.14, where those charged with governance whether they believe the effects of uncorrected misstatements to be immaterial, individually and in aggregate, to the financial statements as a whole a summary of such items must be included in or attached to the written representation.
- **Transactions with directors.** The terminology here is out of date. The disclosure provisions now cover advances and credits granted to directors.
- **Responsibility for internal control.** This must now be covered in the engagement letter – so need not be in the letter of representation. (It does not appear in the ISA 580 example).

15. Stock. I think that you need to note in section 4c why you did not attend the stock count, as required by ISA 501.4, and why you relied on the alternative procedures allowed by ISA 501.7. ISA 210.12 says that “if, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in an ISA (UK and Ireland), the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure”.

conclusion

16. Management letter. Clarity ISA 260 only requires an auditor to communicate in writing with those charged with governance where there are significant findings from the audit. There is no longer any requirement to issue a written communication if there is nothing to which the auditor wishes to draw to the directors’ attention.

17. Completion of the file. For periods commencing on or after 15.6.06 ISA 230R requires completion of the audit file no more than 60 days after signature of the report. You therefore need to record when the file is completed – you could adapt the Audit File Index Page.

notebook

legal developments

new accounting directive

BIS is continuing to consult on proposals reviewed in the last edition for a new EU directive on accounting to replace the Fourth and Seventh directives published in 1978 and 1983. The new directive will trigger changes in UK company law for large, small and micro companies and eventually result in some revision of the checklists.

si 2011.2198 – auditor’s remuneration

From 1 October 2011 amendments have been made to the rules governing disclosure of fees for non-audit work paid by large companies. The new headings are shown in paragraph 2.8.34 of the checklist which has been updated with this edition. There has also been an extension of the disclosure of fees paid for audit work to include amounts paid to associates of the firm.

financial reporting council

reform of uk standard setting system

In March the government announced that it would bring forward legislation to enhance the powers of the FRC and transfer to it powers previously exercised by some of its subsidiary bodies including the ASB. The legislative changes are expected to apply from July 2012. Under the new structure there will be a Codes and Standards Committee, which will take over from the ASB, APB and the boards dealing with corporate governance and actuarial matters. The Committee will be supported by councils advising on accounting, audit and assurance and actuarial matters.

Under the new structure enforcement will be the responsibility of the Conduct Committee and Division of the FRC, with the latter replacing the Financial Reporting Review Panel (FRRP), the Professional Oversight Board, the Audit Inspection Unit and the Accounting and Actuarial Disciplinary Board. Fortunately, most small practitioners are unlikely to come into contact with any of these bodies.

accounting standards

asb update

The ASB is continuing to review responses to its proposals for the future of Financial Reporting Standards in the UK. These were published as FRED 46-48 and reviewed in the last edition. FRED 48 is an FRS for the UK and Republic of Ireland, based on the IFRS for SMEs which would replace all current UK standards. Provision is also to be made for use of full IAS subject to certain exemptions, not currently available under the EU approach. Publication is expected around the end of the year with compulsory application required for periods commencing on or after 1 January 2015, with earlier application allowed.

auditing

audit regulations

In December the ICAEW issued a revised version of the audit regulations including a new definition of an audit. This brings in audits of non-EU companies, which are conducted by UK auditors.

apb update

Since the last edition the APB has published:

- the latest edition of its annual compendium of standards and guidance for 2012. The main changes to the previous edition

concern amendments to the Ethical Standards for Auditors issued in December 2011, reviewed below

- the third revision of Bulletin 2010/10 *Compendium of Illustrative Auditor’s Reports on United Kingdom Private Sector Financial Statements*. This includes new example audit reports on charities to reflect implementation of the Charities Act 2011, with effect from 14 March 2012. (This consolidates previous legislation, with no major changes).
- A new edition of Practice Note 11 *The Audit of Charities in the UK*, to update references to the Charities Act 2011 and to reflect new thresholds for charities in Scotland.

An update for small charity reporting is now being prepared for distribution in June.

The APB has also withdrawn a number of documents which contain out of date references, although these may still contain useful substantive guidance. These include the guidance on “compilation” reports and Bulletins on the FRSS (1997/3), departures from SORPS (2000/3), electronic publication of audit reports (2001/1) and first time application of IFRS (2005/3).

In March the Board also published a briefing paper on *Professional Scepticism*. This a very academic piece of work which discusses scepticism in Greek philosophy, the nature of scientific method and the role of DNA before considering ways in which the profession can foster conditions in which auditors demonstrate the appropriate degree of professional scepticism.

ethical standards

In December the APB revised ES 5 to extend the existing transitional arrangement for tax services on a contingency basis to 31 December 2014. They also amended the Appendix to ES 1 *Illustrative Template for Communicating Information on Audit and Non-audit services provided* to reflect the revised disclosure requirements introduced by SI 2011.2198, outlined above.

points arising

provision and contingent liability

One of our clients is in dispute over a major contract. A customer is claiming £250k for non-performance. Based on past experience the client believes that a settlement of £50k will eventually be reached. How much should we provide? Do we have to disclose the full amount of the claim and should we include an explanatory paragraph in the audit report?

The company should make a provision for the probable amount to settle the claim (FRS 12.14) and make the disclosures under FRS 12.90. Based on past experience, it appears that this should be £50k. FRS 12.93 also requires disclosure of any further amount that may be required to settle the claim, except where such an outcome is remote, showing the link between the provision and the contingency. So if there is a possibility that full settlement of the claim might be made, it should be shown as a contingent liability. Only if this outcome were deemed to be remote could disclosure be avoided. No explanatory paragraph is required in the audit report unless the nature of the provision, or the uncertainty surrounding the amount, is fundamental to a user's understanding of the financial statements. If the amount by which the provision could be wrong would not be sufficient to transform the balance sheet or profit and loss account it is unlikely to be fundamental. Similarly it will not be fundamental where the outcome would transform the accounts but the possibility is remote.

recognising revenue

Our client is the UK subsidiary of an Italian company which manufactures large machinery for the constructional steel industry. For sales of new machinery in the UK, UK Co buys from the parent and then sells to the third party customer in the UK. The usual group policy is to recognise the revenue when Italy dispatches the machine. In the current year there is a large contract covering 6 machines which is being shipped

piecemeal over 3 or 4 months staggering the year end. The parent has invoiced the UK subsidiary as the shipments have been made. Hence a % of the total contract is delivered and invoiced at the year end. The client has included these purchase invoices in the P&L and brought in the equivalent % in Turnover. There are therefore balances carried in Debtors for amounts not invoiced yet to the customer, as a stage payment agreement is in place with them with staged invoicing depending on satisfactory testing and performance. Is this treatment acceptable?

The approach is covered by FRS 5 appendix G, Revenue Recognition which covers all contract work in a way consistent with SSAP9 – not just long term contracts. The subsidiary should recognise the stock when it gains ownership and becomes liable to pay for it wherever it is. Once it has performed installation work, and establishes a right to consideration, it should derecognise the stock, with the cost going to profit and loss account, and recognise an "amount receivable under contract". The value of the sale can be included under turnover, but the balance due is not shown under trade debtors until invoiced in accordance with the contract.

sinking fund

I have been asked an apparently simple question by a client as to whether a sinking fund for external works in their accounts is appropriate. They own long leases on a number of flats in various different blocks in London and as part of the lease they have to pay for their share of any external works. The costs have been estimated by the freeholders agent at roughly £1,300 per annum per flat. Whilst the lease places the obligation on our client, if they decided to dispose of the flats, then they would no longer have any liability for the periodic maintenance costs and thus can avoid the expenditure. Therefore, it appears to me that under FRS 12 a provision or sinking fund is not appropriate.

Thinking it through, I believe a better approach might be to recognise components within the original purchase price (approx £300k). For example, windows, roofs, lifts. These would have shorter lives than the basic structure and when items are replaced then the cost can be capitalised. The client is a "housing association" and there is adequate guidance and data available to estimate the "cost" of any components. Any thoughts would be appreciated.

These days sinking funds are rarely seen in practice – indeed I cannot remember ever coming across one. In principle there is nothing to stop a company putting money by to meet an anticipated future expenditure. However, unless there is an obligation at the balance sheet date arising from a past transaction or event, the fund could only be created by a transfer to a designated reserve. In this case there does not appear to be any obligation and the company could avoid any requirement that is likely to arise in practice by selling. FRS 12 covers this in the Appendix as example 11A – *Refurbishment costs no legislative requirement*. Regarding capitalisation of components, FRS 15 allows for separate rates or depreciation to apply to separate components (paragraph 83) and for subsequent expenditure on assets to be capitalised under restricted conditions (paragraph 36).

subordinated loan shown as equity

We have a client who has a subordinate loan which they wish to reclassify as equity. Are we still allowed to do that?

No! FRS 25.15 and the FRSSSE say that financial instruments must be classified as assets, liabilities or equity. A subordinated loan represents an obligation to repay albeit after other liabilities have been met, so must be shown as a liability. The fact that some creditors are paid before the loan does not stop it being a liability. Only if the rights of the loan holders were identical to those holding equity would it be possible to show it as such.

publication and subscriptions

New subscribers to the paper versions of the small company reporting manual receive two loose-leaf files containing company accounts checklists, specimen small company accounts, a companies act guide accounting standards summary and auditing statements summary. New subscribers to the scr procedures manual receive three loose-leaf files one containing explanatory notes and model working papers covering accounts preparation, small audits and compliance procedures and another dealing with specialist assignments. Disc subscribers receive copies of the paper versions in pdf and selected sections in Word format. All subscribers receive the quarterly bulletin incorporating bulletin pages, and written permission to copy the checklist, specimen accounts and working papers for use by the registered firm

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update instructions

The updates for this quarter's editions of small company reporting and the scr procedures manual are the smallest on record. However, we expect to make major changes once the ASB publishes the proposed FRS 46-48 setting out the new framework for UK accounts and the EU produces its new accounts directive and this is incorporated in UK law.

small company reporting

Introduction. *Replace pages 5-8,*

Part 1 – Small company checklist. Para 1.1.13 amended to make it clear that ineligibility applies if a company falls into an excluded category "at any time during the year". *Replace Page 2.*

Part 2 – Medium-sized and large companies. Para 2.8.23 and 24 amended to reflect SI 2011.2198. *Replace 26.*

Part 3 Supplementary – Para 3.9.2.1 revised to reflect APB Bulletin 2010/2. *Replace 67.*

scr procedures manual

Introductory notes. *Replace pages 8-11*

Part 3 – Accounts preparation. Eligibility checklist paragraph 3 revised to make clear that ineligibility applies if a company falls into an excluded category "at any time during the year". *Replace page AP.7.*

Part 5 – Audit. Audit programme paragraph 4.7 revised to refer to work undertaken by component auditors, as well as by the firm. *Replace page 60/3.*

Part 6 - Compliance. Quality assurance review checklist amended to refer to annual completion of fit and proper forms. *Replace page CP.1/2.*

stop press: uitf abstract – flat management company accounts

On 10 May, in response to a request from ICAEW, the Urgent Issues Task force issued a proposed abstract *Residential Management Companies Financial Statements*. The abstract addresses the issues arising where a flat management company undertakes transactions on behalf of residents. It had been suggested that such payments are made under statutory trust and cannot give rise to assets or liabilities reflected in the balance sheet of the company. The UITF have based their analysis on the section of FRS 5 Appendix G dealing with principles and agents and state that where the RMC acts as a principle it should record the service charge transactions in the profit and loss account but should not do so where acting as an agent.