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Effects of Credit Squeeze on Audit Reports

The effect of the banking sector liquidity problems needs to be taken into account when considering going concern during an audit.

In the present situation we can no longer assume that banks will automatically renew credit facilities. Also, it is likely that interest rates on renewal will increase and stricter covenants will be imposed. Therefore when considering going concern we need to consider whether:

- the client has complied with all conditions and covenants in facility agreements (including supplying management accounts on time).
- the client has achieved projections supplied to the bank.
- the business can afford the likely increased borrowing costs and continue to comply with covenants and stay within agreed facilities.
- the value of any assets or income streams are likely to be impaired as a result of the credit squeeze, and if so, how this will impact on covenants and the ability to stay within agreed facilities.

If there appear to be issues arising from the above considerations, the effect and our audit opinion needs to be carefully considered.

Tech 05/07 “Exposure Draft of Anti-Money Laundering Guidance for the Accountancy Sector”

Tech 05/07 provided guidance on the implementation of the Money Laundering Regulations 2007 coming into force on 15 December 2007.

Despite all the alarmist articles in the press, the new Regulations will not mean a great deal of change for firms already complying with the current CCAB anti-money laundering guidance. The main changes are that firms:

- will need to have a risk assessment in place, and conduct their client due diligence on the basis of that assessment. Firms will need to set up a matrix of risk categorisation of low/normal and high based on factors such as products or services to be offered, client types and sectors, the jurisdictions of client origin, funding, investment and conduct of businesses. Any approach should contain an element of discretion and flexibility. The risk categorisation will need to direct the depth and type of customer due diligence and future monitoring (see below for examples).
- The Regulations provide for ‘Simplified’ due diligence arrangements which will remove the need to undertake the more onerous aspects of “know your client” (or “KYC”) procedures. However the clients to whom this relaxation applies are very restricted and, on a risk-basis, we could still decide to undertake our normal or enhanced procedures.

- The Regulations provide for 'Enhanced' due diligence requirements which will require you to conduct more rigorous due diligence for all higher risk clients, including (specifically) public officials from outside the EU and in relation to remote client services (where no physical meeting with the client takes place). A concept, which may be fairly new to firms, is that of "politically exposed persons" (or "PEPs"). These clients will require enhanced due diligence.
- will be required to monitor, on an ongoing basis, their relationship with the client and have evidence of identity in place for all clients, even those which have been on the books for many years.

Existing clients will usually be well known to the firm, so limited additional evidence of their identity will be required – like a copy of their tax return, or bank correspondence, which are likely to already be on the file. This requirement does not mean that we must immediately request identification information from all our well established clients. It is recommended that during the course of the next engagement for the client, we review the information we hold to verify the client's identity and request any additional information necessary to satisfy our KYC procedures.

Any due diligence needs to identify the beneficial owners of any client entity. The meaning of beneficial owner in the Regulations can be summarised as:

- **Bodies corporate** – beneficial owner means any individual who, in respect of any body other than a company whose securities are listed on a *regulated investment market*, owns or controls, directly or indirectly including through bearer shareholdings, more than 25% of the shares or voting rights in the body or who otherwise exercises control over the management of the body
- **Partnerships** (other than limited liability partnerships established under the Limited Liability Partnerships Act 2000) – beneficial owner means any individual who ultimately is entitled to or controls (directly or indirectly) more than 25% of the capital or profits of the partnership or more than 25% of the voting rights in the partnership or who otherwise exercises control over the management of the partnership.
- **Trusts** – beneficial owner means any individual who is entitled to a *specified interest* in at least 25% of the capital of the trust property, or where a trust is not set up entirely for the benefit of persons with a *specified interest*, the class of persons in whose main interest the trust is set up or operates, or any individual who has control (*a trust controller*) over the trust. Where a class of persons is identified, it is not a requirement for all members of that class to be identified.
- **Other entities and arrangements** (meaning an entity or arrangement which administers and distributes funds) – where the individuals who benefit from the entity or arrangement have been determined, beneficial owner means any individual who benefits from at least 25% of the property of the entity or arrangement. Where those benefiting have yet to be determined, beneficial owner means the class of persons in whose main interest the entity or arrangement is set up or operates, or an individual who exercises control over at least 25% of the property of the entity or arrangement. Where a class of persons is identified, it is not a requirement for all members of that class to be identified. Note that where an individual is the beneficial owner of a body corporate which benefits from, or exercises control over, the property of an entity or arrangement, the individual is to be regarded as having that benefit or control and so is classed as the beneficial owner.
- **Estates of deceased persons** - the beneficial owner is considered to be the executor or administrator of the estate.

If a prospective client refuses to provide identity or other information properly requested as part of due diligence we should not commence acting, or in the case of ongoing monitoring, any relationship must be terminated and the matter reported to the MLRO.

Changes such as the appointment of new senior managers and/or controlling parties, changes in a client's strategy or changes of business profile should prompt us to re-apply customer due diligence procedures. Where it is just the appointment of a key employee as a director or shares issued under an EMI the new due diligence is likely to be restricted to just the new director or shareholder. However, where the risks are assessed as being higher, the extent and scope of due diligence may need to be extended, particularly for long-standing clients where ID is either non-existent or old.

Examples of risk based verification are:

- **Individuals**
 - Met face-to-face and normal risk: obtain either photo identity, or non photo identity and proof of address or date of birth.
 - Not met face-to-face and/or higher risk: obtain ID as above plus an additional piece of evidence.
- **Private Company/LLP**
 - Met a representative face-to-face and normal risk: obtain either a full company search or certified copies of original documents evidencing details of incorporation or registration, registered office and list of directors and shareholders/members.
 - Not met a representative face-to-face and/or higher risk: as above plus ID all directors (including shadow and de-facto directors) and all individuals/entities holding more than 25% of the equity (rights to either income, capital or voting) or where no holding over 25%, the largest holding. Where intermediate holding companies, repeat the above until ultimate beneficial owners have been verified. If any of the entities is a money service business, verify HMRC registered number (either by certified copy of certificate or call HMRC National Advice Service on 0845 010 9000, option 3).

Practice Note 26 – Guidance on Smaller Entity Audit Documentation

The guidance in Practice Note 26 is aimed at

- voluntary audits of small audit exempt companies
- owner-managed companies that are not audit exempt but whose operations are uncomplicated with few sources of income and activities, simple accounting systems and largely informal internal controls.

For such audits the Practice Note sets out the key matters to be documented and provides illustrative documentation covering:

- Understanding the entity
- Audit team planning meeting
- Controls documentation
- Risk assessment

The illustrations show the depth of knowledge and extent of documentation required to satisfy the planning requirements of the ISA's and that it is not possible to adequately document an audit by merely completing the fieldwork and completion sections of proprietary audit documentation.

Distributable Profits under IFRS

ICAEW & ICAS have issued Technical Release Tech 02/07 "Distributable Profits: Implications of Recent Accounting Changes". Tech 02/07 gives guidance on the implications of transition to IFRS and converged UK standards for the determination of realised profits and losses in the context of distributions under the Companies Act 1985 and on distributable profits for public companies. It supplements previous guidance and consolidated guidance, taking account of the Companies Act 2006, will be issued in due course.

Currently IFRS, where adopted, only have to be used in the consolidated accounts. This means that the parent company's individual accounts can still be prepared under UK GAAP. In practice, most parent companies have chosen to continue to prepare their financial statements using UK GAAP, as adoption of IFRS may have an impact on the availability of distributable profits, thus inhibiting the parent company's ability to pay dividends. The advisability of companies only adopting IFRS in their consolidated accounts is illustrated by the following.

Under UK GAAP, when a subsidiary pays a dividend to its parent, it becomes the income of the parent unless the payment of the dividend impairs the value of the investment in the subsidiary. Under IFRS, the payment of a dividend from a subsidiary out of pre-acquisition reserves creates a credit against the cost of investment. It cannot become a distributable profit of the parent company.

This difference is particularly relevant if there is a group re-organisation and a new intermediate holding company is inserted. Under IFRS this makes all the reserves of the new company's subsidiaries pre-acquisition reserves, thus making reserves arising before the re-organisation unavailable for distribution. Under UK GAAP they would be distributable because Merger accounting can be used.

Where a company chooses to apply IFRS it must apply IFRS in their entirety. It cannot "pick and mix" and apply UK GAAP for some of its accounting policies.

Since distributable profits are based on the company's own accounts (and not on the consolidated accounts) the guidance in Tech 02/07 will not be wholly relevant where the consolidated accounts are prepared under IFRS and the company's own accounts under UK GAAP.

Legally, the question of whether or not a profit is realised depends on generally accepted accounting practice and therefore is dependent on whether the company prepares its own accounts under IFRS or UK GAAP. The existing guidance on distributable profits covers the use of UK GAAP. Tech 02/07 provides guidance on distributable profits where a company prepares its own accounts under IFRS or in accordance with FRS 26 under UK GAAP, and in particular on the implications of fair value accounting.

Regardless of the framework under which a company's accounts are prepared, directors have a fiduciary duty to consider whether a company will be solvent following a distribution, having regard to both the immediate cash flow implications of a distribution and the continuing ability of the company to pay its debts as they fall due.

Fair value accounting introduces greater volatility in the measurement of profits and this needs to be taken into account by directors in complying with their fiduciary duties. Therefore directors need to consider whether it would be prudent to distribute profits arising from changes in the fair value of financial instruments considered to be volatile, even though they may otherwise be realised profits in accordance with Tech 02/07.

IAS 39 is based on a "mixed measurement model" whereby some financial instruments may be included at fair value while others may be included on an amortised cost basis. This may, in some cases, lead to volatility in the profit or loss for the period. For example, an asset and a liability may provide an economic hedge but if the asset is measured at fair value and the liability is not, a profit may be reported on one but a loss not reported on the other. Although such profits may be realised profits in accordance with this guidance, directors should consider, as a result of their fiduciary duties, whether it would be prudent to distribute them.

The biggest change made by Tech 02/07 is to the definition of realised profits, moving this further away from the traditional concept of profits represented by cash received or a short-term debtor. A key part of the revised definition refers to

“the recognition in the financial statements of a change in fair value, in those cases where fair value has been determined in accordance with the fair value measurement guidance in the relevant accounting standards, and to the extent that the change recognised is readily convertible to cash.”

The term “readily convertible to cash” is the key part of the revised definition and consequently not all profits recognised as a result of fair value accounting will be realised profits.

There is a lot of discussion in Tech 02/07 of the meaning of readily convertible to cash but in essence the profit will be realised if:

- you can pick up the phone and sell the instrument for a known amount of cash at the balance sheet date without the need for marketing or negotiation. There is no need to have had the intention to sell; it just needs to be possible.
- a derivative contract can be closed out at the balance sheet date so as to ‘lock in’ the profit on the original contract as cash or known future cash flows.

Tech 02/07 also considers the impact of:

- IAS 32 (and FRS 25) whereby certain shares and dividends thereon are accounted for as if they were liabilities. The general guidance is that for realised profit purposes the legal form (rather than the substance) of the instrument should be followed. The guidance sets out 10 principles and 8 example scenarios to illustrate their application covering, inter alia, forward contracts and options to repurchase own equity shares, convertible debt, redeemable preference shares and convertible shares.
- Adjustments that might arise on transition to IFRS.

Table A

New versions of Table A have been published on the Companies House website- one for private companies limited by shares and one for public companies limited by shares. A new Table C for companies limited by guarantee and not having a share capital is also available.

These new versions take account of Companies Act 2006 provisions brought into force on or before 1 October 2007 (such as those relating to directors’ duties, resolutions and meetings).

The new versions will apply to companies incorporated on or after 1 October 2007. They will not automatically apply to existing companies, who will have to change their Articles to adopt them.

The new versions are an interim measure until the new Companies Act 2006 model articles come into force next year.

Disclosure of Auditor Remuneration

ICAEW have adopted and finalised Tech 06/06, which gives guidance on the disclosure of auditor remuneration for the audit of accounts and for other non-audit services in accordance with SI 2005/2417 “Companies (Disclosure of Auditor Remuneration) Regulations 2005”.

These Regulations require Companies that are not SMEs to disclose in their individual accounts in respect of accounting periods beginning on or after 1 October 2005:

- the fee receivable by the auditor for the audit of the company itself. Where consolidated accounts are presented, the audit fee is that for the group and there is no need to separately disclose the fee for auditing the holding company itself.
- any fee receivable by their auditor or associates of their auditor for the supply of other services to the company or its associates.

Guidance was given in Bond Technical Factsheet No. 6 (September 2006).

The revised guidance reflects changes made in July 2007 in the light of practical experience of working with the new disclosure requirements. The main changes relate to:

- clarification that Regulations do not apply to companies incorporated in Northern Ireland.
 - Fees for work performed on consolidation packs, where the cost of that work is separately identifiable. Where the work is performed by the auditor of the holding company itself the fee should be disclosed within the group audit fee. Where the work is performed by an associate of the parent company auditor, the fees should be disclosed under category 1 of other services (i.e. under 'Auditing of accounts of associates of the company pursuant to legislation') in the group accounts. Fees for work on the consolidation pack in the subsidiary company's own accounts should be disclosed in category 2 of other services (i.e. under 'Other services supplied pursuant to such legislation').
 - Clarification that over or under accruals of previous year audit fees should be included within fees for this year, albeit it would be better if they were separately disclosed.
 - Fees paid to an associate of the auditor for the audit of a branch of the company should be included within audit fees where the associate acts as an agent of the auditor. Otherwise it should be included under category 2 of other services.
 - Group audit fees must be apportioned between the companies in the group for the purposes of disclosure even if the cost has not been recharged. A reasonable approximation is acceptable, so this should not involve a great deal of work.
 - The exemptions for the holding company not disclosing separate information in relation to the holding company itself only related to cases where statute requires consolidated accounts. It does not apply to companies preparing intermediate group accounts where such group accounts are not required under Section 228 or 228A of the Companies Act 1985.
 - Clarification that fees for services supplied by a subsidiary's auditor (or their associates) to the parent company do not have to be disclosed in the subsidiary's own accounts.
 - Further guidance on what requires disclosure under each category of other services.
 - IFRS transition fees on first-time implementation should be disclosed under audit fees unless it goes significantly beyond what would be required to give an audit report on the financial statements. Fees for such accounting work would be disclosed under Category 'D' 'All Other Services'.
 - Irrecoverable VAT should be excluded from the amounts disclosed.
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Fourth Companies Act 2006 Commencement Order

SI 2007/2607 "The Companies Act 2006 (Commencement No. 4 and Commencement No. 3 (Amendment Order) Order 2007 came into force on 30 September 2007.

It brings into force the power to make regulations about fees chargeable by companies for the inspection of company records and provision of copies.

It also corrects a number of technical errors in the Third Commencement Order.

Suspicious Activity Reports

SOCA have expressed their appreciation for the Suspicious Activity Reports (SARs) that accountants provide.

What we do in providing SARs is already providing value, but there are further ways in which we can help SOCA maximise their use, whilst avoiding wasted effort and maintaining confidentiality on our part. The ICAEW has issued the following practical hints and tips for effective reporting.

- **Providing the right information**

SOCA understands that we do not always have complete information about the subjects of our reports, particularly because we may frequently be reporting on subjects who are not our clients. Customers, suppliers, acquisition targets etc are all potential SAR subjects as well as clients. On our side, we need to appreciate that the more identifying information and clear explanation of our suspicions we provide to SOCA, the more likely they are to be able to match our data to other intelligence and put it to active use. The following points may help you in compiling high quality SARs of real value.

- **Subject type.** Use the options to classify each subject as suspect, victim or unknown. This helps put each subject's role into context and also makes clear where subjects are not suspected of criminal activity.
- **Subject details – individuals.** Where possible provide any middle names, date of birth (especially helpful), addresses (including postcodes where known) email addresses, web page addresses and any other known identifiers such as national insurance number, passport number, car registration or phone numbers.
- **Subject details – entities.** Wherever possible include the registration number, (tax reference and VAT number is also useful), country of incorporation, addresses (including postcodes where known), email and web addresses, phone numbers and wherever possible the full legal name and designation, e.g. Limited, SA, GmbH etc.
- **Reason for suspicion.** Keep your explanation succinct and focus on what you have seen and why it is unusual or suspicious. Where you feel able to, refer to which predicate offences (i.e. the underlying criminal conduct giving rise to the money laundering) you think may have been committed. If you know the Act and section number detailing the offence (only if you know, you do not have to do legal research), put it in as it helps explain why you are reporting. Keep to plain English, or at least explain any technical terms you use even if they seem obvious to you.

- **Submitting your report.**

- **Format.** Wherever possible use SAR Online or Moneyweb – these systems have the advantage for you of secure transmission and instant acknowledgement with a reference number. For SOCA, it greatly reduces processing time meaning quicker dissemination to law enforcement and less time tied up in administrative tasks
- **Hard-copy reporting.** If you don't have the facilities to use the electronic systems, then please use the SOCA standard forms and type your information – non-standard formats or handwritten reports take a lot of processing time and provide potential for error in interpretation and input
- Do not send supporting documents with your report – if SOCA need further information they will contact you
- Generally when completing the form – think what, who, why, when, how, where and keep it as short and punchy as possible. The SOCA website (www.soca.gov.uk) provides guidance.

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