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## FRS 102 TRIENNIAL REVIEW (LECTURE A566 – 14.48 MINUTES)

In September 2016, the Financial Reporting Council (FRC) issued a Consultation Document *Triennial review of UK and Ireland accounting standards – Approach to changes in IFRS*. This Consultation Document forms part of the FRC's triennial review of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

FRS 102 was first issued in March 2013 and the FRC indicated that it would be reviewed at least every three years. The first triennial review of the standard is now underway and the FRC is keen to hear stakeholders' views on possible improvements and there will be several opportunities for stakeholders' to contribute to the debate. Views which the FRC receive on potential improvements may be developed into the Exposure Drafts, of which there are two expected to be published in 2017.

### *Why the need for change?*

The foundations for FRS 102 is the *IFRS for SMEs* which is issued by the International Accounting Standards Board (IASB) and is a much scaled-down version of full IFRS given its target audience (the SME sector). As FRS 102 is based on the provisions found in IFRSs, any changes to such standards are considered and implemented, unless an alternative treatment better meets the need of the overriding objective. The FRC's 'overriding objective' is to set accounting standards that enable users of accounts to receive high-quality understanding financial reporting proportionate to the size and complexity of the entity and users' information needs. The FRC is proposing to make limited changes to the principle which support the overriding objective (see the next section).

Since the UK referendum vote to leave the EU, many practitioners have enquired as to whether the FRC will 'back-track' on FRS 102. The answer to this is 'no' and the FRC have confirmed that they will continue to develop and maintain accounting standards within the framework set by UK and Ireland company law. As a consequence, the Consultation Document is set within the context of current legal requirements and does not intend to pre-empt any potential future changes as a consequence of Brexit.

The triennial review will therefore consider changes that have been made to IFRS and whether those changes should be reflected within FRS 102. Where the FRC propose amendments to be made to the standard, they will be intended to be proportionate and practical solutions for the entities that fall under the scope of FRS 102.

The main focus of the FRC's triennial review will be FRS 102; however, it will also potentially incorporate all the other UK and Ireland standards as follows:

- FRS 100 *Application of Financial Reporting Frameworks*
- FRS 101 *Reduced Disclosure Framework*
- FRS 103 *Insurance Contracts*
- FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*

The FRC only expect to make limited amendments to the above standards and those amendments are likely to be consequential in nature.

This is because:

- FRS 101 was updated in July 2015 in order to reflect changes in the financial reporting framework as a result of the transposition of the EU Accounting Directive.

- FRS 101 is subject to an annual review process to ensure that its disclosure exemptions are kept up-to-date as IFRS changes. These annual reviews also provide an opportunity to make additional amendments and respond to issues that have been raised by stakeholders (such as the recent FRED 65 *Draft amendments to FRS 101 – Notification of shareholders*).

- FRS 103 was amended in May 2016 for the effects of Solvency II. It is expected that it will be reviewed again once the IASB has completed its project on the new insurance standard (which is likely to be issued in the first quarter of 2017 in the form of IFRS 17).

- FRS 105 was issued in July 2015 to support the implementation of the new micro-entities' regime. The standard itself was developed from FRS 102, but contains significant simplifications to reflect the legal provisions and further simplifications which are judged appropriate to micro-entities. Stakeholders may suggest possible amendments to FRS 105 following its implementation at which point the FRC will consider whether any consequential amendments are necessary.

FRS 104 *Interim Financial Reporting*, which applies to entities that are required to prepare interim financial statements, will be amended automatically for any changes arising from changes in FRS 102. The Consultation Document does acknowledge that the FRC will consider whether any changes made to FRS 102 will necessitate any consequential changes to FRS 104, but this is considered unlikely.

## *FRC's principles supporting overall objective of financial reporting*

To achieve the overall objective of financial reporting, which is:

*'To enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs'*,

the FRC applies five principles. The FRC are using the triennial review as an opportunity to make limited changes to these principles. The changes are considered necessary because the original principles were developed to support the introduction of a new suite of accounting standards which reflect a significant revision to financial reporting. As these new standards are now effective, the triennial review is an opportunity for the FRC to incrementally develop and maintain them. In addition, the FRC firmly believes that an IFRS-based framework allows better benchmarking and comparison between reporting entities and the Consultation Document acknowledges that FRS 102 has already increased the transparency in certain areas, most notably financial instruments.

The Consultation Document outlines the revised principles as follows (inserted text is underlined). The revised principles are to provide succinct financial reporting standards that:

(a) have consistency with international accounting standards through the application of an IFRS-based solution unless an alternatively clearly better meets the overriding objective;

(b) balance improvement, through reflecting up-to-date thinking and developments in the way entities operate and the transactions they undertake, with stability;

(c) balance consistent principles for accounting by all UK and Republic of Ireland entities with proportionate and practical solutions, based on size, complexity, public interest and users' information needs;

(d) promote efficiency within groups; and

(e) are cost-effective to apply.

## *The changes proposed*

New standards and significant changes to IFRS which are not currently reflected in FRS 102 and which form part of the triennial review are:

1. IFRS 3 *Business Combinations* (revised 2008);
2. IFRS 9 *Financial Instruments*;
3. IFRS 10 *Consolidated Financial Statements*;
4. IFRS 11 *Joint Arrangements*;
5. IFRS 12 *Disclosure of Interests in Other Entities*;
6. IFRS 13 *Fair Value Measurement*;
7. IFRS 15 *Revenue from Contracts with Customers*; and
8. IFRS 16 *Leases*.

The FRC are not proposing to make changes to FRS 102 in respect of IFRS 3 or IFRS 12.

The FRC's Consultation Document proposes two styles of change:

- limited amendments; and
- significant amendments.

### Limited amendments

The limited amendments proposed in the Consultation Document are expected to be issued in a Phase 1 FRED, *Triennial Review 2017 Phase 1 – Incremental improvements and clarifications*. This FRED is expected to be issued towards the end of the first quarter of 2017 and would:

(a) incorporate relevant improvements from the *2015 Amendments to the IFRS for SMEs*;

(b) incorporate the control model of IFRS 10 *Consolidated Financial Statements*;

(c) update definitions and the fair value hierarchy to achieve greater consistency with IFRS 13 *Fair Value Measurement*; and

(d) improve the separation of contracts for the purposes of recognising and measuring revenue so that it is similar to the requirements of IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 brings about significant change to revenue recognition and the FRC have confirmed that they will consider incorporating more extensive amendments to FRS 102 to reflect the model of revenue recognition in IFRS 15 as part of the next triennial review.

**Control model in IFRS 10**

In respect of (b), the FRC propose to make limited amendments to the definition of 'control' as well as providing guidance on its application. This will be in addition to any specific circumstances in which company law requires the preparation of group accounts.

The changes in (b) are not expected to have any practical effect on the accounting for many subsidiaries or joint arrangements. The IASB changed their definition of control to address concerns about the boundary of the reporting entity.

Consistency with the control model of IFRS 10 (and consequently joint control in IFRS 11) would represent an improvement in financial reporting and the FRC expects that many entities will be able to cost-effectively determine that any changes in FRS 102 will not have an impact on their accounting (as they will meet the company law criteria for preparing consolidated financial statements), which will, in turn, limit the costs of implementation.

**Fair value measurement**

FRS 102 was amended in March 2016 to require financial institutions to provide information in accordance with a hierarchy that was based on IFRS 13 (Level 1, Level 2 and Level 3). At that time, the FRC indicated that paragraph 11.27 would be reviewed in the future for greater consistency with the requirements of IFRS 13 and the triennial review provides this opportunity. In addition, the FRC will consider the consistency of key definitions. The FRC are not, however, proposing to incorporate any further disclosure requirements of IFRS 13 into FRS 102.

**Revenue from contracts with customers**

IFRS 15 becomes effective for accounting periods starting on or after 1 January 2018 and provides a five-step process for recognising and measuring revenue (it should be noted that at the time of writing this material, IFRS 15 had not yet been endorsed in the EU). The more significant amendments that would be required to FRS 102 to incorporate the provisions of IFRS 15 are planned for the longer term (i.e. it will be reviewed in the next triennial review in 2019). However, the FRC recognise that some entities which apply FRS 102 may be members of a group which applies IFRS in the consolidated financial statements. Promoting efficiency within groups is achieved by minimising consolidation adjustments and hence the FRC are considering whether the requirements of FRS 102 could be strengthened to make it more likely that a single accounting policy for revenue could meet the requirements of IFRS 15 and FRS 102.

As a consequence, the FRC are proposing to include additional guidance in FRS 102 as to how revenue can be allocated to the component parts of a single transaction so as to reflect the substance of the transaction. The guidance is likely to highlight the need to consider all goods and services that have been transferred and recommend the use of relative stand-alone values as a basis for allocation.

**Effective date of the limited amendments**

The limited amendments above are expected to be effective for accounting periods beginning on or after 1 January 2019.

## Significant amendments

There are two significant amendments to FRS 102 proposed in the Consultation Document:

(a) incorporation of the 'expected loss model' for impairment of financial assets which is based on the requirements of IFRS 9 *Financial Instruments*; and

(b) updating of lease accounting by lessees for consistency with IFRS 16 *Leases*.

These two proposals are significant in nature and therefore the FRC (subject to the responses to the Consultation Document) will set out amendments to FRS 102 for the effects of these significant amendments in a Phase 2 FRED, *Triennial review 2017 Phase 2 – Expected loss model and leases*. The FRC expect to issue this FRED towards the end of the third quarter of 2017.

**Expected loss model for financial assets**

IFRS 9 is being completed in phases and the most recent change to IFRS 9 was finalising the requirements for the impairment of financial assets.

IFRS 9 moved from an 'incurred' loss model to an 'expected' loss model as a result of the financial crisis and it is this part of IFRS 9 which the FRC are considering including in FRS 102.

IFRS 9 includes a simplified approach for impairment of trade debtors and hence the impact of amending FRS 102 is expected to be less significant for those entities which are not financial institutions. Financial institutions are expected to be impacted the most as a result of IFRS 9 and some financial institutions are under the scope of FRS 102.

Whilst the proposals for amendments in this respect are yet to be developed, there are a number of approaches which the FRC have available, including:

(a) incorporating similar, detailed, requirements to those found in IFRS 9 – this approach would be similar to the way in which the hedge accounting requirements of IFRS 9 were reflected in FRS 102;

(b) requiring financial institutions (as defined in FRS 102), or a sub-set of financial institutions (such as banks and building societies), to apply the impairment requirements of IFRS 9, whilst replacing the existing impairment requirements of FRS 102 for all other entities with new requirements based on the simplified approach in IFRS 9; or

(c) requiring financial institutions (as defined in FRS 102), or a sub-set of financial institutions (such as bank and building societies), to apply the impairment requirements of IFRS 9 and not making any other amendments to FRS 102 unless there was evidence that the current impairment requirements of FRS 102 were not operating effectively.

The FRC prefer option (b) as this would mean that all financial institutions (or a sub-set of institutions) are calculating impairment losses for financial assets on a consistent basis. It will also mean that for entities which are not financial institutions, the approach is derived from the same principles, but is proportionate and practical.

The FRC proposes to delay the effective date for the expected loss model until 1 January 2022 to allow entities affected by the proposals to prepare for implementation. As a result, this significant amendment will be included in the Phase 2 FRED.

**Leases**

IFRS 16 was issued in 2016 and significantly overhauls the way in which lessees account for leasing transactions. The standard has a single model for lessee accounting and requires more leases to be recognised on the balance sheet (as an asset and a liability) than was the case previous under IAS 17 *Leases*. At the time of writing this material, IFRS 16 had not been endorsed within the EU.

The FRC are proposing to incorporate the requirements of IFRS 16 into FRS 102 which is likely to result in the vast majority of operating leases appearing on lessees' balance sheets than previously. However, in respect of short-life leases (i.e. lives of 12 months or less) and low value leases, the FRC are proposing to incorporate a practical expedient which is expected to mean that such leases will continue to be recognised as operating leases. However, the FRC are planning to give particular consideration as to how the low value expedient will operate for FRS 102.

The FRC recognise that entities will need sufficient time to prepare for implementation and assess the impact on current, and proposed, leases and similar contracts (especially where other financial arrangements will require amendment, such as loan covenants). Therefore, the FRC is proposing to delay the effective date for leases until 1 January 2022 and will include this significant amendment in the Phase 2 FRED.

However, the FRC will consider as to whether the lease disclosure of FRS 102 can be enhanced in order to improve the information available to users.

Where any changes are considered necessary, they will be considered as minor changes and will be included in the Phase 1 FRED for implementation for accounting periods starting on or after 1 January 2019.

## *Other changes to FRS 102*

Other changes which the FRC have identified, following stakeholder feedback, relate to:

- financial instruments;
- share-based payment transactions;
- government grants; and
- disclosure requirements.

### Financial instruments

Some stakeholders have commented that the definition of a 'financial institutions' and the classification of financial instruments may need to be reviewed (in addition to any amendments in respect of IFRS 9). The FRC will consider these issues, among others and may also reconsider the layouts of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* for improvement.

### Share-based payment transactions

While the FRC have not received significant feedback suggesting that Section 26 *Share-based Payment* in FRS 102 is in need of substantial revision, some commentators have suggested that there are difficulties in obtaining reliable fair value measurements for share-based payment transactions which take place in private companies, where share prices may not be easily obtainable.

The principles found in Section 26 have been operating in a broad sense since 1 January 2006 and the FRC consider the converged solution to be well-embedded and one which results in the recognition of an expense when goods or services are received in a share-based transaction. The FRC would like to understand any views about its practical implementation and cost-effectiveness, and whether any alternative could provide useful information to users.

### Government grants

The use of both the accrual model and performance model for grant recognition is resulting in inconsistency in practice. In addition, there is also potentially an inconsistency in accounting for grants depending on the source of the grant. This is because grants which are not from government sources are accounted for under Section 34 *Specialised Activities*, which requires the application of the performance model (i.e. grants are recognised immediately in profit and loss once the performance-related conditions are met).

The FRC have acknowledge that this situation is not ideal and the FRC would like to improve the consistency of accounting in this area. However, the FRC are of the opinion that the time is not yet right for significant change in this area and, instead, the FRC will participate in international efforts to move this debate forward. The issue of government grants is not on the IASB's active or research agendas; but this is not to say that that the FRC will not add the issue to its own research agenda in due course.

### Disclosure requirements

The FRC received some feedback about aligning the disclosure requirements for larger entities with company law requirements at the time that FRS 102 was amended to incorporate the provisions of Section 1A *Small Entities*.

The FRC are using the triennial review as an opportunity to review the disclosure requirements of FRS 102 with a view to seeking greater alignment with the requirements of company law, where possible, and to consider whether, in light of experience, any disclosure requirements should be amended.

## *Amendments to IFRS for SMEs*

As noted above, FRS 102 reflects the provisions in *IFRS for SMEs* and part of the triennial review is to incorporate relevant improvements from the *2015 Amendments to the IFRS for SMEs*. The 2015 amendments to *IFRS for SMEs* introduced undue cost or effort exemptions in several areas of the standard. Section 2 *Concepts and Pervasive Principles* in *IFRS for SMEs* now contains clarifying guidance on the application of the undue cost or effort exemption as well as a new requirement to disclose the entity's reasoning for using such an exemption.

The undue cost or effort exemption should always be applied carefully and will ultimately depend on entity-specific circumstances as well as management's judgement of the costs and benefits from applying a requirement. Specifically, *IFRS for SMEs* requires consideration of how the economic decisions of those which are expected to use the financial statements might be affected by not having that information.

*IFRS for SMEs* then goes on to clarify that undue cost or effort would arise if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information. In addition, the standard says that assessing whether a requirement would involve undue cost or effort on initial recognition within the financial statements, for example at the date of the transaction, should be based on information about the costs and benefits of the requirement at the time of initial recognition.

*IFRS for SMEs* also requires a reporting entity to make disclosure where the application of a specific requirement would give rise to undue cost or effort.

It may be the case that the FRC introduce some of the additional undue cost or effort concessions within FRS 102, such as in respect of the requirement to recognise intangible assets separately in a business combination and obtaining fair values of reliably measurable shares. Practitioners are encouraged to make comments to the FRC on such issues if they feel particularly strongly about them as such comments may be developed into proposals for change during the triennial review.

## *Feedback to FRC*

The Consultation Document is available from the FRC's website (https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/September/FRC-consults-on-approach-to-updating-FRS-102-for-c.aspx) and is available for comment. Please note that the Consultation Document is only that at this stage, it is not yet an Exposure Draft and any proposals contained in the Consultation Document may be subject to change in light of the comments received.

Comments should be despatched to FRC no later than 31 December 2016 and sent by email to ukfrs@frs.org.uk.

## LLP SORP (LECTURE A567 – 7.15 MNUTES)

In August 2016, the Consultative Committee of Accountancy Bodies (CCAB) issued *Draft Statement of Recommended Practice – Accounting by Limited Liability Partnerships* which was open for comment until 1 November 2016. The proposals by CCAB make amendments to the latest edition of the SORP which was last issued on 15 July 2014.

SI 2016/575 *The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016* was issued earlier in 2016. These Regulations amend legislation which relate to the accounting and audit regulatory framework for limited liability partnerships (LLPs) and also introduce an exemption from certain financial reporting requirements for very small (micro) LLPs and very small (micro) partnerships, including limited partnerships, which are 'qualifying partnerships' under *The Partnerships (Accounts) Regulations* (SI 2008/569).

Accountants will be familiar with the changes that took place to the Companies Act 2006 by virtue of SI 2015/980. The implementation of SI 2015/980 now means that the Companies Act 2006 reflects the provisions of the EU Accounting Directive and applies for accounting periods starting on or after 1 January 2016; although early-adoption is permissible. LLPs are not subject to the EU Accounting Directive, but are, however, subject to a very similar accounting regime to that of companies, including the requirement to file accounts at Companies House. SI 2016/575 introduces similar changes to the financial reporting framework for LLPs as SI 2015/980 does for small companies. However, it does not fundamentally change the financial reporting regime itself; although it does allow small and micro LLPs to benefit from a less burdensome financial reporting regime.

The Regulations also align the LLP thresholds to the company thresholds which determine whether an LLP is micro, small, medium-sized or large; hence a small LLP will have turnover of not more than £10.2m (up from £6.5m), a balance sheet total of not more than £5.1m (up from £3.26m) and not more than an average of 50 employees (headcount remains unchanged) and at least two out of the three have to be met.

### *Review of the LLP SORP*

The CCAB are proposing to amend the SORP in light of new and revised accounting standards since the last edition was published in July 2014. The latest review considers:

- the changes made to FRS 102 in July 2014 which relaxed the conditions for determining whether a financial instrument is 'basic' (hence accounted for under Section 11 *Basic Financial Instruments*) or 'other' (hence accounted for under Section 12 *Other Financial Instruments Issues*);
- the amendments made to FRS 102 in February 2015 which clarifies aspects in respect of defined benefit pension plan accounting;
- amendments to UK accounting standards that were published in July 2015 including:
  - the withdrawal of the FRSSE;
  - the inclusion of Section 1A *Small Entities* in FRS 102; and
  - the publication of FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*; and
- amendments made to FRS 102 in March 2016 which updated the fair value hierarchy disclosures.

## *Micro LLPs*

FRS 105 was issued in July 2015 and can be applied by an incorporated entity which meets two out of the following three criteria:

1. Turnover not more than £632,000
2. Balance sheet total not more than £316,000
3. Not more than ten employees

Prior to the implementation of SI 2016/575, LLPs were not eligible to apply FRS 105. However, SI 2016/575 introduces a micro-entities regime for LLPs which meet two out of the above three criteria in respect of turnover, balance sheet total and employee headcount. This means that FRS 105 becomes available to qualifying LLPs which choose to apply the micro-entities regime when preparing the accounts. In recognition of this, the Financial Reporting Council issued amendments to FRS 105 on 17 May 2016 and the amendments apply to accounting periods starting on or after 1 January 2016, with earlier-adoption permissible. The amendments to FRS 105 in respect of LLPs were covered in the Quarter 3 Accounting and Audit Quarterly Update.

In terms of how FRS 105 interacts with the SORP, there are significant differences between FRS 105 and FRS 102 and the SORP is based on the provisions in FRS 102. In light of these differences, the CCAB have concluded that LLPs which choose to apply FRS 105 should be scoped out of the requirements of the SORP and simply follow the requirements of FRS 105.

## *Small LLPs*

The CCAB propose that small LLPs which qualify for, and choose to apply, the small entities' regime in the preparation of their financial statements, must comply with the recognition and measurement requirements of FRS 102 and the SORP. In addition, the CCAB proposes that small LLPs are only required to comply with the disclosure requirements of Section 1A *Small Entities* of FRS 102 as opposed to the disclosure requirements of the SORP (paragraph 27A Draft SORP).

Notwithstanding the reduced disclosure requirements reflected in Section 1A, the accounts of a small LLP must give a true and fair view (as is the case for a small company). This will mean that more judgement is needed when considering whether additional disclosures, over and above those required by Section 1A, are necessary to achieve a true and fair view. This may mean that in some circumstances, some, or all, of the disclosures included in the revised SORP may be needed in order that the small LLP's financial statements give a true and fair view.

LLPs' currently prepare a reconciliation of the movement in members' other interests (which is contained in paragraph 59 of the draft SORP). Under the draft SORP, this reconciliation may need to be presented in some instances by a small LLP so that the accounts give a true and fair view. However, the CCAB does not believe that it is necessary to require all small LLPs to include such a reconciliation. This is consistent with the requirements not to mandate small companies to produce a statement of changes in equity. However, the draft SORP does encourage a small LLP to include such a reconciliation.

## *Loans and other debts*

Paragraphs 63 and 64 of the SORP require an LLP to make disclosure about how loans and other debts due to members rank in relation to other unsecured creditors.

Some respondents to previous consultations about the SORP said that these disclosures were onerous and overly burdensome in comparison to financial reporting by other types of entities, such as companies.

Companies are subject to capital maintenance provisions which LLPs are not subjected to. In light of this, the CCAB are of the opinion that such disclosures are necessary to ensure a true and fair view is given regardless of the size of the LLP. As a consequence, they have been retained in the draft SORP and will also be mandatory for small LLPs which qualify for, and choose to apply, the small entities' regime even though they are additional disclosures which are beyond the requirements of Section 1A of FRS 102.

## *Statement of changes in equity*

Previous editions of the SORP have not explicitly stated that there is no requirement to prepare a statement of changes in equity if the LLP does not have any equity. The draft SORP includes an additional paragraph 59A which confirms that a statement of changes in equity does not need to be prepared if the LLP has no equity. The exception to this would be where the LLP provides the reconciliation of members' interests as a primary statement in accordance with paragraph 60A. Where the LLP does not include a statement of changes in equity, a statement should be made either on the face of one of the other primary statements, or within the notes to the accounts, that the LLP has no equity and consequently a statement of changes in equity is not given.

## *Effective date*

Comments on the draft SORP closed on 1 November 2016. The revised SORP is scheduled to be effective for accounting periods which start on or after 1 January 2016, although early-adoption is permissible for accounting periods starting on or after 1 January 2015 but before 1 January 2016, if the partners so wish. Where early-adoption is chosen, the LLP must apply the provisions in *The Limited Liability Partnerships (Accounts and Audit) Regulations 2016* (SI 2016/575) from the same date.

# PRACTICAL CONSIDERATIONS: PROPERTY, PLANT AND EQUIPMENT (LECTURE A568 – 23.28 MINUTES)

Property, plant and equipment is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 17 *Property, Plant and Equipment*. In most cases, the requirements of FRS 15 *Tangible fixed assets* and the FRSSE are similar. FRS 102 permits an entity to measure fixed assets under Section 17 using either the historic cost model or the revaluation model (by application of the alternative accounting rules) depending, of course, on their accounting policy choices.

Preparers of financial statements under FRS 102 (including small entities) will need to understand the subtle differences between FRS 102 and FRS 15/the FRSSE in order to correctly account for tangible fixed assets and investment property which is not accounted for under Section 16 *Investment Property*. A summary of the subtle differences is shown in the table below:

| FRS 102 | Previous UK GAAP |
|---|---|
| Deals with payments that are deferred beyond normal credit terms. | Did not deal with deferred payment as in practice such arrangements were expected to be relatively rare. |
| Where the revaluation model is adopted, revaluations must be obtained with **sufficient regularity** so the carrying amount is not materially different than fair value. | Revaluations had to be obtained at least every five years, with valuations in the intervening years where there had been a material change in market value. |
| Residual values used to calculate depreciable amount are based on **current** prices. Therefore, depreciation charges can fluctuate. | Residual values were based on historic prices. |
| Deferred tax is recognised on timing differences. | Deferred tax was not recognised unless there was a binding agreement to sell the asset at the balance sheet date. |

## *Previous GAAP valuation as deemed cost*

Paragraph 35.10(d) of FRS 102 (September 2015) says that a first-time adopter of FRS 102 may elect to use a previous GAAP revaluation of an:

(i) item of property, plant and equipment;

(ii) investment property; or

(iii) intangible asset which meets the recognition criteria and the criteria for revaluation in Section 18

at, or before, the date of transition to this FRS as its deemed cost at the revaluation date.

This transitional exemption may be useful for clients that have previously had to obtain revaluations under previous UK GAAP, but who wish to go back to measuring the item at historic cost. However, care does need to be taken to ensure that the previous GAAP revaluation is as at, or prior to, the date of transition. GAAP revaluations after the date of transition cannot be used as deemed cost at the date of transition.

**Example – Previous GAAP valuation as deemed cost**

A company is preparing its first FRS 102 financial statements for the year-ended 31 December 2016. Under previous UK GAAP, the company carried its freehold properties under the revaluation model and always paid a firm of Chartered Surveyors to carry out the revaluations. The directors do not want to continue paying for professional valuations, and the bank have confirmed they do not mind. Rather than revert back to historic cost, the finance director wishes to use the previous GAAP valuation which was obtained at 31 December 2013. When the company acquired the property, the useful economic life was assessed at 50 years and at 31 December 2013 there were 33 years remaining.

To comply with paragraph 17.8 (which says that land and buildings are separable assets and are to be accounted for separately regardless of the fact that the entity may acquire them together), the split of land and buildings is as follows:

| | Valuation at 31.12.13 | Historic cost at 31.12.13 |
|---|---|---|
| | £ | £ |
| Land: cost/valuation | 250,000 | 80,000 |
| Accumulated depreciation | - | - |
| | | |
| Buildings: cost/valuation | 100,000 | 40,000 |
| Accumulated depreciation | - | (13,600) |
| | 350,000 | 106,400 |

The rate of tax for the purposes of deferred tax is assumed to be 20% and the tax base of the property (which also includes adjustment for indexation) is as follows:

| | £ |
|---|---|
| At 31 December 2013 | 249,000 |
| At 31 December 2014 | 257,000 |
| At 31 December 2015 | 262,000 |
| At 31 December 2016 | 270,000 |

Immediately prior to the transition, the position in the accounts is as follows:

| | 31.12.2014 | 31.12.2015 |
|---|---|---|
| | £ | £ |
| Net book value b/fwd | 350,000 | 346,970 |
| Depreciation charge for the year | (3,030) | (3,030) |
| Net book value c/fwd | 346,970 | 343,940 |

As the directors are looking to use the previous GAAP revaluation as deemed cost, the position above will remain unchanged. In addition, the entity will have made a transfer of £2,230 in respect of the excess depreciation due to the revaluation (£3,030 at revaluation *less* £800 at historic cost).

Under previous UK GAAP, the entity did not need to account for deferred tax on the revaluation gain. However, FRS 102 requires the entity to bring deferred tax into account because the calculation of deferred tax is undertaken on a timing difference **plus** approach, rather than the timing difference approach, meaning that timing differences are defined more widely under FRS 102 than was the case under previous UK GAAP.

After transition to FRS 102, the freehold property will be reflected in the financial statements as follows:

| | 31.12.2014 | 31.12.2015 | 31.12.2016 |
|---|---|---|---|
| | £ | £ | £ |
| Net book value b/f | 350,000 | 346,970 | 343,940 |
| Depreciation | (3,030) | (3,030) | (3,030) |
| Net book value c/f | 346,970 | 343,940 | 340,910 |

The revaluation is treated as deemed cost at the date of the valuation and is then depreciated from that point. This will not give rise to any adjustment on transition or prior year adjustment.

| Deferred tax: | 31.12.2014 | 31.12.2015 | 31.12.2016 |
|---|---|---|---|
| | £ | £ | £ |
| NBV | 346,970 | 343,940 | 340,910 |
| Tax base | 257,000 | 262,000 | 270,000 |
| Tax rate | 20% | 20% | 20% |
| Deferred tax | (17,994) | (16,388) | (14,182) |

Deferred tax is now recognised on the excess of the revaluation over the tax base (tax written down value) of the asset. This is adjusted for the effects of indexation where relevant.

**Adjustments to opening equity at 1 January 2015**

| | £ |
|---|---|
| Dr Revaluation reserve | 17,994 |
| Cr Deferred tax provision | (17,994) |

*Being deferred tax on revalued asset*

Companies Act 2006 (SI 2008/410 (Sch 1.43(1)) requires the amount of profit or loss which arises from determination of the value of a fixed asset which is subject to revaluation to be taken to the revaluation reserve (i.e. a separate reserve). Sch 1.43(3) allows a transfer to or from the revaluation reserve in respect of the taxation relating to any profit or loss that has been credited to the reserve. This transfer is also made in the comparative and 2016 year.

**Adjustments to the comparative year (31 December 2015)**

| | £ |
|---|---|
| Dr Deferred tax liability | 1,606 |
| Cr Tax charge (deferred tax) | (1,606) |
| Dr P&L reserve (non-distributable) | 1,606 |
| Cr Revaluation reserve | (1,606) |

*Being deferred tax movement and transfer to revaluation reserve*

| | £ |
|---|---|
| Dr Revaluation reserve | 2,230 |
| Cr P&L reserve | (2,230) |

*Being CA06 excess depreciation transfer*

**Postings in the 31 December 2016 accounts**

| | £ |
|---|---|
| Dr Depreciation charge (P&L) | 3,030 |
| Cr Buildings depreciation | (3,030) |
| *Being 2016 depreciation charge* | |
| | |
| Dr Deferred tax provision | 2,206 |
| Cr Tax charge (deferred tax) | (2,206) |
| *Being deferred tax movement in the year* | |
| | |
| Dr P&L reserve | 2,206 |
| Cr Revaluation reserve | (2,206) |
| *Being CA06 deferred tax transfer* | |
| | |
| Dr Revaluation reserve | 2,230 |
| Cr P&L reserve | (2,230) |
| *Being CA06 excess depreciation transfer* | |

## *Fair value as deemed cost*

Paragraph 35.10(c) allows a first-time adopter to use fair value as deemed cost in respect of:

(i) an item of property, plant and equipment;

(ii) an investment property; or

(iii) an intangible asset which meets the recognition criteria and the criteria for revaluation in Section 18 *Intangible Assets other than Goodwill*.

The fair value used will be the asset's fair value at the date of transition to FRS 102 which will then become its deemed cost on that date if the transitional exemption is taken up.

**Example – Fair value as deemed cost**

A company which is classed as small is preparing its first FRS 102 financial statements for the year-ended 31 March 2017.

At the end of March 2015, the directors commissioned a valuation of its plant and machinery which it was considering selling to an overseas entity. The sale never occurred, but the directors have retained the valuation.

The finance director has been reviewing the content of the valuation and she has decided that it would be beneficial if the company were to use this fair value as deemed cost on transition.

The company is therefore going to use the transitional exemption in paragraph 35.10(c) at its date of transition which is 1 April 2015.

The machinery was originally purchased in April 2010 at a cost of £3.6m and the depreciation policy of the company is to depreciate the equipment for 10 years from this date.

The finance director has extracted the following information from the records of the company:

Per financial statements (pre transition to FRS 102)

| | 31.03.2015 | 31.03.2016 |
|---|---|---|
| | £ | £ |
| NBV b/f | 2,160,000 | 1,800,000 |
| Depreciation charge | (360,000) | (360,000) |
| NBV c/f | 1,800,000 | 1,440,000 |

Per capital allowances computation
(capital allowances assumed to be 20% per annum)

| | 31.03.2015 | 31.03.2016 |
|---|---|---|
| | £ | £ |
| TWDV b/f | 1,474,560 | 1,179,648 |
| Capital allowances | (294,912) | (235,930) |
| TWDV c/f | 1,179,648 | 943,718 |

The valuation obtained in 2015 confirmed the value of the machinery was £1,900,000 with the remaining useful economic life remaining at five years. The company pays tax at a rate of 20% and this is the rate which is used for the calculation of deferred tax.

Prior to the transition to FRS 102, the position in the accounts and tax computation is as follows:

| | 31.03.2015 | 31.03.2016 |
|---|---|---|
| | £ | £ |
| Net book value | 1,800,000 | 1,440,000 |
| Capital allowances c/f | (1,179,648) | (943,718) |
| Timing differences | 620,352 | 496,282 |
| Tax rate | 20% | 20% |
| Deferred tax liability | 124,070 | 99,256 |

The directors wish to use the transitional exemption in paragraph 35.10(c) of FRS 102 and use fair value as deemed cost. This will result in the following position in the accounts post transition to FRS 102:

Per financial statements (post transition)

| | 2015 | 2016 | 2017 |
|---|---|---|---|
| | £ | £ | £ |
| NBV b/f | 1,800,000 | 1,900,000 | 1,520,000 |
| Depreciation | | (380,000) | (380,000) |
| Revaluation | 100,000 | - | - |
| NBV c/f | 1,900,000 | 1,520,000 | 1,140,000 |

Per capital allowances computation

| | 2015 | 2016 | 2017 |
|---|---|---|---|
| | £ | £ | £ |
| TWDV b/f | 1,474,560 | 1,179,648 | 943,718 |
| Capital allowances | (294,912) | (235,930) | (188,744) |
| TWDV c/f | 1,179,648 | 943,718 | 754,974 |

Deferred tax computation

| | 2015 | 2016 | 2017 |
|---|---|---|---|
| | £ | £ | £ |
| Cumulative timing differences | 720,352 | 576,282 | 385,026 |
| Tax rate | 20% | 20% | 20% |
| Deferred tax liability | 144,070 | 115,256 | 77,005 |

Deferred tax movement: 15/16 = £28,814 16/17 = £38,251

**Historic cost disclosures in 31 March 2017 financial statements:**

| | 2016 | 2017 |
|---|---|---|
| | £ | £ |
| Cost of plant and machinery | 3,600,000 | 3,600,000 |
| Accumulated depreciation | (2,160,000) | (2,520,000) |
| Net book value | 1,440,000 | 1,080,000 |

| | | £ |
|---|---|---|
| Deferred tax under the historic cost model would have been: | 2016 | 99,256 |
| | 2017 | 65,005 |
| | Movement | 34,251 |

**Adjustments at the date of transition (1 April 2015)**

| | £ |
|---|---|
| Dr Accumulated depreciation – PPE | 1,800,000 (5 years dep'n at transition date) |
| Cr PPE – cost | (1,700,000) |
| Cr Revaluation reserve | (100,000) |

*Being restatement of plant and machinery valuation*

| | |
|---|---|
| Dr Revaluation reserve | 20,000 |
| Cr Deferred tax provision | (20,000) |

*Being increase to previously stated deferred tax provision (£124,070 less £144,070)*

**Adjustments to the comparative year (31 March 2016)**

| | £ | |
|---|---|---|
| Dr Depreciation charge (P&L) | 20,000 | |
| Cr Accumulated depreciation – PPE | (20,000) | (a) |

*Increase to previous depreciation charge (£360,000 less £380,000)*

| | | |
|---|---|---|
| Dr Deferred tax provision | 4,000 | |
| Cr Tax charge (deferred tax) | (4,000) | (b) |

*Amendment to deferred tax in 2015 (new movement less movement recognised in 2015 (£28,814 less £24,814 or £20,000 x 20%))*

| | |
|---|---|
| Dr Revaluation reserve | 16,000 |
| Cr P&L reserve | (16,000) |

*Being CA06 reserves transfer [(a) – (b)]*

**Postings in the 31 March 2017 accounts**

| | £ |
|---|---|
| Dr Depreciation charge (P&L) | 380,000 |
| Cr Accumulated depreciation – PPE | (380,000) |

*Depreciation charge for the year-ended 31 March 2017*

| | £ |
|---|---|
| Dr Deferred tax provision | 38,251 |
| Cr Tax charge (DT - P&L for year – distributable) | (34,251) |
| Cr Tax charge (DT – P&L for year – not distributable) | (4,000) |

*Being deferred tax movement in 2017*

| | £ |
|---|---|
| Dr Revaluation reserve | 16,000 |
| Cr P&L reserve | (16,000) |

*Being CA06 reserves transfer (£20,000 excess depreciation less £4,000 additional deferred tax)*

The position in the accounts under FRS 102 as at 31 March 2017 if the company had adopted the transitional exemption or had not adopted it can be reconciled as follows:

| | **Para 35.10(c) Exemption not adopted** | **Para 35.10(c) Exemption adopted** | **Difference** |
|---|---|---|---|
| | £ | £ | £ |
| Net book value of the assets | 1,080,000 | 1,140,000 | 60,000 |
| Deferred tax liability | (65,005) | (77,005) | (5,000) |
| Increase in net assets in 2017 | | | 55,000 |
| Annual depreciation charge | (360,000) | (380,000) | (20,000) |
| Deferred tax movement in 2017 | 34,251 | 38,251 | 4,000 |
| Net profit or (loss) effect in 2017 | | | (16,000) |

The impact on distributable reserves is £nil which is represented by the transfer from the revaluation reserve to the profit and loss reserve.

## *Revaluation reserve for property, plant and equipment versus investment property*

It is important to keep in mind that the revaluation reserve is still in existence for assets carried under the revaluation model in Section 17 *Property, Plant and Equipment*. Some confusion surrounds the treatment of revaluation gains and losses because of the different accounting treatment in respect of investment property carried at fair value. The concept of the revaluation reserve does not exist where an investment property is carried at fair value through profit or loss at each balance sheet date under the provisions in Section 16 *Investment Property*. This is because investment property at fair value under FRS 102 is accounted for under the fair value accounting rules and not the alternative accounting rules.

## PRACTICAL CONSIDERATIONS: GOODWILL (LECTURE A569 – 9.30 MINUTES)

Goodwill is dealt with in FRS 102 in Section 19 *Business Combinations and Goodwill*. At the outset it is worth noting that internally generated goodwill is still prohibited from being recognised on the balance sheet, and therefore only purchased goodwill may qualify for recognition.

Paragraph 19.22 says:

*'The acquirer shall, at the acquisition date:*

*(a) recognise goodwill acquired in a business combination as an asset; and*

*(b) initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with paragraphs 19.15, 19.5A to 19.15C.'*

The approach to the recognition of goodwill under FRS 102 versus previous UK GAAP is similar. However, the definition of an 'intangible asset' is wider under FRS 102 and hence it is likely that more intangible assets are separately recognised under FRS 102 rather than subsumed within goodwill.

### *Amortisation*

FRS 102 does not allow goodwill (or any intangible assets) to have an indefinite useful life.

As a consequence, where entities have previously not amortised goodwill in the past due to indefinite useful lives, but instead tested goodwill for impairment at each balance sheet date (as permitted in FRS 10 *Goodwill and intangible assets* using the true and fair override), accounting practices will have to change on adoption of FRS 102. This will mean that entities that previously did not amortise goodwill will need to determine its remaining useful life and then amortise it over that period.

In terms of goodwill amortisation, paragraph 19.23 directs preparers to paragraphs 18.19 to 18.24. In situations where management are unable to reliably estimate the useful economic life of goodwill, paragraphs 19.23(a) caps the useful economic at ten years.

### *Groups*

Groups which are medium-sized under the Companies Act 2006 are still required to prepare consolidated financial statements. Small groups may take up the exemption in the Companies Act 2006 from preparing group accounts and this is still the case under the revised Companies Act 2006 (although some small groups do voluntarily prepare consolidated financial statements).

When a parent acquires a subsidiary, FRS 102 refers to this as a 'business combination' which is defined in the glossary to FRS 102 as:

*'The bringing together of separate entities or **businesses** into one reporting entity.'*

On first-time adoption of FRS 102, a reporting entity can elect not to apply Section 19 *Business Combinations and Goodwill* to business combinations which were effected prior to the date of transition to FRS 102.

However, where a first-time adopter restates any business combination so as to comply with Section 19, all later business combinations must be restated.

When a first-time adopter chooses not to apply Section 19 retrospectively, it must recognise and measure all the assets and liabilities which it has acquired in a past business combination at the date of transition to FRS 102, but it must not separately recognise intangible assets that are already subsumed within goodwill. Therefore, no adjustment is made to the carrying value of goodwill.

This transitional exemption was incorporated within Section 35 *Transition to this FRS* so as to avoid the need of retrospectively identifying and measuring individual intangible assets that were acquired during a business combination, primarily because the information needed to restate the combination would not be easily available. However, deferred tax impacts cannot be ignored. Paragraph 29.11 of FRS 102 says that deferred tax is to be recognised when the amount attributable to an asset, other than goodwill, or liability for the purposes of tax differs from the amount at which it is recognised in the business combination. Therefore, even where a group chooses to take up the exemption from restating previous business combinations, it might still need to restate the deferred tax that arises on those business combinations.

**Example – Deferred tax in a business combination**

Parent Co Ltd acquired an 80% ownership interest in Subco Ltd two years ago. At the date of acquisition, Subco fair valued all its assets and liabilities. The fair value of the assets acquired exceed their associated tax written down values (tax base). The group has previously not accounted for deferred tax in previous business combinations under previous UK GAAP. The group's year-end is 31 July 2016 and this is the first year in which FRS 102 will be adopted. The financial controller has calculated the deferred tax in the acquisition to be £25,000.

The adjustment in respect of the deferred tax, together with any other adjustments on transition relating to the business combination, are made against retained earnings because the standard prohibits any adjustment to goodwill, hence:

Dr Retained earnings (P&L reserves) £25,000
Cr Deferred tax liability £25,000
*Being deferred tax on business combination on transition to FRS 102*

# PRACTICAL CONSIDERATIONS: BASIC FINANCIAL INSTRUMENTS (LECTURE A570 – 13.56 MINUTES)

Uncertainties surrounding financial instruments continue in FRS 102.

Some of the more common financial instruments which entities in the SME sector deal with include:

- trade debtors;
- trade creditors;
- bank loans; and
- overdrafts.

Many of these financial instruments will fall under the scope of Section 11 *Basic Financial Instruments*; however, notwithstanding the title of Section 11, the section itself can be very complex to apply.

The other section in FRS 102 which deals with financial instruments is that of Section 12 *Other Financial Instruments Issues*. Section 12 instruments are instruments which are not basic instruments under the scope of Section 11, and often include:

- loans which have unilateral terms;
- loans which risk the lender losing capital or interest;
- interest rates which are linked to commodity prices;
- leveraged rates; and
- negative margins.

## *Accounting for basic instruments (FRS 102 v previous UK GAAP)*

### Initial recognition

Initial recognition of a basic financial instrument under Section 11 is at transaction price, including transaction costs (transaction costs are not included if the instrument is measured at fair value through profit or loss). This is a similar treatment to previous UK GAAP.

### Subsequent measurement

In terms of subsequent measurement, Section 11 would normally require the instrument to be measured at amortised cost using the effective interest method (the similar method in previous UK GAAP was described as a 'constant rate on the carrying amount').

### Derecognition

A financial liability is derecognised (or partly derecognised) only when it is extinguished (i.e. when the contractual obligation is discharged, cancelled or expires). This is similar to previous UK GAAP.

A financial asset is only derecognised when:

a) the contractual rights to the cash flows from the financial asset expire or are settled; or

b) the entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset; or

c) the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. In this case, the entity shall:

   i. derecognise the asset; and

   ii. recognise separately any rights and obligations retained or created in the transfer.

**Example – Sales ledger sold to a factoring company: risk retained**

On 31 October 2016, Company A sold its sales ledger to a factoring company for £1.1 million.

The fair value of the trade debtors at the date of sale is £1.2 million.

The terms of the sale are that Company A transfers credit risk, but retains late payment risk. Any trade debtors which becomes overdue by more than 130 days are deemed to be in default and Company A will suffer any resulting loss.

The directors have concluded that both credit risk and late payment risk are significant risks.

While the company has transferred some risks to the factoring company, it has still retained some of the significant risks of ownership (it has retained late payment risk).

In this scenario, Company A does not derecognise the value of the sales ledger at the date of sale and treats the £1.1 million consideration as a financial liability (a loan).

**Example – Sales ledger sold to a factoring company: no risks retained**

On 31 October 2016, Company B sold its sales ledger to a factoring company for £1.1 million. The fair value of the trade debtors at this date is £1.2 million. The terms of the sale are that the entire risks and rewards of ownership are transferred to the factoring organisation and Company B is not responsible for any customers who pay late, or who are unable to pay.

In this example, Company B has transferred substantially all the risks and rewards associated with the sales ledger. Company B therefore derecognises the sales ledger from its balance sheet at the date of sale. The difference between the carrying amount of the debtors (£1.2 million) and the cash received (£1.1 million) is recognised immediately in profit or loss as a finance cost.

## *Financing transactions (FRS 102 versus previous UK GAAP)*

A financing transaction might arise when a company sells goods or services and defers payment beyond normal credit terms, or is financed a rate of interest which is below market rate.

### Initial measurement

Initial measurement of the financing transaction is at the present value of the future payments. These future payments are discounted using a market rate of interest for a similar debt instrument.

Under previous UK GAAP, the financing transaction would have been recognised at transaction price with any contractual interest being allocated on a constant rate. Any interest-free loans, under previous UK GAAP, would incur no interest.

**Example – Cash sale on deferred payment terms**

A company sells goods to one of its major customers on a two-year interest-free credit basis for £1,000. The cash sales price of the goods is £900 (VAT has been ignored for the purposes of this example). The market rate of interest is 5.4%.

The company initially recognises the sale at the undiscounted amount of cash receivable from the customer, which is invoice price (i.e. £900), thus the entries are:

Dr Trade debtors £900
Cr Revenue £900
*Being initial recognition of sale*

### Subsequent measurement

After initial recognition at present value, the financing transaction is accounted for using the effective interest method. This is a method of calculating the amortised cost of a financial instrument and allocating the interest income or expense over the relevant period. The amortised cost of a financial instrument is the present value of future cash flows which are then discounted at the effective interest rate.

**Example – Effective interest method**

Using the example above, the difference between the present value (£900) and the amount payable (£1,000) of £100 will be recognised in the financial statements using the effective interest method as follows:

| Year | Opening balance | Interest at 5.4% | Cash flow | Closing balance |
|---|---|---|---|---|
| 1 | 900 | 49 | - | 949 |
| 2 | 949 | 51 | (1,000) | - |

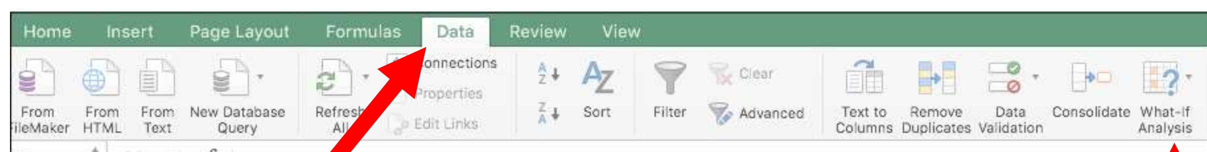
## *Calculating an effective interest rate*

Calculating an effective interest can be done using Microsoft Excel in two ways:

- the 'goal seek' function; and
- the internal rate of return function.

### Goal seek function

The goal seek function is found in the 'Data' tab and 'What-if Analysis':



**Example – Calculating the effective interest rate using goal seek**

A company borrows £1m on 1 January 2017 for a 10-year period with a coupon rate of 7%. The provider charges an arrangement fee of £12,500. Interest is payable at a rate of 7% and this is payable annually starting at the inception of the loan. The redemption amount is at par at the end of year 10. The company has chosen not to prepay any of the loan amounts.

The company reports under FRS 102.

The first step is to calculate the effective interest rate which will be used to charge the interest to the profit and loss account over the life of the loan. The loan can be profiled on an Excel spreadsheet as follows:

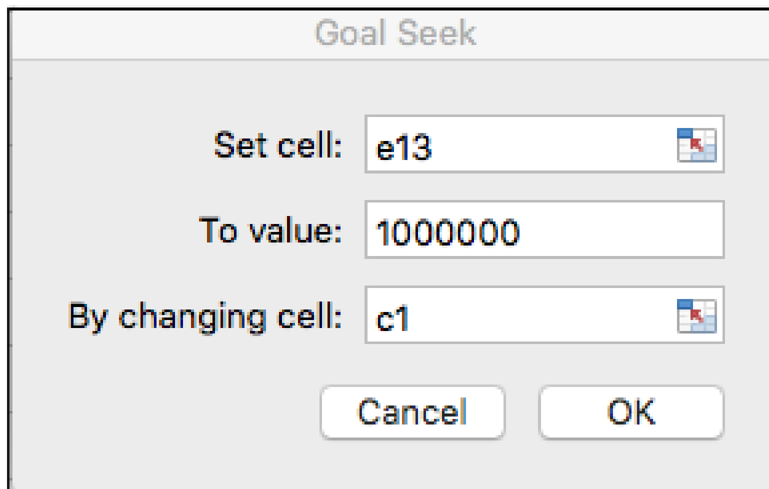
| | A | B | C | D | E |
|---|---|---|---|---|---|
| 1 | Effective interest rate | | | | |
| 2 | | | | | |
| 3 | Year | Amount B/fwd | Interest at EIR | Cash flow | Amount c/fwd |
| 4 | 1 | 987500 | =C1*B4 | -70000 | =B4+C4+D4 |
| 5 | 2 | =E4 | =C1*B5 | -70000 | =B5+C5+D5 |
| 6 | 3 | =E5 | =C1*B6 | -70000 | =B6+C6+D6 |
| 7 | 4 | =E6 | =C1*B7 | -70000 | =B7+C7+D7 |
| 8 | 5 | =E7 | =C1*B8 | -70000 | =B8+C8+D8 |
| 9 | 6 | =E8 | =C1*B9 | -70000 | =B9+C9+D9 |
| 10 | 7 | =E9 | =C1*B10 | -70000 | =B10+C10+D10 |
| 11 | 8 | =E10 | =C1*B11 | -70000 | =B11+C11+D11 |
| 12 | 9 | =E11 | =C1*B12 | -70000 | =B12+C12+D12 |
| 13 | 10 | =E12 | =C1*B13 | -70000 | =B13+C13+D13 |

The above spreadsheet shows the formulas behind the numbers, and is profiled as follows:

| | A | B | C | D | E |
|---|---|---|---|---|---|
| 1 | Effective interest rate | | | | |
| 2 | | | | | |
| 3 | Year | Amount B/fwd | Interest at EIR | Cash flow | Amount c/fwd |
| 4 | 1 | 987,500 | 0 | -70,000 | 917,500 |
| 5 | 2 | 917,500 | 0 | -70,000 | 847,500 |
| 6 | 3 | 847,500 | 0 | -70,000 | 777,500 |
| 7 | 4 | 777,500 | 0 | -70,000 | 707,500 |
| 8 | 5 | 707,500 | 0 | -70,000 | 637,500 |
| 9 | 6 | 637,500 | 0 | -70,000 | 567,500 |
| 10 | 7 | 567,500 | 0 | -70,000 | 497,500 |
| 11 | 8 | 497,500 | 0 | -70,000 | 427,500 |
| 12 | 9 | 427,500 | 0 | -70,000 | 357,500 |
| 13 | 10 | 357,500 | 0 | -70,000 | 287,500 |

The idea behind the goal seek function is to get cell E13 to agree to the redemption amount of £1m by allocating the interest in column C. We can use the goal seek function to do this via Data | What-if Analysis | Goal Seek.

This will bring up the following:




Once you click ‘OK’, Excel will calculate the interest automatically.

| A | B | C | D | E |
|---|---|---|---|---|
| Effective interest rate | | 7.179% | | |
| | | | | |
| Year | Amount B/fwd | Interest at EIR | Cash flow | Amount c/fwd |
| 1 | 987,500 | 70,897 | -70,000 | 988,397 |
| 2 | 988,397 | 70,961 | -70,000 | 989,359 |
| 3 | 989,359 | 71,031 | -70,000 | 990,389 |
| 4 | 990,389 | 71,104 | -70,000 | 991,494 |
| 5 | 991,494 | 71,184 | -70,000 | 992,677 |
| 6 | 992,677 | 71,269 | -70,000 | 993,946 |
| 7 | 993,946 | 71,360 | -70,000 | 995,306 |
| 8 | 995,306 | 71,458 | -70,000 | 996,764 |
| 9 | 996,764 | 71,562 | -70,000 | 998,326 |
| 10 | 998,326 | 71,674 | -70,000 | 1,000,000 |

The effective interest rate is 7.179% and the total interest over the life of the loan is £712,500 equivalent to 10 x £70,000 interest plus the £12,500 arrangement fee. At the end of year 10, the maturity amount is paid and the journals are:

| | |
|---|---|
| Dr Loan payable | £1m |
| Cr Cash at bank | £1m |
| *Redemption of loan* | |

### Internal rate of return

An alternative method of calculating the effective interest rate is to use the internal rate of return function (IRR) in Excel. For the IRR function to work, at least one number must be negative with the other cash flows being positive values.

**Example – Internal rate of return**

Using the facts in the above example, the effective interest rate is calculated as follows:

| | A | B |
|---|---|---|
| 1 | (987,500) | |
| 2 | 70000 | |
| 3 | 70000 | |
| 4 | 70000 | |
| 5 | 70000 | |
| 6 | 70000 | |
| 7 | 70000 | |
| 8 | 70000 | |
| 9 | 70000 | |
| 10 | 70000 | |
| 11 | 1070000 | |
| 12 | | |
| 13 | | 7.179% |

=IRR(A1:A11)

The entries in respect of the loan in year 1 are:

Dr Bank £987,500
Cr Loan payable £987,500
*Being initial recognition of bank loan (net of transaction costs)*

Dr Interest payable £70,897
Cr Loan payable £70,897
*Being year 1 interest*

Dr Loan payable £70,000
Cr Bank £70,000
*Coupon interest at 7%*

## *Loan from a shareholder*

Quite often a shareholder(s) may lend money to the business and either not charge a rate of interest or charge a rate of interest which is below market rate. Where a loan is made by a shareholder which is not at market rate, paragraph 11.13 of FRS 102 would classify this as a financing transaction. The loan would be initially recognised at the present value of the future payments which are discounted at a market rate of interest for a similar debt instrument.

### Loans with no formal terms attached

Loans which do not have formal terms attached to them would be regarded as being repayable on demand. The fair value of a financial liability that is due on demand is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (FRS 102.12.11).

**Example – Fixed rate loan from a shareholder**

Janine is a shareholder of Company A Ltd. On 1 January 2016, she makes a loan to the company of £350,000. Janine has agreed for the company to make repayment in two years' time. The interest on the loan is 5%, but if the company were to obtain a similar loan from its bank, it would be charged interest at a rate of 10%.

The loan is below market rate and hence constitutes a financing arrangement. There are terms in place for the loan and hence it is not repayable on demand. The equivalent rate is 10% and the present value of the loan is calculated as:

| Year | Cash payable | Discount factor (10%) | Present value |
|---|---|---|---|
| 2016 | 17,500 | 0.90909 | 15,909 |
| 2017 | 367,500 | 0.82645 | 303,720 |
| | | | 319,629 |

There is a difference between the cash transferred (£350,000) and the present value of the loan calculated above (£319,629) which amounts to £30,371. This amount is referred to as a 'measurement difference' and must be brought into the financial statements. The measurement difference represents the value of the benefit received by the company because the shareholder has provided it with a loan that is below market rate. It also reflects the substance of the arrangement which is that the shareholder is providing the company with implicit financing as well as the underlying loan through the reduced rate of interest.

The entries in respect of this loan on initial recognition are:

| | |
|---|---|
| Dr Cash at bank | £350,000 |
| Cr Loan payable | £319,629 |
| Cr Capital contribution | £30,371 |

*Being initial recognition of loan from shareholder at present value*

Draft ICAEW TECH 05/16bl *Guidance on Realised and Distributable Profits Under the Companies Act 2006* does not regard the credit to equity as an accounting, or legal, profit and hence is not distributable.

The loan is profiled as follows:

Effective interest rate 10%

| Year | Opening balance | Interest at 10% (EIR) | Cash flow | Closing balance |
|---|---|---|---|---|
| | £ | £ | £ | £ |
| 2016 | 319,629 | 31,962 | (17,500) | 334,091 |
| 2017 | 334,091 | 33,409 | (367,500) | - |

The entity may choose to make a transfer from the capital contribution reserve to the profit and loss account reserve represent an amount equivalent to the annual interest charge, hence the journals in the 2016 year would be:

| | £ |
|---|---|
| Dr Interest | 17,500 |
| Cr Cash at bank | 17,500 |

*Interest paid to shareholder*

| | £ |
|---|---|
| Dr Interest | 14,462 |
| Cr Loan payable | 14,462 |

*Additional loan interest to take interest up to EIR* (£31,962 - £17,500)

| | |
|---|---|
| Dr Capital contribution reserve | 14,462 |
| Cr Profit and loss reserves | 14,462 |

*Being transfer between reserves*

In addition, as this loan has not been concluded under normal market conditions, details would need to be disclosed as related party transactions, even under Section 1A of FRS 102.

## *Transitional issues for small companies*

The majority of small companies will transition to FRS 102 for accounting periods starting on or after 1 January 2016. When a small entity with an accounting period which commences prior to 1 January 2017 moves from previous UK GAAP (i.e. the FRSSE), it can take up the exemption in paragraph 35.10(v) and not restate comparative information for financing transactions involving related parties. This paragraph says:

*'A small entity that first adopts this FRS for an accounting period that commences before 1 January 2017 need not restate comparative information to comply with the requirements of paragraph 11.13 only insofar as they related to financing transactions involving **related parties**.*

*A small entity that chooses to present comparative information that does not comply with the financing transaction requirements of Section 11 in its first year of adoption:*

*(a) shall apply its existing accounting policies to the relevant financing instruments in the comparative information and is encouraged to disclose this fact;*

*(b) shall disclose the accounting policies applied (in accordance with paragraph 1AC.3); and*

*(c) shall treat any adjustment between the statement of financial position at the comparative period's reporting date and the statement of financial position at the start of the first reporting period that complies with paragraph 11.13 as an adjustment, in the current reporting period, to opening equity. The **present value** of the financial asset or financial liability at the start of the first reporting period that complies with this FRS may be determined on the basis of the facts and circumstances existing at that date, rather than when the arrangement was entered into.'*

## PRACTICAL CONSIDERATIONS: FOREIGN CURRENCY (LECTURE A571 – 11.10 MINUTES)

Foreign currency is dealt with in FRS 102 at Section 30 *Foreign Currency Translation*. One of the most notable differences between FRS 102 and previous UK GAAP is the fact that FRS 102 prohibits the use of contracted rates (although micro-entities can use contracted rates in FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*).

Other subtle differences between Section 30 and previous UK GAAP include:

| Issue | FRS 102 | Previous UK GAAP |
|---|---|---|
| Functional currency | Functional currency is dealt with in FRS 102 and is the currency of the primary economic environment in which it operates. | No concept of separate functional v presentation currency but instead had a concept of local currency. |
| Presentation currency | An entity is free to choose which currency it reports its financial information under. | Previous UK GAAP did not permit the use of a presentation currency which was not the local currency. |
| Derivative instruments | Forex derivative instruments are brought onto the balance sheet at fair value through profit or loss, although hedge accounting is available subject to meeting certain criteria. | Initial measurement of derivatives was not specified but were usually the same (i.e. at transaction price). |

### *Forex derivatives*

Under FRS 102, an entity may have to bring derivative financial instruments on the balance sheet which arise through forward foreign exchange contracts. A ‘derivative’ financial instrument is an instrument which ‘derives’ its value from a change in the value of an underlying asset. Therefore, a foreign exchange derivative will derive a value from changes in the exchange rate.

When a company enters into a forward foreign currency contract, say, one month prior to its year-end to sell foreign currency one month after its year-end, then on the date the contract is entered into the fair value of the contract will usually be nil. Over the next two months, foreign exchange rates are likely to fluctuate and these fluctuations will generate a value for the forward foreign currency contract and it is this value that will be reported on the balance sheet and any changes in that value from one reporting period to the next will be recognised in profit or loss; unless hedge accounting is being applied.

**Example – Forward foreign exchange contract**

Company A Ltd has a year-end of 31 March 2017 and reports under FRS 102. On 1 February 2017, the company sells goods to a customer based in America for $120,000 and payment is to be received in three months’ time (i.e. on 30 April 2017).

Company A enters into a forward foreign currency contract to sell $120,000 on 30 April 2017 at a contracted rate of $1.65:£1.

Details of the foreign exchange rates are as follows:

| Date | Spot | Forward rate to 30.04.17 |
|---|---|---|
| | $1:£1 | $1:£1 |
| 01.02.2017 | 1.63 | 1.65 |
| 31.03.2017 | 1.60 | 1.62 |
| 30.04.2017 | 1.58 | - |

Under previous UK GAAP, Company A would have normally accounted for this transaction using the contracted rate (i.e. 1.65); although the company could have also chosen not to and used the spot rate at the transaction date.

**Step 1 – recognise the debtor at the date of sale (1 February 2017)**

Company A would have accounted for this transaction using the rate in the contract (1.65) under previous UK GAAP as paragraph 4 of SSAP 20 *Foreign currency translation* allowed this and hence under old UK GAAP, the company would have recognised a debtor of £72,727 (being $120,000 ÷ 1.65).

FRS 102 at paragraph 30.7 requires the foreign currency transaction to be recorded at the spot rate at the date of the transaction, hence under FRS 102 the company will translate the sale at 1.63, hence:

Dr Trade debtors £73,620
Cr Sales £73,620
*Being translation of sale at spot rate ($120,000 ÷ 1.63)*

**Step 2 – calculate the derivative instrument at 31 March 2017**

As the contracted rate cannot be used under FRS 102, a derivative instrument is recognised on the balance sheet, calculated as follows:

| | £ |
|---|---|
| $120,000 at contracted rate of 1.65 | 72,727 |
| $120,000 at year-end forward rate of 1.62 | 74,074 |
| Loss on derivative instrument | 1,347 |

The loss has arisen because of what has happened with the exchange rates.

If Company A were to sell at the year-end forward rate of 1.62 they would receive £74,074, but as they are selling at a contract rate of 1.65 they would only receive £72,727 and hence a loss has been generated on the contract at the year-end which has to be recognised in the financial statements as follows (note the company is not applying hedge accounting):

Dr Loss on derivative – profit and loss £1,347
Cr Derivative liability – balance sheet £1,347
*Being loss on derivative at year-end*

Under SSAP 20 no entries would have been needed had the company accounted for the transaction at the contracted rate.

**Step 3 – calculate the foreign exchange gain/loss at the year-end 31 March 2017**

Company A will have to work out the foreign exchange gain or loss as follows:

| | £ |
|---|---|
| $120,000 at the year-end spot rate (1.60) | 75,000 |
| Less original debtor recognised | (73,620) |
| Foreign exchange gain | 1,380 |

This gain is taken to the profit and loss account.

**Step 4 – settlement takes place on 30 April 2017**

Calculate the derivative instrument at the settlement date

Calculate the fair value of the derivative instrument at the date of settlement as follows:

| | £ |
|---|---|
| $120,000 at settlement date spot rate 1.58 | 75,949 |
| $120,000 at year-end forward rate 1.62 | 74,074 |
| Loss on derivative at settlement date | 1,875 |

The entries at 30 April 2017 in respect of the derivative instrument are:

Dr Loss on derivative (P&L) £1,875
Cr Derivative liability – balance sheet £1,875
*Being loss on derivative at fair value*

Clear the derivative and the debtor

Company A's customer will pay them £72,727 ($120,000 @ 1.65). The derivative instrument is recognised as a liability of £3,222 (£1,347 + £1,875) and hence the journals are:

Dr Cash at bank £72,727
Dr Derivative liability – balance sheet £3,222
Cr Trade debtors £75,949
*Being removal of derivative instrument and settlement of debtor*

The derivative liability can be reconciled as follows:

| | £ |
|---|---|
| $120,000 @ settlement date spot rate 1.58 | 75,949 |
| $120,000 @ contract rate of 1.65 | 72,727 |
| Loss on forex contract at 30 April 2017 | 3,222 |

The £3,222 loss on the derivative represents the loss that Company A has made by taking out the forward foreign currency contract. In other words, the company would have received £3,222 more had they undertook the transaction using spot rates.

A balance of £949 will be left on the customer's account on the sales ledger which is made up of the £75,000 year-end debtor (see Step 3) less £75,949 (£120,000 ÷ 1.58 – see Step 4). This represents the foreign exchange gain.

A comparison of the above example can be seen as follows:

| | SSAP 20 | FRS 102 |
|---|---|---|
| | £ | £ |
| Profit and loss account – 31 March 2017 | | |
| Turnover | 72,727 | 73,620 |
| Foreign exchange gain | - | 1,380 |
| Loss on derivative instrument | - | (1,347) |
| | 72,727 | 73,653 |
| Balance sheet – 31 March 2017 | | |
| Asset - trade debtor | 72,727 | 75,000 |
| Liability - derivative financial instrument | - | (1,347) |
| | 72,727 | 73,653 |
| Profit and loss account – 30 April 2017 | | |
| Turnover | - | - |
| Foreign exchange gain | - | 949 |
| Loss on derivative | - | (1,875) |
| | - | (926) |
| Balance sheet - 30 April 2017 | | |
| Profit and loss reserves b/f 31.03.17 | 72,727 | 73,653 |
| Profit and loss reserves c/f 30.04.17 | 72,727 | 72,727 |

# ACCOUNTANTS' REPORTS (LECTURE A572 – 13.07 MINUTES)

Professional bodies require an accountant's report to be included when the firm prepares accounts for a client. The accountant's report is not a legal requirement, but is a requirement by the professional body and it explains that the practitioner has undertaken the assignment based on information and explanations provided by the client, that the assignment does not constitute an audit and often includes a Bannerman clause which restricts the practitioner's duty of care to third parties.

The ICAEW have issued two Technical Releases:

- TECH07/16AAF – *Chartered Accountants' reports on the Compilation of Financial Information of Incorporated Entities*; and
- TECH08/16AAF – *Chartered Accountants' reports on the Compilation of historical Financial Information of Unincorporated Entities.*

Both releases are intended to give general guidance to member firms when they compile historical financial information for clients. TECH07/16AAF covers the preparation of financial statements prepared under the Companies Act 2006 as well as financial statements for limited liability partnerships and replaces TECH 02/10 *Chartered Accountants' Reports on the Compilation of Financial Statements of Incorporated Entities*. TECH 08/16AAF covers financial statements prepared for unincorporated entities for specific purposes (such as for tax purposes), partnership accounts or the compilation of financial statements for grant claims and replaces AUDIT 03/10 *Chartered Accountants' Reports on the Compilation of Financial Statements of Unincorporated Entities*.

## *Professional ethics*

Professional accountants are bound by the requirements of their relevant professional body's professional ethics. ICAEW member firms are subject to the ethical and other guidance laid down by the institute. The ICAEW's Fundamental Principles are:

- Fundamental Principle 1 – Integrity: A professional accountant shall be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.
- Fundamental Principle 2 – Objectivity: A professional accountant shall not allow bias, conflict of interest or undue influence of others to compromise their professional or business judgements.
- Fundamental Principle 3 – Professional Competence and Due Care: A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.
- Fundamental Principle 4 – Confidentiality: A professional accountant shall respect the confidentiality of information acquired as a result of professional and business relationships and may not disclose any such information to third parties without proper and specific authority unless there is a legal requirement or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

- Fundamental Principle 5 – Professional Behaviour: A professional accountant should comply with relevant laws and regulations and should avoid any action that may discredit the profession.

Both technical releases say that members shall not knowingly be associated with financial information where the professional accountant believes that the information:

- contains a materially false or misleading statement;
- contains statements or information furnished recklessly; or
- omits or obscures information required to be included where such omission or obscurity would be misleading.

If a professional accountant becomes aware that they have been associated with such information, they must take steps to be disassociated from that information.

## *Quality control*

It is imperative that firms have adequate quality control procedures in place and Practice Assurance standards apply to compilation assignments. During QAD inspections, inspectors will want to ensure that the firm has adequate quality control procedures in place and both technical releases suggest that practitioners may wish to be aware of the guidance issued as a result of the work done by QAD on unaudited financial statements prepared by ICAEW members. The latest version of this guidance 'Accounts filed at Companies House – Avoid a Difficult Conversation' is available at:

http://www.icaew.com/members/practice-regulation/practice-assurance-standards-and-regulations/practice-assurance-guidance.

## *Unincorporated clients*

TECH08/16AAF recognises that unlike companies, there is no statutory requirement for financial statements of unincorporated entities to give a true and fair view, nor do they have to comply with any recognised financial reporting framework (i.e. UK GAAP). It may be appropriate to prepare the financial statements for an unincorporated entity on another basis, such as one that meets the requirements for calculating and reporting profits under s25 of the Income Tax (Trading and Other Income) Act 2005, and omit the disclosures required by accounting standards and the Companies Act. Certain taxpayers can also elect to use the cash basis of accounting under s17, Finance Act 2013 as opposed to s25.

In all cases, if an appropriate financial reporting framework or format cannot be agreed, the professional accountant must not accept the engagement.

## *Engagement terms*

All firms are required to have letters of engagement in place with their clients. Such engagement letters provide a clear understanding between the client and the professional accountant concerning the terms of the engagement. At the outset, clients need to understand the responsibility which the professional accountants accept in relation to the financial statements. Problems can (and do) arise when engagement letters are not issued or when they are not updated. Indeed, the absence of engagement terms or out-of-date engagement terms may result in the practitioner not being adequately covered under their professional indemnity insurance.

Both releases outline certain key items which should be contained within letters of engagement and are shown in the following table:

| Incorporated entities | Unincorporated entities |
|---|---|
| The board of directors as addressees. | The client as addressee. |
| The directors' responsibilities with regard to adequacy of accounting records and truth and fairness of the financial statements as specified in Companies Act 2006. | The client's responsibility for the reliability, accuracy and completeness of the accounting records. |
| The information to be supplied by the client to the professional accountants and a confirmation that any other information that the professional accountants consider necessary for the performance of the engagement will be supplied. | The information to be supplied by the client to the professional accountants and a confirmation that any other information that the professional accountants consider necessary for the purpose of the engagement will be supplied. |
| The nature of the engagement. | The nature of the engagement, including the purpose for which the financial information is being prepared. |
| The professional accountants will make enquiries of management and undertake any procedures that they judge appropriate but are under no obligation to perform procedures that may be required for assurance engagements such as audits or any other type of assurance engagement. | The professional accountants will make enquiries of management and undertake any procedures that they judge appropriate but are under no obligation to perform procedures that may be required for assurance engagements such as audits or any other types of assurance engagement. |
| The engagement cannot be relied on to disclose errors, fraud, weaknesses in internal controls or other irregularities. | The engagement cannot be relied on to disclose errors, fraud, weaknesses in internal controls or other irregularities. |
| An audit or any other type of assurance engagement will not be carried out and so no opinion will be given and no assurance either implied or expressed. | Neither an audit nor any other type of assurance engagement will be carried out and so no opinion will be given and no assurance either implied or expressed. |
| The financial reporting framework based on which the financial statements will be prepared and the fact that any known departures will be disclosed. | The financial reporting framework on which the financial information will be compiled and the fact that the purpose of the financial information and, where not in accordance with a recognised financial reporting framework, such as UK GAAP (including, where relevant the FRSSE) or IFRS as adopted by the European Union, any limitations of the basis adopted, will be disclosed in an accounting policy note to the financial information and referred to in the professional accountant's report. |

| | |
|---|---|
| Professional accountant's ethical and other professional obligations. | A professional accountant's obligation not to be associated with reports, returns, communications or other information where they believe that the information:<br>• contains a materially false or misleading statement;<br>• contains statements or information furnished recklessly; or<br>• omits or obscures information required to be included where such omission or obscurity would be misleading. |
| Written management representations may be required prior to the completion of the engagement and the issuing of the compilation report. | Written management representations may be required prior to the completion of the engagement and the issuing of the compilation report. |
| The form of report to be issued. | The client will approve and sign the financial information which includes a statement acknowledging responsibility for the financial information, including the appropriateness of the financial reporting framework adopted, and for having provided all information and explanations necessary to the professional accountants for its completion. |
| | The form of report to be issued. |

Both releases suggest that after discussions with the client, it might be appropriate to include a section within the engagement terms which limits the professional accountant's liability.

### *Content of financial statements/financial information*

Under company law, the directors of a company must not approve the financial statements until they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for the period.

Micro-entities whose financial statements are prepared under the micro-entities' legislation are presumed to give a true and fair view. Other company accounts are subject to the accounting and disclosure requirements of the Companies Act 2006 and must be prepared in accordance with the applicable financial reporting framework.

For unincorporated entities, financial information is compiled based on an appropriate financial reporting framework, which does not have to be a recognised financial reporting framework. Whichever framework is adopted, its purpose and limitations of the financial information presented should be fully disclosed in a note to the financial information and referred to in the professional accountant's report which accompanies that financial information. This is done so that the financial statements are not misleading.

## *Responsibilities of directors*

It is the directors' responsibility to ensure that the company maintains adequate accounting records which are sufficient to show and explain the company's transactions and disclose with reasonable accuracy, at any time, the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006.

The directors of a company are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK accounting standards have been followed, subject to any material departures disclosed and explain in the financial statements; and
- prepare financial statements on a going concern basis unless it is inappropriate to presume that the company will continue in business.

Company directors are responsible for safeguarding the assets of the company as well as taking steps for the prevention and detection of fraud and other irregularities. Compilation engagements cannot be regarded as providing assurance on the adequacy of the company's systems or controls or on the incidence of fraud, non-compliance with laws and regulations or weaknesses in internal controls. The directors' responsibilities are not relieved simply because they engage a professional accountant to compile the financial statements.

The directors are required to assess the company's going concern ability and to satisfy themselves that it is reasonable for them to conclude whether it is appropriate to prepare the financial statements on a going concern basis. To discharge this responsibility adequately, the directors are required to consider all information at their disposal concerning the future of the entity at the date they authorise the financial statements for issue.

There is no 'one-size-fits-all' where the assessment of going concern is concerned. In the case of smaller companies, it is likely that the going concern assessment will be relatively straightforward; whereas in much larger companies, assessing going concern may be more complex. In all cases, the assessment carried out by the directors should be proportionate in nature and depth taking into consideration the size, level of financial risk and complexity of the company and its operations.

The assessment of going concern should normally cover a period of at least 12 months from the date the financial statements are approved (not 12 months from the balance sheet date). In addition, in order for the financial statements to give a true and fair view, the directors are also required to provide balances, proportionate and clear disclosures which should include any material uncertainties of which they are aware arising from their assessment which may cast significant doubt on the entity's ability to continue as a going concern.

## *Unincorporated clients' responsibilities*

The terms of the engagement between the client and the professional accountant must acknowledge that the client is responsible for the reliability, accuracy and completeness of the accounting records and for the provision and disclosure to the professional accountants of all information which is considered relevant to the purpose and compilation of the financial statements.

It is the client's responsibility for safeguarding the assets of the entity and for taking reasonable steps to prevent and detect fraud and other irregularities. As with directors, the fact that the client has engaged a professional accountant does not relieve the client of their duties.

Where required under the applicable financial reporting framework (e.g. UK GAAP or IFRS), the client is required to satisfy themselves that it is reasonable for them to conclude whether it is appropriate to prepare the financial statements on a going concern basis. In doing this, the client must consider all available information at their disposal concerning the future of the entity on the date that they authorise the financial statements for issue. As with companies, the process the client adopts for assessing going concern should be proportionate in nature and depth depending on the size, level of financial risk and complexity of the entity and its operations. The review of going concern should cover a period of at least 12 months from the date that the financial statements are approved.

The financial statements should include balanced, proportionate and clear disclosures, including any material uncertainties arising from the going concern assessment in order to give a true and fair view.

## *Planning*

For accounts compilation assignments of both incorporated and unincorporated entities, the professional accountant should plan the engagement to compile the financial statements. The level of planning will all depend on the complexity of the accounting records, the accounting system and the professional accountant's experience in dealing with the entity.

## *Procedures*

In all cases, professional accountants must obtain a general understanding of the entity and its operations. The accountant will need to be familiar with the accounting principles and practices of the sector in which the client operates and with the form and content of the accounting information which is appropriate in the circumstances.

Professional accountants must consider whether the financial statements are consistent with their understanding and whether they are misleading. In order to do this, the professional accountant must make enquiries of management and perform appropriate procedures. The professional accountant is not, however, under any obligation to perform procedures that might otherwise be performed in an assurance engagement (such as an audit).

Professional accountants should also consider using disclosure checklists, particularly when the client has certain client-specific issues or complicated transactions to ensure that the disclosures are complete.

## *Documentation*

In an accounts compilation engagement, there is no requirement to document the work that has been carried out. However, documenting the work carried out will go towards assisting the professional accountant demonstrate the adequacy of the work performed and that the engagement was carried out in accordance with the terms of the engagement.

Adequate documentation will also serve to assist the accountant if their work is subsequently challenged, although there is no set rule as to the level of documentation that should be prepared. The level of documentation will of course vary depending on the complexity of the accounting records and accounting procedures.

## *Management representations*

During the compilation engagement, the professional accountant will rely on representations made by management. This is particularly the case in areas such as estimates (for example, valuations of work in progress) and the completeness of information provided.

The professional accountant may consider it necessary to obtain written management representations from the client.

## *Misleading financial statements*

Companies are required to prepare their financial statements in accordance with the Companies Act 2006 and these financial statements are required to give a true and fair view. Micro-entities reporting under the micro-entities' regime can take advantage of the minimal legal disclosure requirements and where these are met, the financial statements of the micro-entity are presumed to give a true and fair view. This presumption is not afforded to small companies outside of the micro-entities regime and hence all other companies must comply with the requirements of the applicable financial reporting framework including, where necessary, any disclosures required when the true and fair override is invoked.

For incorporated and unincorporated entities, professional accountants are unable to form an opinion on the financial statements (this would only be the case where an assurance engagement is being carried out). However, during the course of the engagement, certain matters may come to the attention of the professional accountant which indicate that the financial statements may be misleading, including the inappropriate use of the going concern basis or inadequate disclosure related to going concern. In addition, the professional accountant may also feel that they have not been provided with all the information judged necessary in order to compile the financial statements (note for companies, directors are required by law to maintain adequate accounting records).

The issue of going concern can be a subjective one and directors are required to make adequate going concern disclosures where the going concern basis of accounting has been used, but there are material uncertainties in respect of the entity's ability to continue as a going concern for the foreseeable future. Under the micro-entities regime, there is no requirement in law to make any going concern disclosures (either by way of a note to the financial statements or in an accounting policy).

Professional accountants regulated by ICAEW are bound by paragraph 110.2 of the Code of Ethics (A). This prohibits professional accountants from being associated with information that they consider misleading, including instances where the information may be misleading because of omissions. In respect of micro-entities, there may be rare occasions when professional accountants consider that the information disclosed in accordance with the micro-entities' regime is, in fact, misleading.

Small companies that are required to report under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 1A *Small Entities*, are also not legally required to make any going concern disclosures in their financial statements. However, paragraph 1AD.1(c) does encourage the small entity to make going concern disclosures set out in paragraph 3.9 of FRS 102 and hence going concern disclosures should be made where there are material uncertainties relating to the small entity's ability to continue as a going concern.

Where the professional accountant becomes aware of information which might suggest the financial statements are misleading, they should, in the first instance, discuss the matter with the client with a view to agreeing the necessary action to remedy the situation (such as appropriate adjustments or disclosure in the financial statements). If the client refuses this request, the professional accountant might judge the financial statements to be misleading. If the professional accountant judges the financial statements as being misleading, they must withdraw from the engagement and must not allow their name to be associated with the financial statements.

When the professional accountant is considering whether the financial statements are misleading, they must consider whether any material misstatements arise from:

- misclassifications in the financial statements;
- mistakes in the application of, or non-disclosure of known departures from, any relevant statutory, regulatory or other reporting requirements, including the applicable financial reporting framework and non-disclosure of significant changes in accounting policies; and
- other significant matters of which the professional accountants are aware, such as non-disclosure of a going concern issue or any statements made in the accounts which the professional accountants believe not to be consistent with the accounts themselves.

When a professional accountant withdraws from an engagement, care should be taken. The professional accountant would normally discuss the reasons for their withdrawal with the client, but must not do this if such a discussion would give rise to a breach of legal or other regulatory requirement (such as 'tipping off' under the Anti-Money Laundering Regulations).

The professional accountant might also arrive at the conclusion that despite the financial statements being misleading, it remains appropriate for them to continue acting for the client (the technical release cites an example of stock take records being destroyed in a fire).

In such situations, the professional accountant must check that appropriate disclosures have been made in the financial statements (particularly where the true and fair override is invoked).

## *Approval of the financial statements*

For companies, the financial statements must be approved and signed by the directors before the accountant signs the accountant's report.

For unincorporated entities, there is no statutory requirement for the financial information to be approved or signed, but ICAEW recommends that the client does approve and sign the financial information to acknowledge their responsibility for the financial information, including the appropriateness of the financial reporting framework and having provided all information and explanations considered necessary.

The Companies Act 2006 requires the directors to approve the financial statements and that the balance sheet states the name of the director(s) signing the accounts on behalf of the board.

For audit exempt companies, the directors are required to make a statement on the face of the balance sheet acknowledging their responsibilities for complying with the requirements of the Companies Act concerning accounting records and the preparation of accounts in accordance with the provisions applicable to companies as well as entitlement of the company to audit exemption.

## *Accountants' compilation reports*

Professional bodies usually require member firms to include an accountant's report in financial statements prepared by them.

ICAEW suggests that member firms include the following elements in Chartered Accountants' reports (text in [square brackets] indicates that the wording is optional).

| Incorporated entity | Unincorporated entity |
|---|---|
| A title identifying the persons to whom the report is addressed (usually the board of directors) and include the words 'Chartered Accountant's/Accountant's Report to …). | A title identifying the persons to whom the report is addressed and including the words 'Chartered Accountant's/Accountant's Report to …'. |
| A statement that the professional accountants have prepared the financial statements [which comprise – state which – the primary financial statements such as the profit and loss account, the balance sheet, the cash flow statement and the related notes] from the company's accounting records and from information and explanations given by the client. | A statement that the professional accountants have prepared the financial information [which comprise [state the primary financial statements that have been compiled such as the profit and loss account, the balance sheet and the cash flow statement and, where relevant, related notes] from the client's accounting records and from information and explanations given by the client. |
| [A statement that the report is made to the company's board of directors as a body in accordance with the terms of the engagement]. | [A statement that the report is made to the company's board of directors as a body in accordance with the terms of engagement]. |
| An explanation as to the work carried out being in accordance with the requirements of ICAEW guidance [and the purpose of the work and that, to the fullest extent permitted by law, no responsibility will be accepted for the work or the report to anyone other than the company and the company's board of directors, as a body]. | A reference to the accounting policy note which sets out the financial reporting framework adopted for the compilation and the purpose and limitations of the financial information. |
| A reference to the accounting framework according to which the accounts have been prepared. A similar reference should also be included as part of the directors' approval of the accounts. | A statement that the report is made to the client in accordance with the terms of the engagement. |
| [A statement that it is the directors' duty to ensure that the entity has kept adequate accounting records and to prepare statutory financial statements that give a true and fair view of the assets, liabilities, financial position and profit[/loss] of the entity and that they consider the entity is exempt from the statutory audit requirement for the year [/period] ]. | An explanation as to the work involved and the purpose of the work and that, to the fullest extent permitted by law, no responsibility will be accepted for the work or the report to anyone other than the client. |
| [A statement that the professional accountants have not been instructed to carry out an audit or any other type of assurance engagement of the financial statements, verified the accuracy or completion of the accounting records or | A statement that the professional accountants have carried out the engagement in accordance with technical guidance issued by the Institute and that they have complied with the ethical guidance laid down by the Institute. |

| | |
|---|---|
| information and explanations supplied, and that the professional accountants do not express any opinion on the financial statements]. | |
| The name and signature of the professional accountant and any appropriate designation (but not 'Statutory Auditor'). | A statement that the client has acknowledged his responsibility for the financial information. |
| The date of the report. | A statement that the professional accountants have not verified the accuracy or completeness of the accounting records or information and explanation supplied, and that the professional accountants do not express any opinion on the financial information. |
| | The name and signature of the professional accountant and any appropriate designation (but not 'Registered Auditor'). |
| | The date of the report. |

The financial statements (companies) or financial information (unincorporated entities) should contain a reference that they are unaudited. This reference should either be made on the front cover or on each page of the financial statements/information or both.

## *Filing the financial statements*

ICAEW recommends that the professional accountant's report is filed alongside the copy of the financial statements to Companies House on the grounds that this may help increase the credibility of the financial information that is placed on the public record. In addition, ICAEW considers that filing the professional accountant's report differentiates the financial statements from those prepared by firms and individuals who are not members of one of the CCAB bodies. Where the work is that of an audit, this consideration will not apply.

**Example – Chartered accountant's report for an incorporated client**

**Chartered Accountant's/Accountant's report to the board of directors on the preparation of the unaudited statutory accounts of XYZ Limited for the year [/period] ended dd/mm/20yy.**

In order to assist you to fulfil your duties under the Companies Act 2006, we have prepared for your approval the accounts of XYZ Limited for the year [/period] ended dd/mm/20yy [as set out on pages x-x/which comprise [insert statements]] from the company's accounting records and from information and explanations you have given to us.

As a practising member [/member firm of] of the Institute of Chartered Accountants in England and Wales (ICAEW), we are subject to its ethical and other professional requirements which are detailed at http://www.icaew.com/en/members/regulations-standards-and-guidance/.

[This report is made solely to the board of directors of XYZ Limited, as a body, in accordance with the terms of our engagement letter dated dd/mm/20yy.] Our work has been undertaken [solely to prepare for your approval the accounts of XYZ Limited and state those matters that we have agreed to state to them/the board of directors of XYZ Limited, as a body, in this report] in accordance with ICAEW Technical Release 07/16AAF. [To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than XYZ Limited and its board of directors as a body for our work or for this report].

[It is your duty to ensure that XYZ Limited has kept adequate accounting records and to prepare statutory accounts that give a true and fair view of the assets, liabilities, financial position and profit[/loss] of XYZ Limited. You consider that XYZ Limited is exempt from the statutory audit requirement for the year [/period].]

[We have not been instructed to carry out an audit or a review of the accounts of XYZ Limited. For this reason, we have not verified the accuracy or completeness of the accounting records or information and explanations you have given to us and we do not, therefore, express any opinion on the statutory accounts.]

[Explanatory paragraph: e.g. records destroyed by fire.]

Signature ………….

Typed name of professional accountant

Chartered Accountants

Address

Date …………………….

**Example – Explanatory paragraph to deal with information not being available**

We draw your attention to note x in the financial statements which discloses and explains the year-end stock balance is an estimate derived from management accounts. Following a fire in the warehouse, the records of the year-end stock count were not available.

**Example – Unincorporated client wording for approval of financial information**

In accordance with the engagement letter dated [date], I/we approve the financial information which comprises [state the financial information compiled]. I/we acknowledge my/our responsibility for the financial information, including the appropriateness of the applicable financial reporting framework as set out in note x, and for providing [the accountants] with all information and explanations necessary for its compilation.

Signatures

[XYZ & Co] Date

**Example – Unincorporated client accountant's report**

**Chartered Accountant's/Accountant's Report to [Entity] on the Unaudited Financial Statements of XYZ & Co**

In accordance with the engagement letter dated [date], we have prepared for your approval the financial information of [the entity] for the year [/period] which comprises of [insert statements]] from the entity's accounting records and from information and explanations you have given to us.

As a practising member [/member firm of] of the Institute of Chartered Accountants in England and Wales (ICAEW), we are subject to its ethical and other professional requirements which are detailed at icaew.com/members handbook.

[This report is made solely to you, in accordance with the terms of our engagement letter dated dd/mm/2077.] Our work has been undertaken [solely to prepare for your approval the financial information of [entity] and state those matters that we have agreed to state to you in this report] in accordance with ICAEW Technical Release TECH08/16AAF. [To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than [addressee of this report] for our work or for this report.]

[You have approved the [financial information] [for the year/period] and have acknowledged your responsibility for it, for the appropriateness of the financial reporting framework and for providing all information and explanations necessary for its compilation.

We have not verified the accuracy or completeness of the accounting records or information and explanations you have given to us and we do not, therefore, express any opinion on the financial information.]

Signature ………………….

Typed name of professional accountant

Chartered Accountants

Address

Date ……………………..

## ATTENDANCE AT STOCKTAKES (LECTURE A573 – 8.51 MINUTES)

Auditors are required to attend stock counts when the value of stock and work in progress is material to the financial statements. Attendance at stock counts is dealt with in ISA (UK and Ireland) 501 *Audit evidence – specific considerations for selected items* which was revised in June 2016 and became ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items*. In addition, Practice Note 25 (Revised) *Attendance at Stocktaking* provides guidance to auditors concerning attendance at the stock count.

The overarching objective to attending the stock count is for the auditor to gather evidence to cover the following assertions:

- existence;
- valuation;
- completeness; and
- rights and obligations.

### *Objective of ISA (UK) 501*

ISA (UK) 501 requires the auditor to:

- attend the physical stock count (unless impracticable), if inventory is material to the financial statements; and
- perform procedures on the final inventory records to determine whether they accurately reflect the count results.

It is not the responsibility of the auditor to carry out the stock count. The auditor's responsibility is to evaluate management's instructions and procedures for the count; observe the performance of the count; inspect the inventory and perform test counts.

### *Prior to the stock count*

Before the auditor attends the stock count, they should undertake an element of planning which would normally include:

- performing analytical procedures and discussing any significant variances with management;
- discussing stocktaking arrangements and procedures with management;
- familiarising themselves with the nature of the inventory, volume, identification of high value items and the general accounting method of stock valuation;
- considering the location of the stock;
- considering the quantity and nature of work in progress, quantity of stocks held by third parties and whether an auditor's expert may be required;
- considering the internal controls relating to stocks to identify problems areas (e.g. problems in relation to cut-offs);
- considering whether any internal audit function exists and deciphering the extent to which reliance can be placed on internal audit;
- reviewing the results of previous stock counts; and
- reviewing the prior year audit working papers.

Paragraph 4 of ISA (UK) 501 requires the auditor to attend the stock count if the value of the stock at the balance sheet date is (likely to be) material to the financial statements. Primarily

the attendance at stock count is that of an observation test, i.e. to observe whether the procedures adopted by management would reduce the risk of material misstatement in the final stock valuation.

The auditor is required to obtain sufficient and appropriate audit evidence regarding the existence and condition of the inventory, in addition to other procedures, unless physical attendance at the stock count is impracticable.

### *During the inventory count*

Auditors should attend the inventory count whilst the count is underway as one of the objectives is to ensure that management's instructions are being carried out correctly. Auditors should also ensure that:

- inventory 'teams' are in place so that one person counts whilst another person records the quantities on the 'rough' stock sheets;
- count sheets are completed in ink rather than in pencil;
- no movements of inventory take place during the count;
- sequentially numbered count sheets and a sequence check is performed of these stock sheets once the count is complete;
- count sheets show the description of the goods but do not show the quantities expected to be counted; and
- damaged and/or obsolete items are separately identified so they can be valued appropriately.

The auditor will usually use an audit programme to undertake the work; however, the auditor should carry out some substantive procedures during the audit which often include:

- selecting a sample of items from the inventory count sheets and physically inspecting the items in the warehouse (this verifies **existence**);
- selecting a sample of physical items from the warehouse and tracing to the inventory count sheets to ensure that they are recorded accurately (this verifies **completeness**);
- enquiring of management whether goods held on behalf of third parties are segregated and recorded separately (this verifies **rights and obligations**);
- inspecting the inventory being counted for evidence of damage or obsolescence that may affect estimated selling price (this verifies **valuation**);
- recording details of the last deliveries prior to the year-end. This information will be used in final audit procedures to ensure that no further amendments have been made thereby overstating or understating inventory (this verifies **completeness and existence**);
- obtaining copies of inventory count sheets at the end of the inventory count, ready for checking against the final inventory listing after the inventory count (this verifies **completeness** and **existence**); and
- attending the inventory count (if one is to be performed) at the third party warehouses (this verifies **completeness** and **existence**).

The timing of the stock count is a critical factor to consider. For example, the client may have an accounting reference date of 31 December, but the year-end inventory count may not be undertaken on this particular day (it may be carried out before or after 31 December) and therefore additional procedures may need to be carried out by the auditor, such as roll-back or roll-forward procedures.

The auditor should consider the controls in place over the count. For example, whether the teams carrying out the inventory count are objective and have the necessary experience; what controls the client has over the stock and the susceptibility of stock to theft or deterioration; the degree of fluctuation in stock levels and whether there are any inherent difficulties when it comes to estimates included in the stock valuation.

Sources of evidence relating to the existence of stocks are:

- evidence from audit procedures relating to the reliability of accounting records upon which the stock valuation in the financial statements is based;
- evidence from tests of controls over stock, including the counting procedures; and
- substantive evidence from physical inspections at the stock count.

Where the entity does not maintain detailed stock records, the quantification of stock is likely to be based on a full, physical stock count at the balance sheet date, or very close to the balance sheet date. Evidence to satisfy the existence assertion is therefore greater when the stock count is carried out at the year-end, or at a date very close to the year-end. This could well provide sufficient and appropriate audit evidence; however the auditor must also be satisfied that the records of stock movement are also reliable in the intervening periods.

### *After the inventory count*

The auditor is required to carry out certain procedures after the inventory count, which are normally carried out during the detailed audit fieldwork on the financial statements. Such procedures include:

- tracing the items counted during the inventory count to the final inventory list to ensure it is the same as the one used at the year-end and to ensure that any errors identified during counting procedures have been rectified (this verifies **completeness**);
- casting the list to ensure arithmetical accuracy and agree the total valuation to the financial statements and relevant disclosures (this verifies **completeness** and **classification**);
- inspecting purchase invoices for a sample of inventory items to agree their cost (this verifies **valuation**);
- inspecting purchase invoices to ensure the goods are in the name of the client (this verifies **rights**);
- inspecting post year-end sales invoices for a sample of inventory items to determine if estimated selling price is reasonable. This will also assist in determining if inventory is held at the lower of cost and estimated selling price less costs to complete and sell (this verifies **valuation**);
- inspecting the ageing of the inventory items to identify old and/or slow-moving amounts that may require an allowance and discussing these with management (this verifies **valuation**);
- recalculating work in progress and finished goods valuations using payroll records for labour costs and utility bills for overhead absorption (this verifies **valuation**);
- tracing the goods received immediately prior to the year-end to year-end creditors and inventory balances (this verifies **completeness** and **existence**);
- tracing goods despatched immediately prior to the year-end to the nominal ledger to ensure the items are not included in stock and sales (and debtors where relevant) have been recorded (this verifies **completeness** and **existence**);

- calculating inventory turnover/days ratio and comparing this to the prior year to assess whether inventory is being held longer and therefore requires a provision to bring the value down to the lower of cost and estimated selling price less costs to complete (this verifies **valuation** and is an analytical procedure); and
- calculating gross profit margins and comparing this to the prior year. The auditor should investigate any significant differences which may highlight an error in cost of sales and closing stock (this verifies **valuation** and is an analytical procedure).

### *Stock held at third parties*

Where a third party holds stock on behalf of the client the auditor should obtain external confirmation from the third party of the quantity and condition of the goods to confirm **rights** and **obligations**.

If the goods held by the third party are material, the auditor should attend the inventory count to verify **existence** of the inventory.

The auditor may also obtain a report from the third party's auditors confirming the reliability of the internal controls at the third party.

# FEEDBACK ON FRS 102 IMPLEMENTATION (LECTURE A574 – 21.45 MINUTES)

## *Background*

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* has been applied for large and medium-sized companies since periods commencing 1 January 2015. This means that there have been many accounts prepared under the new requirements and there is now some useful feedback on the practical problems.

## *Software*

It almost goes without saying that there have been major software issues:

- accounts not adding up – especially cashflows not balancing!
- notes not agreeing
- columns not aligning

Interestingly there is some consistency in the disclosure omissions and errors, outlined below. Might the software be weak in these areas too?

## *Accounting policies*

In practice, these disclosures seem to be very lengthy in FRS 102 accounts. There is no particular reason why they need to be, but it seems to be the convention to mention every possible accounting policy.

More importantly companies are not properly editing their accounting policy note to make it specific to them.

## *Judgements and key sources of estimation uncertainty*

This disclosure is often missed in accounts. Understandably, these issues are sometimes not major, but they will often be present and need disclosing.

FRS 102, paragraphs 8.6 and 8.7 contain two completely new requirements, which under IFRS are normally presented together:

- Information about **judgements** that management has made in applying the accounting policies and that have the most significant effect on the amounts recognised in the financial statements.
- Information about **key sources of estimation uncertainty** that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, including details of their nature and carrying amounts

## *Key management personnel remuneration*

This disclosure is regularly being omitted. In practice this disclosure might sometimes be difficult to compile because it may not be straightforward to identify key management personnel (KMP) and there might be some reluctance to disclose this information.

However, most of the time the directors will be KMP and a simple statement and a cross-reference to the directors remuneration note, will be enough.

**FRS 102 defines KMP as:**

*'Those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.'*

## Financial instruments disclosures

This note is sometimes being omitted. In some cases, the only financial assets and liabilities are those that are measured at amortised cost and this can make the note look like a waste of paper. Regardless of this, it is still required to be disclosed.

Financial instruments require much more disclosure under FRS 102, in particular the financial instruments note is required to separately present assets as below.

**Financial assets**

- Measured at fair value through profit or loss.
- Debt instruments measured at amortised cost (including undiscounted items e.g. trade receivables, accrued income but not prepayments).
- Equity instruments measured at cost less impairment.

**Financial liabilities**

- Measured at fair value through profit or loss, showing separately those that are not derivatives or held as part of a trading portfolio.
- Measured at amortised cost (including undiscounted items e.g. trade payables and accruals).
- Loan commitments measured at cost less impairment.

Surprisingly, charities often have more varied financial instruments than commercial undertakings. This arises because of their investments.

## Leasing disclosures

Often the disclosure of lease payments is still prepared on a SSAP 21 *Accounting for leases and hire purchase contracts* basis. FRS 102 requires the **total** minimum lease payments to be disclosed in the bands.

## Transition disclosures

Where there are transitional adjustments on first-time adoption of FRS 102, these of course need to appear in the reconciliations. They also need to be properly disclosed using narrative notes to explain the impact on the financial statements. This is not always being done.

Many charities do not have transitional adjustments, but narrative notes explaining the impact (or lack of it) on the financial statements might still be necessary.

## Audit reports

Errors in audit reports are everywhere! Often the new wording for the opinion of other matters under the Companies Act 2006 is missed.

**Opinion on other matter 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
- the [strategic report and the] directors' report [has]/have been prepared in accordance with applicable legal requirements.

In 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 and the] directors' report.

Also, the chaos created when adopting FRS 102 can lead to other obvious errors being missed such as:

- Bannerman being included three times but no opinion paragraph
- Errors in the wording where words are repeated
- The wrong Companies Act being quoted i.e. 1985 Act!

# DATA ANALYTICS AND THE AUDIT (LECTURE A575 – 16.36 MINUTES)

By John Selwood

For me, 2016 has been the year of data analytics. Previously, I was aware that the largest firms used data analytics in their audit approach but nobody in the audit world that I had regular dealings with had much interest in it. So, I ignored it!

Early in 2016 I was asked my first question on the subject. It was along the lines of '*Is my firm missing out because we are not using data analytics?*' Closely followed by '*What is data analytics?*' Isn't it curious that the questions were asked in that order? This is how my quest began to try and answer this question, which has been asked again many times since.

## *First steps on the trail - Audit & Beyond*

As you might know I have been writing Q&As in *Audit & Beyond* (ICAEW's Audit & Assurance Faculty's newsletter), for many years. I answered this question in that publication as follows:

**Q. I keep on reading about data analytics in auditing. What is it and as the audit compliance partner of a top 50 audit firm is this something I should be getting into now?**

A. Over the past few months this has been a very common question and I would be very surprised if this topic does not continue to rise to the top of the audit agenda over the next five years.

***What is data analytics***

Data analytics involve auditors using technology to manipulate complete data sets to improve audit quality and efficiency. This is a bit simplistic but it will suffice for this question. What is important to understand is that improving audit quality is the main driver.

***How should a top 50 audit firm be using data analytics?***

It all depends on the firm.

It goes without saying that the top four are using the technology now and are leading the way. On the whole, the other larger audit firms are right behind them. Much of the technology and methodologies used by these firms is developed in-house and/or in cooperation with third party suppliers.

Many smaller audit firms make little use of data analytics for a variety of reasons: because they do not understand it, because they do not have the resources to implement it or they might not need it. This last point is worth noting, if an auditor does not audit large data sets, data analytics might be superfluous. However, given recent increases to the audit exemption thresholds, this is becoming increasingly unusual.

I believe that more firms will start to use data analytics in auditing over the coming years as IT companies, publishers and training companies produce a larger choice of off-the-shelf products to help audit firms. The key to the effective use of data analytics in smaller firms is the availability of cost effective tools that successfully integrate with the firm's audit methodology, rather than being add-on tools.

So if you do not use data analytics now I suggest that you start looking at the options that are available to you now and on an ongoing basis, monitor developments in that area to ensure that you do not get left behind in future.

## *Feedback from the big firms*

Over the last few months I have managed to get the opportunity to talk to a number of auditors in the Big Four and Group A firms who use data analytics. The feedback I have received is mixed. Nobody who I spoke to was wholly positive about the way data analytics was being used. In short it is not quite being used in the way that you might think and it is not as 'all-powerful' and as effective as they might publicly have people believe.

## *Feedback from IAASB*

The international auditing standard setter is trying to get on top of this issue, as well. In their May meeting they said:

> '*Data analytics may be an area that many Small and Medium-sized Practices (SMPs) currently have limited knowledge or experience, but it has the potential to transform the existing audit model. Auditors who are unaware of the developments will be disadvantaged if they are not considering how data analytics could enhance audit quality and improve efficiency.*
>
> *SMPs may have advantages over larger firms as they can be more nimble and move faster in making changes to audit approach or methodologies. While there may be technology and investment barriers for SMPs, there are vendors in the market place today offering data analytics solutions that SMPs are able to make effective use of.*'

The big problem from the regulatory perspective is that an audit approach using data analytics is not necessarily compliant with ISAs! The worry is that the ISAs will never keep up with these developments which will either mean audits will fail to comply with the standards or auditors will be held back from taking full advantage of current and future developments in technology.

## *My conclusions (at the time of writing)*

Is data analytics 'the Emperor's new clothes'? Or is data analytics the future of auditing? In fact, it is both!

The reason for this is that its benefits are not necessarily what most auditors, unacquainted with the technology, expect them to be. Most auditors, not using the technique, imagine that data analytics is an audit efficiency tool. It could sometimes be applied in that way, but it is much more than that as well.

My current thoughts are that data analytics delivers the three benefits set out below. The first is the most important and efficiency is the least important benefit.

**Adding value/client service**

The thing that most auditors seem to like about data analytics is that their audit clients love it.

It provides feedback on the operation of certain systems and controls at transaction level as well as giving a both very broad and detailed analysis of the performance of the business. Most clients think that this feedback is the most useful aspect of the audit. In some ways you could regard data analytics as a non-audit service, although the independence issues can be troublesome when providing it as such.

One auditor told me that he needs data analytics because without it he would struggle to win high profile audit tenders. Management value it and they expect their next auditor to use it and give them the valuable feedback that they are starting to expect.

Is data analytics really being used as a marketing tool? The fact that KPMG use McLaren Honda F1 data makes it sound exciting and cutting edge. This must affect the firm's public perception.

**Audit quality**

Some audits with large electronically stored data sets are hard to audit using conventional techniques. Sometimes data analytics is the best tool (perhaps even the only tool?) to ensure a high quality audit.

Data analytics can be very good at testing certain controls and balances because it can quickly test the whole population, not just a sample. For instance, the three way sales test can be done on all sales (***sales order*** checked to **sales *invoice*** checked to ***delivery note***). I heard of one audit where the auditor identified a handful of sales where VAT was erroneously not charged. This had little impact on the audit but management was very impressed.

Also, data analytics can be very valuable as an analytical technique to drive the whole process of understanding the entity and the risk assessment. I understand that integrating data analytics with a conventional audit methodology to achieve this, is not easy. In practice the data analytics can often look a bit 'tacked on' and can in fact duplicate work using more traditional procedures and processes.

**Audit efficiency**

Most auditors that asked me about data analytics expected it to be primarily an efficiency tool. It can produce efficiencies but that is, in my view, very much the third benefit, significantly behind client service and audit quality. In fact, auditors in the big firms told me that using data analytics on smaller audits was usually inefficient because extracting the data and running the various routines was to a large extent a fixed cost, most of the time.

One partner in the big four told me that if the audit fee was relatively modest then data analytics was not cost effective.

## PROBLEMS FILING SMALL COMPANY ACCOUNTS (LECTURE A576 – 5.58 MINUTES)

The following is taken from John Selwood's Q&As in *Audit & Beyond*

**Q. From everything I have read I understand that when audited, filleted financial statements are filed at Companies House that no audit report should be attached and instead certain disclosures about the audit appear on the balance sheet. However, I have recently seen several companies have their accounts rejected by Companies House because the company has neither claimed audit exemption or filed an audit report. I am somewhat at a loss how to respond, because I thought I had got it right. What have I missed?**

A. You might not have missed anything. But then again there are some pitfalls here.

I am aware that this seems to be the third time that I have addressed this question in my Q&As. Despite that, this question keeps on being asked on a startlingly frequent basis, so I think it deserved a more detailed analysis this time.

Regurgitating the basics, s444 of CA2006 has been amended by SI 2015/980 and does not require an audit report where the profit and loss is not filed, as permitted by that section. Using the s444 filing exemption is commonly referred to as 'filleting' the accounts. Filleting is only available to small companies and very many of these are being audited because of the delay in the audit exemption thresholds increasing in line with the small company thresholds.

Where the full audit report is not filed under s444, the company will include certain basic disclosures about the audit on the balance sheet in line with s444(5) of the act.

One problem that I have seen is that auditors have applied the new legislation too early. SI 2015/980 applies for periods commencing 1 January 2016. Early adoption is available but that can be no earlier than periods commencing 1 January 2015. I have seen auditors attempt to use the new legislation before then. Indeed, it is sometimes surprisingly easy to miss this with a long accounting period, say 18 months to March 2016: the period began in October 2014 so the old small company regime still applies and incidentally FRS 102, Section 1A cannot be used.

When the new regime is applicable, another problem, that is being highlighted in your question, is that Companies House do not always recognise that. Perhaps this is simply a mistake by Companies House? Perhaps there is some confusion about whether or not the accounts have been prepared under the new or old Companies Act small company regime?

The special auditors' report on abbreviated accounts is withdrawn when a company adopts SI 2015/980, early or otherwise. But if the accounts are prepared under the earlier regime, then the omission of the audit report is grounds for rejection. What I have noticed is that FRS 102 Section 1A does not require disclosure of the accounting regime that the accounts are prepared under. This seems somewhat ridiculous! Wisely, the FRC have encouraged the disclosure that FRS 102, Section1A has been complied with. I wonder whether disclosing this might help flag up to Companies House that the new regime has been adopted and that an audit report is not required.

## QUARTERLY ROUNDUP

The following are extracts of Press Releases issued by the Financial Reporting Council over the last three months:

### *FRC concludes annual review of FRS 101 and proposes changes in response to feedback*

08 July 2016

Following the conclusion of the latest annual review of FRS 101 *Reduced Disclosure Framework*, the Financial Reporting Council (FRC) has today issued Amendments to FRS 101 – 2015/16 cycle and FRED 65 *Draft amendments to FRS 101 – Notification of shareholders*.

The amendments to FRS 101 are limited, and predominantly provide exemptions from many of the disclosure requirements of IFRS 15 *Revenue from Contracts with Customers*.

FRS 101 is an optional standard that allows entities within groups to prepare financial statements in accordance with IFRS, but with reduced disclosures. As part of the consultation on these amendments, stakeholders took the opportunity to provide feedback on the requirement to notify shareholders before applying the disclosure exemptions in FRS 101. Respondents felt the cost-effectiveness of this requirement could be improved, as well as the guidance provided to ensure consistent application. This feedback has led to the FRC to propose in FRED 65, which is out for public consultation today, that notification is no longer required.

Paul George, Executive Director, Corporate Governance and Reporting, said:

*'In issuing these amendments we are aiming to ensure that FRS 101 remains a cost-effective option for listed groups, by providing additional disclosure exemptions as IFRS changes. In addition, FRED 65 responds to feedback by consulting on eliminating an administrative burden.'*

Responses to FRED 65 should be provided to ukfrs@frc.org.uk by 14 October 2016. the FRC aims to finalise the amendments in December 2016, and proposes that they should apply to accounting periods beginning on or after 1 January 2016.

### *Reminders for half-yearly and annual financial reports following the EU referendum*

12 July 2016

In light of the referendum vote for the UK to leave the EU and the consequential uncertainties in the political and economic environment, the Financial Reporting Council (FRC) highlights some matters for directors to consider when preparing their forthcoming half-yearly [1] and annual financial reports.

The considerations highlighted below are high-level and designed to stimulate thinking and we encourage all companies to instigate early dialogue with their auditors.

Not all businesses will be affected to the same extent. Boards must determine what disclosures, if any, are required to ensure their financial statements and management and strategic reports [2] meet the needs of investors and comply with regulatory requirements.

We draw attention to the importance of high quality narrative information that supplements the financial statements and includes managements' view of the future outlook of the business.

**Business model**

We encourage clear disclosure of a company's business model as part of the strategic report, including a description of the main markets in which the company operates and its value chain. The disclosure should be sufficient to enable readers to make an assessment of the company's exposure arising from the outcome of the referendum.

**Principal risks and uncertainties**

Directors must consider the nature and extent of risks and uncertainties arising from the result of the referendum and the impact on the future performance and position of the business. These may also have an impact on reported amounts which could lead to further consequences such as an effect on debt covenants.

Those which the board judge to be principal risks and uncertainties must be disclosed and explained in the company's interim management [3] or strategic report. The outcome of the referendum may give rise to general macro-economic risks or uncertainties that affect all companies as well as those risks that are specific to a particular company or industry sector. Care should be taken to avoid 'boilerplate' disclosures. Company specific disclosures are more informative and useful to investors, for example, the impact of trade agreements for companies with a high level of exports to Europe.

The FRC attaches great importance to Clear & Concise reporting and any risks and uncertainties that are disclosed should enable the reader to understand how those risks and uncertainties are relevant given the specific facts and circumstances of the company. We would also expect boards to provide an explanation of any steps that they are taking to manage or mitigate those risks.

As part of the assessment of principal risks and uncertainties, boards should consider whether the referendum vote gives rise to solvency, liquidity or other risks that may threaten the long-term viability of the business; and any implications for the viability statement in the annual report.

**Market volatility**

The volatility in the markets following the referendum result may have an impact on balance sheet values at 30 June 2016 or at subsequent reporting dates. For example, financial instruments measured at fair value and discount rates used in measuring pension and other liabilities may be affected by changes in foreign exchange rates, interest rates or market prices. Cash flows included in future forecasts may need to be re-evaluated.

In respect of foreign exchange risk, the board may wish to consider the potential gains or losses arising from transactions in foreign currencies, for example, the impact on future earnings as a consequence of the decline in the value of sterling for non-UK sales.

We encourage directors to consider whether assets may be impaired and/or disclosures made consistent with the requirements of IAS 36 *Impairment of Assets*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*. They may need to consider the continued recognition of deferred tax assets. Attention should also be given to the nature and extent of sensitivity disclosures required by IAS 1 *Presentation of Financial Statements* that support estimates in the annual financial statements where due to volatility, in the short term, ranges may be wider.

Boards should also consider the disclosure of events after the reporting period that have not been adjusted in the financial statements. Examples of such events include abnormally large changes in asset prices or foreign exchange rates.

### Going concern basis of accounting

As part of the preparation of the financial statements, directors must consider whether the going concern basis of accounting is appropriate and whether disclosures of material uncertainties are needed particularly where there is a material risk of breach of covenants.

Further guidance on the application of the going concern basis of accounting is included in the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* and the FRC's *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks* [4].

### True and fair

There is an overarching requirement for annual financial statements and half-yearly reports [5] of listed issuers to give a true and fair view. We encourage directors to consider whether additional disclosures are necessary to ensure that this requirement is met.

### Half-yearly financial reports

There is a general requirement that the interim management report of listed companies must include disclosure of important events that have occurred during the first six months of the financial year, and an indication of their impact on the interim financial statements.

[1] The Financial Conduct Authority's Disclosure and Transparency Rule (DTR) 4.2 requires issuers, whose shares or debt instruments are admitted to trading; and whose Home State is the United Kingdom, to publish half-yearly financial reports. This must include: a condensed set of financial statements; an interim management report; and responsibility statements.

The condensed set of financial statements can be prepared in accordance with International Accounting Standard (IAS) 34 *Interim Financial Reporting*; or for UK issuers not using IFRS, Financial Reporting Standard (FRS) 104 *Interim Financial Reporting* issued by the Financial Reporting Council.

AIM Rule 18 sets out the requirements for half-yearly repots for AIM-quoted companies.

[2] The FRC's *Guidance on the Strategic Report* provides more information on the application of the reporting requirements for the strategic report. https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf.

[3] DTR 4.2.7 requires that the interim management report includes a description of the principal risks and uncertainties for the remaining six months of the financial year.

[4] The FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* and the *Guidance on the Going Concern Basis of Accounting* and *Reporting on Solvency and Liquidity Risks* is available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Conrol-and.pdf and https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Going-Concern-Basis-of-Accounting.pdf.

[5] DTR 4.2.10 requires directors to confirm that the condensed set of financial statements gives a true and fair view of the assets, liabilities, financial position and profit or loss of the company.

## *IASs to facilitate public assurance of insurers' Solvency II reports*

13 July 2016

The Financial Reporting Council has today released a consultation on the adoption of International Standards on Auditing (ISAs) 800 and 805 in the UK. This document seeks views on whether stakeholders believe it is appropriate to adopt these ISAs or if there is an alternative approach to support the Prudential Regulation Authority's (PRA) proposed audit requirement for public reporting in the insurance sector under Solvency II. It also seeks views on whether there are any risks associated with this proposal, and whether it would be appropriate to make UK specific adaptations to the standards.

The ISAs provide a framework for the provision of reasonable assurance opinions by auditors on particular matters. In particular, the FRC considers that their adoption could provide a framework for auditors in providing opinions on aspects of Solvency and Financial Condition Reports, as proposed by the PRA.

Melanie McLaren, Executive Director of Audit, said:

*'The FRC is carrying out this consultation in order to support the provision of high-quality assurance over public regulatory reports, in order to underpin user confidence in the information they contain. Based on our stakeholder engagement to date, we believe that auditors may have difficulty in accepting an engagement to audit Solvency and Financial Condition Reports in accordance with current ISAs (UK). This is because the current ISAs (UK) are designed for the audit of full sets of general purpose financial statements, rather than elements of special purpose reports.'*

## *Confidence grows in audit, but more needs to be done says FRC report*

14 July 2016

Confidence in audit has grown, but more needs to be done in terms of market competition and improving good practice in the profession according to a report issued today by the Financial Reporting Council (FRC).

*Developments in Audit: An Overview 2015/16* is the first report of its kind for the FRC as the UK's Competent Authority for audit. The report focuses on assessing justifiable confidence in UK audit and also summarises the current 'state of play' as seen by the FRC and its stakeholders. It is supplemented by a more detailed report of the FRC's audit related activities and evidence gathering.

The FRC believes there is a justifiably higher level of confidence in audit as a result of changes to independence requirements and the promotion of quality as a driver for competition in the audit market. However, it also notes some remaining concerns around confidence.

Melanie McLaren, FRC's Executive Director for Audit, said:

*'Our vision for audit is that it is trusted to provide reliable assurance on the public reporting o financial information, and in doing so, promotes good governance and facilitates the effective allocation of capital.*

*The FRC's strategy is to promote continuous improvement in audit quality. One of the key factors in achieving this is to engage with other regulatory professional bodies, auditors, audit committees and investors to communicate good practice.'*

Two years ago, the FRC commissioned YouGov to benchmark confidence in audit in the UK. That survey showed while those close to audit expressed confidence in the process, those more removed, including some investors, did not share the same level of confidence.

Fast forward to 2016 and the follow-up survey indicates stakeholders have a clearer understanding of what audit is and a higher level of confidence in it. But recent corporate failures and the resulting increased public scrutiny of auditors, have undermined some of this progress.

The FRC's report on the current state of audit identified these key influences on confidence:

- Audit firms are seen as more independent and competing for audit engagements on quality grounds, but concerns remain that the FTSE 350 audit market is concentrated across the Big Four firms, as the smaller firms are thought to struggle to match on skill level, resource and ability to bear the cost of tendering processes.
- EU regulatory changes have also bolstered confidence with the introduction of mandatory rotation and the tightening of rules around non-audit services provision. However, some fear the increased public and regulatory scrutiny could deter future talent from joining the profession, thus impacting long-term quality.
- The FRC's audit monitoring results and those of the professional bodies show audit quality in the UK is improving. In 2015/16, the FRC assessed 77% of FTSE 350 audits it reviewed as requiring more than limited improvements. The FRC considers that at least 90% of FTSE 350 audits should fall into that category by the end of its 2016/19 strategy.
- The large firms are beginning to improve the effectiveness and efficiency of audit through the transformative use of technology, which should prompt further competition on quality. This raises further concerns about smaller firms' ability to compete, what the role is for the auditor and how regulators and standard setters will be able to keep up.

## *Corporate culture key to sustainable growth*

20 July 2016

Today, the Financial Reporting Council (FRC) publishes the results of a study, exploring the relationship between corporate culture and long-term business success in the UK. Stakeholders and society in general have a vested interest in healthy corporate values, attitudes and behaviours that lead to sustainable growth and long term economic success.

The report is the culmination of the FRC's Culture Coalition, a collaboration with CIMA, the City Values Forum, IBE, IIA and CIPD, as well as interviews with more than 250 chairmen, CEOs and leading industry experts, from the UK's largest companies. The report explores the importance of culture to long-term value and how corporate cultures are being defined, embedded and monitored.

Sir Winfried Bischoff, Chairman of the FRC, said:

*'A healthy corporate culture leads to long-term success by both protecting and generating value in the UK economy. It is therefore important to have a consistent and constant focus on culture, rather than wait for a crisis. A strong culture will endure in times of stress and change.*

*Through our research, it has become clear that establishing the company's overall purpose is crucial in supporting and embedding the correct values, attitudes and behaviours.*

*The extremely positive response from many individuals and organisations, demonstrates how important the subject is. I would like to thank all those who joined the debate to foster sustainable growth and long-term business success in the UK.'*

Key findings of the FRC's study:

- **Recognise the value of culture:** A healthy corporate culture is a valuable asset, a source of competitive advantage and vital to the creation and protection of long-term value. It is the board's role to determine the purpose of the company and ensure that the company's values, strategy and business model are aligned to it. Directors should not wait for a crisis before they focus on company culture.
- **Demonstrate leadership:** Leaders, in particular the chief executive, must embody the desired culture, embedding this at all levels and in every aspect of the business. Boards have a responsibility to act where leaders do not deliver.
- **Be open and accountable:** Openness and accountability matter at every level. Good governance means a focus on how this takes place throughout the company and those who act on its behalf. It should be demonstrated in the way the company conducts business and engages with and reports to stakeholders. This involves respecting a wide range of stakeholder interests.
- **Embed and integrate:** The values of the company need to inform the behaviours which are expected of all employees and suppliers. Human resources, internal audit, ethics, compliance and risk functions should be empowered and resourced to embed values and assess culture effectively. Their voice in the boardroom should be strengthened.
- **Assess, measure and engage:** Indicators and measures used should be aligned to desired outcomes and material to the business. The board has a responsibility to understand behaviour throughout the company and to challenge where they find alignment with values or need better information. Boards should devote sufficient resources to evaluating culture and consider how they report on it.
- **Align values and incentives:** The performance management and reward system should support and encourage behaviours consistent with the company's purpose, values, strategy and business model. The board is responsible for explaining this alignment clearly to shareholders, employees and other stakeholders.
- **Exercise stewardship:** Effective stewardship should include engagement about culture and encourage better reporting. Investors should challenge themselves about the behaviours they are encouraging and to reflect on their own culture.

The FRC intends to reflect on the information gathered and any feedback to the report to inform the Guidance on Board Effectiveness review, and will continue to work with the Coalition partners to encourage debate on culture.

## *Financial Reporting Council publishes Annual Report for 2015/16*

21 July 2016

The Financial Reporting Council's (FRC) Annual Report for 2015/16 outlines its financial position, achievements, and challenges last year. It also details the current 2016/19 strategy in accordance with new corporate governance principles, it also covers the FRC's risk and future viability.

Financially in 2015/16, the FRC operated within its budget and raised the necessary funds through its levies. It consulted on funding arrangements to support its new audit responsibilities.

During the next strategic period, the FRC will focus strongly on making a success of its new role as the competent authority for audit in the UK.

It will, among its work on many key areas, continue promoting the importance of audit quality, corporate culture and Clear & Concise reporting.

The FRC acknowledge that having strengthened the regulatory landscape over the past three years, there is still a way to go in securing further improvements. Boards have made progress in embedding Strategic Report requirements, however, more work is needed to ensure that these disclosures clearly and concisely monitor the company's position, performance and prospects.

Sir Winfried Bischoff, Chairman of the FRC, said:

*'Our Strategic Report explains the actions we have taken to strengthen the regulatory framework in response to the financial crisis. We wish to give boards, auditors and the professions – and investors – the opportunity to absorb and respond to those initiatives before we make any further significant changes to our codes and standards. Under our new three year strategy, for 2016-19, we will continue our work to drive up standards, through our regulatory powers, but also through the work of our Financial Reporting Lab and other non-regulatory initiatives.*

*I have taken a personal interest in our 'culture coalition' project. In my experience, embedding a healthy corporate culture, with a focus on respect and good behaviour, is vital to the success of any business and creates an environment on which investors can depend. We have brought together a number of organisations to gather insight into corporate culture and the role of boards, to understand how boards can shape, embed and assess culture, and to identify and promote good practice.*

*2016 sees a steep change in the FRC's responsibilities. New rules on audit regulation across the EU took effect on 17 June 2016. The FRC has been designated as the UK Competent Authority under the Audit Regulation and Directive. Our clear aim is that by the end of the strategy period at least ninety percent of FTSE 350 audits will require no more than limited improvements as assessed by our monitoring programme.'*

In 2016/17 the FRC will undertake the following actions:

- Make the best use of our role as Competent Authority for Audit regulation to drive further improvements in audit quality and strengthen investor confidence.
- Promote the importance of establishing a company specific corporate culture to support long-term sustainable growth.
- Encourage better reporting against the Stewardship Code by assessing the quality of signatory statements.
- Assess the quality of viability reporting in the light of the 2014 UK Corporate Governance Code.
- Continue to promote Clear & Concise reporting, including through the project to help smaller listed and AIM companies with the quality of their reporting.
- Enhance confidence in actuarial work by implementing a new Technical Actuarial Standards framework.

## *FRC comments on Executive Remuneration Working Group's final report*

26 July 2016

Stephen Haddrill, Chief Executive of the Financial Reporting Council comments on the findings of the final report of the Executive Remuneration Working Group:

*‘Corporate governance in the UK has a justifiably strong global reputation but this and confidence in business generally is being tarnished by the actions of those companies which are doing too little to recognise legitimate shareholder and public concerns on remuneration. Investors have a key role in holding companies to account and we therefore welcome this thoughtful report. The FRC will consider the recommendation on the need for RemCo chairs to have the skills and experience to undertake the role as part of a wider review of measures we can take to address public concern.*

*The FRC welcomes the Government’s focus on improving corporate conduct including on remuneration and its determination to strengthen the voice at the Board of a wider group of stakeholders. This issue was addressed in the FRC’s recent report ‘Corporate Culture and the Role of Boards’, which noted how continuing inconsistent alignment between executive remuneration and company performance, and between executive remuneration and company performance, and between the remuneration of senior executives and employees in some companies has led to an increasing lack of public confidence. Boards and remuneration committees must do more to link culture and values to the design of remuneration policies.’*

## *Revised UK Audit Firm Governance Code: sharpens purpose, enhances transparency*

27 July 2016

The Financial Reporting Council (FRC) has today published a revised version of the UK Audit Firm Governance Code. Following consultation, the Code – which provides a benchmark of good governance practice against which firms that audit listed companies can report – has been updated further to promote good governance of audit, align more with the UK Corporate Governance Code, enhance transparency and improve engagement between firms, investors and independent non-executives.

Stephen Haddrill, FRC CEO, said:

*‘The UK Audit Firm Governance code plays an integral role in enhancing justifiable trust and confidence in the value of audit among the public, particularly investors. The firm’s transparency reports need to reflect this by including content that is of greater relevance to stakeholders.*

*We have clarified the purpose of the Code in the promotion of audit quality; helping secure the reputation of firms more broadly, including their non-audit businesses; and reducing the risk of firm failure. New provisions also promote greater transparency of reporting to all stakeholders including on the firms’ viability. We look for strong governance in all the firms that are covered by the Code in support of their public interest responsibilities for delivering quality audits.’*

The FRC will conduct regular reviews of transparency reports to highlight best practice and innovation in governance. It will consider the extent to which firms are adopting provisions from the UK Corporate Governance Code and assess whether there is scope for their future incorporation into the Audit Firm Governance Code.