TABLE OF CONTENTS

TABLE OF CONTENTS **1**
FRS 102: 1A SMALL ENTITIES (LECTURE A577 – 33.16 MINUTES) **4**
Section 1A 4
True and fair view 5
Complete set of financial statements 6
Transactions with shareholders 8
Presentation of the financial statements 9
Small groups preparing consolidated financial statements 10
Abridging and adapting the balance sheet formats 10
Disclosure requirements for small entities 13
THE NEW LLP SORP (LECTURE A578 – 6.27 MINUTES) **19**
Background to the revisions 19
Increased size thresholds 19
Micro-entity LLPs 20
Small LLPs 20
Statement of changes in equity 21
Group reconstructions 21
CONCLUSION **21**
FRED 66 AND THE REDUCED DISCLOSURE FRAMEWORK (LECTURE A579 – 7.02 MINTES) **22**
Single lease disclosure note 22
Maturity analyses 22
Disclosure initiative – amendment to IAS 7 23
Effective date of the FRS 101 amendments 23
PRACTICAL ISSUE 1: FRS 102, SECTION 1A AND THE DISCLOSURE REQUIREMENTS (LECTURE A580 -16.21 MINUTES) **24**
Accounting policies 24
Section 1A and the true and fair view 24
How do we achieve a true and fair view under Section 1A? 25
PRACTICAL ISSUES 2: FILING REQUIREMENTS UNDER THE NEW COMPANIES ACT 2006 (LECTURE A581 – 10.55 MINUTES) **27**
Filing options under the new small companies regime 27
1. What changes have been made to company law? 27
2. Have any changes been made to accounting standards as a consequence of the new regulations? 27
3. Can I still file abbreviated accounts? 28
4. What options are available under the new regime? 28
5. Can I still take advantage of the exemption available under s444 Companies Act 2006 and not file the profit and loss account? 28
6. Which notes do I need to include if I decide not to file a copy of the profit and loss account? 28

7. Can I exclude details of employee numbers from the 'filleted' accounts? 29
8. If I delete any notes when preparing 'filleted' accounts, should I renumber the notes that remain in order to avoid gaps in the sequence? 29
9. If I produce any additional primary statements, will I need to file them with the 'filleted' accounts? 29
10. Do the directors need to approve the 'filleted' accounts before the accounts are filed? 29
11. Do I need to include the audit report in the 'filleted' accounts at Companies House? 30
12. What are abridged accounts and what do they contain? 30
13. How do the filing rules apply to abridged accounts? 31
14. What consent is needed before abridged accounts can be prepared? 31
15. This all sounds quite complex to me. Is there a concise summary showing what needs to be filed with Companies House in different situations? 31
16. Where can I find examples of the various statements and notes that I may need to include in the accounts filed at Companies House? 31
17. Can I early adopt the new requirements? 31
APPENDIX 1 – COMMON SCENARIOS UNDER THE REVISED SMALL COMPANIES REGIME 32
APPENDIX 2 – EXAMPLE STATEMENTS FOR INCLUSION IN THE ACCOUNTS 33

PRACTICAL ISSUES 3: PROVISIONS AND CONTINGENCIES (LECTURE A582 – 9.08 MINUTES) 34

Provisions for liabilities 34
Creation of an 'obligation' 35
Recognition of a provision in the financial statements 36
Contingent liabilities 36
Contingent assets 37
Offsetting provisions 37

AUDITOR'S REPORTS UNDER THE NEW REPORTING REGIME (LECTURE A583 – 32.49) 38

The applicable financial reporting framework 38
Modified opinions 38
Going concern 40
Emphasis of matter and other matter paragraphs 40
Other information 40
Appendix: Illustrative auditor's report (small entity reporting under UK GAAP with material going concern uncertainties) 46

FRC'S ETHICAL STANDARD FOR AUDITORS (LECTURE A584 – 22.11 MINUTES) 49

Part A Overarching principles and supporting ethical provisions 49
Part B 49
Section 1: General Requirements and Guidance 50
Financial, business, employment and personal relationships 54

ISA 450 (REVISED JUNE 2016) *EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT* *(LECTURE A585 – 7.58 MINUTES)* 61

Objective of the auditor 61

Progression of the audit 61
Communicating and correcting misstatements 62
Evaluating the effect of uncorrected misstatements 62
Communication with those charged with governance 63
Written representation 63
Documentation 63
RECENT FAQ'S 65
Under the small companies' regime, is it true that directors' remuneration will not be disclosed in the accounts? 65
Will I have to include an accountant's report in with my client's FRS 102 financial statements, even if it is a small client? 65
Are fair value gains and losses for a fixed asset accounted for under Section 17 treated in the same way as a fair value gain/loss for an investment property? 65

FRS 102: 1A SMALL ENTITIES (LECTURE A577 – 33.16 MINUTES)

For small entities that have not early-adopted FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, 2017 will be the year in which they are required to apply FRS 102 for the first time, with December 2016 year-ends being the first that are required to be prepared under the new regime.

Practitioners should, by now, have a sound understanding as to the mechanics of FRS 102 and the differences in accounting treatments and disclosures which the standard brings in comparison to previous UK GAAP. In addition, as many practitioners dealing with companies at the smaller entities will also have micro-entities on their portfolio, the decision as to whether to apply FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* or FRS 102 should now have been made. It is worth emphasising that FRS 105 is an optional standard and whilst the standard is appropriate to the majority of micro-entities (including micro-LLPs), it may not be suitable for them all.

On transition to FRS 102, practitioners should apply the standard retrospectively to the client's date of transition (which is the start date of the earliest period reported in the financial statements). Therefore, for a 31 December 2016 year-end, the date of transition will be 1 January 2015, being the first day of the comparative year. The rules are applied retrospectively to this point so that the opening balance sheet position as at the date of transition is compliant with FRS 102. If this were not the case, and the rules were simply applied to the comparative year-end, the comparatives would be meaningless because the opening balance sheet position would be based on old UK GAAP.

Section 1A

At the time of writing these notes, the latest edition of FRS 102 is the September 2015 edition. This is also the first edition of FRS 102 which incorporates small entities by the inclusion of Section 1A *Small Entities* (this section was not found in previous editions of FRS 102). The Financial Reporting Council (FRC) took the decision to include a separate section for small entities following the withdrawal of the FRSSE for accounting periods starting on or after 1 January 2016.

Section 1A sets out the information that a small entity is required to present and disclose in its financial statements. The term 'small entity' in the context of FRS 102 means those entities which choose to apply the small companies' regime in the preparation of their statutory financial statements. In the extremely rare case that a small entity prepares its financial statements under EU-adopted IFRS, that entity will not be able to apply Section 1A. It might also be the case that a small entity chooses not to apply the small companies' regime in the preparation of its financial statements, and in these instances such an entity must prepare its financial statements in accordance with full FRS 102.

LLPs are also eligible to prepare their financial statements under Section 1A of FRS 102, although regard must also be had to the LLP SORP, the latest version of which was released in January 2017. LLPs that prepare their financial statements under FRS 105 are scoped out of the provisions of the SORP.

If there is any conflict between the requirements of FRS 102 (including Section 1A) and legislative requirements, the legislative requirements will prevail.

True and fair view

The requirement for an incorporated entity to prepare financial statements that give a true and fair view has been enshrined in legislation for decades. There has never been any statutory definition of what is 'true and fair' and the most authoritative statements as to the meaning of true and fair are legal opinions written by Lord Hoffman and Dame Mary Arden in 1983 and 1984 and again by Dame Mary Harden in 1993. Lord Hoffman said that true and fair was an 'abstraction or philosophical concept expressed in simple English.' Lord Hoffman then goes on to acknowledge that it was considered wise for the courts not to offer to define true and fair in a legal context.

A significant period of time has elapsed since Lord Hoffman's and Dame Mary Arden's opinions were expressed and, during that time, there have been tremendous changes to accounting standards and company law. These changes beg the question as to whether those opinions remain applicable in the modern accountancy world.

The true and fair debate has raged on over the years, more recently the concept has been challenged where IFRSs are concerned. The FRC commissioned a further legal opinion from Martin Moore QC who confirmed that the true and fair view requirement underpins the preparation of financial statements in the UK, regardless of whether the reporting entity prepares its financial statements under UK GAAP or IFRS.

In 2015, the Companies Act 2006 was amended by SI 2015/980 so as to reflect the provisions in the EU Accounting Directive (the Directive). The Directive has reduced the levels of disclosure requirements that a small company is required to make in its statutory financial statements and, for a micro-entity, significantly reduces the disclosure requirements.

Practitioners have expressed concern as to how financial statements, particularly for a micro-entity, will give a true and fair view in light of the reduced disclosures. For micro-entities, this is, to some extent, dealt with in the deeming provisions whereby financial statements prepared in accordance with the micro-entities' legislation are presumed to give a true and fair view. The Small Companies' Regulations do not contain such deeming provisions and professional judgement will be required where a true and fair view is concerned.

Paragraphs 1A.5 and 1A.6 of FRS 102 give prominence to the true and fair requirements so as to remind preparers of small company financial statements that directors of small companies still have a legal duty to prepare financial statements that give a true and fair view. Indeed, section 393 of the Companies Act 2006 is clear: the directors of a small company must not approve financial statements unless they are satisfied that they give a true and fair view of the state of the company's affairs.

Appendix C *Disclosure requirements for small entities* reflects the provisions of the EU Accounting Directive and therefore the disclosure requirements in Appendix C are mandatory disclosures. Paragraph 1AC.25, which requires disclosure of the tax treatment of amounts credited or debited to the fair value reserve is superfluous as SI 2015/980 repealed this requirement and the FRC have acknowledged that this paragraph will be removed in the next edition of FRS 102.

Whilst many practitioners may welcome a reduced level of disclosure requirements, the preparation of financial statements in accordance with the basic legal requirements may not be enough to satisfy the true and fair requirements of the Companies Act 2006. This is where some problems may emerge for directors and their professional advisers and care must be taken so as to ensure that the directors adequately discharge their responsibilities under company law.

In June 2014, the FRC published a document entitled *True and Fair* and whilst this document was published prior to the adoption of FRS 102 for small entities, it is still relevant guidance because it acknowledges that the FRC still regard the true and fair concept as being of fundamental importance when it comes to preparing the financial statements of an entity, regardless of whether those financial statements are prepared under EU-adopted IFRS or FRS 101 to 105. Professional judgement is needed where this important issue is concerned and some examples of why professional judgement is needed are as follows:

- UK GAAP allows choices in accounting policy and therefore directors must ensure that any change in accounting policy is appropriate and reflects the circumstances of the entity.
- FRS 102 may not deal with a transaction, event or condition, and hence the directors may have to develop an accounting policy; or interpret policies for unclear transactions, events or conditions.
- Professional judgement may be needed in subjective areas, such as where valuations may be needed.
- To avoid applying detailed accounting rules as an excuse for poor accounting and financial reporting.
- Consideration of what is, and what is not, material.
- Providing appropriate disclosures over and above those required by the FRSs so as to achieve a true and fair view.
- Ensuring that significant information is not obscured by the inclusion of immaterial or irrelevant disclosures (the FRC are keen to emphasise that clear and concise financial reporting is as relevant to a small company as it is to a large, listed PLC).
- To be able to 'stand back' at the end of the financial statement preparation process and conclude that the financial statements give a true and fair view.

It is to be emphasised that the above list is not exhaustive and additional professional judgements may be pertinent to a company.

The disclosures required by Section 1A are dealt with on pages 13 to 17 but the important point to emphasise where disclosures and achieving a true and fair view are concerned is to ensure that any contentious or subjective issues which may give rise to the true and fair view being challenged are documented, together with the reasons why disclosure/non-disclosure has been made. Practitioners sometimes view the need to document situations on file as an arduous task; however, in some cases having documentation on file as to why, or why not, something has, or has not, been done can prove to be invaluable if the practitioner's work is challenged further down the line.

Complete set of financial statements

At the outset it is worth noting that a cash flow statement will *not* be required for a small company. Some practitioners were worried that on adoption of FRS 102, the cash flow statement would become mandatory. Some small companies do choose to prepare a cash flow statement as part of their complete set of financial statements and, where the directors wish to continue doing this, they are not precluded from doing so and such a statement will be prepared in accordance with Section 7 *Statement of Cash Flows* (note: there are considerable presentational differences between an FRS 102-style cash flow statement and an FRS 1-style one).

Paragraph 1A.8 requires a small entity to include the following as part of its complete set of financial statements:

- a balance sheet (referred to as a 'statement of financial position' in FRS 102) as at the reporting date;
- a profit and loss account (referred to as an 'income statement' in FRS 102) for the reporting period; and
- notes to the financial statements.

Practitioners will note that FRS 102 uses international terminology, such as a 'statement of financial position' and an 'income statement'. It is equally permissible to continue to prepare a balance sheet and a profit and loss account; in other words, to continue to use traditional terminology. SI 2015/980 did, however, amend the Companies Act 2006 so that the use of international terminology is also permitted.

Total comprehensive income

It is not unusual for a small company to recognise gains or losses through reserves (such as a revaluation reserve). This is referred to in FRS 102 as 'other comprehensive income'. If a small entity has items of other comprehensive income, for example, a revaluation gain on an item of property, plant and equipment, then the entity is **encouraged** to present a statement of total comprehensive income. Whilst the standard does not mandate a small entity to produce such a statement, if the small entity does have material items of income and expense that have been recognised outside of the profit and loss account, then it should consider producing such a statement.

Under previous UK GAAP, items taken directly to reserves would have been reported through the statement of total recognised gains and losses. The statement of comprehensive income presents all items of income and expense that the entity has recognised in the period as follows:

	31.12.2016 £'000	31.12.2015 £'000
Turnover	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Administrative expenses	(X)	(X)
Interest payable and similar expenses	(X)	(X)
Profit on ordinary activities before tax	X	X
Taxation	(X)	(X)
Profit on ordinary activities after taxation and profit for the financial year	X	X
Other comprehensive income:		
Revaluation gain on freehold property	X	-
Actuarial gain (loss) on defined benefit pension plan	X	(X)
Total comprehensive income for the year	**X**	**X**

Section 5 *Statement of Comprehensive Income and Income Statement* permits an entity to produce the above statement in one of two ways:

- as a single statement of comprehensive income (as shown above); or
- in two statements: as a profit and loss account and a statement of comprehensive income. Under this option, the entity will present all items of income and expense that are recognised in the period. Items of income and expense recognised outside of profit and loss (i.e. in reserves) are presented in total comprehensive income for the year.

Transactions with shareholders

Most small companies will enter into transactions with shareholders; the most common one being dividends paid to shareholders. When a small company enters into transactions with its shareholders, Section 1A encourages it to present a statement of changes in equity OR a statement of income and retained earnings. The statement of changes in equity would include the following items:

- share issues and redemptions;
- purchase and sale of treasury shares;
- dividends;
- issue of equity instruments in a share-based payment transaction; and
- the equity component of any convertible loans that have been issued.

An illustration of the statement of changes in equity prepared under FRS 102 is shown below:

	Share capital	**Share premium**	**Retained earnings**	**Total equity**
	£	£	£	£
Balance at 1 January 2015	X	X	X	X
Profit for the year			X	X
Dividends paid			(X)	(X)
Issue of additional share capital	X	X		X
Balance at 31 December 2015	X	X	X	X
Profit for the year			X	X
Dividends paid			(X)	(X)
Balance at 31 December 2016	X	X	X	X

The statement of income and retained earnings is presented where the only changes in both the current and prior periods arise from:

- profit or loss;
- dividends;
- prior period adjustments due to changes in accounting policies; and
- prior period adjustments due to the correction of material errors.

An illustration of how the statement of income and retained earnings is shown below

	2016	**2015**
	£'000	£'000
Turnover	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Administrative expenses	(X)	(X)
Other operating income	X	X
Operating profit	X	X
Interest receivable and similar income	X	X
Interest payable and similar expenses	(X)	(X)
Profit on ordinary activities before tax	X	X
Taxation	(X)	(X)
Profit on ordinary activities after taxation	X	X
Retained profit at 1 January 2015	X	X
Dividends paid	(X)	(X)
Retained profit at 31 December 2016	X	X

Presentation of the financial statements

Small entities are required to present a balance sheet and profit and loss account in accordance with the requirements of the Companies Act 2006 using either Part 1 *General Rules and Formats* of Schedule 1 to the Small Companies' Regulations or Part 1 *General Rules and Formats* of Schedule 1 to the Small LLP Regulations.

Appendix A to Section 1A *Guidance on adapting the balance sheet formats* provides guidance on the application of these requirements for the balance sheet; whereas Appendix B to Section 1A *Guidance on adapting the profit and loss account formats* deals with the profit and loss account. See page 12 of these notes.

Notes to the financial statements

The notes to the financial statements must comply with the requirements of Appendix C *Disclosure requirements for small entities* and, where applicable, Appendix D *Additional disclosures encouraged for small entities*. See pages 13 and 17 of these notes.

Small groups preparing consolidated financial statements

It is worth emphasising that small groups are not required to prepare group accounts as section 398 allows a small group to voluntarily prepare consolidated financial statements. However, where the directors decide to voluntarily prepare group financial statements, the group must:

- conform to the consolidation procedures that are outlined in FRS 102, Section 9 *Consolidated and Separate Financial Statements*;
- consider making the disclosures that are set out in paragraph 9.23 of FRS 102 (although these disclosures are not mandatory, they are encouraged for small groups);
- comply, as far as is practicable, with the requirements of Section 1A of FRS 102 as if the group was a single reporting entity; and
- provide any disclosures which are required by Schedule 6 of the Small Companies Regulations.

Abridging and adapting the balance sheet formats

SI 2015/980 brought in a new concept of 'abridged' financial statements. In practice, an abridged balance sheet will not look much different than what it would otherwise look like. The difference is in relation to the disclosure notes that provide the detail behind the numbers on the face of the balance sheet. This is because an abridged balance sheet only provides information in the statutory formats which are preceded by letters and Roman numerals. Information preceded by Arabic numerals (such as the fixed assets reconciliation table) are not required to be disclosed.

On first glance, this may seem like quite an attractive option for small companies; and, indeed, is being quite well-received by a number of practitioners within the profession. However, it must be borne in mind that the Companies Act 2006 requires the **unanimous** consent of all shareholders **before** abridged financial statements can be prepared (this also includes the abridged profit and loss account). In addition, the unanimous consent of all shareholders must be obtained on an annual basis; this is because the shareholders can only agree to abridging the entity's financial statements in respect of the preceding accounting period. One unanimous agreement cannot cover all subsequent financial periods and hence the onerous nature of obtaining this agreement may prove to be a significant disadvantage for some reporting entities.

In addition, FRS 102, paragraph 1AA.2 requires the directors of a small entity that is preparing abridged financial statements to have regard to the requirements of paragraph 1A.16. This paragraph requires an entity to provide sufficient information within the financial statements so that a true and fair view is achieved. In practice, this may mean the abridged financial statements might need to contain additional disclosures (i.e. disaggregating the abridged balance sheet) if doing so will enable the accounts to give a true and fair view.

Adapting the balance sheet formats

The first thing to emphasise where adapted balance sheets are concerned is that some software providers are not allowing this option at the present time. This is because the concept of adapted balance sheets is very much in its infancy and there are a huge number of ways in which the balance sheet (and profit and loss account) could be adapted. Some software providers are, therefore, waiting to see what the most common requests are for adapted financial statements before enabling this functionality.

The Department for Business Innovation and Skills (now replaced by the Department for Business, Energy and Industrial Strategy) brought in the ability to adapt the financial statements primarily to allow a smoother consolidation exercise where a reporting entity is required to prepare Companies Act accounts, which are then consolidated in with those of a parent reporting under EU-adopted IFRS. Prior to the amendment to the Companies Act 2006, it was quite difficult to consolidate Companies Act accounts in with EU-adopted IFRS accounts, which was largely due to the flexible approach that IAS 1 *Presentation of Financial Statements* takes allows where the presentation of financial statements is concerned.

Where a reporting entity does adapt one of the balance sheet formats, it must include the following items in its adapted balance sheet which must also be distinguished between those items which are current and those which are non-current:

- property, plant and equipment (tangible fixed assets);
- investment property which is measured at fair value through profit and loss;
- intangible assets (i.e. patents, copyrights and goodwill);
- financial assets, but excluding:
  - investments in associates;
  - investments in joint ventures;
  - trade and sundry debtors; and
  - cash (including cash equivalents);
- investments in associates;
- investments in joint ventures;
- biological assets (i.e. living animals or plants) that are measured under the historic cost model;
- biological assets that are measured at fair value through profit or loss;
- stock and work in progress;
- trade and sundry debtors;
- cash (including cash equivalents);
- trade and other creditors;
- provisions for liabilities;
- financial liabilities, which must exclude:
  - trade and other creditors; and
  - provisions for liabilities;
- amounts due to or from HMRC in respect of current tax;
- deferred tax provisions (both assets and liabilities) which are classified as long-term;
- non-controlling interest (previously known as 'minority interest') which are included within equity, but are distinguished from the equity that belongs to the parent; and
- equity which belongs to the parent company.

An adapted balance sheet must also contain certain additional disclosures, which must be contained either on the face of the balance sheet or within the notes to the financial statements. The additional disclosures relate to sub-classifications of the following line items:

- property, plant and equipment (tangible fixed assets) in classifications that the directors of the small entity deem to be appropriate;
- goodwill and other intangible assets owned by the small entity;
- investments distinguishing between loans and shares in other entities;
- trade and other debtors – amounts which are due from related parties must be distinguished from amounts due from other third parties;
- trade and other creditors – amount which are due to related parties must be distinguished from amounts due to other creditors; and
- equity balances, such as called up share capital, share premium, profit and loss reserves (retained earnings), revaluation reserve, fair value reserve and any other reserve (e.g. capital redemption reserve).

FRS 102, Section 1A does allow a reporting entity flexibility insofar as the line item descriptors, ordering of the items or aggregation of similar items are concerned. Such descriptors, ordering or aggregation may be amended by the directors depending on the nature of the small entity and the transactions in which it has entered into with the objective of providing information that is relevant to an understanding of the small entity's financial position. The information that is given in the adapted balance sheet must also be at least equivalent to the information that would have been provided had the balance sheet not been adapted.

Adapting the profit and loss account formats

As with the balance sheet (see above), SI 2015/980 brought in the ability for a small entity to prepare an abridged profit and loss account. The same legal protocol as with the abridged balance sheet must be followed in that the unanimous consent of all the shareholders must be obtained on an annual basis.

In an abridged Format 1 (expenses by function) profit and loss account line items in respect of turnover, other income and cost of sales are all combined, thus an abridged profit and loss account will start at Gross profit or (loss). In an abridged Format 2 (expenses by nature) profit and loss account, the following items are combined:

- Turnover
- Change in stocks of finished goods and in work in progress
- Own work capitalised
- Other operating income
- Raw materials and consumables
- Other external charges

A concern of the Financial Reporting Council (FRC) is how an abridged profit and loss account can achieve a true and fair view if the headline figure (turnover) is not disclosed because in the vast majority of cases, turnover is often the largest number in the financial statements. To that end, the FRC requires directors of small companies that are preparing an abridged profit and loss account to consider providing any additional disclosures that are deemed necessary to achieve a true and fair view within the notes to the accounts. A notable mention in paragraph 1AB.2 is the disaggregation of gross profit or loss by disclosing turnover.

When a small company prepares an adapted profit and loss account, Appendix B to Section 1A requires certain line items to be presented as follows:

- turnover;
- finance costs (interest payable and similar expenses);
- the entity's share of profit or loss, accounted for using equity accounting, of:
  - investments in associates; and
  - joint ventures;
- pre-tax profit or loss;
- the tax charge which must not include any tax that has been posted to other comprehensive income or equity; and
- profit or loss for the year/period.

A small entity is allowed to include any additional line items that it considers is necessary in its circumstances. It is also afforded the flexibility of changing the line item descriptors and the ordering of the items where this will enable an understanding of the elements of the entity's financial performance during the accounting period. However, the information that is presented in the adapted profit and loss account must be at least equivalent to that which would have been required by the statutory formats had the profit and loss account not been adapted.

Disclosure requirements for small entities

The disclosure requirements for a small entity are split into two distinct Appendices:

- Appendix C *Disclosure requirements for small entities* – this Appendix outlines those disclosures which are required by law and which essentially reflect the provisions in the Companies Act 2006 as amended by 2015/980.
- Appendix D *Additional disclosures encouraged for small entities* – this Appendix outlines those disclosures which a small entity is required to consider in order that the financial statements give a true and fair view.

Disclosures required by law

Appendix C requires a small entity to provide the following disclosures which are required by the Companies Act 2006:

Accounting policies

- The entity's (material) accounting policies which must also include:
  - details of any changes in presentation, accounting policies and any corrections of prior period errors; and
  - where the small entity has departed from any of the company law requirements (true and fair override), provide particulars of the departure, the reasons for the departure and the effect of the departure.
- Notes supporting the balance sheet. If an asset or a liability relates to more than one item in the small entity's balance sheet, disclosure is required of the relationship of the asset or liability to such items.

Fixed assets

- Fixed assets, which will include the usual fixed assets reconciliation showing the composition of net book value. This disclosure requirement applies equally to:
  - investment property;
  - tangible fixed assets (property, plant and equipment);
  - intangible assets (also goodwill);
  - fixed asset investments;
  - biological assets (i.e. living animals or plants); and
  - heritage assets.

  The reconciliations of fixed assets do not have to be presented for prior periods.
- Revalued fixed assets. When any fixed assets are measured at revaluation, the items that are revalued and the basis of valuation that has been adopted must be disclosed in the accounting policies section. In addition, the small entity must also disclose:
  - the years in which the fixed assets were valued (to the extent that this information is known by the directors);
  - where fixed assets have been revalued during the period, disclose the name of the person(s) that carried out the revaluation or details of their qualifications together with the basis of the valuation that they applied;
  - for each revalued fixed asset, disclose the comparable amounts that would have been recognised had the revalued fixed assets been carried under the historic cost model (i.e. total cost, total accumulated depreciation and total impairment losses);
  - movements in the revaluation reserve during the reporting period, together with an explanation of the tax treatment, and the carrying amount of the revalued fixed assets that would have been recognised in the balance sheet had the assets not been revalued (this is to be presented in tabular form); and
  - the tax treatment of the amounts credited to or debited from the revaluation reserve.
- Where the reporting entity has a policy of capitalising borrowing costs, disclose the amount of interest that has been included within the cost of the asset(s).

Impairment of assets

- Where any items of fixed assets (which also includes fixed asset investments) have been impaired, the small entity must disclose the provisions for impairment in the notes to the accounts if the small entity has not shown this amount separately in the profit and loss account.
- If the small entity has reversed any provisions for impairment on the grounds that the reasons for the impairment no longer exist, the value of such reversals must be disclosed. This disclosure can be made either separately for each type of reversal or in aggregate and should be shown in the notes to the accounts if not shown separately in the small entity's profit and loss account.

Fair value measurement

- If the small entity measures any financial instruments or other assets at fair value, with changes in fair value going through the profit and loss account, disclose:
  - the significant assumptions used in the valuation models as well as the techniques applied to determine fair value;
  - for each class of financial instrument or other asset, the fair value of the assets within that class together with the change in value that is included directly in the profit and loss account or taken to the fair value reserve;
  - for each class of derivative financial instrument, the extent and nature of the derivative instruments which should also include significant terms and conditions which may affect the amount, timing and certainty of the future cash flows; and
  - if any amount is transferred to, or from, the fair value reserve during the accounting period, provide (in tabular form) the opening and closing balance of the fair value reserve and the amount that has been transferred to, or from, the reserve.

FRS 102 (September 2015) includes paragraph 1AC.25 which requires disclosure as to the tax treatment of amounts taken to the fair value reserve. This disclosure requirement is superfluous as it was repealed in SI 2015/980 and the FRC have confirmed that it will be removed in future editions of FRS 102. Therefore, such a disclosure need not be made in the financial statements.

- In the extremely rare situation that a small company reports under EU-adopted IFRS, such standards allow certain financial instruments to be included in the accounts at fair value. Where this is the case for the small entity, the disclosures required by the relevant standards (e.g. IFRS 7 *Financial Instruments: Disclosures*) should be made.

Liabilities, guarantees and commitments

- In respect of the total value of items within creditors, disclose the total value of any liabilities which are repayable otherwise than by instalments and fall due for settlement (or repayment) after the end of the period of five years which starts with the first day after the balance sheet date. Where any instalments fall due for payment after the five-year period, the small entity should also disclose these amounts.
- If any security has been pledged for any items shown within creditors in the balance sheet, disclose the aggregate amount of such debts together with the nature and form of the security pledged.
- Where the small entity has any financial commitments, guarantees or contingencies that have not been included in the balance sheet, disclose such amounts. Any commitments relating to pensions should be separately disclosed.
- If the small entity undertakes any commitments for the benefit of another undertaking in which the small entity has a participating interest, it must separately disclose such commitments from any commitments it undertakes for the benefit of:
  - a parent;
  - a fellow subsidiary; or
  - any subsidiary belonging to the small entity.
- When the small entity pledges any security for any commitments, guarantees or contingencies, then it must provide an indication as to the nature of form of such security.

- When the small entity has been a party to any an off-balance sheet arrangement and the risks or rewards from such arrangements are material, disclose the nature and business purpose of such arrangements. The disclosure must be sufficient enough for a user to understand and assess the financial position of the entity.

Other notes to be disclosed

- If there are any exceptional sizes or incidences of individual items of income or expenses contained in the profit and loss account, these must be disclosed (such as an exceptional bad debt).
- A small entity is now required to disclose the average number of employees in the reporting period. In addition, this disclosure is required to be filed at Companies House as this disclosure relates to the employees within the business as a whole, rather than a payroll disclosure. Whilst the positioning of this disclosure in Section 1A is under the 'Notes supporting the income statement' section, the Financial Reporting Council do not consider the filing requirements at Companies House to be within their remit; so whilst the disclosure requirement does seem to be at odds with what would be required to be filed in, say, a set of 'filleted' accounts, the average number of employees is required to be filed on the public record.

Related party disclosures

- Small entities which are subsidiaries should disclose the following information in respect of the parent of the smallest group for which consolidated accounts are prepared of which the small entity itself belongs:
  - the name of the parent that draws up the consolidated accounts;
  - the address of the registered office of the parent (this applies even if the registered office is outside of the UK); or
  - where the parent is an unincorporated entity, the address of its principal place of business.
- A small entity may enter into related party transactions with:
  - owners that have a participating interest in the small entity;
  - companies that the small entity itself has a participating interest; and
  - its directors or members of its governing body.

  When the small entity enters into related party transactions with the above and those transactions are not undertaken on an arm's-length basis (referred to in the standard as not concluded under normal conditions), the small entity must disclose:
  - the value of the transactions;
  - the nature of the related party relationship; and
  - any other information that will enable a user to understand the impact such transactions have had on the financial position of the entity.

  The information above can be aggregated on the basis of the nature of the transactions. However, separate disclosure should be made if making such separate disclosures enables an understanding of the effect that the transactions have had on the financial position of the business.

It should also be noted that transactions between group members need not be disclosed. This exemption only applies, however, if any subsidiary that is a party to the transaction is wholly-owned within the group.

Directors' transactions (advances, credits and guarantees)

The requirement to disclose directors' advances, credits and guarantees is dealt with in Section 413 of the Companies Act 2006.

- Where the small entity grants an advance or credit to a director, disclose:
  a) the amount;
  b) the interest rate;
  c) the main conditions;
  d) any amounts that have been repaid;
  e) any amounts that have been written of; and
  f) any amounts that have been waived.

  Monetary amounts must be stated in respect of items a), d), e) and f).

- In respect of a guarantee, disclose:
  a) its main terms;
  b) the amount of the maximum liability that the small entity may incur; and
  c) any amount that the small entity has paid and any liability that has been incurred to fulfil the guarantee which should also include any loss suffered by the small entity to enforce the guarantee.

     Monetary amounts are required to be disclosed in respect of items b) and c).

Other disclosure requirements

- The part of the UK in which the small company is registered.
- The registered number of the business.
- Whether the small entity is a public or a private company and if the company is limited by shares or by guarantee.
- The address of the registered office.
- Where appropriate, the fact that the small entity is being wound up.
- Where the small entity has prepared abridged financial statements (and hence has combined items which have been assigned Arabic numbers in the statutory formats), if any items combined are material, disclose the individual amounts of any such items in the notes to the accounts.
- Any non-adjusting post-balance sheet events.

Encouraged disclosures

The directors of a small company have a legal obligation to prepare financial statements that give a true and fair view. Indeed, section 393 of the Companies Act 2006 prohibits directors from approving financial statements if they do not give a true and fair view.

The reduced disclosure requirements that the EU Accounting Directive brings effectively place more responsibility on the part of the directors to ensure that the financial statements which they approve give a true and fair view. This may mean that additional disclosures, over and above those required by Section 1A of FRS 102, are required.

To assist small company directors to discharge their legal responsibilities, the Financial Reporting Council included Appendix D to Section 1A *Additional disclosures encouraged for small entities* which requires the directors to consider whether any of the following are material and, if so, to make the required disclosures:

- A statement of compliance with FRS 102 (see paragraph 3.3 of FRS 102) which should be adapted so that it refers to Section 1A.
- Where the small entity is a public benefit entity, disclose such a statement as outlined in paragraph PBE3.3A.
- Where there are material uncertainties relating to the small entity's ability to continue as a going concern, provide the disclosures as set out in paragraph 3.9.
- Dividends that have been declared and paid (or payable) during the accounting period. Paragraph 6.5(b) of FRS 102 provides the requirements in this respect.
- On first-time adoption of FRS 102, the transitional disclosure information as required by paragraph 35.13.

THE NEW LLP SORP (LECTURE A578 – 6.27 MINUTES)

On 26 January 2017, the Consultative Committee of Accountancy Bodies (CCAB) issued a revised *Statement of Recommended Practice – Accounting by Limited Liability Partnerships (LLPs SORP)*. The revised LLP SORP reflects amendments to legislation by virtue of SI 2016/575 *The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016*. The revised LLP SORP is effective for accounting periods which start on or after 1 January 2016 with early adoption permissible. Where an LLP early adopts the revised LLP SORP, it must also apply SI 2016/575 from the same date.

Background to the revisions

Accountants will, by now, be familiar with the changes made to the Companies Act 2006 to reflect the provisions in the EU Accounting Directive (the directive). The directive made changes to the financial reporting framework for companies, primarily to reduce the administrative burdens that were associated with the preparation and publication of financial statements for small companies and also the very smallest of companies that would fall to be classed as a micro-entity.

LLPs are not subject to the directive, but they are subjected to a similar reporting regime as an incorporated company, such as the obligation to file accounts with Companies House. SI 2016/575 makes similar changes to the financial reporting framework for LLPs that were introduced in 2015 for companies and hence the two frameworks are now aligned. The government have acknowledged that this will help avoid unnecessary complexity for those preparing and using the accounts. In addition, groups which include LLPs and companies within their group structure will now be able to apply the same reporting requirements across the group.

The government estimate that there are some 58,000 LLPs and the vast majority (approximately 98%) are said to be small, hence a significant majority will benefit from the deregulatory changes.

Increased size thresholds

The size thresholds which determine whether an LLP is small, medium-sized or large are now aligned to the size thresholds that determine the same classification for a company. Therefore, an LLP is small when it meets two out of the following three criteria for two consecutive years:

- turnover not more than £10.2 million
- balance sheet total (fixed assets plus current assets) not more than £5.1 million
- not more than an average number of 50 employees

For groups, a group is small if it meets two out of the following three criteria for two consecutive years:

- turnover not more than £10.2 million net or £12.2 million gross
- balance sheet total (fixed assets plus current assets) not more than £5.1 million net or £6.1 million gross
- not more than an average number of 50 employees

Micro-entity LLPs

The scope of FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* is now extended so that LLPs can use the framework. An LLP qualifies to be classed as a micro-entity if it is not in a business that is precluded from applying the framework (such as a financial institution) and the LLPs financial statements are not subsequently consolidated in with those of a parent – as groups are outside the scope of FRS 105. In addition, an LLP qualifies as a micro-entity LLP if it can meet two out of the following three criteria:

- turnover not more than £632,000
- balance sheet total (fixed assets plus current assets) not more than £316,000
- not more than ten employees

The Financial Reporting Council issued amendments to FRS 105 in May 2016 to extend the standard's scope so it caters for LLPs.

Micro-LLPs applying FRS 105 are scoped out of the requirements of the LLP SORP and hence must only prepare financial statements in accordance with FRS 105. This is because the LLP SORP complements the requirements of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, not FRS 105. As there are fundamental differences between the two standards, CCAB took the decision to prohibit micro-LLPs from applying the provisions within the LLP SORP.

As a result of this prohibition, where a micro-LLP enters into a transaction that is not dealt with in FRS 105, it must develop an accounting policy in line with the *Concepts and Pervasive Principles* outlined in Section 2 of the standard.

Small LLPs

A small LLP will fall within the provisions of the LLP SORP. The SORP requires that small LLPs comply with the disclosure requirements of Section 1A *Small Entities* in FRS 102 rather than the disclosure requirements of the SORP. In respect of the recognition and measurement of amounts in the financial statements, these will be based on full FRS 102.

It is still a legal requirement that the small LLP prepares financial statements that give a true and fair view. Section 1A of FRS 102 contains the disclosure requirements in Appendix C *Disclosure requirements for small entities* and Appendix D *Additional disclosures encouraged for small entities*. Professional judgement will be needed to consider whether any additional disclosures, over and above those contained in Section 1A, will be required to achieve a true and fair view. To that end, the SORP recognises that, depending on the individual facts and circumstances, some, or all, of the disclosures in the SORP and the rest of FRS 102 may be needed in order to give a true and fair view.

A disclosure requirement within the SORP which has received criticism from some respondents is how loans and other debts due to members rank in relation to other unsecured creditors (paragraphs 63 and 64 of the SORP). The views of some respondents is that these disclosures are considered to be onerous and overly burdensome. CCAB have confirmed that such disclosures are needed for all LLPs, regardless of the fact that the LLP may be small, in order that the financial statements give a true and fair view. It should be noted that this disclosure is above and beyond the requirements of Section 1A of FRS 102. The LLP SORP mandates this disclosure because LLPs do not have any of the capital maintenance provisions which apply to companies

Small LLPs are also encouraged, rather than mandated, to include a reconciliation of movements in members' other interests, outlined in paragraph 59 of the SORP.

Statement of changes in equity

Paragraph 59A has been inserted into the January 2017 SORP which says that a statement of changes in equity need not be prepared if the LLP has no equity. This was not explicit in previous versions of the SORP. Where a statement of changes in equity is not included on the basis that the LLP does not have any equity (and is not replaced as a primary statement by the reconciliation of members' interests), a statement must be made on either the face of one of the other primary statements, or in the notes to the accounts, that the LLP does not have equity and hence a statement of changes in equity is not given.

Group reconstructions

Paragraph 19.27 of FRS 102 allows the use of merger method of accounting, rather than the purchase method, provided the criteria in that paragraph are met. Paragraph 19.27(a) says that the use of the merger method of accounting must not be prohibited by company law other relevant legislation. Paragraph 105 of the SORP has been redrafted to confirm that the LLP Regulations do not prohibit the user of the merger method and refers to GAAP as the authoritative guidance on whether the merger method is appropriate.

CONCLUSION

The revised LLP SORP is mandatory for accounting periods starting on or after 1 January 2016, which is in line with when small companies must transition mandatorily to FRS 102 following the withdrawal of the FRSSE. The revised LLP SORP can be obtained free of charge from ccab.org.uk.

FRED 66 AND THE REDUCED DISCLOSURE FRAMEWORK (LECTURE A579 – 7.02 MINTES)

In December 2016, the Financial Reporting Council (FRC) issued FRED 66 *Draft amendments to FRS 101 Reduced Disclosure Framework – 2016/17 cycle*. The FRED proposes limited amendments to FRS 101 *Reduced Disclosure Framework* in respect of IFRS 16 *Leases*.

Single lease disclosure note

IFRS 16 *Leases* was issued in January 2016 and significantly overhauls the way in which leases are recognised in the lessee's financial statements. Paragraph 52 of IFRS 16 requires a lessee to disclose, in a single note or a separate section of the financial statements, information concerning leases. Paragraph 52 does not require this information to be duplicated if it is presented elsewhere in the financial statements, but instead this information is cross-referenced.

Paragraph 42(2) of Schedule 1 to the Regulations requires a reporting entity to present the notes to the financial statements in the same order in which they are presented in the balance sheet and profit and loss account.

The FRC believes that the requirements of paragraph 52 of IFRS 16 will result in unnecessary work for preparers which is not outweighed by the benefits it would bring to the users. As a result, the FRC are proposing to amend FRS 101 so that the standard includes an exemption from the requirements of paragraph 52 of IFRS 16.

Maturity analyses

Paragraph 58 of IFRS 16 requires a lessee to disclose a maturity analysis of lease liabilities by applying the provisions in paragraphs 39 and B11 of IFRS 7 *Financial Instruments: Disclosures*. This maturity analysis must be shown separately from the maturity analyses of other liabilities.

Paragraphs 94 and 97 of IFRS 16 also requires lessors to provide a maturity analysis in respect of lease payments that are receivable from finance and operating leases respectively, although there is no cross-reference to IFRS 7 for lessors.

FRS 101, as currently drafted, provides an exemption from the disclosure requirements of IFRS 7 provided that the equivalent disclosures are made in the consolidated financial statements. This means that a lessee could take the exemption from paragraph 58 and not disclose a maturity analysis of lease liabilities, whereas lessors would not be able to because there is no cross-reference to IFRS 7.

FRS 101 does not provide any exemptions from the disclosure requirements of IAS 17 *Leases* (which is superseded by IFRS 16). The FRC have acknowledged that they have not been notified of any specific issues faced by preparers by providing the disclosures required by IAS 17. In addition, the Companies Act 2006 mandates all companies to disclose an analysis of the total amounts of all items shown under 'creditors' in their balance sheet. This requirement means that all companies currently provide a breakdown of all creditors between those that fall due within one year and those that fall due after five years and, by deduction, those that fall due in the intervening periods.

The Companies Act 2006 require the disclosures in respect of creditors to be made on a net (discounted) basis because they are based on the balance sheet amounts. IFRS 16 (and IAS 17) are on a gross (i.e. undiscounted) basis.

The FRC are proposing that both lessees and lessors should disclose maturity analyses required by IFRS 16 on the basis that qualifying entities are already making the equivalent IAS 17 disclosures. In addition, the FRC believes that these disclosures provide useful information concerning the financial position of the reporting entity.

The FRC are proposing to insert a paragraph 8A into FRS 101 which will prohibit lessees from taking an exemption against paragraph 58 of IFRS 16 by virtue of the cross-reference to IFRS 7.

Disclosure initiative – amendment to IAS 7

As part of the IASB's 'Disclosure Initiative', IAS 7 *Statement of Cash Flows* has been amended to insert paragraphs 44A to 44E. These paragraphs require a reporting entity to provide disclosures which will enable the user of the financial statements to assess changes in liabilities arising from financing activities, which would include changes arising from cash flows and non-cash changes.

FRS 101 currently provides an exemption from the requirements of IAS 7 and hence a qualifying entity will not be required to provide this new disclosure concerning its liabilities.

Effective date of the FRS 101 amendments

As paragraph 8 of FRS 101 confirms that exemptions within the standard are available from when the relevant standard is applied, the FRC have not amended the effective date for these proposed amendments.

PRACTICAL ISSUE 1: FRS 102, SECTION 1A AND THE DISCLOSURE REQUIREMENTS (LECTURE A580 -16.21 MINUTES)

Concerns have been raised by many practitioners as to the disclosure requirements of Section 1A *Small Entities* in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Pages 13 and 17 of these notes outline the requirements in Appendix C *Disclosure requirements for small entities* and Appendix D *Additional disclosures encouraged for small entities*.

Some practitioners that have completed financial statements for companies classed as small (quite often early-adopters of FRS 102 that would have been classed as medium-sized prior to the revisions to the company size thresholds) have expressed their disbelief at the size of some of the disclosures produced by accounts production software systems under FRS 102, Section 1A, in particular the accounting policies note.

Accounting policies

Accounting policies, as well as general disclosures in the financial statements, have always seemed to be a contentious issue. Many practitioners rely on automated accounts production software systems to get things like accounting policies and disclosure notes correct. The problem with this approach is that such accounts production systems will usually only produce the bare minimum and they will often not be tailored to the client's specific circumstances. 'Boiler-plating' is one of the most commonly cited criticisms of professional body inspectors and file-reviewers undertaking reviews of financial statements.

Unfortunately, the problem does not go away under FRS 102, and if anything, the problem will become more of a problem! Some practitioners are already citing the accounting policies disclosure note and other disclosures as being somewhat 'overkill'.

Some financial statements that have already been prepared under FRS 102 contain very lengthy accounting policies and, in some cases, it is apparent that the accounting policy is there simply because the accounts production system has included it (or it has been reproduced from model financial statements). Some financial statements reviewed included a very lengthy policy for assets held under hire purchase agreements and finance leases, when there were no such assets held under such agreements.

If policies are produced but are not relevant, they should be removed. This is where the use of a red pen might come in handy. Do not be afraid of 'cutting clutter'. The FRC have a 'Clear & Concise' policy that applies to all companies, not just large companies, hence if a disclosure is irrelevant, remove it from the accounts.

Conversely, where a policy is produced by an automated accounts production software system, take time to check that it is tailored specifically to the client. For example, the classic *'Turnover is stated net of VAT and trade discounts*'. Such a policy does not explain at what point the entity recognises turnover (such as when the risks and rewards of ownership of the goods passes to the customer) or, where relevant, when service revenue is recognised or how deferred revenue is dealt with. These issues will be client-specific and should be built into the accounting policy. Just because a policy is software-generated, does not mean that it is correct and this is what gives rise to policies being classed as 'boiler-plate'.

Section 1A and the true and fair view

Section 1A of FRS 102 is specific to small entities and micro-entities that choose not to report under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

All accountants understand that financial statements prepared under the Companies Act 2006 have to give a true and fair view. Indeed, section 393 of the Companies Act 2006 prohibits company directors from approving financial statements that do not give a true and fair view and where the directors do approve financial statements that do not give a true and fair view, they will be committing a criminal offence.

The concept of true and fair has not changed under new UK GAAP and prior to Section 1A of FRS 102, small companies would usually prepare their financial statements under the FRSSE. The FRSSE was effectively withdrawn because it requires more disclosures than are currently permitted in the Companies Act 2006 following the transposition of the EU Accounting Directive (the Directive). The Directive reduces the mandatory disclosures needed in a small entity's financial statements and prohibits regulatory bodies (such as the FRC) from mandating additional disclosures which are beyond the scope of the Directive. However, the FRC have included five additional disclosure requirements that are encouraged in order for a small entity's financial statements to give a true and fair view as the mere application of the disclosures required by law may not be enough to achieve a true and fair view.

A recent comparison of three sets of financial statements prepared under FRS 102 versus the same entities' financial statements prepared under the FRSSE confirm some 20 disclosure requirements that are not statutorily required to be included in a set of FRS 102, Section 1A financial statements. The 20 such items are:

1. A statement of compliance*
2. Information about dividends*
3. A going concern justification*
4. Turnover note
5. Operating profit note
6. Interest payable note
7. Taxation note
8. Information concerning the net book value of assets held under finance leases
9. The amount recoverable on contracts that is included within debtors
10. Any factored debts included within debtors
11. Any finance lease obligations included within creditors
12. Provisions note
13. Share capital note
14. Reserves note
15. Separate disclosure of annual commitments under non-cancellable operating leases
16. Separate disclosure of capital commitments
17. Separate disclosure of contingent liabilities
18. The name of the controlling party
19. Transactions with a director's close family
20. Transactions with a company owned by a director

*specifically encouraged by Appendix D of Section 1A.

All the above disclosures were necessary under the FRSSE in order to give a true and fair view and all of the above would be required under full FRS 102.

How do we achieve a true and fair view under Section 1A?

The reduction in disclosure requirements may be seen to be a welcome reduction by some practitioners; however, the problem is that such a reduction impedes on the true and fair requirements in law.

What practitioners must not do is to default back to old UK GAAP where they feel that additional disclosures are needed because this could result in the financial statements being inconsistent with FRS 102. Old UK GAAP for small companies is redundant for, say, a December 2016 year-end.

The key to achieving a true and fair view is to use professional judgement and to assess whether any disclosures, over and above those required by Section 1A, are needed in order to give a true and fair view.

Example – Disclosure of key sources of estimation uncertainty

Smallco Limited has a year-end of 31 December 2016 and is reporting under FRS 102 for the first time. The company has a freehold building on the balance sheet which it is carrying at fair value. The valuation exercise was undertaken by a professional valuer, Smith & Co Chartered Surveyors, who have experience in the location and Smallco's category of freehold property. The revaluation exercise resulted in an uplift of the net book value of the property by £45,000, which is considered to be material to the financial statements.

There will be a considerable degree of estimation used by the surveyor in arriving at their valuation. The directors of Smallco should consider making additional disclosures concerning this key source of estimation uncertainty (which is required under full FRS 102 at paragraph 8.7). Such a disclosure might be as follows:

Key sources of estimation uncertainty

Valuation of property, plant and equipment (land and buildings)

As described in note 15 to the financial statements, the company's land and buildings are measured at fair value. The valuation was carried out by an independent firm of Chartered Surveyors, Smith & Co, who have recent experience in the location and category of property that has been valued.

The valuation report confirms that the surveyor used observable market prices, which can fluctuate upwards as well as downwards, and were adjusted, as necessary, for any difference in the condition of the asset.

It is expected that small companies will provide less disclosure than before, given the reduced disclosure requirements found in company law. However, there will more than likely be entity-specific issues that are required to be disclosed in order that a true and fair view is given.

PRACTICAL ISSUES 2: FILING REQUIREMENTS UNDER THE NEW COMPANIES ACT 2006 (LECTURE A581 – 10.55 MINUTES)

The following sections reproduce the ICAEW FAQ helpsheet compiled by the Financial Reporting Faculty relating to the filing options under the new small companies regime.

Filing options under the new small companies regime

Recent changes to UK company law removed the option for small companies to file an abbreviated version of their full accounts with Companies House for periods beginning on or after 1 January 2016. Small companies are, however, still able to take advantage of certain filing options. This document answers frequently asked questions about the filing options available under the new small companies regime. It does not consider options available to companies that take advantage of the simplified accounting regime available to micro-entities.

1. What changes have been made to company law?

In March 2015, the UK Government approved *The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015* (which are hereafter referred to as 'the new regulations') which implemented in UK company law the requirements of the new EU Accounting Directive.

The most significant changes arising from the new regulations relate to the UK small companies regime. These include new criteria for qualifying as a small company, changes to the information required in small company accounts, amended accounts formats, and different filing obligations. However, many more changes have also been introduced which affect a much wider range of companies, depending on their individual circumstances.

This document focuses solely on the revised filing obligations for small companies that do not take advantage of the exemptions available to micro-entities.

2. Have any changes been made to accounting standards as a consequence of the new regulations?

Yes. The Financial Reporting Council has withdrawn *The Financial Reporting Standard for Smaller Entities* with effect for accounting periods beginning on or after 1 January 2016. This means that many small entities will be applying FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* for the first time in accounting periods beginning on or after 1 January 2016.

Section 1A *Small Entities* has been added to the September 2015 version of FRS 102, setting out simplified presentation and disclosure requirements for entities that choose to apply the small entities regime. While small entities are not required to comply with the disclosures elsewhere in FRS 102, in some cases they are encouraged to do so. Small entities can also choose to apply FRS 102 in full.

The very smallest entities may be eligible to apply the micro-entities regime. If they are eligible for this regime and choose to adopt it, they must apply FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Such entities are beyond the scope of this document.

See icaew.com/smallcompanyreporting for more details of the new financial reporting regime for small and micro-entities.

3. *Can I still file abbreviated accounts?*

Small and medium-sized companies can continue to file an abbreviated version of their accounts with Companies House for accounting periods ending before 31 December 2016 provided they have not opted to adopt the new regulations early. However, the new regulations remove this option for accounting periods beginning on or after 1 January 2016.

Although the option to file abbreviated accounts has been removed, small companies are still able to take advantage of certain filing options. These are discussed below.

4. *What options are available under the new regime?*

The new regime introduces what is sometimes referred to as a 'file what you prepare' model. The basic principle is that the accounts filed at Companies House are the same as those prepared for the members.

Small companies can, however, choose not to file the profit and loss account and/or the directors' report. These so-called 'filleted' accounts are discussed further in questions 5 to 11 below.

The new regulations introduce an important new option for small companies to prepare and file an abridged balance sheet, abridged profit and loss account, or both. However, very few companies have taken advantage of this option to date as – for now – they can continue to file abbreviated accounts under the old regime. Preparing and filing abridged accounts may, however, become more popular once the option to file abbreviated accounts is withdrawn.

Abridged accounts are discussed further in questions 12 to 14 below.

5. *Can I still take advantage of the exemption available under s444 Companies Act 2006 and not file the profit and loss account?*

Yes. Small companies continue to have the option of filing what are sometimes referred to as 'filleted' accounts i.e., they can elect not to file a copy of the profit and loss account and/or the directors' report with Companies House. Although this option isn't new, it is likely to become more widely used as companies look for an alternative to filing abbreviated accounts.

Under the new regulations, if a small company chooses not to file the profit and loss account or the directors' report, the balance sheet delivered to Companies House must disclose that fact.

6. *Which notes do I need to include if I decide not to file a copy of the profit and loss account?*

If a profit and loss account is not filed, there is no need to file any notes that relate solely to it. Under the new small companies regime, the only mandatory note that falls into this category relates to 'the amount and size of any individual items of income or expense of exceptional size or incidence'. This note can therefore be excluded from the accounts filed at Companies House.

Any other notes that are included in the accounts in order to provide a true and fair view may also be omitted from the accounts filed at Companies House if they relate directly to a profit and loss account line item.

Notes specifically relating to the balance sheet and any other notes to the accounts must be included in the accounts filed at Companies House. In our view this includes the entire accounting policies note, including any policies that relate to items appearing in the profit and loss account.

7. Can I exclude details of employee numbers from the 'filleted' accounts?

As noted above, if a profit and loss account is not filed, there is no need to file any notes that relate specifically to it. There has, however, been some debate about whether the 'employee numbers' note is or isn't a profit and loss account note and whether it can or can't be omitted. Some of this confusion seems to have arisen as paragraph 1AC.33 of FRS 102 includes suggesting that this information is a note 'supporting the income statement'.

In our view, however, the 'employee numbers' note is not a note related to the profit and loss account since it does not relate to a specific profit and loss account line item. Therefore, a company choosing not to file the profit and loss account and the related notes would still be required to include details of employee numbers in the accounts filed at Companies House.

8. If I delete any notes when preparing 'filleted' accounts, should I renumber the notes that remain in order to avoid gaps in the sequence?

There is no guidance in the law on this point, although in our view it is reasonable to renumber the remaining notes for the benefit of users. Accounts preparation software may in any case renumber the notes automatically.

9. If I produce any additional primary statements, will I need to file them with the 'filleted' accounts?

Section 1A of FRS 102 encourages small companies to produce a statement of other comprehensive income and/or a statement of income and retained earnings where they are needed to give a true and fair view. Some small companies may also choose to prepare a statement of comprehensive income or – where eligible – a statement of income and retained earnings.

Section 444 of Companies Act 2006 (CA 2006, the Act) remains silent as to whether companies electing to file 'filleted' accounts are or aren't required to file these additional primary statements. In our view, there is no need to file these statements as they are not specifically mentioned in the Act, which simply states that a small company must deliver a copy of the balance sheet and that it may deliver a copy of the profit and loss account and a copy of the directors' report.

10. Do the directors need to approve the 'filleted' accounts before the accounts are filed?

While the accounts filed with Companies House in paper format must include a director's signature on the balance sheet, there is no requirement in the law for the directors to formally approve the 'filleted' accounts.

However, many companies will be filing more information than they did when filing abbreviated accounts in the past and some changes will have been made to the accounts approved for the members. It would therefore be advisable in our view for those preparing the 'filleted' accounts to ask the board of directors to confirm formally that they consider the accounts suitable for filing, not least to avoid any misunderstanding about what will end up on the public record.

Firms assisting in the preparation of accounts may wish to update their engagement letters to specify what procedures will be undertaken in this respect. It would be advisable to ensure that they have clear authority from the client before filing the 'filleted' accounts.

11. Do I need to include the audit report in the 'filleted' accounts at Companies House?

Prior to the introduction of the new regulations, companies filing 'filleted' accounts were required to include the audit report in the accounts filed at Companies House.

Under the new regulations, a small company that is required or chooses to have an audit is required to file its audit report only when it has chosen to file a copy of the profit and loss account. A small company that does not file its profit and loss account is not required to file its audit report.

If a small company that is required or chooses to have an audit chooses not to file the profit and loss account, the notes to the balance sheet filed at Companies House must disclose:

- whether the auditor's report was qualified or unqualified;
- if the report was qualified, the basis of the qualification;
- if the report was unqualified, whether a reference was made to any matters to which the auditor drew attention by way of emphasis; and
- the name of the auditor and the name of the person who signed the auditor's report as senior statutory auditor or, in circumstances in which the names may be and have been omitted, a statement that a resolution has been passed and notified to the Secretary of State in accordance with s506 CA 2006.

This additional note would only be included in the set of accounts that is filed at Companies House. In our view it could be included as an additional numbered note or simply attached as an additional page in the copy of the accounts that is filed.

12. What are abridged accounts and what do they contain?

The abridged balance sheet need include only those line items preceded by letters (for example 'current assets') and Roman numerals (for example 'debtors') in the formats set out in the regulations, but not the items preceded by Arabic numbers (for example 'trade debtors', 'other debtors', etc.).

The abridged profit and loss account will combine certain line items under a single line item called 'gross profit or loss'. For companies following format 1 of the profit and loss account, the items combined will comprise turnover, cost of sales, other operating income and gross profit or loss. For companies following format 2, the items combined will comprise turnover, changes in stocks of finished goods and work in progress, own work capitalised, other operating income, raw materials and consumables and other external charges.

A company choosing to prepare abridged accounts is still required to comply with the small company disclosures required by law. In addition, the abridged accounts must still meet the requirement to give a true and fair view.

13. How do the filing rules apply to abridged accounts?

When a small company chooses to abridge all or part of its accounts, it must also deliver to Companies House a statement that all the members have consented to the abridgement. In practice this requirement can be met by including a note in the filed accounts to state that consent has been received.

Small companies that choose to file abridged accounts can elect not to file a copy of the profit and loss account and/or the directors' report with Companies House i.e., they can choose to 'fillet' the abridged accounts.

14. What consent is needed before abridged accounts can be prepared?

The decision to abridge all or part of the accounts must be agreed by all members. Consent must be obtained each year and can only be made in respect of the preceding financial year.

This requirement appears to be intended to require consent to be obtained each year so that a continuing authority is not permitted. The reference to the 'preceding financial year' suggests in our view that consent must be obtained after the year end (but before the financial statements are approved).

15. This all sounds quite complex to me. Is there a concise summary showing what needs to be filed with Companies House in different situations?

Appendix 1 to these FAQs provides a summary of what in our view needs to be filed in a number of common scenarios.

16. Where can I find examples of the various statements and notes that I may need to include in the accounts filed at Companies House?

Appendix 2 to these FAQs includes examples of the statements and notes that will typically be included in 'filleted' and abridged accounts.

17. Can I early adopt the new requirements?

Yes. The new regulations can be early adopted for accounting periods beginning on or after 1 January 2015 provided that the September 2015 version of FRS 102 is also early adopted.

However, it should be noted that entities wishing to early adopt the new regulations must apply all of their provisions. In particular, entities wishing to take advantage of the increased small company limits in 2015 should be aware that doing so will mean losing the ability to file abbreviated accounts for that year.

APPENDIX 1 – COMMON SCENARIOS UNDER THE REVISED SMALL COMPANIES REGIME

The following table does not identify **all** the statements that may be required in accounts prepared under the revised small companies regime. Instead, it focuses on any **additional** statements and notes that may be required in the accounts filed at Companies House, depending on the individual circumstances of the company.

	Full accounts prepared[1]	Abridged accounts prepared	Company is subject to audit	Filing filleted accounts	Accounts[2] to be delivered at Companies House	Additional statements and notes required in accounts delivered to Companies House
Scenario 1	✓				Full accounts	None
Scenario 2	✓		✓		Full accounts including audit report	None
Scenario 3	✓			✓	Full accounts excluding profit & loss account and any related notes	Balance sheet delivered to Companies House must contain a statement that the profit and loss account has not been filed and that the annual accounts and report are delivered in accordance with small companies regime.
Scenario 4	✓		✓	✓	Full accounts excluding profit & loss account, and any related notes and the audit report	Balance sheet delivered to Companies House must contain a statement that the profit and loss account has not been filed and that the annual accounts and report are delivered in accordance with small companies regime. The notes to the balance sheet delivered to Companies House must include certain details about the audit.
Scenario 5		✓			Abridged accounts	Must file a statement that all members agreed to the abridgement.
Scenario 6		✓	✓		Abridged accounts including audit report	Must file a statement that all members agreed to the abridgement.
Scenario 7		✓		✓	Abridged accounts excluding profit & loss account and any related notes	Must file a statement that all members agreed to the abridgement. Balance sheet delivered to Companies House must contain a statement that the profit and loss account has not been filed and that the annual accounts and report are delivered in accordance with small companies regime.
Scenario 8		✓	✓	✓	Abridged accounts excluding profit & loss account, and any related notes and the audit report	Must file a statement that all members agreed to the abridgement. Balance sheet delivered to Companies House must contain a statement that the profit and loss account has not been filed and that the annual accounts and report are delivered in accordance with small companies regime. The notes to the balance sheet delivered to Companies House must include certain details about the audit.

[1] Whether prepared using Section 1A of FRS 102 or applying FRS 102 in full

[2] This table only deals with the filing of accounts. The directors' report is also not required to be filed as long as a statement is given.

APPENDIX 2 – EXAMPLE STATEMENTS FOR INCLUSION IN THE ACCOUNTS

Example statement: applying the small companies regime

These accounts have been prepared and delivered in accordance with the provisions applicable to companies subject to the small companies regime.

Example statement: abridged accounts

All of the members have consented to the preparation of abridged accounts in accordance with Section 444(2A) of the Companies Act 2006.

Example statement: balance sheet wording when profit and loss account not filed

The profit and loss account [and directors' report] has/have not been delivered to the Registrar of Companies in accordance with the special provisions applicable to companies subject to the small companies regime.

PRACTICAL ISSUES 3: PROVISIONS AND CONTINGENCIES
(LECTURE A582 – 9.08 MINUTES)

In practice, the issue surrounding provisions for assets and liabilities and contingent assets and liabilities can be a complex one. Care needs to be taken to not only account for provisions and contingencies correctly, but also to recognise any provisions at an appropriate amount; particularly where there may be associated tax implications as HM Revenue and Customs (HMRC) may disallow excessive provisions where tax relief has been obtained on such provisions. With interest and penalties potentially being levied by HMRC, excessive provisions can prove costly.

The requirements for provisions and contingencies are outlined in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* are contained in Section 21 *Provisions and Contingencies*. This particular section is similar to the previous standard governing provisions and contingencies; that of FRS 12 *Provisions, contingent liabilities and contingent assets*.

Provisions for liabilities

In accounting, the term 'provision' is interchangeable; for example, a 'provision for bad debts' or 'provisions for depreciation'. In these contexts, the term 'provision' is the adjustment to carrying values in the financial statements rather than in the same context as that used in Section 21 as a provision for a liability.

In respect of provisions for liabilities, FRS 102 says that a provision is a liability whose timing or amount is uncertain. The fact that there is uncertainty in respect of the timing and amount is why it is important to ensure that any provisions made in the financial statements would be able to stand up to scrutiny in the event, for example, of a HMRC enquiry into the entity's corporation tax return.

There are three criteria which have to be met before a provision can be recognised in the financial statements:

1. The entity must have a present obligation that has arisen because of something that has occurred in the past.
2. It is more likely than not that the entity will have to transfer some economic benefit (e.g. cash or another form of asset) in order to settle the obligation.
3. The amount of the obligation can be measured with some degree of reliability (i.e. a reliable estimate can be made).

Where any of the above criteria **cannot** be met, a provision cannot be recognised in the financial statements and a contingent liability will be disclosed (if material).

All three criteria have to be met (it is not one or two out of the three). This is to stop companies from deliberately recognising provisions that are unlikely to crystallise. Prior to the introduction of accounting standards in this area, it was not uncommon for companies to deliberately manipulate the profit (or loss) of a business by creating or releasing provisions that effectively would not crystallise. This act of manipulation was coined 'big bath accounting' or 'big bath provisioning' and worked by focussing on the profit or loss of the business first and then working upwards through the profit and loss account until a desired profit or loss figure was arrived at. The requirement to meet all three criteria was designed to outlaw the act of big bath provisions.

Creation of an 'obligation'

Not all obligations will give rise to a provision being recognised in the financial statements. Only those obligations which exist at the balance sheet date that have arisen as a result of a past event will give rise to a provision. This means that the reporting entity has no realistic alternative to settling the obligation which can be created in one of two ways:

- by way of a **legal** obligation; or
- by way of a **constructive** obligation.

Legal obligation

A legal obligation is one which can be enforced by law. It will usually be obvious when a company has a legal obligation, for example by way of agreement or a court order. Provisions can also be made for normal day-to-day transactions, such as a provision for goods and/or services received by the period-/year-end but not yet invoiced; i.e. an accrual.

A business cannot base a provision on its future actions. Paragraphs 21.6 of FRS 102 is strict on its approach to an entity's future actions because such actions do not meet the definition of a provision and the entity has not got an obligation at the balance sheet date for its future actions, regardless of how likely or unlikely they are to occur. An obligation arises because of an obligating event and hence it follows that the obligating event must have occurred at, or by, the balance sheet date in order to give rise to a provision.

Example – No obligating event

In 2015, legislation was passed which requires an entity operating in the chemical industry to reduce its effluent levels by 40% by 31 October 2017 which means investing in additional denitrification processes (the process by which nitrogen is removed from water).

At 31 December 2016, which is the company's year-end, the entity had not done anything to reduce its effluent levels. The financial controller has included a provision for the costs that she estimates will be needed to complete the work.

The provision should not be included in the accounts to 31 December 2016. This is because there is no obligating event (the investment in the additional denitrification processes).

At 31 December 2017 the company had still not made any attempts to reduce its effluent levels. The financial controller has made a provision again on the grounds that the date has now passed for the company to have completed this work.

There is still no obligating event at the year-end 31 December 2017 because the company has still not done anything to invest in additional denitrification costs. The company may need to make a provision for fines and penalties for non-compliance with the legislation but this would only be the case if it were to be probable that such fines and penalties will be imposed and a reliable estimate could be made of the penalties. There is an obligating event in respect of the fines and penalties which is the non-compliance with the legislation.

Constructive obligation

A constructive obligation arises when an entity creates an expectation in the mind-sets of others that it will discharge its obligations. This usually arises because of the entity's past practice, published policies or by way of a specific statement.

Example – Constructive obligation

A retailer of office equipment has a sign above its cash desk informing customers that it will give refunds on goods purchased provided the item is returned within 14 days from the date of purchase. This applies regardless of whether the goods are faulty or not.

In this example, the published policy of the retailer goes over and above any legal obligation but a constructive obligation arises from the retailer's established published practice. Conversely, any ad-hoc refunds would be less clear in establishing any obligation.

Extra care should be taken where constructive obligations are concerned because these are less clear-cut than legal obligations and in order for a constructive obligation to be recognised as a provision in the financial statements, an expectation must be created in the mind-sets of those affected that the entity will discharge its obligations.

Recognition of a provision in the financial statements

FRS 102 says that where a provision meets the recognition criteria, it should be recognised at the best estimate of the amount that will be required to settle the obligation. When a provision involves a large population of items, the estimate must reflect the weighting of all possible outcomes by their associated probabilities.

Example – Provision for defective goods

A well-established company sells electrical products such as dishwashers, washing machines, TV and audio equipment. It sells goods to the general public with a warranty which covers customers for the costs of repair that occur during the first six months from the date of purchase. The company is preparing its financial statements for the year-ended 31 December 2016 and calculations carried out by the financial controller suggest that if all the products sold contained minor defects, the costs of repair would be £1 million. If major defects occurred in all the products, the costs of repair would be £4 million.

Management have concluded that past experience, and future expectations, suggest that for the coming year 75% of the goods sold will contain no defects; 20% will contain minor defects and 5% will have major defects.

The provision for the year is calculated as follows:

	£
75% x nil	nil
20% x £1 million	200,000
5% x £4 million	200,000
Total provision	400,000

Contingent liabilities

Contingent liabilities are not recognised in the financial statements because they fail to meet the recognition criteria for a provision. There is, however, one exception to this rule which applies to contingent liabilities which have been assumed by the acquirer of an acquiree in a business combination and for which paragraphs 19.20 and 19.21 of FRS 102 apply (Section 19 deals with business combinations and goodwill).

Contingent liabilities are disclosed in the notes to the financial statements, unless the possibility of an outflow of economic benefit resources is considered to be remote.

Example – Contingent liability

A company has made a provision for damages amounting to £10,000 in its financial statements for the year-ended 31 December 2016 in respect of a legal claim brought against the company by one of its customers. The legal advisers have advised the company that at the reporting date, they are uncertain as to the potential outcome of the case. The case is considered to be material to the company.

The company should not recognise a provision for damages because it is not 'probable' that an outflow of resources will be required to settle the case. The legal advisers are unsure as to the outcome of the case. In such situations, disclosure of a contingent liability in the notes to the financial statements should be made.

Contingent assets

A contingent asset is directly the opposite of a contingent liability and, again, is not reflected in the financial statements of the reporting entity. Contingent assets will only become provisions (and hence be recognised in the financial statements) if it is 'virtually certain' that an entity will realise the contingent asset (for example, an insurance company agreeing to pay out a claim to the company). The recognition criteria is stricter because of the underpinning principle in financial reporting that assets cannot be stated in an entity's balance sheet at any more than recoverable amount.

Offsetting provisions

There may be occasions when a company has to recognise a provision for liabilities in its financial statements as the recognition criteria have been met, but that liability will be reimbursed by a third party (such as an insurance company).

In these cases, it is important that the entity recognises the asset and the liability separately; they must **not** be offset in the balance sheet because this would mean assets and liabilities are both understated; thus presenting a misleading financial position. Section 21 does, however, allow the expense relating to the provision in the profit and loss account to be offset, thus presenting the expense net of the reimbursement in the profit and loss account.

AUDITOR'S REPORTS UNDER THE NEW REPORTING REGIME
(LECTURE A583 – 32.49)

In October 2016, the Financial Reporting Council issued *Bulletin: Compendium of illustrative auditor' reports on United Kingdom private sector financial statements for periods commencing on or after 17 June 2016.* The Compendium contains illustrative auditor's reports which set out how the requirements of ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements* can be applied. The Compendium itself is not prescriptive and other innovative approaches may be adopted by audit firms provided that the form and content of the reports meet the requirements of ISA (UK) 700, other relevant standards and the applicable legal and regulatory requirements.

The Compendium of illustrative auditor's reports is applicable to UK private financial statements for periods commencing on or after 17 June 2016.

The applicable financial reporting framework

ISA (UK) 700 requires the Opinion section of the auditor's report to make reference to the 'applicable financial reporting framework' that has been used in preparing the financial statements. In the UK this will be one of the following:

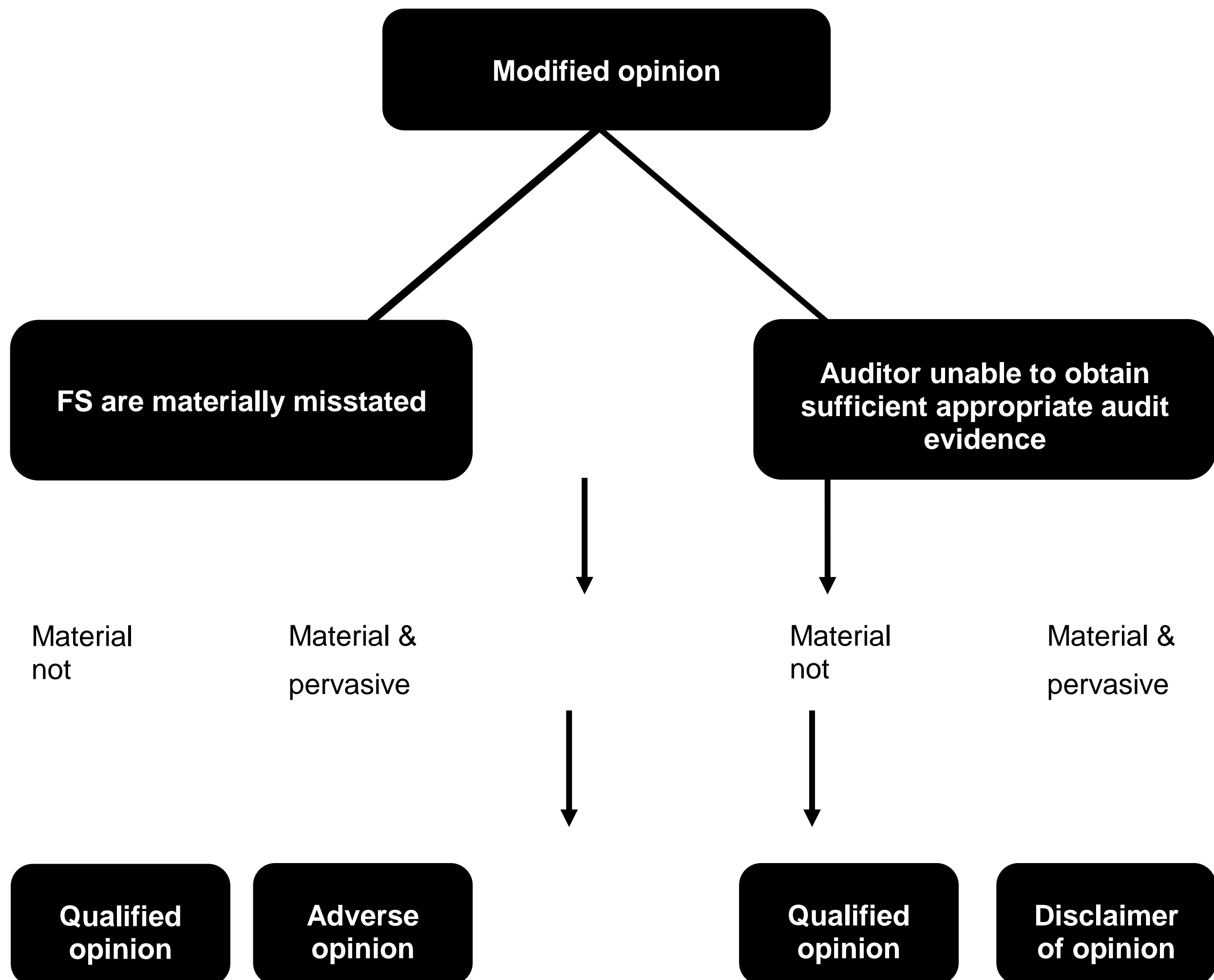
- EU-adopted IFRS;
- UK GAAP which comprises UK law and one of the following UK accounting standards:
  - FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*;
  - FRS 101 *Reduced Disclosure Framework*; or
  - FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

If an acceptable financial reporting framework has not been used by the auditor, then the preconditions (as per ISA (UK) 210 (Revised June 2016) *Agreeing the Terms of Audit Engagements*) will not be met and the auditor will need to discuss the situation with management and not accept the proposed audit engagement (unless law or regulation compels the auditor to accept the engagement). In many cases, however, the applicable financial reporting framework will be acceptable.

Modified opinions

If the auditor concludes that the financial statements, as a whole, are **not** free from material misstatement, or they have been unable to obtain sufficient appropriate audit evidence to conclude that the financial statements, as a whole, are free from material misstatement then the auditor is required to modify their opinion. Modified auditor's opinions are dealt with in ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*.

Below is a summary of the appropriate types of audit opinion:



When the auditor deems it necessary to express a modified opinion, they must also consider the impact of the modification on the auditor's other reporting responsibilities, including those on which they are required to report by exception.

Example – Reporting by exception

The audit of a company's financial statements for the year-ended 31 October 2016 has been completed and the audit team have been unable to obtain sufficient appropriate audit evidence for several material areas of the financial statements including stock and work in progress, trade debtors and creditors and several related party transactions due to a lack of accounting records. The audit engagement partner has concluded that the inability to obtain sufficient appropriate audit evidence is both material and pervasive and will be expressing a disclaimer of opinion on the financial statements.

In addition to expressing a disclaimer of opinion, the audit engagement partners should also express a modified conclusion stating that the adequate accounting records have not been maintained by the company.

Going concern

The directors of a company are still required to carry out a going concern assessment for a period covering at least 12 months from the date of approval of the financial statements. The auditors still have a responsibility to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis and form a conclusion on the appropriateness of the use of the going concern basis. It is not, however, the auditor's responsibility to make this assessment.

In addition, the auditor must also form a conclusion as to whether a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern for the foreseeable future. The term 'foreseeable future' means at least 12 months from the date of the auditor's report, not 12 months from the balance sheet date.

No material uncertainty exists

Where the auditor concludes that the going concern basis is appropriate and no material uncertainty exists, the auditor reports by exception on such issues (the Appendix to this section illustrates this concept).

Material uncertainty exists but is adequately disclosed

Where a material uncertainty exists, but this is adequately disclosed within the financial statements by management, the auditor expresses an unmodified (unqualified) opinion. In addition, the auditor makes reference to the material uncertainty by way of a separate section in the auditor's report headed up 'Material Uncertainty Related to Going Concern'. This is notably different than what was the case under the previous ISA (UK and Ireland) 570 *Going Concern* which would have required the auditor to make reference to the material uncertainty by way of an Emphasis of Matter paragraph. See the illustrative auditor's report at the end of this section.

Emphasis of matter and other matter paragraphs

ISA (UK) 706 (Revised June 2016) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* deals with the communication in the auditor's report when the auditor deems it necessary to:

- draw users' attention to a matter(s) presented or disclosed in the financial statements which the auditor considers is of fundamental importance to the users' understanding of the financial statements; or
- draw users' attention to a matter(s), other than those presented or disclosed in the accounts, that the auditor considers is of fundamental importance to the users' understanding of the auditor, the auditor's responsibilities or the auditor's report.

Other information

Some entities are required to prepare 'other information' as described in ISA (UK) 720 (Revised June 2016) *The Auditor's Responsibilities Relating to Other Information*. Other information may consist of information that has been included within the annual report that is not in the financial statements and the auditor's report thereon. The auditor's report on the financial statements does not cover the other information and it follows, therefore, that the auditor is not required to obtain evidence beyond that required to allow the auditor to form an opinion on the financial statements.

There are two exceptions to this:

1. when the auditor is required to provide on opinion on the statutory other information (e.g. the directors' report, the strategic report and the separate corporate governance statement) and state the nature of the work that the auditor has performed; or
2. when required by law or regulation.

If the audited entity has not prepared other information for inclusion in the annual report, the auditor must include a statement that the auditor's opinion on the financial statements does not cover the other information as follows:

Other information

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

If the audited entity has included statutory other information, this statement by the auditor is amended as follows:

Other information

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

Strategic reports and directors' reports

Where an audit client is required to prepare a directors' report or a strategic report, the auditor is required to report on whether the information contained in these reports is consistent with the financial statements as well as reporting on whether these reports have been prepared in accordance with the applicable legal and regulatory framework.

Example – Entity only prepares a directors' report

Smallco Ltd is a small company that chooses to have an audit. The audit of the financial statements for the year-ended 31 July 2017 has been completed and the auditors have found no inconsistencies between the content of the directors' report and the financial statements. The auditor's report in this respect will be drafted as follows:

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of our audit:

- the information given in the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the directors' report has been prepared in accordance with applicable legal requirements.

Example – Entity prepares both a directors' report and a strategic report

Mediumco Ltd is required by law to have a statutory audit. The audit of the financial statements for the year-ended 31 July 2017 has been completed and the auditors have found no inconsistencies between the content of both the directors' report and the strategic report. The auditor's report in this respect will be drafted as follows:

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit the:

- information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- strategic report and directors' report have been prepared in accordance with applicable legal requirements.

Auditors are also required to report on whether, based on their knowledge and understanding of the audit client, and the environment in which it operates, there are any material misstatements contained within those reports.

Example – Entity prepares a directors' report only

Smallco Ltd chooses to have an audit and the auditors have not discovered any material misstatements contained within the directors' report for the year-ended 31 July 2017. The auditor's report in this respect will be drafted as follows:

Matters on which we are required to report by exception

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the directors' report.

Example – Entity prepares both a directors' report and a strategic report

The auditors of Mediumco Ltd have not discovered any material misstatements within the report of the directors or the strategic report for the year-ended 31 July 2017. The auditor's report in this respect will be drafted as follows:

Matters on which we are required to report by exception

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or the directors' report.

Reporting by exception on other matters

The auditor is also required to report by exception if, in the auditor's opinion:

- the entity has not maintained adequate accounting records or the auditor has not received returns adequate for the audit from branches that they have visited; or
- the financial statements do not agree with the accounting records and returns; or
- certain disclosures in respect of directors' remuneration required by law are not made; or
- the auditor has not received all the information and explanations required for the audit; or
- the directors are not entitled to prepare the financial statements in accordance with the small companies' regime and hence take advantage of the small companies' exemptions when preparing the report of the directors and from the requirement to prepare a strategic report.

Corporate governance statement

Public companies must include a corporate governance statement within their annual report. This can be either:

- as a specific section within the report of the directors (DTR 7.2.1R); or
- in a separate corporate governance report, which is either:
  - published with, and in the same manner as, its annual report (DTR 7.2.9(1)R); or
  - by means of a cross-reference in the directors' report to where the statement is publicly available on the company's website (DTR 7.2.9(2)R).

When the corporate governance statement is not included in the directors' report, the Companies Act 2006 requires the auditor to fulfil specific reporting responsibilities concerning the corporate governance statement. Guidance relating to the auditor's responsibilities where the corporate governance statement is concerned is contained in Bulletin 2009/4 *Developments in Corporate Governance Affecting the Responsibilities of Auditors of UK Companies*.

Example – Information in the corporate governance statement is consistent

The auditors of Public Co PLC have finalised their audit for the year-ended 31 July 2017. There are no inconsistencies or material misstatements within the corporate governance statement. The auditor's report in this respect will be drafted as follows:

Opinion on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information about internal control and risk management systems in relation to financial reporting processes and about share capital structures, given in compliance with rules 7.2.5 and 7.2.6 in the Disclosure Rules and Transparency Rules sourcebook made by the Financial Conduct Authority (the FCA Rules), is consistent with the financial statements and has been prepared in accordance with applicable legal requirements; and
- information about the company's corporate governance code and practices and about its administrative, management and supervisory bodies and their committees complies with rules 7.2.2, 7.2.3 and 7.2.7 of the FCA Rules.

Matters on which we are required to report by exception

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in:

- the information about internal control and risk management systems in relation to financial reporting processes and about share capital structures, given in compliance with rules 7.2.5 and 7.2.6 of the FCA Rules.

Section 498A of the Companies Act 2006 requires the auditor to report on whether, or not, the company has prepared a corporate governance statement where it is required to do so. In this respect, the auditor reports by exception as follows:

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- ... ;or
- we have not received all the information and explanations we require for our audit; or
- a corporate governance statement has not been prepared by the company.

Auditor identifies material misstatement of other information

In situations where the auditor discovers an uncorrected material misstatement of the other information, they must describe that material misstatement within the auditor's report. Illustrative reports in these situations are contained in ISA (UK) 720 (Revised June 2016) *The Auditor's Responsibilities Relating to Other Information* in Appendix 2.

In addition to the above, if there is an uncorrected material misstatement of the statutory other information, the auditor must also consider the reporting implications for the specific opinions, conclusions or statements that are required by the UK ISAs, legislation or regulation.

Placement of the auditor's responsibilities for the audit of the accounts

There are three possible areas within the auditor's report where the auditor's responsibilities for the audit of the accounts can be placed:

- within the body of the auditor's report (this is usually the most common);
- within an appendix to the auditor's report (the auditor's report must include a cross-reference to the appendix); or
- by a specific reference within the auditor's report to the location of the description of the auditor's responsibilities on the FRC's website (www.frc.org.uk/auditorsresponsibilities).

Directors' remuneration report

Quoted companies are required to prepare a directors' remuneration report and the auditor has to report on certain aspects of that report. For those areas of the directors' remuneration which are under the scope of the audit, the auditor must include the following wording in the auditor's report:

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the part of the directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

Auditors are also required to report by exception if the part of the directors' remuneration report under the scope of the audit is not in agreement with the accounting records and returns as follows:

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- …; or
- [the parent company financial statements and] the part of the directors' remuneration report to be audited are not in agreement with the accounting records and returns; or
- …; or

Group accounts

Section 408 of the Companies Act 2006 gives a company that prepares consolidated financial statements (group accounts) the option of omitting the parent company's profit and loss account from the company's financial statements. There are two rules that have to be complied with in this respect:

- the parent company's balance sheet shows the parent company's profit or loss for the financial year determined in accordance with the Companies Act 2006; and
- disclosure is made in the parent company's financial statements that the exemption applies.

The auditor's report must make reference to the provisions in the Companies Act 2006 where the parent company's profit and loss account is omitted from the group accounts as follows (the relevant wording is underlined):

Opinion

We have audited the financial statements of ABC Group Ltd for the year-ended 31 July 2017, which comprise the consolidated profit and loss account, consolidated statement of changes in equity, consolidated balance sheet, consolidated cash flow statement and notes to the financial statements, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and UK Generally Accepted Accounting Practice <u>and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006</u>. *[The underlined text would not be included where the Section 408 exemption is not taken].*

In our opinion:

- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 31 July 2017 and of the group's profit for the year then ended; *[reference would be made to the parent company's profit or loss where the Section 408 exemption had not been applied]*
- the group financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice;
- the parent company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice as applied in accordance with the provisions of the Companies Act 2006; and *[reference would only be made to the requirements rather than the provisions of Companies Act 2006 where the Section 408 exemption had not been taken]*
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

Appendix: Illustrative auditor's report (small entity reporting under UK GAAP with material going concern uncertainties)

Opinion

We have audited the financial statements of Small Co Ltd (the 'company') for the year-ended 31 July 2017 which comprise the profit and loss account, balance sheet and notes to the financial statements, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards, including Financial Reporting Standard 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (United Kingdom Generally Accepted Accounting Practice).

In our opinion, the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 July 2017 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material uncertainty related to going concern

We draw attention to note 23 in the financial statements, which indicates that the company's major contract is being retendered in 2018 and that the company is uncertain whether they will be successful in its tender submission. As stated in note 23, these events or conditions, along with the other matters as set forth in note 23, indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Note:

If there are no material uncertainties in relation to going concern, the following paragraph will be included:

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

Other information

The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon. In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

We have nothing to report in this regard.

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the directors' report has been prepared in accordance with applicable legal requirements.

Matters on which we are required to report by exception

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the directors' report.

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit; or
- the directors were not entitled to prepare the financial statements in accordance with the small companies' regime and take advantage of the small companies' exemptions in preparing the directors' report and from the requirement to prepare a strategic report.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement set out on page 3, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative .

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Paul Brown

Paul Brown (Senior Statutory Auditor)

For and on behalf of Brown & Co, Statutory Auditors

123 High Street

Anytown

28 September 2017

FRC'S ETHICAL STANDARD FOR AUDITORS (LECTURE A584 – 22.11 MINUTES)

A new Ethical Standard (ES) for auditors was issued by the Financial Reporting Council (FRC) in early 2016. This new ES will replace the existing ESs 1 to 5 and the new ES reflects the provisions of the EU Audit Regulation and Directive and also restricts the supply of non-audit services to UK public interest entity audit clients.

The new ES will apply to audits of financial statements for years beginning on or after 17 June 2016 and audit firms can complete engagements relating to periods starting prior to 17 June 2016 in accordance with the outgoing ESs and put in place any necessary changes in the subsequent engagement period. Therefore, where an audit client has, say, a 31 December 2017 year-end, the new ES will apply.

This Quarter 1 Accounting & Audit Quarterly Update course will consider Part A and Sections 1 and 2 of Part B. The remaining sections 3 to 6 of Part B will be examined in Quarter 2.

The June 2016 ES refers to 'covered persons'. A covered person is a person who is in a position to influence the conduct, or outcome, of a statutory audit.

Part A Overarching principles and supporting ethical provisions

Part A of the ES outlines the overarching principles and supporting ethical provisions in respect of integrity and objectivity and independence.

This part of the ES requires that all parties within an audit firm (being the firm, its partners and staff) behave with integrity and objectivity in all professional, business activities and relationships.

In terms of independence, the ES requires that both the firm and each covered person must ensure that they are free from any conditions and relationships which would impede on their independence. Conditions and relationships are said to impact on independence when an objective, reasonable and informed third party would conclude that the independence of either the audit firm or its covered persons is compromised. This is referred to in the ES as the 'third party test'.

Threats to independence must be reduced to an acceptably low level by the use of safeguards. For example, if a self-review threat arises, a safeguard may be to have a separate team involved in the audit that has had no previous connection to the audit client.

Part B

Part B is split into six sections as follows:

- Section 1: General Requirements and Guidance
- Section 2: Financial, Business, Employment and Personal Relationships
- Section 3: Long Association with Engagements and with Entities Relevant to Engagements
- Section 4: Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation
- Section 5: Non-Audit/Additional Services
- Section 6: Provisions Available for Audits of Small Entities

Section 1: General Requirements and Guidance

Generally, this section of the ES requires an audit firm to implement appropriate policies and procedures which prevents any owners, shareholders, members of the administrative, management and supervisory bodies of the firm (or affiliate firm) from carrying out an engagement in any way that may call into question the integrity, objectivity or independence of the firm or covered persons. To that end, Section 1 requires the firm to put in place appropriate and effective organisational and administrative arrangements which aim to prevent, identify, eliminate or manage and disclose any threats to independence.

The processes implemented by the firm must also ensure that they deal with and record any incidents which have, or may have, any serious consequences in respect of the integrity of the audit or public interest assurance activities.

Firms must ensure that the policies and procedures it puts in place are appropriate in terms of its size and complexity of the activities which the firm undertakes. The Financial Reporting Council or Recognised Supervisory Body (e.g. ICAEW or ACCA) will seek to ensure that such policies and procedures are appropriate in terms of the size of the audit firm and the nature of the engagements its carries out.

The ES requires the firm to promote a strong control environment and therefore the policies and procedures which the firm establishes must include:

a) a requirement for both partners and staff to report, where applicable:
   - family and other personal relationships that involve an audit client;
   - financial interests in an audit client; and
   - decisions to leave the audit firm to join an audit client;
b) monitor compliance with the audit firm's policies and procedures insofar as integrity, objectivity and independence are concerned. This would include a periodic review of the engagement partner's documentation of the consideration of integrity, objectivity and independence of the audit firm to include its partners and staff;
c) identification of entities which partners, staff and (where appropriate) persons that are closely connected with them, need to be independent from;
d) procedures for prompt communication of any possible (or actual) breaches of the firm's policies and procedures to the relevant audit engagement partner;
e) evaluation by the engagement partner(s) of the consequences of any possible or actual breaches that have been identified and reported to them;
f) reporting by engagement partners in respect of any particular situations or relationships which are required by the ES;
g) the operation of an enforcement regime which promotes compliance with the firm's policies and procedures; and
h) allowing staff the power to voice any concerns, without fear of any repercussion from senior levels, about the quality of the firm's work, professional judgement and values. This includes issues relating to integrity, objectivity or independence that is of concern to the staff member(s). The ES encourages the use of confidential communication channels which are open to all staff members and to encourage staff to use these channels as a means of giving comfort to staff that they will not be discriminated against or disciplined by voicing any concerns.

Ethics partner

The ES requires the audit firm to appoint a partner in the firm that has the necessary level of seniority, expertise, authority and leadership levels to be the ethics partner. The ethics partner has responsibility in ensuring that the firm complies with supporting ethical provision 1.1 in the ES (June 2016) and is supported, where appropriate, by other persons with relevant experience. This function in the ES is referred to as the 'ethics function'.

The main responsibilities of the ethics partner are to ensure that the firm's policies and procedures that relate to integrity, objectivity and independence comply with the ethical outcomes required by the overarching principles and supporting ethical provisions of the ES. In addition, the ethics partner is also required to provide guidance to both individual partners and staff in achieving a consistent approach to applying the ES.

In some cases, a difference of opinion may arise between an ethics partner and a person/persons consulting him or her. Where differences of opinion do arise, the firm's policies and procedures for dealing with those differences of opinion will be triggered.

The ethics partner must ensure that they do not undertake another role within the audit firm which may conflict with their responsibilities as ethics partner.

It is important that the audit firm also makes provisions for alternative arrangements where the position of the ethics partners is concerned, for example:

- to provide guidance on audits or other public interest assurance engagements when the ethics partner is the engagement partner; and
- in situations when the ethics partner is unavailable (such as sickness or holidays).

Breaches of the ES

Whenever there is a possible or actual breach of the ES, the engagement partner and, where appropriate, the ethics partner, must assess the implications of the breach and determine whether there are appropriate safeguards which can be put in place, or any other actions that can be taken, to address the breach. The engagement partner and, where appropriate, the ethics partner, must also consider whether there is a need to resign or withdraw from the audit.

Accidental breaches of the ES would not necessarily call into question the firm's ability to provide an audit or other public interest assurance opinion, provided that:

- the firm's policies and procedures require all partners, staff and other covered persons to promptly report any breach to the engagement partner or ethics partner, as appropriate;
- that the engagement or ethics partner notifies the relevant partner, member of staff or other covered persons on a timely basis that the matter giving rise to the breach must be addressed as quickly as possible (the engagement or ethics partner must also ensure that such action is taken);
- safeguards, where appropriate, are applied; and
- the actions that have been taken, together with the rationale for those actions, are adequately documented.

Management decisions

The audit firm and each covered person must not be involved in any of the decision-making issues of an audit client. The EU Audit Regulation provides that in the case of a statutory audit of a public interest entity, non-audit services **must not** be provided which would involve contributing to any of the management or decision-making functions of the public interest entity.

Decision-making can involve a myriad of situations and it is impossible to pinpoint those types of decisions which should be made by management. However, in broad terms, management decisions are usually those which involve the leading and directing of the audit client (for example recruitment of management or employees, acquisition of a business and such like).

Identifying and assessing threats

The ES requires the engagement partner to identify and assess the circumstances that could create a threat to integrity or objectivity, including those that could impair independence. In such situations the engagement partner must eliminate the threat (for example by removing an individual(s) from the audit engagement team) or reduce the threat to an acceptable level. An 'acceptable level' would be a level where independence is not compromised.

Threats to integrity, objectivity and independence usually arise as follows:

- **Self-interest threat**: Where any of the partners, staff or covered persons, has financial or other interests which could make the person concerned reluctant to take any action that may be adverse to those interests. A typical example would be where the audit firm has overdue fees and the audit engagement partner is reluctant to issue a modified opinion as this may cause the overdue fees not to be paid.
- **Self-review threat**: Where non-audit or additional services are provided to the client by the firm which are then subsequently audited by the audit firm. A typical example would be where the firm has been involved in the accounts preparation work and then audits that work. The ES places additional restrictions on non-audit work that can be performed by an audit firm for a public interest entity.
- **Management threat**: This type of threat was covered briefly above on page 54. The firm and each covered person must not be involved in any role that could be perceived to be a management role, and hence taking management decisions.
- **Advocacy threat**: Advocacy threats arise when the audit firm undertakes work that involves acting as an advocate for an entity and supporting a position taken by management in an adversarial or promotional context (e.g. supporting the client in a HMRC investigation).
- **Familiarity (trust) threat**: A familiarity (or trust) threat arises through long association with the audit client, such that the auditor becomes sympathetic to the client's requirements or becomes insufficiently questioning of the client.
- **Intimidation threat:** These types of threats arise when the conduct of the firm or covered persons is influenced by the audit client (for example where the audit client may have an aggressive and/or dominating individual).

Threats to integrity, objectivity and independence must always be reduced to an acceptably low level. A threat(s) is reduced to an acceptably low level when independence will not be compromised. Where the threat cannot be reduced to an acceptably low level, or mitigated completely, the audit firm must withdraw from the engagement. Where a threat is clearly insignificant, no safeguards need be applied.

The audit firm must have policies and procedures in place which require the audit engagement partner to identify and assess the significance of threats to the integrity and objectivity of the firm and covered persons on both an individual and cumulative basis.

Using other firms in an engagement

A firm may use another firm (including network firms) during an audit engagement. It is the responsibility of the lead firm to be satisfied that another firm involved in the audit engagement is independent of each entity relevant to the audit engagement. The engagement partner must also obtain sufficient appropriate evidence, as deemed necessary, to be satisfied that other firms and third party firms are independent of each entity relevant to the audit engagement. When the engagement partner is unable to obtain such evidence, or obtains evidence that the other firm is not able meet the relevant independence requirements, the engagement team cannot use the work of that other firm.

For public interest entities (or a listed entity), the engagement partner has to establish that the entity relevant to the engagement has communicated its policy on the use of firms to supply non-audit/additional services to its affiliates and must obtain confirmation that the other firms involved in the engagement will comply with this policy.

Conclusions at the end of the engagement

At the end of the engagement, when forming the opinion that is to be reported (or reporting on the work that has been undertaken), the engagement partner must reach an overall conclusion that any threats to integrity, objectivity or independence on both an individual and cumulative basis, have been appropriately addressed in accordance with the ES (June 2016). This consideration must be done before the auditor's report is issued.

If situations are such that the audit engagement partner cannot make such a conclusion, the partner must not report and the firm shall either resign from the engagement or withdraw accordingly. The exception to this would be where law or regulation prohibits resignation or withdrawal.

Communicating with those charged with governance

It is the responsibility of the audit engagement partner to ensure that those charged with governance of each entity that is relevant to an engagement are appropriately informed (promptly) of all significant facts and circumstances which may impact on integrity, objectivity and independence of the audit firm or covered persons.

Where an audit committee exists, this committee will be responsible for oversight of the relationship between the entity and the audit firm. Where there is no audit committee, or equivalent body, the ES requires such communication to be with the board of directors.

For listed entities and public interest entities (other than an investment circular reporting engagement – see paragraph 1.67 of the ES (June 2016)), the engagement partner must provide the audit committee with:

- a written disclosure of relationships that may impact on integrity, objectivity or independence;
- details of any non-audit or additional services that the firm has provided together with the fees charged for such services;
- written confirmation that the firm and each covered person is independent;
- details of any inconsistencies between the ES (June 2016) and the policy of the company for the provision of non-audit and additional services by the firm together with any apparent breach of that policy; and
- an opportunity to discuss issues relating to independence.

Documentation

The audit working papers must contain documentation of the significant threats to integrity, objectivity and independence together with the safeguards that have been applied in order to minimise those threats. The audit engagement partner must also ensure that his/her consideration of the firm's integrity, objectivity and independence is also appropriately documented.

Financial, business, employment and personal relationships

Section 2 of the ES (June 2016) deals with financial, business, employment and personal relationships.

Financial relationships

A financial interest in an entity would arise when any member of the audit engagement team has interests in a financial instrument issued by the reporting entity. Such an interest can be a 'direct' interest whereby the member directly owns the financial instrument (e.g. shares in a business) or a 'direct beneficial interest' which would be an interest held through an intermediary that is controlled by the person holding the financial interest, including where the person has the ability to influence the intermediary's investment policy.

Financial interests can also be held indirectly, such as where a financial interest is held through an investment trust or pension scheme.

The ES is strict on its approach to financial relationships. In respect of an audit client, the firm, each partner within the firm, each covered person and any person who is closely associated with any such person or covered person must not hold:

- any direct financial interest in an audit client, or an entity that is affiliated to the audit client; or
- any indirect financial interest in an audit client, or any entity that is affiliated to the audit client that is material to the firm, or the person, or the intermediary; or
- any other indirect financial interest in an audit client (or affiliate of the audit client) where the person holding it can influence the investment decisions of the intermediary and has actual knowledge of the existence of the underlying holding of a direct financial interest by the intermediary.

For investment circular reporting engagements, the provisions of paragraph 2.5 of the ES is applicable.

In situations where a partner in the firm or a covered person becomes aware that someone who is a close family member holds any financial interest referred to in paragraphs 2.3D, 2.4D or 2.5 of the ES, that person must promptly notify the matter to the engagement partner so that he/she can take appropriate action. Where the holder of the financial interest is a close family member of the engagement partner, the matter must be resolved by way of consultation with the ethics partner or ethics function. This applies also where the engagement partner is in doubt as to the action to be taken.

Financial interests held as trustee

When a direct or indirect financial interest is held in a trustee capacity by a covered person or a person closely associated with the covered person, a self-interest threat might be created. This is because the existence of the trustee interest could influence the outcome or conduct of the audit engagement or the trust might influence the actions of the entity. Such a trustee interest would not be held when:

- the relevant person is an identified potential beneficiary of the trust;
- the financial interest that is held by the trust in the entity is material to the trust;
- the trust can exercise significant influence over the entity (or an entity affiliated to the entity);
- the relevant person holds significant influence over the investment decisions that are made by the trust to the extent that they relate to the financial interest in the entity; and
- such a holding is precluded by the requirements in paragraph 2.4D of the ES.

In situations where it is unclear whether the financial interest in the entity held by the trust is material to the trust or whether the trust exerts significant influence over the entity, this financial interest must be reported to the ethics partner or ethics function in order that a decision can be made as to the steps that need to be taken.

Financial interests held by firm pension schemes

In situations where the firm's pension scheme has a financial interest in an audit client (or in any of the client's affiliates) and the audit firm has any influence over the investment decisions of the trustees (except those which are indirect strategic and policy decisions), the ES regards this self-interest threat as so great that no safeguards can eliminate it, or reduce it to an acceptably low level.

Loans and guarantees

Generally, loans and guarantees involving audit clients are a 'no-go-area'. Even overdue fees can, in some circumstances, be construed as a loan to a client and therefore care needs to be taken in this area.

Loans and guarantees are, more often than not, prohibited because a self-interest and intimidation threat to integrity or objectivity is created and hence independence is compromised. In such cases, no safeguards exist which could reduce these threats to an acceptably low level.

A similar preclusion exists in the reverse scenario; i.e. where a client may make a loan to an audit firm, or guarantee its liabilities. There are, however, three exceptions to this which are where:

(a) the client is a bank or similar deposit-taking institution; and

(b) the loan or guarantee is made in the ordinary course of business, including on normal business terms; and

(c) the loan or guarantee is not material to the audit firm and the client.

The above provisions also apply to covered persons and persons closely associated with them.

Business relationships

The ES recognises that business relationships involve two parties having a common commercial interest. As a result, this may create self-interest, advocacy or intimidation threats to integrity, objectivity and independence. For example, if the audit firm were to lease part of its premises to an audit client.

The ES prohibits persons or firms referred to in paragraph 2.4D of the ES from having a business or other relationship with an audit client which would compromise independence. Where a person has such a business or other relationship, they must be excluded from any role in which they would be a covered person.

There are a couple of exceptions where business relationships are concerned, which are where the relationship:

- involves the purchase of goods or services from the audit firm or the audit client and the transaction is undertaken under normal commercial terms and on an arm's-length basis and which are not material to either party; or
- in the eyes of an objective, reasonable and informed third party, would be inconsequential.

If there are any doubts as to whether a relationship would be inconsequential in the eyes of an objective, reasonable and informed third party, then the relationship is deemed not be inconsequential.

Employment relationships

The ES makes a prohibition for persons or firms referred to in paragraph 2.4D from having an employment relationship with an audit client, or affiliate of an audit client.

Conversely, a firm cannot admit to the firm's partnership, or employ a person in a position as a covered person, a person who is also employed by any audit client, or affiliate of the audit client.

Partners or staff of the audit client generally are prohibited from being seconded to audit clients, unless:

- the agreement is for a short period of time and does not involve the partners or staff performing non-audit/additional services that are prohibited by the ES;
- the entity agrees that any individual loan staff will not hold a management position and will also not be involved in the decision-making process of the entity
- for a public interest entity, the entity agrees that the loan staff will not play any role in the management of the entity; and

- the entity acknowledges its responsibility for directing and supervising the work to be performed and that work will not include:
  - undertaking management decisions; or
  - committing the entity to a particular position or accounting treatment.

Paragraph 2.40 deals with issues concerning investment circular reporting engagements.

When the partner or employee returns to the audit firm after completion of the loan assignment, the partner or employee must not be given any role which involves any function or activity that they have worked on at the client. The length of time that the partner or employee is prohibited from working on those areas will depend on the level of threats to integrity, objectivity and independence. However, as a minimum the ES requires this restriction to be in place until at least the first engagement has been completed following the completion of the loan staff assignment.

Partner or staff joins the audit client

The ES says that when a former partner in the firm joins an audit client, the firm must act swiftly and certainly before any further work is done by the firm in respect of that client. This is to ensure that no significant connections remain between the audit firm the individual. The other alternative is to resign from the audit.

The ES requires that audit firms have policies and procedures in place that require an individual that is, or was at any time over the previous year (two years in the case of a partner), directly involved:

(a) for all such engagements:

  (i) senior members of the engagement team to inform the audit firm of any circumstance which may involve their potential employment with any audit client; and

  (ii) other members of the engagement team to inform the audit firm of any circumstance which involves their probable employment with an audit client;

(b) for an engagement which is not an investment circular reporting engagement:

  (i) all partners within the audit firm to notify the firm of any circumstance which involves their potential employment with an audit client; and

  (ii) any other employee of the audit firm, including other natural persons whose services are at the disposal of the audit firm, where such employee is the senior statutory auditor, to notify the audit firm of any circumstance which involves their potential employment with an audit client;

(c) anyone who has informed the audit firm of such employment with an audit client to be removed from the audit engagement team; and

(d) a review of the work undertaken by the resigning or former engagement team member be conducted in the current and, where appropriate, most recent audit engagement.

SI 2016/649 does not allow a person that is appointed as a statutory auditor, or key audit partner for an audit client, to take up:

- any key management position;
- a position on the audit client's audit committee;
- a role on a body within the audit client that performs equivalent functions to that of an audit committee; and
- any other position of a director or on a management body or other committee or membership of that management body or committee,

before the end of:

- two years for a public interest entity; or
- one year for other entities.

The two-year/one-year clock starts ticking from the day on which the person ceased to be the statutory auditor or key audit partner.

When a partner, or another person who is approved as a statutory auditor accepts an appointment as a director, including non-executive director, a member of the entity's audit committee or body that performs similar functions to that of an audit committee, or accepts a role involving a key management position and has previously been a covered person:

(a) in the case of a partner, at any time during the two years prior to the appointment; or

(b) in the case of another person, at any time during the year prior to the appointment,

the firm must resign from the engagement and not accept another engagement for that particular client until:

(a) in the case of a partner, a two-year period has elapsed; or

(b) in the case of another person, a one-year period has elapsed.

The two-year/one-year clock starts ticking from the sooner of the person ceasing to be a covered person, the timescale lapsing or the person ceasing employment with the client.

Where law or regulation prohibits the auditor resigning in such circumstances, the firm must consider alternative safeguards that can be applied to reduce threats to integrity or objective to an acceptable level where independence is deemed not to be compromised.

If a person that is either a partner or another person that is approved as a statutory auditor, or was a former member of the engagement team, joins the audit client as a director, including non-executive director, a member of the client's audit committee or equivalent body or joins in a key management position, within two years of ceasing to be a covered person, the audit firm must ensure that no significant connections remain between the audit firm and the individual. In addition, consideration must also be given as to whether the structure of the audit engagement team remains appropriate.

When a former partner of the firm, or another person who was personally approved as a statutory auditor has joined an audit client as a director, non-executive director, member of the audit committee or equivalent body or in a key management position, the audit firm must not accept an audit engagement where that person had been a covered person for any engagement involving any partner of the audit firm who would be a member of the audit engagement team, or would be the engagement quality control reviewer for the audit client if it were to be accepted:

(a) in the case of a partner, within two years prior to acceptance of the engagement; or

(b) in the case of another person, within one year prior to acceptance of the engagement.

In cases where a former partner or person who was personally approved as a statutory auditor left the audit firm earlier than the periods in (a) or (b) above, the audit firm must evaluate the significance of the threats to integrity or objectivity. The audit firm must not accept the engagement unless any threats that have been identified can be reduced to a level which deems independence not to be compromised.

Family members employed by an audit client

When a covered person, or any partner within the audit firm, becomes aware that someone closely associated with them, including a close family member who is not closely associated with them, is employed by an audit client and that particular person holds a position which allows them to exercise influence on the accounting records or financial statements, that covered person or partner must:

(a) in the case of a person that is closely associated with them being in employment with the audit client, be excluded from any role in which they are a covered person; or

(b) in the case of a close family member of a covered person who is not a person closely associated with them, or for an engagement other than an investment circular reporting engagement, any close member of the family of any partner in the firm who is not a person closely associated with them, inform the engagement partner so that he/she can take appropriate action. If the person is a close family member of the engagement partner or the engagement partner is in any doubt as to the action that should be taken, the issue must be resolved through consultation with the ethics partner or ethics function.

Governance roles

The audit firm, partner or staff member of an audit firm must not accept an appointment with an audit client to perform the role:

(a) of an officer or member of the board of directors of the audit client;

(b) of a member of any sub-committee of the board; or

(c) in such a position within an entity that holds directly/indirectly more than 20% of the voting rights in the audit client, or in an entity which the audit client holds directly or indirectly more than 20% of the voting rights.

When a covered person becomes aware that someone closely associated with them, or a close family member that is not a person closely associated with, holds a position described in (a) to (c) above, the audit firm must take action to ensure that the relevant person does not assume a role in which they would be a covered person.

When a partner or staff member, who is not a covered person, becomes aware that someone closely associated with them, or a close family member that is not a person closely associated with them, holds a position in (a) to (c) above, that individual must report the issue to the audit engagement partner. The audit engagement partner will then consider whether the relationship would compromise independence. If the engagement partner considers that independence would be impaired, they must consult with the ethics partner/ethics function to establish whether any safeguards exist that may be applied. Where no such safeguards exist, the audit firm must withdraw from the engagement.

Employment with the audit firm

Sometimes staff from an audit client may join the audit firm. Care must be taken when this happens because if an ex-employee of the audit client joins the firm and that person was in a position to exert significant influence over the preparation of the financial statements, or any other subject matter connected with the financial statements, that individual must be excluded from any role in which they would be a covered person for a period of two years following the date of leaving the audit client.

Family and other personal relationships

The audit firm must establish policies and procedures which require:

(a) partners and professional staff members to inform the firm of any persons closely associated with them, any close family who are not a person closely associated with them and any other personal relationships which involve audit client staff/board members where the audit engagement partner may perceive that the relationship would threaten integrity and objectivity or compromise independence; and

(b) the relevant audit engagement partners to be informed, on a timely basis, of any information reported by partners and other professional staff members as required by (a).

The audit engagement partner will then assess the threats to integrity and objectivity and consider whether independence would be compromised. Appropriate safeguards should be applied to minimise any threats to an acceptable level, or mitigate them in totality. Where there are any issues that are unresolved, or the engagement partner needs any additional clarification, then consultation with the ethics partner/ethics function must be undertaken.

Use of external consultants

It is not unusual for an audit assignment to utilise the services of an external consultant. It is the responsibility of the audit engagement partner to ensure that any external consultants deployed on an audit assignment will act with integrity and objectivity. In addition, the audit engagement partner must also document his/her rationale for that conclusion.

ISA 450 (REVISED JUNE 2016) *EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT (LECTURE A585 – 7.58 MINUTES)*

ISA (UK) 450 (Revised June 2016) *Evaluation of Misstatements Identified During the Audit* outlines the auditor's responsibilities when it comes to evaluating the effect of identified misstatements on the audit of a reporting entity as well as the effect of any uncorrected misstatements. The audit engagement partner is required to form an opinion as to whether the financial statements give a true and fair view and thus ISA (UK) 450 will heavily influence that opinion as well as ISA (UK) 320 (Revised June 2016) *Materiality in Planning and Performing an Audit*.

ISA (UK) 450 (Revised June 2016) is applicable for audits of financial statements for periods which commence on or after 17 June 2016, although early adoption of the standard is permissible.

Objective of the auditor

During an audit of financial statements, some misstatements are bound to arise which are documented on an 'unadjusted audit error' schedule (sometimes referred to as an 'audit error schedule'). ISA (UK) 450 requires the auditor to evaluate:

(a) the effect of misstatements that have been identified during the audit; and

(b) the effect of misstatements that have not been corrected (if any) on the financial statements.

'Uncorrected misstatements' in the context of ISA (UK) 450 refer to those misstatements which the auditor has documented on the audit error schedule and which have not been corrected within the accounts. It is worth noting that misstatements which are deemed to be clearly trivial are ignored. Amounts that are to be classed as clearly trivial are established at the planning stage of the audit.

Progression of the audit

ISA (UK) 300 (Revised June 2016) *Planning an Audit of Financial Statements* says that planning is a '… continual and iterative process'. This means that the audit plan may need to be revised during the detailed audit fieldwork if circumstances arise which the auditor was not previously aware of. This principle links into the requirements of ISA (UK) 450 because the standard requires that the auditor must determine whether the overall audit strategy and audit plan should be revised where misstatements are discovered. For example, where:

(a) the misstatements that the auditor has discovered, together with the circumstances in which they arise, indicate that other misstatements may be present and that these misstatements, when combined with other misstatements discovered during the audit, could be material; and

(b) where the total value of misstatements accumulated during the audit approaches the materiality level determined in accordance with ISA (UK) 320.

In such situations, the auditor may need to revisit and revise the audit strategy and audit plan and undertake additional audit procedures to address the revised levels of risk. Obviously, the more misstatements that are noted during the audit, the higher the level of risk of material misstatement thus sample sizes may need to be increased or more substantive procedures may need to be applied than was originally considered necessary at the planning stage of the audit.

Example – Management corrects misstatements

During the audit of Clumsy Co Ltd, the audit semi-senior discovered several misstatements within the payroll. Incorrect journal entries had been prepared for the months within the sample which resulted in the payroll expense and associated PAYE/NIC liabilities being understated. In addition, some consultancy invoices had been misposted into directors' remuneration. The auditor has discussed the situation with the finance director who has now corrected the misstatements. The audit semi-senior has decided that as the finance director has corrected the misstatements he has identified, no further procedures need to be applied.

The audit semi-senior is incorrect in his decision not to undertake additional audit procedures. When management have corrected a misstatement(s) discovered by the auditor, the auditor must perform additional procedures to determine whether any misstatements remain. The months that the audit semi-senior has not sampled may also contain misstatements, which could also be material, either in isolation, or when combined with other misstatements.

Communicating and correcting misstatements

ISA (UK) 450 requires that the auditor must notify the appropriate level of management about all misstatements that have been accumulated by the auditor on a timely basis. The exception to this requirement would be where law or regulation prohibits such notification.

When management refuse to correct some, or all, of the misstatements brought to their attention by the auditor, the auditor must understand the reasons for such refusal. These reasons will then be taken into consideration when evaluating whether, or not, the financial statements are free from material misstatement. It is therefore crucially important that audit staff clearly document any such reasons so they can bring these to the attention of the audit engagement partner who will ultimately be the individual responsible for forming the opinion on the financial statements.

Evaluating the effect of uncorrected misstatements

Before the auditor evaluates the effect of uncorrected misstatements, the auditor must reassess the materiality levels that were established in accordance with ISA (UK) 320. The objective of this exercise is to ensure that the materiality levels remain appropriate in the context of the entity's actual results.

Materiality levels can be changed during the course of the audit and may be decreased from those determined at the planning stage if the auditor deems this appropriate, especially where misstatements are concerned. This is one of the reasons why planning is not a 'one-off' exercise and is regarded as a continual and iterative process under the UK ISAs.

Once materiality has been reassessed, the auditor must then determine whether the uncorrected misstatements are material from both an individual and aggregated perspective. Keep in mind that an uncorrected misstatement may be immaterial individually, but may become material when combined with other uncorrected misstatements. This is particularly the case where the client is being audited in a year that it first applies FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* because issues such as unpaid holiday pay accruals, deferred tax, revaluations/fair values and such like may individually be immaterial, but may become material when aggregated.

ISA (UK) 450 specifically requires the auditor to consider:

(a) the size and nature of the misstatements; in this respect the auditor must consider this issue in the context of the particular classes of transactions, account balances or disclosures and the financial statements as a whole as well as how the misstatements came to arise in the first place; and

(b) the effect of uncorrected misstatements which relate to prior periods on the relevant classes of transactions, account balances or disclosures as well as the financial statements as a whole.

Communication with those charged with governance

The auditor is required under ISA (UK) 450 to discuss with those charged with governance the uncorrected misstatements identified by them during the audit together with the effect that the misstatements, both individually and in aggregate, may have on the auditor's opinion. The exception to this requirement would be where the auditor is prohibited by law or regulation from discussing these issues (see ISA UK) 260 (Revised June 2016) *Communication with Those Charged with Governance* paragraph 7).

Where law or regulation does not prohibit the auditor from discussing the uncorrected misstatements with those charged with governance, the auditor should request that they be corrected. It is quite rare for an audit client not to at least correct the material misstatements because this would clearly result in the auditor expressing a qualified auditor's opinion.

ISA (UK) 450 also requires the auditor to discuss with those charged with governance the effect of uncorrected misstatements which relate to prior periods and the effect that these have on the relevant classes of transactions, account balances or disclosures and the effect on the financial statements as a whole.

Written representation

As mentioned in the previous section, it is unusual for management and/or those charged with governance not to correct a material misstatement(s) because this would result in a qualified opinion being expressed by the auditor. Sometimes, management and those charged with governance decide to correct the material misstatements and leave immaterial misstatements as uncorrected. Provided the immaterial misstatements remain immaterial when combined, there will not be any issues where the auditor's opinion is concerned.

However, the auditor must request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, both in isolation and in combination, to the financial statements as a whole. Attached to the written representation will be a summary of such uncorrected misstatements.

Documentation

ISA (UK) 450 requires certain documentation be included on the working papers file as follows:

(a) the amount below which a misstatement would be deemed as 'clearly trivial';

(b) all misstatements that have been discovered during the audit, together with whether or not they have been corrected (this is usually in the form of an audit error schedule); and

(c) the auditor's conclusion as to whether the value of the uncorrected misstatements is material both individually or in combination together with the basis for that conclusion.

RECENT FAQ'S

We round off this course with some of the most frequently asked questions about new UK GAAP over recent months.

Under the small companies' regime, is it true that directors' remuneration will not be disclosed in the accounts?

The requirement to disclose directors' remuneration in the financial statements of a small company was repealed by SI 2015/980. That does not mean, however, that for a small company, it may not be caught under the related party disclosure requirements.

In respect of a small company, paragraphs 1AC.34 to 1AC.36 of FRS 102 provide the disclosure requirements for small companies. Only those related party transactions that have been undertaken on a non-arm's-length basis need to be disclosed (the standard refers to this as transactions that are not concluded under normal conditions). FRS 102 does not define the concept of 'normal market conditions' and some commentators argue that this is not the same meaning as 'normal market rate'. Until the standard becomes more firmly established, it is uncertain what practices may emerge where this issue is concerned.

For many small companies, directors' remuneration is structured in a tax-efficient manner (i.e. salary up to the PAYE threshold with the balance of remuneration being in the form of dividends). Professional judgement is needed to establish whether, or not, the remuneration of the director(s) is equivalent to that which would be paid to the director(s) under normal market conditions.

There is no simple answer where this is concerned and it is the directors' responsibility to ensure the accounts give a true and fair view. If it is clear that directors' remuneration is not being paid under normal market conditions, then it will need disclosure in the accounts. Where judgements such as these are concerned, it is always advisable to document such decisions in case those decisions are challenged further down the line.

Will I have to include an accountant's report in with my client's FRS 102 financial statements, even if it is a small client?

There is no legal requirement to include an accountant's report in the statutory financial statements of a company. However, professional bodies require member firms to include the accountant's report and this will continue to be the case under FRS 102. Some professional bodies also strongly advise member firms to include an accountant's report in the financial statements that are filed with Companies House (as was the case under the old abbreviated accounts regime). This, too, will also continue to be the case.

Are fair value gains and losses for a fixed asset accounted for under Section 17 treated in the same way as a fair value gain/loss for an investment property?

No. This is where many practitioners seem to be confusing the two sections of FRS 102. Section 16 *Investment Property* is fundamentally different in its requirements for fair value gains and losses than previous SSAP 19 *Accounting for investment properties* and the FRSSE. Section 16 requires fair value gains and losses on investment properties to be taken to the profit and loss account and deferred tax brought into account (the deferred tax associated with the gain or loss will also be taken to profit and loss).

Under Section 17 *Property, Plant and Equipment*, if an asset has been subjected to revaluation, then revaluation gains and losses are treated in the same way as under old UK

GAAP (i.e. taken to a revaluation reserve and reported through other comprehensive income). Deferred tax consequences will also arise which are also taken to other comprehensive income.

Losses on a revalued asset accounted for under Section 17 will be taken to the revaluation reserve to the extent that there is a revaluation surplus; any remaining loss is then taken to the profit and loss account. In subsequent years, if the asset appreciates in value, the gain is taken to the profit and loss account to the extent of any previously recognised loss taken to profit and loss, with any remaining surplus being taken to the revaluation reserve.

Care needs to be taken because the different accounting treatment has been well-publicised in the accounting press and sometimes this creates confusion between the accounting for gains and losses on an investment property and gains and losses on tangible fixed assets accounted for under Section 17.