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small company reporting

Vol. 21.3 Autumn 2012

A quarterly bulletin dealing with Accounting and Auditing matters affecting the smaller company

ISSN 0 968 8897

www.smallcompanyreporting.co.uk

audit exemption extended

For accounting periods ending on or after 1 October 2012 new rules govern entitlement to audit exemption. These are contained in SI 2012.2301 *The Companies and Limited Liability Partnerships (Accounts and Audit Exemptions and Change of Accounting Framework) Regulations 2012.* The most significant change is to extend audit exemptions to all small companies and LLPs by removing the previous requirement for an audit where turnover or the balance sheet total exceeded the threshold. In addition the separate turnover and balance sheet criteria have been abolished to small groups. It is estimated that 36,000 companies will benefit from this change.

At the same time exemption has been extended to subsidiary companies and LLPs whose parents provide a guarantee of the liabilities at the year end. This exemption is restricted to subsidiaries of EEA parents where the shareholders unanimously agree to dispense with an audit. The parent must deliver a statement to the registrar that it guarantees the liabilities at the end of the year and the company is included in consolidated accounts drawn up by the parent, where use of the exemption is disclosed. The subsidiary must file written notice of the guarantee, a statement by the parent to that effect and a copy of the parent's consolidated accounts and audit report thereon. The guarantee covers all liabilities of the subsidiary at the end of the financial year to which the guarantee relates and is enforceable against the parent by any person to whom the subsidiary is liable in respect of those liabilities.

In theory 83,000 active companies could benefit from taking advantage of the guarantee exemption. However, whether it will be advantageous to do so will depend upon the structure and nature of the group. The affairs of the unaudited subsidiary will have to be included in the consolidated accounts of the parent, and it will be necessary to obtain sufficient appropriate audit evidence on the amounts concerned. Where a subsidiary operates in the same or a similar way to its parent and shares a common accounting function, it will be entirely appropriate to extend the parents audit to cover the balances and transactions concerned. However, in many cases the affairs of the subsidiary may be very unlike those of it parent. The nature of the business and the associated risks, may be entirely different to those of the parent. It may have different products and supply different markets. Its accounting procedures may be quite separate and different. In such a case it may be more effective and efficient to audit the subsidiary separately, rather than attempt to adapt and extend the audit of the parent to encompass the affairs of the subsidiary.

A further change in the statutory instrument is abolition of the requirement for a dormant subsidiary company or LLP to prepare and file individual accounts. Once again it will be necessary for the parent undertaking to be established under the law of an EEA state and to guarantee the liabilities of the dormant subsidiary at the end of the financial year. The conditions applying are the same as those for the active subsidiaries audit exemption. However, it should be noted that the exemption from filing accounts is separate from the exemption from their preparation. Companies may choose to prepare individual accounts, for example as part of the preparation of consolidated accounts by the parent but need not file them, if it does.

A final change in the rules governing company accounts under the new regulations is a relaxation of the rules under which a company using IAS may switch back to UK GAAP – described as Companies Act accounts. Previously this was only allowed when becoming a subsidiary of an undertaking not preparing IAS accounts or when it or its parent delisted. However, for periods ending on or after 1 October 2012 is may revert to UK GAAP for any reason, provided it has not done so in the five years preceding the first day of the financial year.

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icas audit monitoring in 2012

In the last edition we summarised the reports of the FRC Audit Inspection Unit and the ICAEW Quality Assurance Directorate on audit monitoring in 2011, and noted common points from the reports. We have no been given access to the report by ICAS over the same period.

	FRC AIU	ICAEW QAD	ICAS AM
Firms covered	55	3800	230
Visited	19	716	56
Audits reviewed	94		120

Common points from the FRC, ICAEW and ICAS reports¨

- **Need for appropriate level of professional scepticism – especially in relation to evaluation of estimates and impairment of intangibles and for ICAS use of analytical review in verifying sales and expenditure.**
- **More rigorous work necessary on revenue recognition and management override**
- **Full appreciation and application of ISA requirements on materiality including use of performance materiality**

audit evidence

The ICAS report drew attention to the need to obtain enough audit evidence in a number of common areas including:

- **Fixed assets brought forward:** A failure to test for existence of items brought forward from preceding years,
- **Property title**: no testing over the title to the property;
- **Debtors recoverability**: recoverability of trade debtors not fully considered;
- **Accruals completeness**: accruals have not been tested for completeness:
- **Bank confirmations:** bank letters have not been obtained, or differences have not been investigated.
- **Profit and loss account testing**: Failure to test for complete recording of turnover – instead selecting test items from sales shown in sales ledger, rather than the origin of sale and overreliance on analytical review to test turnover and expenses.

ICAS draw attention to the following requirements for substantive analytical review to be effective:

- setting a valid and independent expectation. This can often be the prior year figure, or a budgeted figure, but there should be a justification for the expected figure is
- documented justification on file as to the appropriateness of the source of the data used to formulate this expectation;
- comparison between the expectations set and the actual figures being audited;
- receiving an explanation of the variance;
- corroborating the explanation: these must be validated/audited to source documentation and challenged to ensure that sufficient audit comfort is obtained to support the audit opinion.

documentation

Other points made by the ICAS report include:

- **Incomplete documentation.** Documentation must meet the criteria in ISA 230 that it is sufficient to enable an experienced auditor with no previous connection with the audit to understand. This is by far the most common issue raised on visits and should be identified by reviews, including that of the engagement partner, before the report is signed.
- **Risk assessments.** Must be documented in accordance with the framework set out in ISA 3415 and 240**.** Many firms are not carrying out an assessment of the design and implementation of key controls. In addition many firms do not record the client's assessment of fraud and the steps taken to mitigate it.
- **Disclosure issues.** Common problem areas being dividends set after the year being shown as liabilities, disclosures for large and medium companies omitted from directors reports, accounting policies insufficiently tailored and auditors remuneration not disclosed or analysed properly.
- **Ethical issues.** Some firms fail to identify threats and implement appropriate safeguards, most commonly in relation to the engagement partner holding office for more that 10 years, fee dependence issues and use of PASE.

clarified isas

The ICAS report draws attention to four common issues associated with application of the clarified ISAs:

- **Performance materiality**: Clarified ISA 320 requires performance materiality to be calculated in addition to materiality. Firms are either not calculating or justifying the level.
- **Presumed fraud risks:** firms are not often identifying, or addressing two presumed risks of fraud in Clarified ISA 240, revenue recognition and management override. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities'.
- **Risk of fraud in related party transactions - discussions at planning**: ISA 550 now requires that the engagement team discussion held at planning should include specific consideration of the risk of fraud that could result from related party transactions.
- **Management representation letters not being used as audit evidence**: it is now explicit that management's representations are not considered to provide audit evidence in the absence of any audit work performed.

notebook

accounting standards

frc update

Since the last update the FRC has published a revised version of FRED 48 (FRS 102). This will form the basis of UK accounting for all companies not using the FRSS or IAS for periods beginning on or after 1 January 2012. The final version of the standard is expected early in 2013 and, provided the planned FRS 100 and FRS 101 have also been issued it will be possible to use the new rules on a voluntary basis. The revisions to FRED 48 concern accounting in specific circumstances where there is an agreement to fund a deficit in a multi-employer pension plan and accounting, by grantors, for service concession arrangements.

In October the FRC also published a discussion paper '*Thinking about financial reporting disclosures in a broader context*'. The paper aims to improve the quality of financial reporting disclosures. The paper sets out a road map for a disclosure framework for financial reporting aimed at improving the quality of disclosure and their value to the users. In particular, the paper covers the reduction of clutter in financial reports by avoiding duplication in disclosures and using tests of materiality more rigorously. This paper is likely to be of most relevance to listed companies.

auditing

apb update

In October the Council also published PN 23 containing updated guidance on the audit of financial instruments. However this is unlikely to be of great interest to smaller companies.

points arising

changed headings in profit and loss account?

I have a question for you in respect of a recently acquired client company, no audit required. What was in the past its principal activity has now changed. Last year it was about 50% of total income but this year what was previously its "other income" has now become 80% of income leaving 20% to its principal activity. This was not envisaged and in the opinion of the Director this split will more than likely occur in the foreseeable future. In the past the company was a property trading company with the cost of sales being the costs of the property that was sold. With the present economy future sales of properties are unlikely and the company now receives commissions for e.g. its property insurances bought and also received ground rents etc.

Is it merely a case of swapping the Turnover and other income changing the accounting policy for this and last year ?

CA 06 s.474 defines turnover as *the amounts derived from the provision of goods and services falling within the company's ordinary activities*. If a company provides more than one sort of goods or services I think that it can all be turnover – with other income being used for amounts that are not derived from providing goods and services. This would avoid the need to re-classify if things alter again in the future. If thought it useful you could include a breakdown as a note and omit this from abbreviated accounts. In the year of change you would need to reclassify the preceding year other income as turnover and add a note saying what had been done.

management override of controls

During a recent audit monitoring visit the inspector criticised us for not paying sufficient regard to the risk arising from override of controls. The client is very small and we rely entirely upon substantive procedures, rather than control tests to provide sufficient appropriate audit evidence.

Under ISA 240.32 an auditor is required to perform certain audit procedures "irrespective of the assessment of the risks of management override of controls". These include testing journal entries, including those made in the preparation of the financial statements, reviewing accounting estimates for bias, and evaluating the business rationale of transactions outside the ordinary course of business. Most audit programmes will include these procedures, although some firms overlook the relevant sections, and the auditor is often closely associated with the work on work journals covering preparation of the financial statements. However, ISA 33 requires an auditor to determine, whether any additional procedures are required in order to respond to the risk of management override. Some audit inspectors are now looking for a specific reference to this point in the audit planning memorandum or in the notes of the audit planning meeting. Given that few auditors of smaller audits are likely to rely upon application of the controls it hardly seems sensible to require specific reference to overriding them. However, it may be safer to include a routine reference to the issue in the planning memorandum or meeting template.

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 to scr and the scr pm cover the changes arising from SI 2012.2031, which are applicable for accounting periods ending on or after 1.10.12. A clarification has also been made to the audit evidence summary and an extra bullet point added to paragraph 4.3 of the audit planning programme in Parts 5,7 and 9. This refers to the requirement in ISA 240.33 to determine what additional audit procedures should be performed in order to respond to identified risks of management override of controls. Omission of a sufficient reference to this point had been pointed out by the QAD,

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Introduction. *Replace pages 5-8.*

Part 3 Supplementary – Paras 3.13.21.1-3.13.21.3 added. *Replace page 37*

Part 5 – Companies Act Guide Paras 1.3.1, 1.3.5, 2.7.6 2.8.8, amended and paragraphs 1.3.6-1.3.8, 2.7.8-3.7.11, 3.3.2, 3.3.4, 7.6.3 and 7.6.4 added. *Replace page 6 and add page 6/1. Replace page 14 and add page 14/1. Replace pages 16, 19-20 and 70.*

scr procedures manual

Introduction. *Replace pages 8-11.*

Part 1 – Explanatory notes. Paragaphs 2.1.1, 2.1.2, and 2.1.4 amended and paragraphs 2.1.9 - 2.1.11 added. Replace page EN.4 and add page EN.5/1

Part 3 – Accounts preparation. Audit exemption checklist revised. *Replace page AP.7.*

Part 5 – Audit. Reference to additional audit procedures regarding management override of controls added to Audit Planning Programme para 4.3 and column for performance materiality added and risk “category level” heading revised *Replace page AU.25 and 38.*

Part 7 – Pensions Schemes. Reference to additional audit procedures regarding management override of controls added to Audit Planning Programme para 4.3 *Replace page PEN.67*

Part 9 – Clubs. Reference to additional audit procedures regarding management override of controls added to Audit Planning Programme para 4.3 *Replace page CL.35.*

next edition

In the next edition, due early in the new year, we expect to outline the content of FRS 100 and 101 covering the new framework for UK GGAP and the reduced disclosure reductions in the requirements of the SME standard for some entities including subsidiaries.