Accounting and Audit Quarterly Update – Quarter 3

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1 FRS 102: Emerging issues (Lectures A597 and A598 – 26.28 and 22.55 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* has tightened its grip on small companies mandatorily from 31 December 2016 year-ends onwards. This means that all companies in the UK and Republic of Ireland are either going through, or have gone through the transition to 'new' UK GAAP.

The transition to a new financial reporting regime was not going to be 'plain-sailing' for all companies; indeed, some practitioners have reported a relatively smooth transition, whereas others have had considerable difficulty. For companies at the smaller end of the scale, there are fewer transitional and prior year adjustments being effected in the financial statements, but for larger companies this is not the case. Indeed, given the increase in the size thresholds which determine the size of a company, many 'smaller' companies are experiencing some fairly complex transitions and lessons can be learnt from the transition process, particularly where audit issues are concerned.

Some issues have begun to emerge now that FRS 102 is being put into practice across the board which will be addressed in this course, including:

- Directors' loans to a company following FRED 67
- Investment property accounting treatment
- Property, plant and equipment revaluations and previous revaluations as deemed cost
- Distributable versus non-distributable reserves
- Disclosure of the average number of employees
- Disclosure of accounting policies

1.1 Directors' loans to a company following FRED 67

The Audit and Accounting Quarterly Update – Quarter 2 examined the detailed provisions in FRED 67 *Draft Amendments to FRS 102 – Triennial Review 2017* which was issued by the FRC on 23 March 2017. One of the most notable changes to FRS 102 concerned directors' loans and the treatment of these under the standard.

Directors' loans to a company are often made at favourable terms; i.e. at zero per cent interest rates or at a rate of interest which is below market rate. The default treatment in FRS 102 (September 2015) is that these types of loans are discounted to present value using a market rate. In practice this has caused considerable difficulty in some entities and the FRC have provided a relief which should resolve the problem for small companies.

The changes proposed in FRED 67 are not expected to be finalised until the end of 2017. On 8 May 2017, the FRC published a Press Release confirming that they are to bring in immediate relief for directors' loans to a small company. This has been misinterpreted by a number of practitioners and it is important to emphasise some key points where this relief is concerned.

Firstly, the relief is only available for **small companies** as defined in the Companies Act 2006. The relief is not available for companies that are not eligible to apply the small companies' regime in the preparation of their financial statements, therefore medium-sized entities upwards will not have the relief available to them.

Secondly, the relief is only available in respect of loans **to** the company from a director who is also a **shareholder**. The relief is not available where the company makes a loan to a director. Some practitioners have misinterpreted the relief as being available in respect of directors' loans (both to and from a director) and this is not the case. The loan has to be from a director-shareholder, but it can also be from a close family member of the director-shareholder. The Glossary to FRS 102 defines 'close members of the family of a person' as:

FRS 102 Glossary ***close members of the family of a person***

'Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:

(a) that person's children and spouse or domestic partner;

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner.'

The relief is available for director-shareholder loans in the financial statements of a small company for accounting periods ending on or after 31 December 2016. The FRC brought forward the relief on the basis that they are not expecting objections to it and means that all small companies can reflect loans from a director-shareholder, or a close family member of that director-shareholder, at cost.

1.2 Key points to note: directors' loans

- The relief in respect of a director-shareholder's loan to a company only applies to a small company (as defined in the Companies Act 2006).
- The director must be a shareholder; they do not have to be a majority shareholder.
- The relief only applies to loans **from** a director-shareholder, not a loan to a director-shareholder.
- The loan can also be provided from a close family member of the director-shareholder.
- The relief is immediately available and can be applied by small companies from 31 December 2016 year-ends onwards.

1.3 Investment property accounting treatment

There appears to be some confusion surrounding the accounting treatment for investment properties including too much reliance on the 'undue cost or effort' exemption contained in Section 16 *Investment Property* at paragraph 16.1. In addition, it is apparent that some practitioners have also been incorrectly depreciating investment property under old UK GAAP, when this should not have been the case, as investment property should have been carried at open market value at each balance sheet date. Effectively, investment property is not depreciated; it is revalued at each reporting date to fair value and this is also the case under FRS 102.

Paragraph 16.2 of FRS 102 says that:

'Investment property is property (land or a building, or part of a building, or both) held by the owner or by the lessee under a ***finance lease*** *to earn rentals or for capital appreciation or both, rather than for:* *FRS 102.16.2*

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.'

Some practitioners have incorrectly classified properties as investment property and vice versa. Essentially, if the entity earns rentals from a property, or a group of properties, it will meet the definition of investment property and hence should be accounted for under the provisions in Section 16.

Example
A plant hire company has a bank of land which it is planning to hold for several years until its value appreciates to an optimum level at which point the company will sell it. The land would meet the definition of investment property under paragraph 16.2 and hence should be accounted for under the provisions in Section 16 and measured at fair value at each reporting date.

The definition of investment property in paragraph 16.2 makes it clear that investment property does not have to be a property in its own right, it can be land or a combination of land and buildings. It can also be:

- land which is held by the entity for an undetermined length of time (the default presumption is that the land is being held for capital appreciation purposes);
- property in the course of construction for future use as investment property;
- a vacant building which will be leased out under an operating lease; and

- a building which is owned, or held, under a finance lease by an entity which is leased out to a tenant under an operating lease.

Example

A company has a bank of properties from which it earns rentals from tenants. The finance director has included these properties within property, plant and equipment and is depreciating the buildings on a straight line basis of 50 years (i.e. 2% on cost).

The finance director is incorrect to account for the properties as property, plant and equipment as they meet the definition of investment properties as the company is earning rentals from them. They should be accounted for under Section 16 of FRS 102, as they meet the definition of investment property.

Once it is established that a property meets the definition of investment property it should be accounted for under Section 16 (not Section 17 *Property, Plant and Equipment*). On initial recognition, the investment property will be included in the balance sheet at cost which may include:

- legal and brokerage fees;
- property transfer taxes; and
- other directly attributable costs.

'Other directly attributable costs' are not defined in FRS 102, but are taken to be those costs which would be avoided if the entity had not acquired the property.

After initial recognition, the investment property must be measured at fair value at each balance sheet date with changes in this fair value going through profit and loss – **not** a revaluation reserve as was the case under previous UK GAAP. Investment property is not depreciated, nor is it carried under the revaluation model; it is measured at fair value through profit or loss each year. The reason that the accounting is notably different in respect of gains and losses on an investment property is because FRS 102 uses the fair value accounting rules, which require fair value gains and losses to be taken to the profit and loss account. Previous UK GAAP used the alternative accounting rules which requires gains and losses to be taken to a revaluation reserve.

This change in accounting treatment has caused some confusion in the profession and it is important that accountants clearly understand the accounting because otherwise the financial statements may be materially incorrect, and may also be brought to the attention of the practitioner during any routine monitoring visit/file review if the practitioner is not aware of the rules in FRS 102.

Example

On 1 April 2017, a company purchases a property that it intends to let out to a third party for £250,000. The company has a 31 March accounting reference date.

<u>On initial recognition</u>

Dr Investment property	£250,000
Cr Cash at bank	£250,000

On 31 March 2018, the property has increased in value by £40,000.

<u>Revaluation at 31 March 2018</u>

Dr Investment property	£40,000
Cr Fair value adjustment (P&L)	£40,000

In the example above, the fair value gain has been taken directly to the profit and loss account as a fair value adjustment (i.e. within operating profit). It has not been taken directly to the revaluation reserve as was the case under previous UK GAAP.

Deferred tax should also be brought into account in respect of the gain to comply with paragraph 29.16 which says:

'Deferred tax relating to ***investment property*** *that is measured at* ***fair value*** *in accordance with Section 16 Investment Property shall be measured using the tax rates and allowances that apply to sale of the asset, except for investment property that has a limited* ***useful life*** *and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time.'* *FRS 102.29.16*

Therefore, in the example above where there has been a £40,000 fair value gain, if it is assumed that the property will be held for a number of years, the deferred tax liability is £6,800 (£40,000 x 17%) as the rate of tax that may apply to the sale of the property and that has been enacted by the balance sheet date will be the rate of tax applicable on 1 April 2020 for the corporation tax Financial Year 2020 of 17%.

The deferred tax is taken to the tax expense in profit and loss as follows:

Dr Income tax expense	£6,800
Cr Deferred tax provision	£6,800

1.4 Undue cost or effort exemption

A notable feature of FRS 102 is that it contains a number of 'undue cost or effort' exemptions. For example, paragraph 16.1 of FRS 102 (September 2015) says that only investment property whose fair value can be measured reliably without undue cost or effort on an on-going basis should be accounted for under Section 16, otherwise it is accounted for under Section 17 *Property, Plant and Equipment* under the historic cost model.

FRED 67 is proposing to remove several undue cost or effort exemptions because they are not being applied properly. They are being treated as accounting policy choices, which they are not. Therefore, the FRC will remove the undue cost or effort exemption in paragraph 16.1 once the triennial review of FRS 102 has been completed (a final version of the revised standard is expected towards the end of 2017) and the consequence of this will be that all property which meets the definition of an investment property must be measured at fair value through profit and loss at each balance sheet date. The change will apply mandatorily for accounting periods starting on or after 1 January 2019, although it is likely early adoption will be permitted. It is therefore unwise to use the undue cost or effort exemption as it will not be available for periods starting on or after 1 January 2019. Applying the undue cost or effort exemption might also raise questions by professional bodies during the course of any monitoring visit and so it is strongly advisable to document the reasons why any undue cost or effort exemptions have been exercised (especially where the client is an audit client).

Groups will get some relief from having to fair value investment property as FRED 67 proposes to bring in an accounting policy choice where investment property let to, and occupied by, group members can be measured at fair value through profit or loss or at historic cost – but this relief will **only apply to groups** which have investment property that is occupied by a group member. Effectively, this will restore the previous position found in SSAP 19 *Accounting for investment properties* which contained a scope exemption for properties let to, or occupied by, group members from being accounted for as investment property.

1.5 Key points to note: investment property

- Fair value gains and losses are taken directly to profit and loss not to a revaluation reserve.
- Deferred tax is brought into account and this is also taken to tax expense in the profit and loss account.

- Deferred tax is calculated using the tax rates that apply to the sale of the property; in practice this will be either 19% (if the sale is expected to arise before 1 April 2020) or 17% if the sale is expected to take place after 1 April 2020.
- It is unwise to use the undue cost or effort exemption in paragraph 16.1 of FRS 102 as it is being withdrawn.
- Groups will get some relief from having to measure investment property let to, or occupied by, group members at fair value as FRS 102 will contain an accounting policy choice to allow such properties to be measured under the historical accounting rules.

1.6 Property, plant and equipment revaluations and previous revaluations as deemed cost

Property, plant and equipment are dealt with in Section 17 *Property, Plant and Equipment* in FRS 102. Section 17 allows a reporting entity to measure property, plant and equipment (PPE) under either the cost model or the revaluation model. Where the entity applies the revaluation model, it will be applying the alternative accounting rules in the Companies Act 2006 and hence additional disclosures will be necessary. It should also be noted that deferred tax must be considered where an item of property, plant and equipment is revalued due to the timing difference plus approach in Section 29 *Income Tax*.

The revaluation model in Section 17 works in much the same way as the revaluation model in the previous FRS 15 *Tangible fixed assets*. The asset is revalued to fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent impairment losses.

In practice the most common type of fixed asset to be revalued is a property. FRS 15 at paragraph 45 said that where properties are revalued, an up-to-date revaluation should be obtained at least every five years with an interim valuation in year 3. Interim valuations should also be obtained in years 1, 2 and 4 where there had been a material change in value.

FRS 102 is not as specific as previous FRS 15 and this is where professional judgement will need to be carefully exercised. Paragraph 17.15B of FRS 102 (September 2015) says that revaluations should be made with **sufficient regularity** to ensure that the carrying amount of the revalued fixed asset does not differ materially from that which would be determined using fair value at the balance sheet date.

The frequency of the revaluation exercise will all depend upon fluctuations in the fair value of the asset. Some assets may experience significant and volatile movements in fair value and therefore it may be the case that annual revaluations are necessary; whereas other types of assets may experience insignificant and less volatile movements in fair values which would mean the revaluation exercise is carried out less frequently. FRS 102, paragraph 17.32A(a) requires disclosure of the effective date of the revaluation and this also applies to small companies per paragraph 1AC.15(a).

FRS 102 is inherently simpler than previous FRS 15 because all revalued assets are measured at fair value, whereas previous FRS 15 required a variety of valuation bases for different kinds of properties.

For example, non-specialised properties were based on existing use value. The existing use basis assumed that the property could only be used for the foreseeable future for its existing use; whereas the focus of FRS 102 is on fair value which does not reflect such an assumption as can be seen in the following example:

Example

A building that was used as a 'do-it-yourself' retailer is going to be converted in to apartments.

Under FRS 15, the building would have been valued as a retail outlet; whereas under FRS 102, the valuation will reflect the alternative use. As a consequence, the valuation under FRS 102 may be higher than what would have been achieved under previous FRS 15 and hence a higher depreciation charge would be reflected in the financial statements.

When an item of property, plant and equipment is revalued the revaluation gain or loss is taken directly to a revaluation reserve within the equity section of the balance sheet and is reported as other comprehensive income. Gains should only be recognised in profit and loss to the extent that they reverse a revaluation decrease of the same asset that was previously recognised in profit or loss.

Conversely, losses on revaluation should only be recognised in the revaluation reserve to the extent of a credit balance on the revaluation reserve. Any remaining loss is taken to the profit and loss account. Should the asset appreciate in value at the next revaluation, the gain is recognised in profit or loss to the extent of the loss recognised, with any further gain being recognised in the revaluation reserve.

This is notably different than under previous FRS 15. Under FRS 15, it was possible to recognise a fall in value below historical cost in the statement of recognised gains and losses (STRGL) and revaluation reserve in certain circumstances. Any fall in value below depreciated historic cost was recognised in the profit and loss account unless it could be demonstrated that the recoverable amount of the asset was greater than its revalued amount, in which case the loss was taken to the STRGL to the extent that the recoverable amount of the asset was greater than its revalued amount.

Example

On 1 January 2016, a company acquired some land for £75,000 and at its year-end 31 December 2016, the land was revalued to £60,000. On 31 December 2017, the land had increased in value to £85,000.

The revaluation loss on 31 December 2016 is £15,000 and this is recognised in the profit and loss account.

The land appreciates in value as at 31 December 2017 to £85,000 which is a £25,000 increase in its carrying value. The revaluation gain is accounted for as follows:

- £15,000 is credited to the profit and loss account to reverse the previously recognised loss
- £10,000 is credited to the revaluation reserve and reported as other comprehensive income

1.7 Revaluations and depreciation

FRS 102 is silent on how accumulated depreciation on an asset that has been revalued should be treated. Paragraph 35 of IAS 16 *Property, Plant and Equipment* allows a choice of one of two treatments:

Method 1: adjust the gross carrying amount in a manner which is consistent with the revaluation of the carrying amount of the asset. The accumulated depreciation at the date of the revaluation is adjusted so that it is equal to the difference between the gross carrying mount and the carrying amount of the asset after taking into account accumulated impairment losses; or

Method 2: the accumulated depreciation is eliminated against the gross carrying amount of the asset.

Example

A property has a carrying value of £188,000 made up of cost of £200,000 and accumulated depreciation of £12,000. The property is revalued to fair value of £225,600.

	Method 1	**Method 2**
Cost/valuation	£	£
Prior to revaluation	200,000	200,000
Revaluation adjustment	40,000*	25,600
After revaluation	240,000	225,600
Accumulated depreciation		
Prior to revaluation	12,000	12,000
Revaluation adjustment	2,400	(12,000)
After revaluation	14,400	-
Revalued amount	225,600	225,600

*Property fair value increased by 20% (£225,600 - £188,000/£188,000 x 100) hence uplift of 20% on cost and 20% on depreciation.

1.8 Transfer between revaluation reserve and retained earnings

The Accounting Regulations say that an amount may be transferred from the revaluation reserve to retained earnings (profit and loss reserves) if the amount was previously charged to that account or represents realised profit. There is no specific requirement to make this transfer but if it is not done, the balance on retained earnings will understate the profits which are available for distribution.

Note: the Accounting Regulations refer to the profit and loss 'account' which means the reserve, not the detailed trading and profit and loss account.

There are two types of transfer which can be undertaken:

- Each year, a transfer from the revaluation reserve to the profit and loss reserves equivalent to the excess depreciation that has been charged in respect of the revalued asset (i.e. the depreciation charged under the revaluation model less the depreciation that would have been charged under the cost model).
- When the entity disposes of the asset, the balance remaining on the revaluation reserve is transferred to the profit and loss reserves.

Example

A company has an item of property, plant and equipment which is carried under the revaluation model. The annual depreciation under the revaluation model is £20,000 but under the cost model would have been £15,000. The difference of £5,000 should be transferred from the revaluation reserve to the profit and loss reserves each year so that the value of the revaluation reserve which becomes realised by the depreciation charge is correctly reflected in the equity section of the entity's balance sheet as only the depreciation charge calculated under the historical cost accounting rules should impact on the balance of profit and loss reserves available for distribution.

1.9 Previous revaluations as deemed cost

As companies complete their transition to FRS 102, this issue will largely fade away from the start of next year but there are some important considerations that should be borne in mind when a company applies paragraph 35.10(d) ***Revaluation as deemed cost*** on transition to FRS 102.

Under previous FRS 15, a company could measure its tangible fixed assets using the revaluation model. This would have represented a change in accounting policy from the historic cost model. A company changes an accounting policy voluntarily when the revised policy results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the financial position, financial performance or cash flows.

It was virtually impossible to revert back to the historic cost model when an entity revalued an asset because the entity would not be able to justify how a switch back to historic cost provides reliable and more relevant information than the revaluation model. Therefore, once a company was on the revaluation model, it was essentially stuck with it.

This transitional exemption may be particularly useful where a company has previously revalued an asset, but no longer wishes to obtain periodic revaluations. Where this transitional exemption is applied, the valuation used must be at, or before, the date of transition but not after. For example, a small company with a 31 December 2016 year-end is mandatorily required to transition to FRS 102 and its date of transition will be 1 January 2015. A valuation carried out on 31 December 2015 cannot be used as deemed cost as it would be inappropriate to apply this valuation to a balance sheet which is made up a year earlier.

A company applying paragraph 35.10(d) and using a previous GAAP revaluation as deemed cost will be applying the alternative accounting rules in the Companies Act 2006. Notwithstanding the fact that the company is using a revaluation as deemed 'cost', the company is still using a revalued amount because the asset(s) concerned is not stated at its purchase price or production cost. As a consequence, the reporting entity must present a revaluation reserve within the equity section of its balance sheet and make the disclosures required by paragraph 34(3) of Schedule 1 to the Accounting Regulations. Paragraph 34(3) of Schedule 1 to the Accounting Regulations was amended by SI 2015/980 and says:

'In the case of each balance sheet item affected, the comparable amounts determined according to the historical cost accounting rules must be shown in a note to the accounts.'

Sch 1 Accounting Regulations paragraph 34(3)

This means that the entity must disclose the historical cost equivalent amounts (cost and depreciation) that would have been reported had the revalued asset(s) not been revalued.

Paragraph 34(4) states that 'comparable amounts' relate to:

- the aggregate amount that would have been shown in respect of the revalued asset if the asset's carrying value had been determined by the historical cost accounting rules; and
- the aggregate amount of accumulated depreciation or diminution in value which would be permitted or required in determining the amounts under the historical cost accounting rules.

In addition, deferred tax should also be brought into account on the revaluation surplus regardless of the fact that the asset is stated at a 'deemed cost'.

Example

A company uses a previous revaluation as deemed cost on transition to FRS 102 as at 1 April 2015 (for a 31 March 2017 year-end). The associated revaluation surplus is £45,000 and the company is not planning on selling the asset for the foreseeable future.

On transition, deferred tax will be recognised on this previous revaluation amount of £7,650 (£45,000 x 17%). The entries on transition will be:

Dr Profit and loss account reserves £7,650

Cr Deferred tax provision £7,650

The term 'deemed cost' is defined in the Glossary to FRS 102 as:

'An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent ***depreciation*** *or* ***amortisation*** *assumes that the entity had initially recognised the* ***asset*** *or* ***liability*** *at the given date and that its cost was equal to the deemed cost.'*

FRS 102 Glossary
deemed cost

It is not possible to use a previous GAAP carrying value (i.e. net book value) as deemed cost for any type of property, plant and equipment, investment property or intangible asset. In addition, it should also be borne in mind that when a micro-entity chooses to apply FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, it will not be able to revalue any assets and will also not be able to use a previous GAAP revaluation as deemed cost as the standard requires all assets to be stated under the historical cost accounting rules. This is an issue which should be considered carefully when determining the appropriateness of FRS 105 to a micro-entity that has previously revalued an asset. Any restatement of the asset back to historic cost principles is likely to have an adverse impact on the balance sheet position, so an impact assessment should be carried out beforehand.

1.10 Key points to note: revaluations and previous GAAP revaluations as deemed cost

- While the accounting for a revaluation is similar to that under previous UK GAAP, deferred tax should also be brought into account.
- FRS 102 requires revaluations to be carried out with 'sufficient regularity' to ensure there is no material difference between fair value at the balance sheet date and carrying value. Professional judgement will be needed in this respect.
- The date of the last revaluation exercise should be disclosed in the financial statements.

- Revaluation losses are taken to the revaluation reserve to the extent of a surplus on the revaluation reserve; any excess loss is taken to profit or loss.
- Revaluation gains can be taken to the profit and loss account to the extent of a previous loss recognised in profit and loss; any excess gain is taken to the revaluation reserve.
- Annual transfers from the revaluation reserve to the profit and loss reserve should be carried out in respect of the excess depreciation so that the balance of distributable profit is not understated, although the Companies Act 2006 does not mandate such a transfer.
- Where a previous GAAP revaluation is used as deemed cost, a revaluation reserve will need to be presented.
- Disclosures under paragraph 34(3) of Schedule 1 to the Accounting Regulations with regard to revalued assets versus their equivalent values under the historical cost accounting rules should be made when a previous GAAP revaluation is used as deemed cost.

1.11 Distributable and non-distributable reserves

FRS 102 is going to give rise to more non-distributable reserves due to the emphasis on fair value accounting (e.g. investment property fair value gains) and care must be taken to ensure these are not distributed to the shareholders; especially where a 'lifestyle' business is concerned.

In April 2017, ICAS and ICAEW issued TECH 02/17BL *Guidance on Realised and Distributable Profits Under the Companies Act 2006*. This technical release acknowledges that while 'new' UK GAAP does not raise any fundamentally new issues in relation to realised and distributable profit, the application of the new suite of standards may lead to changes in the timing and amount of profit which an entity recognises.

The term 'distribution' is not confined to dividends. Section 829 of the Companies Act 2006 says:

'In this Part "distribution" means every description of a company's distribution of assets to its members, whether in cash or otherwise, subject to the following exceptions.'

Companies Act 2006 Section 829(1)

Section 829(2) then goes on to clarify that the following are not distributions:

Companies Act 2006 Section 829(2)(a) to (d)

(a) an issue of shares as fully or partly paid bonus shares;

(b) the reduction of share capital—

(i) by extinguishing or reducing the liability of any of the members on any of the company's shares in respect of share capital not paid up, or

(ii) by repaying paid-up share capital;

(c) the redemption or purchase of any of the company's own shares out of capital (including the proceeds of any fresh issue of shares) or out of unrealised profits in accordance with Chapter 3, 4 or 5 of Part 18;

(d) a distribution of assets to members of the company on its winding up.

Distributions can only be made out of distributable profit. Section 830(2) of the Companies Act 2006 says:

'A company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.'

Companies Act 2006 Section 830(2)

An important point to emphasise is that realised losses **cannot** be offset against unrealised profits.

A company is prohibited in law from making a distribution to a shareholder (often referred to as a 'member'), or a company owned by a shareholder, for less than its fair value, or to assume a liability from them for receipt of consideration at below fair value. An exception to this rule would be where the value of distributable reserves is still positive after the transfer has been made and taking account of any profit or loss on the transfer.

Paragraph 2.9B of TECH 02/17BL (which replaces TECH 02/10) cites the case of *Aveling Barford v Perion Ltd [1989]*. In this case, the defendant owned and controlled Aveling Barford which was sold to Perion Ltd, a company which was also controlled by the defendant. The property consisted of a country house and 18 acres of land in Grantham, which was sold for £350,000 as opposed to £1,150,000 for which it had been valued for mortgage purposes. The court looked at the substance of this transaction and concluded that it was an unlawful distribution because it was known, and intended, to be a sale at below market value.

When a distribution becomes unlawful, the consequences are serious because it cannot be ratified by the shareholders. The recipient of the unlawful distribution can be forced to repay it (and often is if the company is being liquidated). If the distribution involves non-cash assets, the recipient can be forced to repay an amount equivalent to the fair value of the non-cash asset transferred in the distribution.

While the courts ruled in the Aveling Barford case that the distribution was unlawful, it did raise an element of confusion for companies that were considering distributing company assets to shareholders because it was unclear as to whether sufficient distributable reserves would be needed to cover the difference between the transfer price and fair value if fair value was higher than book value, or whether the book value of the asset in question was the relevant amount.

This issue has been codified in the Companies Act 2006. Section 845 effectively says that where a company has distributable reserves, any transfer of an asset for at least its book value will not be an unlawful distribution. Where the asset is transferred to a shareholder for less than book value, the difference between the transfer price and the book value has to be covered by distributable reserves. If the company does not have distributable reserves, then it will not be able to transfer any assets to shareholders at below market value.

In practice, the effect of the rules is more likely to affect group companies because often group companies will transfer assets at book values rather than fair values to avoid the need to obtain a valuation of the asset and then put consolidation adjustments through the group accounts.

1.12 Profit available for distribution

All references to 'realised profits' and 'realised losses' are dealt with in section 853(4) of the Companies Act 2006. This section says that realised profits and realised losses are to profits or losses which are treated as realised in accordance with principles generally accepted at the time when the accounts are prepared (i.e. GAAP).

When a company makes a distribution out of distributable profit (for example a dividend), the directors must consider whether this distribution would be lawful having regard to the company's 'relevant accounts'. Section 836(2) says:

'The relevant accounts are the company's last annual accounts, except that—

Companies Act 2006 Section 836(2)(a) and (b)

(a) where the distribution would be found to contravene this Part by reference to the company's last annual accounts, it may be justified by reference to interim accounts, and

(b) where the distribution is proposed to be declared during the company's first accounting reference period, or before any accounts have been circulated in respect of that period, it may be justified by reference to initial accounts.'

It should be noted that group accounts are not relevant accounts for the purposes of determining a company's profit available for distribution.

1.13 Unrealised gains and losses

Certain accounting treatments in FRS 102 will give rise to gains and losses being recognised which are unrealised for distribution purposes. Care must be taken where such unrealised gains are concerned because if they are distributed to the shareholders, they can be forced to repay the unlawful distribution.

Example

A small company reporting under FRS 102 for its year-end 31 March 2017 has an investment property on the balance sheet which has increased in value on 31 March 2017 by £10,000. The company is not planning on selling the investment property and has correctly accounted for the fair value gain in profit and loss and has also recognised an associated deferred tax liability of £1,700 (£10,000 x 17%). The company has historically maintained a low level of profit and loss reserves as the shareholders extract the profit in the form of a dividend.

Care must be taken to ensure that the net gain of £8,300 (£10,000 less £1,700) is not distributed to the shareholders because fair value gains on an investment property are not realised gains for the purposes of distributions.

Where unrealised gains and losses are concerned, it is advisable to ring-fence such non-distributable reserves in a 'Fair value reserve' account which would sit within the equity section of the balance sheet. This would ensure that these reserves are not inappropriately distributed to the shareholders. Most reputable accounts production software systems will cater for this as it is considered much more effective in prohibiting non-distributable reserves from being distributed, even though there is nothing in company law which specifically requires this treatment. The alternative would be to keep a record of the value of non-distributable reserves on file, although this method is more prone to error as it may not be updated as regularly as it should be if the preparer forgets.

1.14 Key points to note: distributable v non-distributable profit

- TECH 02/17BL replaces TECH 02/10 and must be considered where distributions are concerned.
- If a distribution becomes unlawful, the consequences are serious because it cannot be ratified by the shareholders.
- Where a company does not have distributable reserves then it will not be able to transfer any assets to members at below market value.
- The various accounting treatments in FRS 102 will give rise to more profits being non-distributable and these should be ring-fenced wherever possible.

1.15 Average number of employees

A new disclosure requirement under FRS 102, including small companies, is the average number of employees employed during the reporting period.

Questions have arisen as to whether directors are employees for the purposes of this disclosure. The answer would all depend on the situation. For example, a non-executive director (NED) is not employed by the company, whereas an executive director is. A NED would not form part of the average number of employees during the period, but an executive director would. For charitable companies, a trustee would not generally be an employee as they would act in the same capacity as a NED.

The calculation of the average number of employees is spelt out in the Companies Act at section 382(6) as follows:

Companies Act 2006 Section 382(6)

(a) find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not);

(b) add together the monthly totals; and

(c) divide by the number of months in the financial year.

It is important that this calculation is carried out correctly and the **average** number of employees is used rather than the actual number of employees on the payroll at the year-end. For example, at the year-end a company may have 48 employees on the payroll, but an average number throughout the year of 53, hence the company may be tipping into medium-sized territory. As the size thresholds determining the size of a small company have been increased to £10.2 million turnover and £5.1 balance sheet total, more companies will fall under the small companies' umbrella and hence the importance of calculating the average number of employees correctly has moved up the ranks.

Example

A company is considering whether it qualifies to use FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* for its first financial statements prepared under new UK GAAP for the year-ended 31 March 2017.

The accounts semi-senior has calculated the average number of employees to be 10.2 and has asked if he should round that figure up or down.

Rounding up or down is irrelevant where the threshold for micro-entity qualification is concerned. The maximum number of employees for micro-entity classification is 10 and 10.2 is more than 10 so it would fail to qualify to use FRS 105 on employee numbers. It may qualify to use FRS 105 if turnover is not more than £632,000 and its balance sheet total (fixed assets plus current assets) is not more than £316,000.

It should be noted that the average number of employees should be disclosed in the accounts lodged at Companies House (e.g. in the 'filleted' accounts). Some practitioners incorrectly assume that the average number of employees relates to payroll which is a profit and loss account item and hence can be 'filleted' out in the accounts for Companies House. The average number of employees is not a payroll disclosure and relates to the business as a whole as it informs the user how many employees the business has and hence should be included in the accounts lodged with Companies House.

Micro-entities

FRED 67 includes proposals for micro-entities reporting under FRS 105 to include the average number of employees in their financial statements. This is actually a requirement of section 411 of the Companies Act 2006 and so should have always been a requirement of FRS 105, and hence should have always been disclosed. While the provisions in FRED 67 are not scheduled to take effect until periods starting on or after 1 January 2019, it is probably advisable to include the average number of employees as a matter of course straightaway to ensure that the deeming provisions are met (the deeming provisions being the presumption that the micro-entity's accounts give a true and fair view if the minimum legal requirements are complied with).

1.16 Key points to note: employee numbers

- The average number of employees is a calculation specified in section 382(6) of the Companies Act and is not the actual number of employees employed by the business at the balance sheet date.
- The inclusion of directors in the calculation would depend on specific facts and circumstances (e.g. non-executive directors are not actually employed by the entity and hence would not be included, whereas executive directors would).
- The average number of employees should be disclosed in both the accounts prepared for the shareholders and in the filleted accounts, where these are lodged at Companies House.
- Micro-entities should disclose the average number of employees in their financial statements as this is a requirement of section 411 of the Companies Act 2006.

1.17 Accounting policies

Accounts production software systems will, in most cases, generate a large proportion of the client's accounting policies but over-reliance on accounts production software can be detrimental.

Paragraph 3.17(e) requires an entity to disclose its 'significant' accounting policies in the notes to the financial statements. This does not mean that every conceivable accounting policy should be disclosed and quite often accounts production software systems will produce standard notes, some of which may not be applicable to the client.

Preparers should not be afraid to remove accounting policies which are either immaterial or not applicable to the client. For example, if a company does not have any assets under hire purchase or finance leases, there is little point in having a lengthy accounting policy explaining how assets held under hire purchase or finance leases are treated in the financial statements.

Conversely, accounting policies which are judged to be significant in the preparation of the financial statements should be concisely structured. Boiler-plating is actively discouraged by both the FRC and the professional bodies.

Example

A company has a material amount of stock in the balance sheet at its year-end. Its accounting policy in respect of stock is worded as follows:

Stock is valued at the lower of cost and net realisable value.

This is an example of an accounting policy which would be considered 'boiler-plate' as well as the fact that it is using out of date terminology. The company should explain how 'cost' is made up; it should use 'estimated selling price less costs to complete and sell' instead of 'net realisable value' (unless it is reporting under IAS 2 *Inventories* which still uses net realisable value). It should explain how estimated selling price less costs to complete and sell is made up and how it treats any damaged, obsolete or slow-moving items of stock. An illustrative example of a properly worded stock accounting policy is as follows:

Stocks are stated at the lower of cost and estimated selling price less costs to complete and sell. Costs, which comprise direct production costs, are based on the method most appropriate to the type of inventory class, but usually on a weighted average cost basis. Overheads are charged to profit and loss as incurred. Estimated selling price less costs to complete and sell is based on the estimated selling price of the goods less any estimated completion or selling costs likely to be incurred on the sale.

When stocks are sold, the carrying amount of those stocks is recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of stocks to estimated selling price less costs to complete and sell and all losses of stocks are recognised as an expense in the period in which the write-down or loss occur. The amount of any reversal of any write-down of stock is recognised as a reduction in the amount of stocks recognised as an expense in the period in which the reversal occurs.

For some transactions, such as financial instruments, the wording of the accounting policy may be lengthier than under previous UK GAAP due to the recognition of additional financial instruments (such as interest rate swaps and/or forward foreign currency contracts). The key message is not to assume that the accounts production software has generated all the appropriate accounting policies and therefore to consider the appropriateness of those that are contained in the financial statements. Do not be afraid to delete, amend or tailor accounting policies as this is actively encouraged by both the FRC and the professional bodies.

Key accounting policies that will often be needed in the financial statements are:

- Basis of preparation of the financial statements
- Statement of compliance (this is encouraged for a small entity)
- Going concern (this is encouraged for a small entity)
- Revenue
- Inventory
- Fixed assets (tangible and intangible)
- Financial instruments
- Hire purchase and leasing
- Deferred tax

The list above is by no means exhaustive and other significant accounting policies should be disclosed where appropriate to the reporting entity.

1.18 Key points to note: accounting policies

- FRS 102 only requires an entity's significant accounting policies to be disclosed.
- Accounting policies should be client-specific and appropriate.
- Superfluous or immaterial accounting policies should be removed.
- Always avoid 'boiler-plating' as this is not viewed favourably by either the FRC or professional bodies.

2 Related party transactions (Lecture A599 – 16.37 minutes)

Related party transactions are dealt with in FRS 102 at Section 33 *Related Party Disclosures*. Small companies applying Section 1A *Small Entities* are required to comply with the disclosure requirements in paragraphs 1AC.34 to 1AC.36; however, in some cases it may be that a small company chooses to include additional disclosures beyond the requirements of these paragraphs to achieve a true and fair view.

2.1 Section 33 *Related Party Disclosures*

Section 33 requires an entity to provide disclosure of related party transactions undertaken with related parties regardless of whether a price is charged.

Section 33 was amended in July 2015 so that the definition of a related party was aligned with its international counterpart, IAS 24 *Related Party Disclosures*. The amendment was made so that the definition includes entities which provide key management personnel services and hence paragraph 33.2(viii) says that an entity is related to a reporting entity if:

'(viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.' *FRS 102.33.2(viii)*

The FRC took the decision to include paragraph 33.2(viii) to reflect the same amendment which the IASB made to IAS 24 although the amendment has not had a significant impact in the UK for entities reporting under FRS 102.

While Section 33 is broadly similar to the previous accounting standard on related party disclosures, namely FRS 8 *Related party disclosures*, there are some notable differences in FRS 102 that should be understood by preparers as follows:

- Names of transacting related parties. FRS 8 required the name of the transacting related parties to be disclosed. Section 33 does not require the names of the transacting related parties to be disclosed in the financial statements, but it does require the name of the controlling parties to be disclosed (paragraph 33.5). Section 33 also requires the nature of the related party relationship to be disclosed and separate disclosures to be given in respect of transactions with entities in each of certain specified categories (see 2.2 below).
- Disclosure is required in respect of key management personnel compensation in totality. This disclosure was not required under FRS 8, although the Companies Act 2006 does require certain disclosures in respect of directors' remuneration.
- Paragraph 20 of FRS 8 included guidance on the application of materiality. Section 33 does not include such guidance.

While Section 33 is based on the principles in IAS 24, a notable difference between the two standards is that Section 33 does not require disclosure of transactions that are entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly-owned by such a member. This exemption is not contained in IAS 24.

2.2 Categories of disclosure

Section 33 requires disclosures of related party transactions separately for each of the following categories:

(a) entities with control, joint control or significant influence over the entity;

(b) entities over which the entity has control, joint control or significant influence;

(c) key management personnel of the entity or its parent (in total);

(d) entities that provide key management personnel services to the entity; and

(e) other related parties.

Section 33 requires disclosure of terms and conditions together with outstanding amounts and whether balances are secured together with the nature of the consideration to be provided in settlement.

2.3 Key management personnel compensation

The Glossary to FRS 102 defines 'key management personnel' 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.'

FRS 102 Glossary ***key management personnel***

It follows that key management personnel are not just confined to the directors of the entity, but it can also include managers and supervisors. The explicit requirement in Section 33 to disclose the remuneration of key management personnel may result in the disclosure of remuneration of individuals who are not directors.

Key management personnel are usually permanent employees of the entity; however, FRS 102 does not provide exemption for members of the key management personnel that are not in permanent employment. The consequence of this is that key management personnel may include staff who have been seconded to the entity or individuals who are engaged under management contracts.

Example

A company has four non-executive directors on its board. The finance director is not proposing to include the remuneration of these non-executives in the financial statements. Her conclusion is drawn from the requirements of the UK Corporate Governance Code which requires a certain number of 'independent' non-executives whose role, among other things, involves scrutinising the performance of management. The finance director has concluded that as they are independent they are not part of management and hence need not be included in the key management personnel compensation disclosure.

The definition of 'key management personnel' per the Glossary to FRS 102 is clear. It specifically says '… including any director (whether executive or otherwise) …'. Therefore, the finance director should include the non-executive directors' remuneration within the key management personnel compensation disclosure.

FRED 67 proposes to insert paragraph 33.7A into FRS 102 following completion of the first triennial review. This paragraph is expected to say that when there is a legal or regulatory requirement to disclose directors' remuneration (or equivalent), an entity will be exempt from the requirement of paragraph 33.7 (which requires an entity to disclose key management personnel in totality), if key management personnel and the directors are the same.

2.4 Small company related party disclosures

Small companies are required by law to have two disclosure notes. Additional disclosures would only be needed in order to achieve a true and fair view, or where the directors voluntarily choose to make additional disclosures.

The two notes are as follows:

Directors' advances, credit and guarantees

Details of advances and credits granted by the small entity to its directors and guarantees of any kind entered into by the small entity on behalf of its directors must be shown in the notes to the financial statements. *FRS 102.1AC.36*

The details required of an advance or credit are:

(a) its amount;

(b) an indication of the interest rate;

(c) its main conditions;

(d) any amounts repaid;

(e) any amounts written off; and

(f) any amounts waived.

Monetary amounts are required to be disclosed in respect of items (a), (d), (e) and (f).

The details required of a guarantee are:

(a) its main terms;

(b) the amount of the maximum liability that may be incurred by the small entity; and

(c) any amount paid and any liability incurred by the small entity for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

Related party transactions

A small entity must provide particulars of material related party transactions which are not concluded under normal market conditions that are entered into with:

(a) owners holding a participating interest;

(b) companies in which the entity has a participating interest; and

(c) directors (or members of the entity's governing body).

The particulars required are:

(a) the amount of such transactions;

(b) the nature of the related party relationship; and

(c) other information about the transactions necessary for an understanding of the financial position of the small entity.

Example
Jack Smith and Jill Hill are both directors of a company. Jack owns 80% of the ordinary share capital with the remaining 20% being owned by Jack's wife. Jill is not related to Jack and is not a shareholder. Both directors live in houses provided by the company. Jack pays a peppercorn rent of £100 per annum and Jill pays full market rent of £36,000. There are no amounts of rent outstanding or prepaid at the company's year-end 31 December 2016. **Disclosure under FRS 8** During the year the company rented a property to Jack Smith with rentals of £100 (2015: £100) being paid and Jill Hill with market rentals of £36,000 (2015: £34,000) being paid. At the balance sheet date, there are no amounts outstanding (2015: £nil). The ultimate controlling party is Jack Smith. **Disclosure under FRS 102 Section 33 (medium/large entity)** During the year the company rented two properties to key management. One property attracted a peppercorn rent, and the other property a commercial rent. Total rents received in the year to 31 December 2016 were £36,100 (2015: £34,100). No amounts are outstanding (2015: £nil). The ultimate controlling party is Jack Smith. **Disclosure under FRS 102, Section 1A (small company)** During the year the company rented a property to a director. A peppercorn rent of £100 was charged (2015: £100). **Micro-entity (FRS 105)** No disclosure required

The example above illustrates how the disclosures may look if the company is medium-sized/large, small and micro, hence the larger the company, the more comprehensive the disclosure notes.

It is notable that a micro-entity is not required to make any related party disclosure in connection with the above properties. This is because the concept of related parties does not apply to a micro-entity under FRS 105 (indeed the term 'related parties' is not defined in the Glossary to FRS 105).

Micro-entities are, however, required to comply with the disclosure requirements of section 413 of the Companies Act 2006 in respect of directors' advances, credit and guarantees. Such disclosures are made at the foot of the micro-entity's balance sheet and will also be filed at Companies House.

2.5 Directors' remuneration for small companies

The requirement to disclose directors' remuneration and other benefits was repealed by SI 2015/980 which transposed the requirements of the EU Accounting Directive into legislation. As many small companies are now applying FRS 102, Section 1A *Small Entities* for the first time for December 2016 year-ends onwards, some practitioners are surprised at the absence of the directors' remuneration disclosure. However, just because it is no longer a legal requirement does not mean that it can be forgotten about entirely!

The disclosure requirements in respect of related parties for a small company are outlined in paragraphs 1AC.34 to 1AC.36 of FRS 102 (September 2015). These paragraphs reflect the provisions of the EU Accounting Directive and hence only require 'limited' related party transactions.

In the broadest terms, a small company is only required to make disclosure of related party transactions (including directors' remuneration) where the transactions are material and have not been concluded under normal market conditions. The difficulty is the fact that FRS 102 does not define the term 'normal market conditions'.

In practice, it is not uncommon for a director-shareholder to receive a salary equivalent to the PAYE threshold and the balance of his/her remuneration to be paid by way of dividend as quite often there are tax advantages of structuring the director's remuneration in this way. The question that must be asked for related party disclosure purposes is 'is this considered normal market conditions?' If the answer is 'yes' then no disclosure is required; if the answer is 'no' then disclosure is required.

There is no clear-cut answer where this situation is concerned, although it is expected that most small companies will not disclose directors' remuneration on the basis that the directors consider that structures such as salary to the PAYE limit and the balance is dividends is considered to be normal market conditions. In addition, many automated accounts production software systems appear to be defaulting to no disclosure, presumably because it is no longer a legal requirement. However, do bear in mind that this may not always be correct and professional judgement is needed.

The advice at the present time is to document any conclusions as to whether disclosure has, or has not, been made and why remuneration has been judged to be/not to be concluded under normal market conditions. Auditors of small companies will also need to satisfy themselves that any disclosure/non-disclosure gives rise to the financial statements giving a true and fair view.

To a certain extent, paragraph 1AC.35 tries to steer companies into making disclosure of all related party transactions by saying:

'Although disclosure is only required of material transactions with the specified related parties that have not been concluded under normal market conditions, small entities disclosing all transactions with such related parties would still be compliant with company law.'

FRS 102, paragraph 1AC.35

2.6 Key points to note: related parties

- Under Section 33 the names of transacting related parties need not be disclosed, although the names of the controlling parties are required to be disclosed as is the nature of the relationship.
- Transactions among group members are exempt from disclosure as related party transactions if any subsidiary which is a party to the transaction is wholly-owned by such a member.
- Key management personnel are not just confined to the directors and hence individuals who are involved in the planning, directing and controlling of the company, including non-executive directors, will fall under the scope of key management personnel and their compensation will be disclosed in totality.
- For small companies, only those material related party transactions which have not been concluded under normal market conditions are required to be disclosed, although additional disclosures may be needed to achieve a true and fair view.
- While directors' remuneration is no longer legally required to be disclosed, it is advisable to document the reasons for disclosure/non-disclosure.

3 Liabilities and equity

Section 22 *Liabilities and Equity* outlines the requirements in classifying financial instruments as either a financial liability (i.e. debt) or equity. It also deals with the issue of 'compound financial instruments' which are defined in the Glossary to FRS 102 as:

'A financial instrument that, from the issuer's perspective, contains both a ***liability*** *and an* ***equity*** *element.'*

FRS 102 Glossary ***compound financial instrument***

In many cases, debt will be treated as a liability in the balance sheet of a reporting entity, but this is not always the case. The overriding principle in Section 22 is that where the issuer (i.e. the borrower) does not have an unconditional right to avoid the settlement in cash, or by way of another financial asset, and the contract does not, in substance, evidence a residual interest in the net assets of the issuer (the lender) after deducting all of its liabilities, the financial instrument is classified as a financial liability.

So what does this mean in layman's terms? Effectively, where a borrower has an obligation to part with cash or other assets in either complying with the terms of the financial instrument, such as paying the lender interest; or by way of redemption at some point in the future, the contract is a financial liability. So whenever there is a contractual obligation on the part of the borrower to pay cash or settle an obligation by parting with another asset, a liability is recognised.

Example

A company issues 7,000 £1 preference shares and the owners of the preference shares are entitled to receive a 5% dividend each year.

The preference shares contain an obligation to deliver cash to the owners and hence are recognised as a financial liability, they are not recognised as equity. The 5% coupon payments are recognised as interest expense in the company's profit and loss account each year.

A financial instrument is classified as equity when it fails to meet the definition of a financial liability (i.e. there is no obligation to deliver cash or other financial assets to another entity). The key requirement is to consider whether there is an unconditional ability to avoid delivering cash or other assets.

Example

A company wishes to raise finance in order to help finance its expansion plans. The bank has agreed to finance some of the working capital requirements, but it requires the shareholders to invest further into the business to demonstrate their commitment to the company. Two individuals subscribe to ordinary shares in the company. Dividends on the ordinary shares are paid at the entity's discretion and there is an option whereby the company can redeem equity shares for cash.

The existence of the option which allows the company the option to redeem equity shares for cash does not, in itself, mean the ordinary shares should be classified as a financial liability; nor does the fact that the company may pay future dividends on the ordinary shares. This is because the issuer retains an unconditional right to avoid delivering cash or another financial asset and hence the ordinary shares are recognised in equity. A contractual obligation to deliver cash or another financial asset would only arise at the point when the issuer exercises its right to redeem the shares.

3.1 Equity instruments issued prior to payment being received

Paragraph 22.47(a) of *IFRS for SMEs* says:

'if the equity instruments are issued before the entity receives the cash or other resources, the entity shall present the amount receivable as an offset to equity in its ***statement of financial position****, not as an asset.'*

IFRS for SMEs paragraph 22.47(a)

FRS 102 does not reflect the same provisions as paragraph 22.47(a) of IFRS for SMEs on the grounds that offsetting the receivable against equity would be inconsistent with UK company law.

Example

On 29 December 2016, a company issued 5,000 ordinary £1 shares to a long-standing employee. Payment for these shares was received on 5 January 2017 and the company is preparing its financial statements for the year-ended 31 December 2016.

In the financial statements to 31 December 2016, the £5,000 share issue will be recorded in the books of the company as:

Dr Called up share capital not paid £5,000

Cr Ordinary shares (equity) £5,000

Being share issue on 29 December 2016

3.2 Equity instruments subscribed for but not issued

Paragraph 22.7(c) says that when equity instruments have been subscribed for but not issued (or called up), and the entity has not received the cash or other resources to pay for the shares, no increase in equity is recognised.

3.3 Convertible debt

Convertible debt or similar compound financial instruments are dealt with in FRS 102 (September 2015) at paragraphs 22.13 to 22.15. There is also an appendix to Section 22 providing an example of the issuer's accounting for convertible debt.

Convertible debt contains both a liability feature and an equity feature. Convertible bonds, for example, may require the issuer to pay fixed coupons (interest) and there is an option for the holder to convert some of the instrument (usually the capital element) into shares. The legal form of such instruments is that of debt, but its substance is of two instruments:

(a) a financial liability to deliver cash by making interest payments or interest and capital payments as long as the bond is not converted; and

(b) a call option which grants the holder the option to convert the bond into a fixed number of ordinary shares of the entity, thus meeting the definition of equity.

There is a two-stage process to initially recognising convertible debt:

- Stage 1. Determine the amount of the liability component as the fair value of a similar liability which does not contain the conversion option.

- Stage 2. Allocate the difference between the liability calculated in Stage 1 and the fair value of the proceeds received as equity.

Example

On 1 April 2016, an 8% convertible bond was issued with a nominal value of £600,000. It is redeemable on 31 March 2020 at par, or it may be converted into equity shares. An equivalent loan note without the conversion option would have carried interest at 10%. Interest of £48,000 has already been paid and has been included within interest payable and similar expenses.

Present value rates are as follows:

End of year	8%	10%
1	0.926	0.909
2	0.857	0.826
3	0.794	0.751
4	0.735	0.683

The first stage involves calculating the amount that has to be recognised as a liability in the entity's financial statements, with the balance being recognised in equity. This is calculated as follows:

	8% interest (£600k x 8%)	10% factor	Present value
Year 1	48,000	0.909	43,632
Year 2	48,000	0.826	39,648
Year 3	48,000	0.751	36,048
Year 4	648,000	0.683	442,584
Liability amount			561,912
Proceeds			(600,000)
Equity			38,088

The journals to record the above are:

Dr Cash at bank	£600,000
Cr Loan payable (financial liability)	£561,912
Cr Equity	£38,088

The profit and loss account currently recognises year 1 interest of £48,000 being the coupon rate paid to the holder of the bond. An equivalent loan without the conversion option would carry interest at 10% which is the rate that the cash flows in the bond have been discounted at in the table above. The present value of the debt portion is £561,912 and at 10%, interest would be £56,191. Therefore, additional interest of £8,191 (£56,191 less £48,000) will need to be recognised in the financial statements. The journals to account for the additional interest are:

Dr Interest payable and similar expenses	£8,191
Cr Loan payable	£8,191

Paragraph 22.14 says that the entity shall not revise the allocation in a subsequent period. *FRS 102.22.14*

The liability portion of the debt will be subsequently accounted for at amortised cost using the effective interest method in Section 11 *Basic Financial Instruments* or at fair value through profit or loss under Section 12 *Other Financial Instruments Issues*. It is anticipated that the Section 11 accounting treatment will be more common in practice.

Example

The liability of £561,912 is accounted for under the amortised cost method as follows:

Opening balance	**Cash flow**	**Interest 10%**	**Closing balance**
£	£	£	£
561,912	(48,000)	56,191	570,103
570,103	(48,000)	57,010	579,113
579,113	(48,000)	57,911	589,024
589,024	(648,000)	58,976*	-
*=adjusted for rounding			

On conversion, the liability portion is extinguished (as is the case in the example above) and equity is issued. The value of the equity recognised since initial inception will remain in equity, although it may be reallocated to another line item within equity.

3.4 Early redemption of a compound instrument

Section 22 is silent on the issue where a compound instrument is redeemed early (i.e. before the date it contractually matures). It would therefore be acceptable that when a compound instrument is redeemed early, the redemption amount plus any directly attributable transaction costs, will need to be allocated between the liability and equity components on the date early redemption takes place. An acceptable method would be to allocate part of the redemption amount to the liability component based on the liability's fair value at the date of redemption, with any residual amount being allocated to the redemption of the equity component.

Where the redemption amount allocated to the liability exceeds the carrying amount of the liability component at the redemption date, a loss is recognised in profit and loss. Where the redemption amount is lower than the carrying amount of the liability, a gain is recognised in profit and loss.

4 Basic financial instruments: loans and debtors

Section 11 *Basic Financial Instruments* in FRS 102 is probably the main section that companies in the SME sector will apply when it comes to dealing with their financial instruments. The definition of a financial instrument in FRS 102 is fairly complex, but in the broadest sense of the term, a financial instrument is a contract between two parties – one party to the contract wishes to raise finance and the other party provides that finance.

Financial instruments come in a variety of forms, including:

- trade debtors;
- trade creditors;
- bank loans;
- hire purchase agreements;
- derivative instruments;
- share capital; and
- directors' loans.

The above list is clearly not exhaustive, but does provide some everyday examples of financial instruments that a SME business is likely to hold.

The definition of a financial instrument is broad but items such as deferred revenue and warranty obligations which require delivery of goods and services rather than an obligation to deliver cash or another financial instrument are not considered to be financial instruments.

Example

A company has a year-end of 31 July 2017. On 1 July 2017, the company made a payment to the local rugby club of £24,000 which represents 12 months' worth of advertising space on a display board in the stadium from 1 July 2017. At the year-end 31 July 2017 an amount of £22,000 (£24,000 x 11/12) is shown in current assets as a prepayment. The managing director has asked if this is regarded as a financial instrument?

Prepaid expenses would not fall under the definition of a financial asset because there is no contractual obligation to receive cash or other assets; the prepaid expense represents the advertising services that the company will receive in settlement of the upfront payment; it will not receive cash or another financial asset in settlement.

Loans are a common financial instrument and in many cases, these will qualify for treatment under Section 11. However, not all loans are straightforward and some of the more common features which may push loans into Section 12 *Other Financial Instruments Issues* include:

- interest rates are linked to commodity prices;
- interest rates are leveraged (e.g. 2 x standard variable);
- inverse floaters (e.g. LIBOR less 10%);
- loans which give the lender power to alter the terms unilaterally;
- loans which risk the lender losing principal or interest (as part of the contractual terms); and
- prepayments contingent on future events other than for defaults, change of control or to protect either party against central bank levies, tax changes, etc.

4.1 Basic debt instruments

Paragraph 11.8 of FRS 102 lists various types of financial instrument which it considers to be basic, including:

(a) cash;

FRS 102.11.8

(b) a debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9 and is not a financial instrument described in paragraph 11.6(b);

(c) commitments to receive or make a loan to another entity that:

  (i) cannot be settled net in cash; and

  (ii) when the commitment is executed, are expected to meet the conditions in paragraph 11.9; and

(d) an investment in non-convertible preference shares and non-puttable **ordinary shares** or preference shares.

Some points to note where the above are concerned are as follows:

FRS 102 Glossary ***cash***

- The term 'cash' is defined as 'cash on hand and demand deposits'. The term 'demand deposits' is not a defined term in FRS 102 but should be taken to mean those deposits where the reporting entity can withdraw cash without giving any notice and without suffering any penalty. Where a deposit account requires notice to be given prior to a withdrawal being made, this would not qualify as cash (although it could be reported as a cash equivalent in the statement of cash flows).
- A 'debt instrument' is not a defined term in FRS 102 and therefore professional judgement will be required in order to interpret it.

While it is always preferable for entities to account for financial instruments under Section 11 (as Section 12 will invariably require financial instruments to be measured at fair value through profit or loss), care must be taken to ensure that the instrument is correctly classified as certain characteristics (as noted in 4 above) may push the instrument into Section 12 territory.

4.2 Basic debt instruments: FRS 102 versus previous UK GAAP

Financial instruments are one of the main areas that have been subjected to significant change under FRS 102. The differences can be split into three categories:

- Instruments issued at market rate
- Instruments issued at off-market rate
- Other financial instruments

Instruments at market rate FRS 102 v old UK GAAP	
FRS 102	**Old UK GAAP**
Initial measurement is usually at transaction price including transaction costs (except if at fair value through profit or loss) (paragraph 11.13).	Similar treatment.
Subsequent measurement of the instrument is at amortised cost using the effective interest method (paragraph 11.14).	Similar treatment, although FRS 4 required interest to be allocated to periods over the term of the debt at a constant rate on the carrying amount.
Substantial modification of terms or exchange of financial instruments with significantly different terms (or part thereof) is regarded as extinguishment of the old instrument and recognition of a new instrument (paragraph 11.37).	

Off-market rate (financing transactions)	
FRS 102	**Old UK GAAP**
Initial measurement is at the present value of the future payments which are discounted at a market rate of interest for a similar debt instrument (paragraph 11.13).	Initial measurement is at transaction price with the contractual rate of interest allocated on a constant rate; hence interest-free loans will incur no interest.
Where a loan is repayable on demand, the present value is equal to the undiscounted cash amount payable.	Similar treatment.

Cash sales price in an arms-length transaction is approximate to its present value where the payment is deferred beyond normal credit terms. Subsequent measurement of off-market rate debt instruments is at amortised cost using the effective interest method using a market rate of interest (paragraph 11.14(a)). Debt instruments which are payable or receivable within one year (i.e. current) which are also regarded as a financing transaction are discounted at a market rate of interest for a similar debt instrument (paragraph 11.14(a)).	

Other financial instruments	
FRS 102	**Old UK GAAP**
Derivative financial instruments (interest rate swaps, options, forward contracts etc) are recognised on balance sheet at fair value, which is normally transaction price (often £nil on inception) (paragraph 12.7).	Initial recognition of derivatives not specified but usually the same and generally only recognised where an entity applied FRS 26 which implemented the provisions in IAS 39.
Subsequent measurement of derivative instruments at fair value through profit or loss although hedge accounting (paras 12.15 – 12.25A) is available for use when certain criteria are met (paragraph 12.8).	Amounts payable or receivable under derivative contracts are recognised as they accrue. Where a derivative financial instrument becomes onerous, the present obligation is measured as a provision.

4.3 Bank overdrafts

Many companies operate bank overdrafts and usually the terms of the overdraft are that it is repayable on demand and hence is shown as a current liability in the balance sheet.

Under FRS 102, there would be no impact on the accounting treatment of this overdraft due to its repayable on demand status. It would still be recognised at the undiscounted amount payable with interest recognised as it is accrued.

Paragraph 11.42 says:

'An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its ***financial position*** *and* ***performance****. For example, for long-term debt such information would normally include the terms and conditions of the debt instrument (such as interest rate, maturity, repayment schedule, and restrictions that the debt instrument imposes on the entity).'* *FRS 102.11.42*

In other words, the purpose of the above disclosure is to enable the users of the financial statements to evaluate the significance of the entity's financial statements on the balance sheet and profit or loss. For small companies applying the provisions in Section 1A, this would not be required and small companies would disclose the total amount of any debts included under that item in respect of which any security has been pledged, together with an indication of the nature and form of such security (paragraph 1AC.28).

4.4 Bank loans

Bank loans which fall to be treated as basic financial instruments under Section 11 and hence are measured at amortised cost using the effective interest method will be common for most businesses.

Example

A company takes out a secured five-year bank loan of £2m on 1 May 2017. Loan repayments are £500,000 per annum which represents an interest rate of approximately 7.93% (calculated using the internal rate of return function in Excel). This interest rate is considered to be market rate and an arrangement fee of £250,000 was incurred on inception of the loan.

Accounting treatment under FRS 102

As the interest is at market rate, the amount is initially recorded at transaction price of £2m less the arrangement fee (a transaction cost per paragraph 11.13) of £250,000, hence initial recognition is at £1,750,000. The present value of the loan repayments equal transaction price as the interest on the loan is at market rate as follows:

Discount factor = 1 / 1+int rate^{year} hence in year 3 (2019) it is 1 / 1.079308^{3} = 0.7954. Use internal rate of return function in Excel to calc the EIR of 7.9308% as follows:

Year	Cash payable	Discount factor (7.9308%)	Present value

2017	500,000	0.9265	463,250
2018	500,000	0.8584	429,200
2019	500,000	0.7954	397,700
2020	500,000	0.7369	368,450
2021	500,000	0.6828	341,400
			2,000,000

The amount initially recognised is £1,750,000 with subsequent measurement at amortised cost using the effective interest method. We can use the Goal Seek function in Excel (see Quarter 2 notes) to calculate the interest at the effective interest rate as follows:

Year	**Balance b/f**	**Interest at EIR**	**Cash flow**	**Balance c/f**
2017	1,750,000	231,028	(500,000)	1,481,028
2018	1,481,028	195,519	(500,000)	1,176,547
2019	1,176,547	155,323	(500,000)	831,870
2020	831,870	109,820	(500,000)	441,690
2021	441,690	58,310	(500,000)	-

In respect of the example above, the journals for the 2017 financial year would be:

	£
Dr Cash at bank	1,750,000
Cr Loan	1,750,000

Being inception of bank loan net of transaction costs

Dr Interest expense	231,028
Cr Loan	231,028

Being interest at EIR

Dr Loan	500,000
Cr Cash at bank	500,000

Being loan repayment

At the end of 2017 the loan creditor will be £1,481,028.

4.5 Loan from a shareholder

Where a director-shareholder makes a loan **to** a **small company** (or the loan is from a close family member of that director-shareholder), the loan can be recognised at transaction price, i.e. there is no need to discount the loan to present value (see section 1.1 of the notes). The example below will therefore assume the company is not small.

Example

On 1 January 2017, a shareholder lends £350,000 to a company which is formalised. The terms of the loan make provision for repayment in two years' time. Interest is being charged at 5% but if the company were to obtain a similar loan from its bank, interest would be charged at 10%. As this is a financing transaction, the loan is discounted to present value as follows:

Year	Cash flow £	Discount factor (10%)	Present value £
2017	17,500	0.90909	15,909
2018	367,500	0.82645	303,720
			319,629

A measurement difference has arisen between the transaction price of the loan (£350,000) and the present value of the loan (£319,629) of £30,371. This measurement difference must be reflected in the financial statements under FRS 102. The measurement difference represents the value of the benefit which the company has received because the shareholder has provided it with a loan at a rate of interest which is below market rate. The loan is accounted for as follows:

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

The capital contribution amount reflects the fact that a shareholder has made a contribution to the company by providing it with a loan at a rate of interest which is below market rate. This capital contribution amount is reflected in the equity section of the balance sheet.

A capital contribution amount arises because of the implicit financing, in addition to the underlying loan, that the shareholder has provided to the company. It is important to emphasise that this credit to equity is not an accounting, or legal, profit and is therefore non-distributable.

Over the life of the loan, interest is recognised in the profit and loss account at the effective interest rate of 10% as follows:

Year	**B/f**	**Interest (10%)**	**Cash flow**	**C/f**
2017	319,629	31,962	(17,500)	334,091
2018	334,091	33,409	(367,500)	-

FRS 102 is silent on the subsequent treatment of the capital contribution reserve. As a result, the company may choose to transfer an amount equivalent to the annual interest charge from the capital contribution reserve to the profit and loss account reserve, hence the journals in 2017 would be:

Dr Interest	£17,500
Cr Cash	£17,500

Being cash paid to shareholder

Dr Interest	£14,462
Cr Loan	£14,462

Being additional financing interest charge to reflect EIR

Dr Equity (capital contribution)	£14,462
Cr Profit and loss account reserve	£14,462

Being transfer between reserves

The example above assumes that the company is non-small. It should be noted that where a director-shareholder of a small company provides a loan at below market rates (as is fairly common), the loan will not have been concluded under normal market conditions and hence details of the loan would require disclosure under FRS 102 Section 1A.

4.6 Transitional exemption for small entities in respect of financing transactions

A small company making the transition to FRS 102 for an accounting period which starts before 1 January 2017 (e.g. from FRSSE (effective January 2015)) can choose not to restate comparative information in respect of financing transactions that involve related parties. Section 35 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: *FRS 102.35.10(v)*

(a) shall apply its existing accounting policies to the relevant financial 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.'*

4.7 Trade debtors

In the majority of cases, a company will have agreed terms in place with its trade debtors that will provide for settlement of its invoices within, say, 30 days from the date of the invoice. FRS 102 will have little impact on these because the debtor would still be recognised at the undiscounted amount of cash receivable from the customer. The undiscounted amount of cash receivable would be the invoice price and usually transactions with trade debtors are carried out under normal market conditions and there is no financing element incorporated.

However, if the sale were, say, on three-years interest-free credit and this was not normal credit terms (i.e. not usually available to other customers), then the debtor recognised on initial recognition would be the current cash sale price of the goods. If the current cash price is not known (which would be fairly uncommon), then the present value of the cash receivable would be used instead.

5 Historic goodwill (Lecture A600 – 7.52 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with goodwill in Section 19 *Business Combinations and Goodwill*. Section 19 was amended in July 2015 to change the default amortisation period in respect of goodwill to a maximum of ten years (see 5.3 below) where management are unable to come up with a reliable estimate for the useful economic life of goodwill. Paragraph 19.23(a) also clarifies that it will only be in **exceptional circumstances** that management will be unable to reliably estimate the useful life of goodwill. The amendments were as a result of SI 2015/980. These Regulations also made changes to the qualifying conditions in the Accounting Regulations for the use of merger accounting (merger accounting is beyond the scope of this course).

5.1 Section 19 versus previous FRS 7, FRS 10 and the FRSSE

A summary of the notable differences between Section 19 in FRS 102 and previous UK GAAP in the form of:

FRS 7 *Fair values in acquisition accounting,*

FRS 10 *Goodwill and intangible assets* and

FRSSE (effective January 2015), are shown in the table below:

FRS 102	FRS 7, 10 and the FRSSE
All identifiable intangible assets (whether separable or arising from contractual/legal rights) are recognised at fair value at the date of acquisition (para 19.15/18.11). FRED 67 does, however, propose to relax this requirement so fewer intangibles will be separated from goodwill.	Identifiable intangible assets recognised if they are both separable and arise from contractual or custody rights.
Deferred tax is recognised in a business combination in respect of assets acquired and liabilities assumed (para 19.15A).	No deferred tax was recognised in an acquisition due to the use of fair value adjustments.
Liabilities/assets in respect of employee benefit arrangements are recognised (para 19.15B).	Silent but similar treatment applied in FRS 17.

Share-based payments are recognised (para 19.15C).	Presumed similar treatment under FRS 20.
Goodwill is amortised over a ten-year period if management unable to reliably estimate its useful economic life (para 19.23(a)). No indefinite useful lives permitted.	Presumed maximum was 20 years in FRS 10 (five years in FRSSE (January 2015)). Indefinite lives were permissible but had to be tested annually for impairment.

5.2 Transitional exemption

A transitional exemption is available for first-time adopters of FRS 102; although this is unlikely to be used on a widespread basis going forward as all medium-sized groups will have made the transition to FRS 102 and hence it is only likely to apply to small groups that voluntarily prepare group accounts.

When a first-time adopter takes up the exemption in paragraph 35.10(a), it need not restate business combinations that were effected prior to the date of transition to FRS 102. The effect of this exemption is to eliminate the need to retrospectively identify and measure individual intangible assets acquired as the data to achieve this is usually not readily available. However, where previous business combinations are restated, all later business combinations must also be restated.

No adjustment to goodwill is permitted (paragraph 35.10(a)(ii)). This means that if an entity does make adjustments to assets and liabilities acquired in a business combination, the adjustments are made against opening retained earnings.

5.3 Goodwill amortisation

Paragraph 19.23(a) requires all goodwill to be amortised over its useful economic life. There is no rebuttable presumption in FRS 102 allowing goodwill to have an indefinite useful life as there was in previous UK GAAP. The same principle applies to intangible assets (other than goodwill) under paragraph 18.19.

Some confusion surrounds the rules in FRS 102 for goodwill amortisation. Paragraph 19.23(a) says that if, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall not exceed ten years.

The ten-year rule is **not** a ten-year maximum. It may be the case that the business has justifiable reasons for an amortisation policy of, say, 15 years or longer and this would be permissible. Paragraph 19.25(g) requires the useful life of goodwill to be disclosed and where the useful life of the goodwill cannot be reliably estimated, supporting reasons should be disclosed for the period chosen.

Example

A small company has a year-end of 31 March 2017 and these accounts are the first set prepared under FRS 102, Section 1A. The company has recognised goodwill on its balance sheet from when the sole trader sold the business to the limited company. The business has not amortised this goodwill since the company started to trade on the basis that the directors viewed it as having an indefinite useful life and have since tested the goodwill annually for impairment.

On transition to FRS 102, the directors are unable to reliably estimate the useful economic life for amortisation purposes. Paragraph 19.23(a) would require this goodwill to be amortised over a maximum of ten years.

It should be noted that a change in useful life is a change in estimation and not a change in accounting policy. Section 10 *Accounting Policies, Estimates and Errors* requires that changes in estimation are accounted for prospectively (i.e. going forward) from the date of the change. When adopting FRS 102 for the first time and the need to reassess the useful life of goodwill arises (as in the example above), the new estimated life is applied prospectively from the date of transition.

6 ISA (UK) 250 (Revised July 2017) (Lecture A601 – 17.05 minutes)

On 14 July 2017, the Financial Reporting Council (FRC) issued ISA (UK) 250 (Revised July 2017) *Section A – Consideration of Laws and Regulations in an Audit of Financial Statements*. The amended ISA (UK) 250 takes effect for audits of financial statements for periods commencing on or after 15 December 2017.

The amendments to ISA (UK) 250 were as a result of the International Auditing and Assurance Standards Board's amendment to the international version of the standard ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. There were limited amendments made to ISA 250 in order to address actual or perceived inconsistencies of approach between the non-compliance with laws and regulations (NOCLAR) provisions in the revised International Ethics Standards Board for Accountants (IESBA) Code and the ISAs.

6.1 Effects of laws and regulations

ISA (UK) 250 acknowledges that the effect of laws and regulations on financial statements varies considerably. Some laws and regulations have a direct effect on the financial statements in that they determine the amounts and disclosures in the financial statements (e.g. tax legislation); whereas other laws and regulations have an indirect effect on the financial statements because they set out requirements that management have to comply with (e.g. Health and Safety legislation) or set provisions under which the entity is allowed to carry on business. Other types of entity operate in heavily regulated businesses (such as chemical processing companies) and have to comply with applicable regulation and legislation pertinent to their business type.

Example

An audit client operates in the financial services sector in the UK.

This sector is primarily regulated by the Financial Conduct Authority and the client will be subject to detailed laws and regulations which specifically require the entity to have systems in place to ensure compliance with those laws and regulations. Any NOCLAR could have a material effect on the financial statements (and potentially an adverse effect on the going concern basis of accounting).

NOCLAR may result in fines, litigation or other consequences that may have a material effect on the business and in some cases may threaten the going concern ability of the business such that the going concern basis of accounting may not be appropriate.

The revised ISA (UK) 250 clarifies the requirement concerning the auditor's determination of whether to report identified or suspected NOCLAR to an appropriate authority (e.g. a regulator) and the auditor's duty of confidentiality.

6.2 Responsibilities

Management, with the oversight of those charged with governance, of the entity are responsible for ensuring compliance with laws and regulations. This responsibility also extends to compliance with laws and regulations which determine amounts and disclosures that are included in the financial statements. It should be noted that in the UK, those charged with governance are responsible for the preparation of the financial statements.

The directors are ultimately responsible for the preparation of the financial statements and ensuring that these give a true and fair view. It follows, therefore, that the directors are also responsible for ensuring that identified, or suspected, NOCLAR is appropriately reflected in the financial statements and/or disclosed.

The revised ISA (UK) 250 highlights that the auditor may have additional responsibilities under law, regulation or relevant ethical requirements (including possible documentation requirements) and communication to other auditors, such as in a group audit.

ISA (UK) 250 has been designed in such a way so as to assist the auditor in identifying material misstatement of the financial statements due to NOCLAR. It must be emphasised that it is not the auditor's responsibility for preventing non-compliance; nor can the auditor be expected to detect NOCLAR with every law or regulation applicable to the entity.

The overall objective of the auditor in an audit of financial statements is to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether due to fraud or error. The auditor also takes into consideration the requirements of the applicable financial reporting framework.

The inherent limitations of an audit are well-known which is the main reason why an auditor only ever gives **reasonable** not absolute assurance. Even an audit that has been well planned and executed properly may not necessarily detect a material misstatement. These limitations also extend to laws and regulations because there are so many of them which may not necessarily affect the financial statements and hence are not included within the accounting system. Auditors should keep in mind, however, that the limitations of an audit should not be used as an excuse to avoid undertaking necessary audit procedures as this is likely to give rise to a poor quality audit resulting in sanctions being imposed on the auditor/audit firm by their professional body or the FRC.

Example

A chemical processing company has discovered that it has illegally discharged trade effluent into nearby waters in contravention of Clause 111 of the Water Industry Act (1991). The water authority has not yet been notified nor have they been in contact with the company.

The illegal act of discharging trade effluent would not be captured by the accounting system, although it has been discovered by the entity because the non-compliance has an indirect effect on the accounts. While the non-compliance with legislation would not have an immediate impact on the financial statements, any fines levied by the water authority would be included. In such cases, management may need to consider whether a provision or contingent liability disclosure is necessary in the financial statements.

There are occasions when management, or those charged with governance, or both, may attempt to conceal any NOCLAR. This could arise because of:

- deliberate concealment;
- deliberate failure to record transactions;
- management override of controls (although this is judged as a significant risk in the ISAs (UK)); or
- intentional misrepresentations to the auditor.

Issues such as these are deliberately intended not to be discovered and hence the auditor may not discover such NOCLAR arising from these acts. The revised ISA (UK) 250 enhances the consideration of the implications of NOCLAR on the audit and requires the auditor to consider the reliability of management's representations, the implications for the auditor's report and the consideration of whether to withdraw from the engagement.

It should be noted that paragraph 5 of ISA (UK) 250 says:

'Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.'

ISA (UK) 250 (Revised July 2017) paragraph 5

It should also be borne in mind by auditors, and directors, that it is a criminal office in the UK to give the auditor information or explanations which are misleading, false or deceptive.

6.3 Tipping off

The revised ISA (UK) 250 emphasises the fact that, in some situations, communication with management or those charged with governance may be restricted or prohibited by law or regulation (such as Anti-Money Laundering Regulations). This is because discussion of certain types of NOCLAR may give rise to the client being 'tipped off' which may then prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act (such as tax fraud).

Auditors and audit teams must be careful where this is concerned and, especially where money laundering is concerned, must be up-to-date with the new Anti-Money Laundering Regulations issued on 26 June 2017.

6.4 NOCLAR is identified or suspected

When the auditor becomes aware of information relating to an instance of (suspected) NOCLAR, paragraph 19 requires the auditor to obtain:

(a) an understanding of the nature of the act together with the circumstances in which it has arisen; and

(b) further information to evaluate the potential effects on the financial statements.

Example

A company has been awarded a contract to provide accommodation to families arriving into the country. The terms of the contract include a clause that the accommodation provided (regardless of ownership) must be of a certain standard, up-to-date gas and electrical checks have been carried out and all properties must be provided with carbon monoxide detectors. Failure to comply with these requirements will result in the contract being immediately withdrawn as it will be a breach of legislation.

During the course of the audit the auditor becomes aware that a large number of properties fail to comply with the requirement of the contract and the legislation. The auditor has made inquiries of management and those charged with governance who have said that it is not their responsibility to ensure these properties are compliant as the company only acts as an intermediary between the contract provider and the owner of the property.

The auditor is not satisfied that management and those charged with governance have provided sufficient information that suggests the company is in compliance with the terms of the contract and judges the effects of non-compliance to be material as it could result in the contract being withdrawn.

Paragraph 20 of ISA (UK) 250 (Revised July 2017) says that where the effect of suspected non-compliance may be material to the financial statements, the auditor must consider the need to obtain legal advice.

6.5 Communicating and reporting NOCLAR

The auditor should communicate with those charged with governance any acts of NOCLAR that come to their attention during the course of the audit. The exception to this requirement would be where the auditor is prohibited by law or regulation from doing so (e.g. due to the tipping off provisions) or where the matters are clearly inconsequential.

Where the entity is a public interest entity and the auditor suspects, or has reasonable grounds to suspect, that irregularities (including fraud) have occurred or may occur, the auditor must inform the entity and invite it to investigate the matter and take appropriate steps to deal with the irregularities to prevent reoccurrence in the future. Again, the exception to this requirement would be where the auditor is prohibited by law or regulation from informing the entity.

When the auditor discovers an act of NOCLAR which is being committed by management or those charged with governance, the auditor must communicate the matter to the next higher level of authority. Where there is no higher level of authority (e.g. an audit committee or board), or if the auditor does not believe that any communication may be acted upon, the auditor must consider the need to obtain legal advice.

6.6 Implications on the auditor's report

There are three issues in ISA (UK) 250 (Revised July 2017) which the auditor should consider for their report:

- Material acts of NOCLAR which have not been reflected in the financial statements.
- Preclusion by management in obtaining sufficient appropriate audit evidence to evaluate if NOCLAR is material (or is likely to have occurred).
- The auditor is unable to determine whether NOCLAR has occurred due to external limitations.

NOCLAR not reflected in the financial statements

Where the auditor concludes that identified or suspected NOCLAR has a material effect on the financial statements and it has not been adequately reflected in the financial statements, the auditor must express a qualified opinion or an adverse opinion on the financial statements in accordance with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor' Report*.

Preclusion by management in obtaining sufficient appropriate audit evidence

Where the auditor is precluded by management (or those charged with governance) from obtaining sufficient appropriate audit evidence so they can evaluate whether NOCLAR that is material to the financial statements has, or is likely to have, occurred, the auditor must express a qualified opinion or disclaimer of opinion on the financial statements. They do this on the grounds of limitation of scope in accordance with ISA (UK) 705 (Revised June 2016).

Auditor is unable to determine whether NOCLAR has occurred to external limitations

When the auditor is unable to determine whether NOCLAR has occurred because of limitations imposed by the circumstances, as opposed to management or those charged with governance, the auditor must evaluate the effect on the auditor's opinion in accordance with ISA (UK) 705 (Revised June 2016).

6.7 Documentation

Audit documentation is dealt with in ISA (UK) 230 (Revised June 2016) *Audit Documentation*. Any acts of identified or suspected NOCLAR must be included in the auditor's documentation together with:

(a) the audit procedures that have been performed, the significant professional judgements made and the conclusions reached; and

(b) the discussions of significant matters related to NOCLAR with management, those charged with governance and others, including how management and, where applicable, those charged with governance, have responded to the matter.

7 ISA (UK) 330 (Revised July 2017) *The Auditor's Reponses to Assess Risks* and ISA (UK) 505 *External Confirmations* *(Lecture A602 – 9.21 minutes)*

On 14 July 2017, the Financial Reporting Council (FRC) issued a revised ISA (UK) 330 (Revised July 2017) *The Auditor's Responses to Assessed Risks*. This revised ISA (UK) is effective for audits of financial statements for periods commencing on or after 15 December 2017. There have also been conforming amendments made to ISA (UK) 505 *External Confirmations* which is also effective for audits of financial statements for periods commencing on or after 15 December 2017.

The limited amendments to ISA (UK) 330 have the effect of streamlining and integrating the guidance relating to bank audit reports (bank letters/bank confirmation) and in light of these amendments, the FRC has withdrawn Practice Note (PN) 16 *Bank reports for audit purposes in the United Kingdom* from the date the revised ISA (UK) becomes effective.

The amendments to the standards are shown below:

7.1 Amendments to ISA (UK) 330

Additional application material has been included in paragraph A50 as follows:

'In the UK, depending on the auditor's risk assessment, the auditor considers whether confirmation is needed in relation to additional information such as trade finance transactions and balances or information about guarantees and other third party securities, in addition to the confirmation of balances and other banking arrangements usually provided in such a request.'

ISA (UK) 330 (Revised July 2017) paragraph A50

In light of this amendment to paragraph A50, the FRC decided to withdrawn PN 16. The upshot of this amendment is that the auditor will consider the need to obtain a bank confirmation based on their own assessed levels of risk, rather than the view taken by PN 16 which was that a bank confirmation letter is required. It is always advisable for the auditor to document their conclusions as to whether, or not, a bank confirmation is required once ISA (UK) 330 (Revised July 2017) becomes effective.

7.2 Amendments to ISA (UK) 505

ISA (UK) 505 contains limited amendments in the form of an additional footnote in paragraph A4 as follows:

'Pro-forma templates to obtain bank confirmations in the United Kingdom which have been agreed with the British Bankers' Association on behalf of the industry can be found at https://www.bba.org.uk/policy/financial-policy-and-risk/financial-reporting/audit/instructions-for-using-pn16-templates/.'

ISA (UK) 505 additional footnote[13a]

8 Modifications to the auditor's report (Lecture A603 – 25.32 minutes)

As practitioners will be aware, the Financial Reporting Council (FRC) revised most of the ISAs (UK) in June 2016 and in practice these will apply to years ending on or after 30 June 2017. Auditor's reports were considered in a lot of detail in the Quarter 1 Accounting and Audit update which examined the new structure of the report and other notable differences in the auditor's report, such as having material uncertainties in respect of going concern within a separate section of the auditor's report headed up 'Material Uncertainty Related to Going Concern' as opposed to it being within an emphasis of matter paragraph as before.

As a brief recap, the structure of the revised auditor's report in respect of a private company reporting under the small companies' regime is as follows:

- Opinion
- Basis for opinion
- Conclusions related to going concern
- Other information
- Opinions on other matters prescribed by the Companies Act 2006
- Matters on which we are required to report by exception
- Responsibilities of directors
- Auditor's responsibilities for the audit of the financial statements

Where the auditor concludes that a Material Uncertainty Related to Going Concern paragraph is required in the auditor's report, this would normally be positioned underneath the 'Basis for opinion' paragraph.

Modifications to the auditor's report can cause some confusion for practitioners and this topic is dealt with in ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*.

Where an emphasis of matter is required, ISA (UK) 706 (Revised June 2016) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* should be consulted. These are examined further in the next section.

8.1 Types of modified opinion

The expression of a modified (qualified) auditor's opinion is usually the 'last resort' after attempts have been made by the auditor to resolve the issue(s) giving rise to the modification. There are three types of modified opinion:

- qualified opinion;
- adverse opinion; and
- disclaimer of opinion.

The auditor decides on which type of opinion is appropriate having regard to the nature of the matter giving rise to the material misstatement or the inability to obtain sufficient appropriate audit evidence. In addition, the auditor must also consider the pervasiveness of the effects, or possible effects, of the matter on the financial statements.

In all cases, the auditor should always document their reasons for the opinion in the independent auditor's report. The auditor should also ensure that the audit evidence on file justifies the opinion as a lack of sufficient or appropriate audit evidence on file may mean questions are asked as to the appropriateness of, say, an unqualified opinion, during the course of any file review carried out by a professional body, the FRC or external reviewers.

8.2 Pervasiveness

A misstatement in the accounts may be material or it may be material *and* pervasive. Paragraph 5 of ISA (UK) 705 (Revised June 2016) contains the definition of 'pervasive' which is:

'A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment: *ISA (UK) 705.5(a)*

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.'

The term 'pervasive' is therefore taken to mean that a misstatement is not only material, but could affect several areas of the financial statements.

Example

A large private company operates a defined benefit pension plan for its employees and has a year-end of 31 December 2017. Due to a dispute with the actuarial firm, the company has refused to commission a valuation for financial reporting purposes of the pension scheme. The pension scheme is significantly material to the financial statements and the directors are insistent that they will not obtain a valuation.

As the accounting input and disclosures are expected to be material and affect multiple areas of the accounts, i.e. the balance sheet for the resulting surplus/deficit, profit and loss account for the interest charge and current/past service cost and other comprehensive income for actuarial gains and losses together with the disclosure notes required under Section 28 of FRS 102, it can be said that the misstatements would be both material and pervasive.

8.3 Determining the type of modification

As noted in 7.1 above, the determination of the type of modification to the auditor's opinion will depend on a number of factors, including materiality, pervasiveness and the effects of any disclosure/non-disclosure.

Qualified opinion

A qualified opinion is expressed by the auditor when they conclude that a material misstatement (individually or in aggregate) exists but is not pervasive. The auditor will also include the phrase 'except for' when expressing a qualified opinion which states that 'except for' the matters giving rise to the material misstatement, the financial statements otherwise give a true and fair view and have been prepared in accordance with the applicable financial reporting framework and legislation (e.g. Companies Act 2006).

Example

A company operates in the pharmaceutical industry and has a significant amount of capitalised development expenditure on its balance sheet. The company reports under full FRS 102 and has a year-end of 30 September 2017. During the year the company capitalised an amount of £450,000 worth of development expenditure which is considered significantly material to the financial statements. No amortisation has been charged on the additional development expenditure as the project was still nearing completion at the year-end.

During the audit fieldwork, the auditor discovered that of the £450,000 worth of additions to intangible fixed assets, £220,000 was, in fact, research expenditure which should have been written off to the profit and loss account per paragraph 18.8E of FRS 102. The auditor concludes that this amount is material to the financial statements. Management have refused to correct this misstatement on the basis that they disagree with the auditor's conclusion and the auditor disagrees with management that it should be capitalised. All other misstatements identified during the audit have been corrected.

In this example, the auditor disagrees with management's accounting treatment of the research expenditure. Assets and profit are overstated but the misstatement, despite being material, is not pervasive. The auditor concludes that the requirements of FRS 102 have not been complied with and hence will express a qualified opinion as follows:

Qualified opinion

We have audited the financial statements of …

In our opinion, except for the matter described in the Basis for qualified opinion section of our report, the accompanying financial statements:

- give a true and fair view of the state of the company's affairs as at 30 September 2017 and of its profit for the year the ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for qualified opinion

The company has recognised an amount of £220,000 of research expenditure as capitalised development expenditure on the balance sheet as at 30 September 2017 which, in our opinion, is not in accordance with the requirements of FRS 102. The company should have recognised the research expenditure in profit and loss for the year-ended 30 September 2017 to comply with paragraph 18.8E of FRS 102. Accordingly, the company's intangible fixed assets should be reduced by an amount of £220,000 with a corresponding reduction in profit.

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

Adverse opinion

When the auditor has obtained sufficient appropriate audit evidence, but then concludes that misstatements – both individually and in the aggregate – are both material and pervasive to the financial statements, they must express an adverse opinion. Essentially, the auditor expresses an adverse opinion when the financial statements do not give a true and fair view and a qualified opinion is not appropriate due to the magnitude of the misstatements.

Example

The financial statements for a company with a year-end of 31 October 2017 are being audited. On 14 November 2017, the bank confirmed that they would no longer be willing to support the company as the company had defaulted on its loan terms, breached its overdraft facility on a number of occasions during the year and had failed to supply the bank with management accounts as requested. In addition, the company had entered into an arrangement with HMRC to pay an accelerated payment notice in respect of a tax avoidance scheme over a period of six months, but the company was already in arrears and HMRC have threatened to issue winding up proceedings.

The director has approached a number of other banks who have refused to help the company but is confident that eventually the company will find a bank to support it. The financial statements have been prepared using the going concern basis of accounting but the auditor disagrees that this basis is appropriate. The director has refused to have the financial statements prepared on a basis other than the going concern basis of accounting as he feels this may influence the decision of any potential lender.

Paragraph 21 of ISA (UK) 570 *Going Concern* says that if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgement, this basis is inappropriate, the auditor must express an adverse opinion. This is because the effects of the inappropriate use of the going concern basis of accounting are both material and pervasive. The adverse opinion will be expressed as follows:

Adverse opinion

We have audited the financial statements of …

In our opinion, because of the significance of the matter discussed in the Basis for adverse opinion section of our report, the financial statements:

- do not give a true and fair view of the state of the company's affairs as at 31 October 2017 and of its loss for the year then ended;
- have not been properly prepared in accordance with United Kingdom General Accepted Accounting Practice; and
- have not been prepared in accordance with the requirements of the Companies Act 2006.

Basis for adverse opinion

As explained in note 3 of the financial statements, the financial statements have been prepared on the going concern basis. However, in our opinion, due to the number and significance of the material uncertainties, the company is not a going concern in accordance with paragraph 3.8 of FRS 102 and therefore the financial statements should not be prepared on the going concern basis. Following a breach of the company's loan terms and overdraft facility, the company's bank has expressed their unwillingness to support the company and the directors have so far been unable to source financiers to continue to support the business. In addition, the terms of an arrangement to pay with HMRC in respect of a tax avoidance scheme has also not been complied with.

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

Disclaimer of opinion

A disclaimer of opinion is expressed by the auditor when they are unable to obtain sufficient appropriate audit evidence in order to form an opinion on the financial statements and the auditor concludes that the potential effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In practice, disclaimers of opinion are rare, but will often involve multiple uncertainties – for example if the company's accounting records have been destroyed and the financial statements reconstructed from incomplete records.

Example

A wholly-owned subsidiary has prepared its financial statements using the going concern basis of accounting for the year-ended 31 July 2017. Management of the subsidiary have prepared the financial statements on the going concern basis of accounting on the grounds that the parent of the group itself will support the business. The auditor of the subsidiary has discussed the issue with the group auditor who has confirmed that the group has a significant level of overdue debt owed to it and, in the group auditor's opinion, the group nor the parent, has been able to produce any detailed projections, in the form of budgets or forecasts, which demonstrate the group's ability to continue as a going concern. The subsidiary is reliant on additional finance/investment which has not yet been secured.

Based on these facts, the auditor has concluded that they are unable to form an opinion as to whether the going concern basis of accounting is appropriate and has expressed a disclaimer of opinion which is expressed as follows:

Disclaimer of opinion

We have audited the financial statements of …

We do not express an opinion on the accompanying financial statements. Because of the significance of the matter described in the Basis for disclaimer opinion section of our report, we have not been able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements.

Basis for disclaimer of opinion

The audit evidence available to us to confirm the appropriateness of management's use of the going concern basis of accounting was limited because the company is reliant on support from the Group. The Group has not been able to provide any corroboratory evidence that it is able to continue to trade for the foreseeable future as a going concern. The Group has significant levels of indebtedness and has not provided any financial projections which would indicate that it has the ability to continue to trade as a going concern for the foreseeable future.

As a result, we were unable to determine whether the going concern basis of accounting is appropriate in the company's circumstances.

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

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. However, because of the matter described in the Basis for disclaimer of opinion section of our report, we were not able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements.

8.4 Use of 'Bannerman' paragraphs in auditors' reports

Bannerman paragraphs in previous versions of the auditors' report were worded as follows:

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Bannerman paragraphs are considered vital for audit firms as was proved in the case of *Barclays Bank plc v Grant Thornton UK*. This case confirmed that a

Bannerman paragraph does limit liability to third parties in respect of the contents of the auditor's report.

Overview of the case

Grant Thornton carried out non-statutory audits of the Von Essen Hotels Limited Group (VEH) and expressed unqualified audit opinions for both 2006 and 2007. Barclays alleged that the financial statements had been manipulated to show that VEH was capable of meeting bank covenants on its loan facility when, in reality, it could not. As a result, Barclays suffered losses of some £45 million when VEH went into administration in April 2011 and said that it relied upon the unqualified audit opinions when making the loans to VEH.

Barclays said that Grant Thornton owed a duty of care and that this duty of care was breached because the auditors failed to uncover the alleged fraud. Barclays also said that Grant Thornton would have been aware that they would be placing reliance on the auditor's report. Grant Thornton's auditor's reports contained the Bannerman wording which set out that they did not accept or assume responsibility in respect of the reports to anyone other than the company and its directors.

The judge said that Barclays should have been aware of Bannerman. Nonetheless, the paragraph itself was included in the first two paragraphs of the auditor's report and therefore if Barclays had not read it, it should have.

The judge concluded that the Bannerman paragraph was reasonable having regard to the 1977 Unfair Contract Terms Act.

Relevance of Bannerman to the current auditors' reports

At the time of writing these notes, it is currently unclear as to whereabouts in the report the paragraph should be placed. However, this case does confirm that if a Bannerman paragraph is not included in the auditor's report, they are at much greater risk of a successful legal claim being brought against them.

9 Emphasis of matter and other matter paragraphs

(Lecture A604 – 6.26 minutes)

Emphasis of matter paragraphs (EOM) are dealt with in ISA (UK) 706 (Revised June 2016) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. There is often confusion surround when it is appropriate to include an EOM in the auditor's report.

The first point worthy of note is that an EOM paragraph **does not** qualify the auditor's opinion in any way. It merely flags the user to a disclosure contained within the financial statements that the auditor considers is important.

The most common type of matter that was included in an EOM paragraph under the previous versions of the ISAs (UK and Ireland) was a material going concern uncertainty. If the company had made adequate disclosure in respect of a material uncertainty relating to going concern, the auditor would include an EOM paragraph in their report which cross-referenced to the relevant disclosure note. The EOM paragraph would sit immediately below the Opinion paragraph.

Of course, ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements* has been significantly revised, including the restructuring of the auditor's report (see section 8).

There are two definitions contained in ISA (UK) 705 at paragraph 7 as follows:

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

ISA (UK) 705 (Revised June 2016) paragraph 7(a) and (b)

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

9.1 Examples of circumstances which may warrant an EOM paragraph

An EOM paragraph is used to refer to a matter which has been adequately presented or disclosed in the financial statements by the directors. When the auditor concludes that these matters are of such fundamental importance to users' understanding, the auditor draws attention to this matter through an EOM paragraph in their report.

Examples of such fundamental matters may include:

- the financial statements have been prepared on a basis other than the going concern basis;
- there is an uncertainty relating to the future outcome of a legal case or regulatory action;

- a significant post balance sheet event occurs between the balance sheet date and the date of the auditor's report;
- the entity early adopts an accounting standard;
- a major catastrophe has occurred that has had a significant effect on the entity's financial position;
- corresponding figures have been restated; and
- the financial statements have been reissued and the auditor has provided an amended auditor's report.

9.2 Purpose of an EOM paragraph

An EOM paragraph is only used by the auditor to emphasise a point that has been adequately disclosed in the financial statements – it is not to be used for anything else. Therefore, if adequate disclosure of a material event has not been made in the financial statements, the auditor does not include an EOM paragraph; instead, the auditor's opinion should be modified.

For listed entities, ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report* requires the auditor to communicate key audit matters in a separate section of the report, headed up 'Key Audit Matters' (KAM). An EOM paragraph should not be used to highlight issues that are already included within the KAM section of the report. It may be the case that the auditor includes both an EOM and a KAM paragraph in their report; where this does happen, KAM can be included either directly before, or after, the EOM paragraph based on the auditor's judgement as to the relative significance of the information included in the EOM paragraph. In the FRC's *Compendium of illustrative auditor's reports*, KAM is included after the EOM paragraph.

There is no need to include an EOM paragraph in the auditor's report in respect of immaterial misstatements because the mere fact that they are immaterial means they do not warrant the attention of shareholders.

Example

Emphasis of matter

Without qualifying our opinion, we draw attention to note 20 of the financial statements which describes the effects of a major restructuring of the company being carried out in the succeeding financial year.

In the compendium of auditor's reports issued by the FRC (the 2016 edition), the EOM is included after the 'Conclusions relating to going concern' section of the auditor's report.

9.3 Other matter paragraphs

When the auditor considers it necessary to communicate matters, other than those which are presented or disclosed in the financial statements which, in the auditor's judgement, is relevant to users' understanding of the auditor, the auditor includes an Other Matter (OM) paragraph in the auditor's report. Care must be taken to ensure correct application in the financial statements because an OM paragraph cannot be included in the auditor's report if:

- it is prohibited by law or regulation; and
- the company is a listed entity, applying ISA (UK) 701, and the matter has been included as a key audit matter.

Example

The group auditor of a listed group includes an Other Matter paragraph in the auditor's report for the year-ended 30 September 2017 confirming that the audit firm has not carried out any non-audit services which are prohibited by the FRC's Ethical Standard as follows:

Other matters which we are required to address

We were appointed by XYZ PLC on 1 October 2016 to audit the financial statements for the period ending 30 September 2017. Our total uninterrupted period of engagement is three years, covering the periods ending 30 September 2014 to 30 September 2017.

The non-audit services prohibited by the FRC's Ethical Standard were not provided to the group or the parent company and we remain independent of the group and the parent company in conducting our audit.

Our audit opinion is consistent with the additional report to the audit committee.

Generally, OM paragraphs are included in the auditor's report if the auditor considers it necessary to communicate matters which are not presented or disclosed in the financial statements but which are, in the auditor's professional judgement, relevant to an understanding of the audit, the auditor's responsibilities or the auditor's report.

Examples of such matters include:

- Communication of audit planning and scoping matters where laws or regulation require (in the UK paragraph 16-1 to ISA (UK) 701 must be complied with in this respect).
- Explaining why the auditor has not resigned when a pervasive inability to obtain sufficient appropriate audit evidence is imposed by management and

the auditor is unable to withdraw from the engagement due to legal restrictions.

- When law, regulation or generally accepted practice requires, or allows the auditor to provide a further explanation of their responsibilities.