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Mike Marcus, the Technical Partner, can be contacted on 0870 850 6007 or mdm@bondpartners.co.uk if you have any queries on any of the topics covered or for a range of technical services.

Wishing you a Happy, Prosperous and Healthy New Year

Auditing in a Group Context: Practical Considerations for Auditors

The ICAEW Audit & Assurance faculty has updated its 2005 publication "Promoting best practice in group audits" to take account of the EU Statutory Audit Directive, revisions to ISA 600 "Special Considerations – Audit of Group Financial Statements (including the work of Component Auditors)", and the Companies Act 2006 requirement for medium-sized groups to prepare group accounts.

The key points made are:

- **Understand the Group Structure.** Remember that groups change over time and the materiality and risks of components will change. These changes are as critical as acquisitions and disposals. It is also important to be aware of changes in control of components (for example, an associate becoming a subsidiary or a dilution in shareholding due to employee share incentive schemes) and of unusual corporate structures (for example, partnership arrangements that are really joint ventures or components in tax havens).
- **Understand component auditors including their competence and quality control procedures, awareness of the applicable financial reporting framework and auditing standards.** The need to visit component auditors or get them to complete consolidation questionnaires and/or representations needs to be considered.
- **Understand the group's timetable and process.** It is important to be involved early and to ensure that any draft accounting packages to be completed by components contain enough information to enable any GAAP conversion that is required and consolidation, and that there is sufficient time to enable group auditors and component auditors to do their work. Clear instructions should be given to component auditors covering the matters in paragraphs 40 and 41 of the revised and redrafted ISA 600. These instructions should include a requirement for the component auditors to acknowledge the instructions and a request for component auditors to communicate promptly any issues such as delays by local management or unexpected material audit issues.
- **Focus the group audit on high risk areas.** The component auditors should be included in the risk assessment process for their components. The risks should include those arising from the consolidation process itself.
- **Understand internal controls across the group** and request details of internal control weaknesses identified by component auditors.
- **Identify complex accounting areas.** These include:
 - Differing accounting policies and frameworks around the group.
 - Intra-group transactions and balances.
 - Fair values on acquisitions.
 - Financial instruments.
 - Capturing post-balance sheet events.
 - The basis and calculation of share options, bonuses.
 - Tax.

- **Clearly communicate expectations and information required** including timetable to group management, component management and component auditors to ensure they all understand what is expected of them and when.
- **Obtain information early where practicable.**
- **Keep track of whether reports have been received and respond to any issues raised in a timely fashion.**
- **Conclude on the audit and consider possible improvements for next year's process** including feedback from component auditors and management letter issues.

Access to Non-EEA Auditors Working Papers

The EU Statutory Audit Directive applies to audits for accounting periods commencing on or after 6 April 2008. Article 27 deals with group audits.

Article 27(c) requires that, where part of a group audit has been carried out by a non-EEA auditor whose regulator does not have a mutual co-operation agreement with the UK Professional Oversight Board, the group auditor:

- a) obtains the other auditor's agreement that they will provide unrestricted access to their working papers to them and to their regulator;
- b) obtains copies of that auditor's working papers; or where (a) or (b) is not possible
- c) documents the reasonable steps they have taken in order to obtain copies or access and why this cannot be achieved.

The Directive and the Audit Regulations implementing it do not impose this requirement in respect of EEA auditors. It is expected that where issues arise in relation to the work of an EEA component auditor, the Public Oversight Board would request their opposite number in the relevant Member State to inspect the relevant audit.

This is a significant change and likely to cause difficulty in practice. There are two practical issues:

- Group auditors need to make the request early enough to show that they have taken reasonable steps to obtain access or copies. The easiest way to do this is to include a request in the referral instructions issued to component auditors requesting them to confirm whether or not they will provide access or copies in their confirmation letter.

Possible wording for inclusion in instructions might be as follows:

"If you are outside the EEA then we are required by law to:

- a. Obtain unrestricted access to your audit working papers (including access by our regulators); or*
- b. Obtain copies of your audit working papers.*

In acknowledging these instructions, please confirm that you will provide unrestricted access or copies, or explain the legal or regulatory reasons why you are unable to do so."

Possible wording for the letter acknowledging receipt of instructions might be:

"As a non-EEA auditor:

a. * *we will provide you and your regulators with unrestricted access to our working papers;*

b. * *we will provide you with copies of our working papers; or*

c. * *we will be unable to provide you with unrestricted access to our working papers or copies of these because [...describe legal or regulatory reasons why unrestricted access to, or copies of, working papers is not possible]*

* *delete as applicable*"

- Where component auditors will not provide unrestricted access or copies of their working papers, what will constitute "reasonable steps" to obtain access or copies? Neither the Directive nor the Audit Regulations provide examples, but it is likely that restrictions on access imposed by local laws and regulations would be deemed "reasonable"; whereas claiming client confidentiality (that could be waived by component management) would be less acceptable. Ultimately this is a judgement for the audit engagement partner that will need to be documented on the group audit file.

ASB Publishes Amendment on Financial Reporting Standard 8 'Related Party Disclosures'

The ASB has issued an Amendment to FRS 8 'Related Party Disclosures'. The Amendment reflects changes to the law introduced by 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008' (the "Regulations").

The Amendment is effective for accounting periods beginning on or after 6 April 2008 and, in particular, it:

- Changes the definition of 'related party' in FRS 8 to be the same as that in the law; and
- Provides an exemption only for 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 such a member. This is a change from FRS 8, which provided a scope exclusion for 90 per cent controlled subsidiaries.

The Regulations include a requirement for particulars to be given in the notes to the accounts of transactions which an entity has entered into with a related party, where such transactions are material and have not been concluded under normal market conditions. The Amendment clarifies that this requirement will be met by complying with FRS 8, which requires disclosure of all material related party transactions.

ASB Issues Bulletin 2008/10 "Going Concern Issues During the Current Economic Conditions"

Current economic conditions provide particular challenges to all involved with annual reports and accounts. One consequence is expected to be an increase in the disclosures in annual reports and accounts about going concern and liquidity risk. As a result, the current conditions will present challenges for:

- directors – who will need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures;

and

- auditors – who will need to ensure that they fully consider going concern assessments and only refer to going concern in their auditor's reports when appropriate.

The current economic environment leads to added uncertainty regarding:

- bank lending intentions and the availability of finance more generally;
- the impact of the recession on a company's own business; and
- the impact of the recession on counterparties, including customers and suppliers.

These conditions will create a number of challenges for those preparing financial statements and their auditors.

The effect of the current market conditions on any particular entity requires careful evaluation. However, the general economic situation at the present time does not, of itself, necessarily mean that a material uncertainty exists about an entity's ability to continue as a going concern or justify our modifying our auditor's reports to draw attention to going concern. We make judgements on the need, or otherwise, to draw attention to going concern on the basis of the facts and circumstances of the entity at the time of signing the auditor's report. This Bulletin gives guidance on relevant factors to be considered and highlights certain requirements and guidance in the ISAs (UK and Ireland).

This Bulletin supplements the existing guidance Bulletin 2008/1 "Audit Issues when financial market conditions are difficult and credit facilities may be restricted", and in particular:

- updates the listing of risk factors included in Bulletin 2008/1 (see Appendices 2 and 3 of Bulletin 2008/10); and
- provides guidance on a number of going concern issues that we are likely to encounter during the forthcoming reporting cycle.

This guidance draws on ISA (UK and Ireland) 570 "Going concern" and does not establish any new requirements.

The risk factors draw attention, inter alia, to guarantees and the need to consider the risk of these being called in or of the guarantor no longer being able/prepared to provide the guarantee. They also refer to fair values, impairments, current versus non-current classification, revenue recognition, pensions, hedging and deferred tax.

To assist directors, the Financial Reporting Council (FRC), has published guidance entitled "An update for directors of listed companies: going concern and liquidity risk". Its purpose is to bring together existing guidance in the context of recent developments relating to going concern and liquidity risk disclosures to assist directors, audit committees and finance teams of listed companies during the forthcoming reporting season. It is expected that this Update for Directors will also be useful to directors of unlisted companies and other entities that have similar responsibilities to assess going concern and make appropriate disclosures. This Update for Directors is attached as Appendix 1 to Bulletin 2008/10.

Further Companies Act 2006 Regulations

The Regulations relating to annual returns will apply from 1 October 2009 and are contained in SI 2008/3000 "The Companies Act 2006 (Annual Return and Service Addresses) Regulations 2008". They cover the following:

- The amendments to s855 of the 2006 Act which specify the particulars of directors and secretaries required to be provided in the annual return, including the use of service addresses rather than residential addresses. A service address must be a place where the service of documents can be effected by physical delivery and the delivery of documents is capable of being recorded by the obtaining of an acknowledgement of delivery.
- The requirement of s1136A of the 2006 Act to indicate the address of the places where the register of members and register of debenture holders are kept (if not at the company's registered office) and the records kept there.
- The requirement to indicate whether the company's shares are admitted to trading on a regulated market.
- The classification of company type; there are seven and the most common will be T2 'Private company limited by shares'.
- The classification of a company's principal business activities as set out in the Standard Industrial Classification 2003. 7499 'Non-trading company', 9800 'Residents' property management company' and 9999 'Dormant company' have been added to the SIC classifications.
- The amendment to s856 of the Companies Act 2006 which specifies the information to be given about the company's shareholders were shares admitted to trading on a regulated market during the period to which the return relates.
- The amendment to s858(1) and 859 of the 2006 Act under which the annual return need not give details of any shadow director, although a shadow director may still be liable for failure to deliver the annual return.

The regulations relating to the form of a company's constitutional documents will also apply from 1 October 2009 and are contained in SI 2008/3014 "The Companies (Registration) Regulations 2008". Whereas the Companies Act 1985 requires a company to include a substantial amount of information in its Memorandum of Association and allows a company's constitutional rules to be divided between its Memorandum and Articles of Association, the Companies Act 2006 requires all the constitutional rules to be contained in the Articles of Association. Consequently, the Memorandum will be a much shorter document. The statutory instrument prescribes the form of the Memorandum and covers:-

- A schedule giving the name of each subscriber to form a company and to take at least one share (unless the company has no share capital).
- The information to be contained in the statement of capital (or statement of guarantee) to identify the name and address of each subscriber.
- A schedule prescribing the form of assent for re-registration of a private limited company as unlimited.
- A schedule prescribing the form of assent for re-registration of a public company as private and unlimited.

APB issues Revised Guidance on the Audit of Charities

The APB has published a revision of Practice Note (PN) 11: 'The Audit of Charities in the United Kingdom'.

The previous version of PN 11 was issued in 2002 and was supplemented by Bulletin 2005/1: 'Audit risk and fraud – supplementary guidance for auditors of charities', both of which are superseded. The update to PN 11 reflects:

- The replacement of Statements of Auditing Standards by ISAs (UK and Ireland);
- Changes to the Charities Act 1993 (which apply to charities in England and Wales) as a result of the implementation of the Charities Act 2006 on 1 April 2008;
- Changes to the legal and regulatory arrangements for charities in Scotland, including the establishment of the Office of the Scottish Charity Regulator (OSCR) which apply to accounting periods commencing on or after 1 April 2006;
- Changes in the guidance on the Charity Commission's interpretation of 'material significance' in the context of whistle blowing responsibilities. Appendix 5 gives useful guidance including a list of reportable circumstances (which include matters suggesting dishonesty, fraud or money laundering, significant breaches in a charity's trust or legislative requirements, and failures of internal controls that resulted in or create a significant risk of misappropriation of funds).
- The need, where an auditor resigns or otherwise ceases to hold office, to send a copy of any circumstances relating to their ceasing to hold office, that were given to the charity's directors/trustees, to the Charity Commission.

Illustrative auditor's reports for charities in both England and Wales and in Scotland were included in the consultation draft of the revision. These will now be included in a supplementary Bulletin to be issued shortly.

Appendix 1 gives a useful summary of the legislation including accounting and audit thresholds covering both charitable trusts and companies. Appendix 3 gives revised example Engagement Letter Paragraphs and Appendix 5 gives illustrative example Statements of Trustees Responsibilities. Appendix 6 gives examples of controls specific to charitable organisations.

Late Filing Penalties – Grounds for Appeal

The Independent Adjudicator to Companies House has issued its report covering the period from 1 August 2007 to 31 March 2008. In that period it considered 35 Appeals against Penalties and rejected 34 of them. The only ground for appeal accepted was Obstruction of Previous Directors.

Grounds for appeal rejected include postal delay; Director/Company Secretary ill, bereaved or catastrophe occurred (not sole director); missing in the post; accounts not correct, need to be re-submitted; change of registered office or directors address not notified so correspondence not received; accountant or member of staff ill or died; incompetence by person submitting accounts; alleged wrong advice from Companies House; reminder not received and accounts handed into London Office but lost.

As can be seen from the above the likelihood of a successful Appeal is remote.

Under-Age Directors

From 1 October 2008 directors must be at least 16 years old. Any person under-age at 1 October 2008 will cease to be a director with no notification to the Registrar required. However, the company will need to amend their Register of Directors to reflect the fact that the appointment has ceased.

Therefore these rules apply retrospectively.

When an under-age director reaches 16 s/he will have to be formally re-appointed as a director.

Company Names Adjudicator issues first decision

The Company Names Adjudicator has made an order against Coke Cola Limited to change its name within one month following a complaint from The Coca Cola Company Limited.

Since Coke Cola Limited was incorporated before 1 October 2008, the date the relevant legislation came into force, the decision also confirms that complaints can be made regardless of when the company was incorporated.

Also, the speed of the decision, just over 2 months from the date of the application, is good news for brand owners with a strong basis for complaint.

Money Laundering - Countries with Higher Perceived Risk

The countries on the FATF list of higher perceived risk of money laundering and terrorist financing risks are:

Uzbekistan
Iran
Pakistan
Turkmenistan
Sao Tome and Principe
The northern part of Cyprus

We need to recognise the continuing need for increased scrutiny and enhanced due diligence in respect of these countries.

Breaking Property Leases – Avoiding the Pitfalls

In the current economic climate many companies are looking to rationalise their property requirements. This could include taking advantage of rights to terminate leases of premises which are now surplus to requirements.

However, landlords are equally anxious to ensure that they minimise, as far as possible, unexpected vacancies in the current market. Landlords are therefore likely to try and frustrate as far as possible the exercise of tenant's rights to terminate.

Therefore, exercising rights to break leases can be fraught with difficulties from the tenant's point of view and they should be aware of the following if they want to break a lease and get it right:

- The service requirements of each lease can be difficult and can be complex. Sometimes notices may need to be served abroad or served in a specific way which is not obvious from the lease.
- Often options to break are conditional. The conditions may not be straightforward and the legal interpretation may seem to go against common sense. The Courts have always required strict

compliance with any pre-condition. It may not be possible to argue that a condition is trivial and non-compliance would make no practical difference to the premises or the value of the landlord's interest. For example, in *Bairstow Eves (Securities) Limited v. Ripley* (1992) the tenant was required to paint the premises in the last year of the term to comply with the break conditions. The tenant did not do so as the premises had been painted 13 months from the break date. The tenant lost its right to break the lease even though the breach was of no practical significance – the tenant had painted 1 month early!

- The date when the conditions need to be complied with. This could be, for example, the date the break notice is served or on expiry of the lease at the end of the notice period?
- The wording of notices can be difficult to get right to avoid a challenge by the landlord

As break notices are often a hotly contested area it is advisable to take legal advice in the service and preparation of the notice and in relation to what to do about complying with preconditions. If the break notice is not correctly served or worded the opportunity to break the lease may be lost and the only other option would be to try and negotiate a surrender of the lease or to try to assign or underlet the premises. In current market conditions, either of these could be both costly and difficult.

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