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Common Audit Failings

Common failings found by the Quality Assurance Department ("QAD") of the ICAEW from their reviews of firms include:

- Letters of engagement refer to incorrect legislation, or Statements of Auditing Standards (instead of International Standards on Auditing ("ISAs")) and National Criminal Intelligence Service (instead of Serious Organised Crime Agency)
- Audit documentation that does not clearly set out the nature, timing and extent of the audit procedures performed, the results of those procedures and the audit evidence obtained, and significant matters arising and the conclusions reached.
- Lack of the required documentation of discussions with management at the planning and completion stage, of the audit including the discussion of fraud risk at the planning stage. This is a vital requirement.
- Lack of documentation of the audit team discussion of risk of material misstatement and risk of fraud, or holding such discussions without the Responsible Individual ("RI") being present.
- Where income recognition is not treated as high risk, lack of documentation of justification why it is not.
- Lack of consideration and documentation of key legal and regulatory requirements affecting the audit at the planning stage and of follow-up of matters identified during the fieldwork. Also, a lack of documentation of discussion of this area with the client, review of regulatory reports and correspondence, and lack of review of correspondence or direct confirmation with legal advisors.
- Insufficient recording of the understanding of the entity, no confirmation of the design and implementation of the controls used by the client (eg via observation or walk-through testing), and risk assessments not always performed at the assertion level. Also, often no significant risks identified. This is a key part of the ISAs.
- Lack of sufficient audit work in the following areas, often resulting from a failure to identify the key audit areas and to tailor the approach at the planning stage:
 - bank and cash – lack of bank confirmations
 - expenditure – occurrence
 - creditors – completeness
 - turnover – completeness
 - other debtors – existence and/or value
 - stock – valuation
- Not documenting sufficient narrative to explain key variances arising from the preliminary and final analytical review and not adequately documenting their impact on the audit
- Lack of documentation to support conclusions reached on post-balance sheet events and going concern. The work on going concern is vital in the current economic climate and does not always cover 12 months from date of signing of audit report.
- Specific matters often omitted from Letters of Representation.
- Auditors Report not complying with latest standards.

- Errors/omissions in financial statements, many of which could be avoided by the use of disclosure checklists (see below)
- Inadequate Audit Compliance Review.
- Long association with client (i.e. acting as RI for more than 10 years) without either implementing safeguards or informing directors in writing and obtaining their approval.

Common Failings in Financial Statements

Common failings found by the QAD of the ICAEW from their review of firms include the following, many of which could be avoided by using a disclosure checklist:

- **Directors' reports:** no risks and uncertainties; no fair review of business activities; no statement regarding the disclosure to auditors, and no disclosure in relation to future developments.
- **Accounting policies:**
 - turnover and income recognition;
 - fixed asset policies; depreciation or non-depreciation; investment properties (including true and fair review override); intangible fixed assets, including goodwill; revaluation of properties;
 - pension scheme;
 - going concern where there were apparent issues.
- **Profit and loss account:**
 - auditor's remuneration, including analysis of non-audit services;
 - taxation; mainly omitting reconciliation of current year tax charge where FRSSE not used;
 - directors' remuneration and pension contributions; the numbers accruing pension benefits.
- **Balance sheet:**
 - fixed assets: hire purchase/finance lease disclosures; the details regarding revaluations;
 - bank loans: terms, interest, maturity analysis;
 - operating leases: no commitment note.
- **Related parties:** no controlling party note; directors' loans omitted; and other missing RPT disclosures.

Disclosure of Dividends to Directors

When directors interests were disclosed in the Directors Report it was deemed unnecessary to give disclosure of dividends paid to directors as related party disclosures.

However, since the disclosure of directors interests were removed on 6 April 2007, it is necessary to disclose dividends to directors as related party transactions in the notes to the accounts.

Ceasing to hold office as auditor

Auditors of private companies are deemed to be re-appointed under Section 487 of the Companies Act 2006 (the "Act") unless:

- They were appointed by the directors and this has not been approved by the members.
- The company's Articles require actual re-appointment
- The deemed re-appointment is prevented by members holding 5% or more of the voting rights giving notice to the company of a resolution not to re-appoint the auditors
- The members have resolved that no auditors should be appointed for the year in question.

An issue arises as to what happens when a company that previously required an audit becomes audit exempt on the grounds of size or dormancy.

Nothing in law compels the auditor to leave office when a company becomes audit exempt and there may be reasons why they should continue, for example because the audit exemption is likely to be temporary, or because a client money report is required by the Financial Services Authority ("FSA"). However, in many cases it is unlikely that an audit will be needed in the future.

In such circumstances, the ICAEW consider that it may be safest for the auditors to resign after completing the final audit to avoid problems in the future, when perhaps many years later the directors resolve under Section 485 of the Act that the company does not need to appoint auditors. If the auditors are unaware of this, they will be in breach of Section 519 of the Act, which requires auditors to notify the company when they ceased 'for any reason to hold office' and not just when they resign or are removed by shareholders.

In these circumstances, there will probably be no need for the auditors or the company to notify the ICAEW or ACCA under Sections 522 and 523 of the Act respectively as the directors resolving not to appoint auditors is more likely to result in the auditor ceasing to hold office at the end of their term. It should be noted that if the audit is a major audit, the auditor and the company will have to notify the Professional Oversight Board ("POB").

A related issue is what happens when an audit client is liquidated or struck-off. When a company is dissolved, the office of auditor ceases to exist and no notifications are required. However, at the earlier stages of insolvency proceedings the office of auditor continues to exist even if no further audited accounts will ever be required. If the auditor chooses to resign, rather than wait for the eventual dissolution, then notification to the company and, if this is not at the end of the normal course of office, the ICAEW or ACCA, or POB will be required.

New Arrangements for Reporting to the Civil Aviation Authority ("CAA")

On 1 April 2008, the CAA introduced a reform to the Air Travel Organisers' Licensing ("ATOL") Scheme and has revised its Guidance Note 10 ("GN 10"). GN10 gives details of the licensing process and reporting requirements for licence holders. It is available from www.caa.co.uk/docs/33/atolgn10.pdf.

The ICAEW Audit & Assurance Faculty has issued Technical Release AAF 02/09 ("AAF 02/09") to provide guidance on the revised reporting arrangements.

The main changes relate to:

- Removal of the general requirement for ATOL bonding and the introduction of licence limits. Where a bond is still required this will be clearly stated in the offer letter in relation to the licence.

- Additional reporting requirement. The introduction of the £1 ATOL Protection Contribution (“APC”) has led to two additional reports from accountants, namely public licensable passenger numbers on a booking date basis and public licensable passenger numbers on a departure date basis.
- Changes in the calculation of the proposed liability cap, which will generally now be based on the higher of 15% of the Licenceholder’s Public Revenue Licence Limit or, where required, the actual Bond.
- Introduction of clauses the suggested Model Engagement Terms designed to make accountants’ liability proportionate to their responsibility in.
- Disclosure of accountants’ reports and confirmations to the Air Travel Trust Fund insurers.

AAF 02/09 provides guidance on:

- Further reporting considerations (Appendix 1) for the use of accountants reporting on information that is required to support Licence holders’ licence applications/renewals;
- Model engagement terms (Appendix 2) and example confirmation of terms of engagement letter (Appendix 3) to be used;
- Suggested work procedures covering the accountants’ work (Appendix 4) on:
 - Annual public licensable revenue;
 - Ticket provider sales (non-licensable revenue);
 - Public licensable passenger numbers on a booking date basis;
 - Licensable passenger numbers on a departure date basis;
 - Factual confirmations; and
 - Ring fencing confirmations.
- Recommended wording for the accountants’ reports (Appendix 5) on:
 - Annual public licensable revenue (Forms 3032 and 3037);
 - Ticket provider sales (non-licensable revenue) (Form 3039);
 - Public licensable passenger numbers on a booking date basis (Forms 3030 and 3035);
 - Licensable passenger numbers on a departure date basis (Forms 3031 and 3036);
 - Factual confirmations; and
 - Ring fencing confirmations.

There are complicated transitional arrangements that are explained in AAF 02/09. AAF 02/09 will first be applicable for License holders with a licence renewal date of 30 September 2009 (which excludes all financial years ending on or before 30 November 2008. Certain transitional arrangements will apply for financial year ends from 31 December 2008 to 28 February 2010.

Accountants reports will need to be submitted between four and six months of the financial year end in the transition period and four months after the financial year end once the transitional period ends. As a

result of this, it is possible that certain reporting will need to follow the guidance in AAF 02/03, whilst other reporting will need to follow AAF 02/09.

Controlling Shareholders as Employees

The Court of Appeal has recently given further guidance as to when a controlling shareholder will be an “employee” for the purposes of the employment protection and insolvency legislation. If the shareholder is an employee for these purposes they will, for example, be entitled to claim redundancy payment and other payments from the National Insurance fund in the event that their business becomes insolvent. The Court of Appeal laid down the following guidelines for whether a controlling shareholder is an employee for these purposes.

- There is no reason in principle why a controlling shareholder cannot also be an employee of the company under a contract of employment.
- It does not matter that the control means in effect that the company cannot dismiss the employee.
- Whether or not a controlling shareholder is an employee is a question of fact for a Court or Tribunal to decide. The fact that there is no written contract is no justification for rejecting that the shareholder is an employee. The conduct of the parties needs to be carefully considered to decide whether any contract is a contract of employment or a contract for services (which means there is no employee relationship). Of relevance will be how the shareholder was paid; salary points towards an employee, fee-based payment or payment solely by dividend points away from that conclusion.
- The fact that the shareholder has made loans to the company or provided personal guarantees to secure loans to the company should not be given undue weight in coming to a conclusion on the employment status.

Execution of Documents

A recent case, *Re Carson Country Homes*, held that the forgery by one director of another director’s signature on a debenture in favour of the company’s bankers did not render the document invalid under Section 44 of the Companies Act 2006 (dealing with the execution of documents). The director who forged the signature had dealt with all financial issues and dealings with the bank over the course of the company’s relationship with the bank and had acted with apparent authority. Consequently, the bank was entitled to rely on the document as a properly executed document. Therefore the company had no grounds for challenging the validity of the appointment of administrators under the debenture.

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