ACCOUNTING AND AUDIT UPDATE

Tolley®CPD

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FRS 102: THE FINANCIAL REPORTING STANDARD APPLICABLE IN THE UK AND REPUBLIC OF IRELAND

Introduction *(Lecture A420 – 17.36 minutes)*

The Financial Reporting Council (FRC) published FRS 102 in March 2013. It applies to entities in the United Kingdom and Republic of Ireland and is compulsory for accounting periods beginning on or after 1 January 2015. It may be adopted early for accounting periods ending on or after 31 December 2012. For entities that are within the scope of a SORP, early application is permitted providing it does not conflict with the requirements of a current SORP or legal requirements for the preparation of financial statements.

Early adoption must be disclosed.

FRS 102 is a single financial reporting standard that aims to provide entities with succinct financial reporting requirements. FRS 102 applies to public benefit entities as well as profit-oriented entities.

The requirements in FRS 102 are based on the International Accounting Standards Board's (IASB) International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). When compared with the full International Financial Reporting Standards (IFRS), the IFRS for SMEs contains fewer disclosures and is drafted in a simpler form. Also, in most cases, where IFRS offers a choice of accounting treatment, the IFRS for SMEs includes only the simpler accounting treatment.

Initially, in FRED 44 ("The FRSME") the Accounting Standards Board (ASB) proposed a standard that followed the IFRS for SMEs very closely. However, the proposal to remove accounting options was not popular. The ASB responded with a revised approach in FRED 48 which the FRC has now endorsed. Accordingly, where options are permitted in existing UK GAAP and IFRS, those options are now included in FRS 102.

The general principle is that FRS 102 will be updated three-yearly. However, the FRC accepts that there may be circumstances where FRS 102 would require updating in an interim period between the three-year cycles. When this occurs the amendments proposed should be limited. As an illustration of this need for more regular amendments, it is accepted that FRS 102 will probably be amended before it comes into force as a result of the review currently being performed by the IASB of hedge accounting and impairment requirements.

Format

FRS 102 is organised by topic with each topic presented in a separate numbered section. Paragraphs that apply solely to public benefit entities are identified by the prefix 'PBE'. Some sections include appendices of implementation guidance that are not part of the FRS but which provide guidance concerning its application.

The first 10 sections of FRS 102 could be said to deal with general principles and the primary financial statements. We will cover most of those chapters today.

Sections 11 to 34 contain the detailed accounting treatment and disclosure requirements that apply to both individual and consolidated accounts ending with specialised activities covered in section 34. We will cover the key elements of these sections in future update notes.

Transition to FRS 102 is dealt with in section 35. For an entity first applying FRS 102 for an accounting period ending 31 December 2015, transition date is 1 January 2014 (the start of the comparative year presented with the December 2015 accounts). A reconciliation will need to be prepared as at 1 January 2014 and this involves a number of decisions that may need to be taken before the end of 2013. We will deal with transition and the necessary reconciliations in the next update notes.

Following Section 35, FRS 102 contains a glossary of terms and four appendices:

1. Significant differences between FRS 102 and IFRS for SMEs
2. Equivalence for CA 2006
3. Note on legal requirements
4. Development of FRS 102

A separate impact assessment has also been published. Particularly interesting is Appendix 2 which considers the cost of implementing FRS 102 for a range of different types of company.

Section 1: Scope ***(Lecture A4210 – 10.03 minutes)***

This section starts by repeating the principles in FRS 100 (covered in detail in the previous set of update notes):

- Financial statements (whether consolidated financial statements or individual financial statements) that are required by the IAS Regulation or other legislation or regulation to be prepared in accordance with EU-adopted IFRS, must continue to be prepared in accordance with those requirements. FRS 102 is not relevant to such financial statements.
- An entity eligible to apply the FRSSE, may continue to do so;

- An entity not eligible to apply the FRSSE (or an entity that is eligible to apply the FRSSE but chooses not to do so) must prepare financial statements in accordance with:
  - FRS 102;
  - EU-adopted IFRS; or
  - if the financial statements are the individual financial statements of a qualifying entity, FRS 101.

Some entities (such as listed companies) are required (or choose) to disclose extra information. FRS 102 does not include these requirements but, instead, requires such entities to comply with the relevant International Standards as adopted in the EU. The relevant standards are IAS 33 Earnings per Share, IFRS 6 Exploration for and Evaluation of Mineral Resources and IFRS 8 Operating Segments. Also, where relevant, entities are required to apply FRS 103 Insurance Contracts (not yet issued).

Reduced disclosures for subsidiaries (and ultimate parents)

There is a reduced disclosure regime in FRS 102 that mirrors the regime introduced by FRS 101 regarding disclosure concessions.

The reduced disclosure regime in FRS 102 is likely to be used by UK GAAP groups where the consolidated accounts will follow the recognition and measurement rules of FRS 102. In this case the subsidiaries and ultimate parent will use FRS 102 (with the reduced disclosure regime) in preparing their own individual accounts.

Conversely, FRS 101 is likely to be used by IFRS groups where the consolidated accounts will follow the recognition and measurement rules of either full or EU-adopted IFRS. In this case the subsidiaries and ultimate parent would use the recognition and measurement rules of EU-adopted IFRS in preparing their own individual accounts. These accounts will be UK GAAP accounts and will need to comply with The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (The Regulations) however the accounts can take advantage of the reduced disclosure regime of FRS 101. FRS 101 was covered in the previous set of update notes.

Having made the generalisations in the previous two paragraphs, it should be noted that neither FRS 101 nor FRS 102 mandate the use of a particular GAAP for the consolidated accounts. The requirement in both standards is that the group accounts show a true and fair view. Thus I have encountered an example where a parent company preparing consolidated accounts using US GAAP wishes the UK subsidiary to take advantage of FRS 101 since the parent company considers that it will be easier to consolidate a subsidiary using the recognition and measurement rules of IFRS rather than UK GAAP.

Let us return to the reduced disclosure regime in FRS 102.

The definition of a qualifying entity is:

"A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation."

FRS 102 sets out disclosure exemptions for the individual financial statements of qualifying entities. The exemptions for entities that are financial institutions are restricted as shown below.

The exemptions apply to subsidiaries, intermediate parents and ultimate parents in their individual financial statements. The exemptions are not available in consolidated financial statements be they the group accounts for the entire group or any sub-group even if these group accounts are prepared voluntarily.

Conditions

There are three conditions that apply to an entity wishing to take advantage of the reduced disclosures in FRS 102:

- Its shareholders must be notified in writing and do not object to the use of the disclosure exemptions. The immediate parent of the entity may object. Otherwise, objections may be made by a shareholder or shareholders holding in aggregate 5% or more of the total allotted shares in the entity or more than half of the allotted shares in the entity that are not held by the immediate parent.
- It otherwise applies as its financial reporting framework the recognition, measurement and disclosure requirements of FRS 102.
- it discloses in the notes to its financial statements a brief narrative summary of the disclosure exemptions adopted and the name of the parent of the group in whose consolidated financial statements its financial statements are consolidated, and from where those financial statements may be obtained.

Disclosure exemptions

All qualifying entities can take advantage of the following disclosure exemptions:

- Reconciliation of the number of shares outstanding at the beginning and at the end of the period.
- Cash Flow Statement.
- Providing equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated, all of the disclosures concerning share-based payment with the exception of paragraphs 26.18(a) and 26.22. This exemption applies provided that for a qualifying entity that is:
    - a subsidiary, the share-based payment arrangement concerns equity instruments of another group entity;

  - an ultimate parent, the share-based payment arrangement concerns its own equity instruments and its separate financial statements are presented alongside the consolidated financial statements of the group.

  For information, paragraph 26.18(a) requires a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (eg whether in cash or equity). Paragraph 26.22 applies where the entity is part of a group share-based payment plan, and it recognises and measures its share-based payment expense on the basis of a reasonable allocation of the expense recognised for the group. In this case, the entity discloses that fact and the basis for the allocation.

- Compensation paid to key management personnel in total.

In addition, providing equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated, a qualifying entity that is not a financial institution is not required to provide any of the disclosures required by Sections 11 and 12 (which deal with Financial Instruments).

However, it should be noted that, in relation to paragraph 1.12(c), where the qualifying entity has financial instruments held at fair value subject to the requirements of paragraph 36(4) of Schedule 1 to the Regulations, it must apply the disclosure requirements of Section 11 Basic Financial Instruments to those financial instruments held at fair value. This will not apply to financial liabilities that are held at fair value that are either part of a trading portfolio or are derivatives. In this case, the qualifying entity can take advantage of the exemptions.

When deciding whether the consolidated financial statements of the parent provide disclosures which are equivalent to the full requirements of FRS 102, reference should be made to the Application Guidance in FRS 100 which we covered in our previous update.

Section 2: Concepts and pervasive principles (Lecture A422 – 11.14 minutes)

With only minor amendments, Section 2 is identical to the IFRS for SMEs. Note that this means that going concern is still dealt with in Section 3 paragraphs 3.8 to 3.9 (see later). This is surprising since The Regulations consider going concern to be an ‘accounting principle’ along with accruals (which is dealt with in paragraph 2.36 of FRS 102, that is in a different section from going concern). The draft of new EU accounting directive, Article 5 also lists going concern as an accounting principle.

An interesting change from FRED 48 (and a variation from IFRS for SMEs) is the addition of paragraph 2.1A. This indicates that, in some circumstances there may be inconsistencies between the concepts and principles in Section 2 and the specific requirements of another section. In these circumstances the specific requirements of the other section within the FRS take precedence over this section.

“The objective of financial statements is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.” (Paragraph 2.2)

“Financial statements also show the results of the stewardship of management – the accountability of management for the resources entrusted to it.”(Paragraph 2.3)

These paragraphs are broadly comparable with the objectives section of the existing statement of principles (SoP) published by the ASB in 1999. However, that document is very much more detailed than the equivalent sections of FRS 102. In particular, each chapter of the SoP states the principles involved and then goes on to explain those principles in great detail. FRS 102 contains the principles with little explanation.

In the notes that follow, I shall draw attention to changes in the SoP that may appear to be significant. The lack of any comment implies that there is no significant variation from the existing SoP.

Qualitative characteristics of information in financial statements

FRS 102 lists the qualitative characteristics of information in financial statements as:

- Understandability
- Relevance
- Materiality
- Reliability - Information is reliable when it is free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.
- Substance over form
- Prudence
- Completeness
- Comparability
- Timeliness
- Balance between benefit and cost

The SoP presents the above in a different fashion recognising four qualities of financial information that make it useful namely relevance, reliability, comparability and understandability. Relevance includes timeliness whereas faithful representation (substance over form), neutrality, freedom from material error, completeness and prudence are seen as part of reliability. Clearly cost/benefit was not seen as an issue by the ASB!

In the event of the need to make a choice between relevance and reliability, the SoP gave precedence to the one that results in the relevance of the information provided being maximised. FRS 102 says 'In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the needs of users in making economic decisions.'

Materiality was described in the SoP as a threshold quality demanded of all information in the financial statements. Furthermore, when immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided. In such circumstances, the immaterial information will need to be excluded.

FRS 102 contains the following:

'Information is material - and therefore has relevance - if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor. However, it is inappropriate to make, or leave uncorrected, immaterial departures from this FRS to achieve a particular presentation of an entity's financial position, financial performance or cash flows.'

The words material or materiality appear in many places in FRS 102 but there is no attempt to provide more detailed guidance about materiality.

Financial position

Paragraph 2.15 states that the financial position of an entity is the relationship of its assets, liabilities and equity as of a specific date as presented in the statement of financial position. Paragraph 4.1 tells us that the statement of financial position is referred to in CA 2006 as the balance sheet.

Definitions:

Term defined	FRS 102	Existing Statement of Principles
Asset	An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.
Liability	A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits	Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events.
Equity	Equity is the residual interest in the assets of the entity after deducting all its liabilities.	Ownership interest is the residual amount found by deducting all of the entity's liabilities from all of the entity's assets.

Recognition of assets or liabilities depends on the criteria for recognition shown below. In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion before an asset or liability is recognised.

Paragraph 2.19 makes the point that, in determining the existence of an asset, the right of ownership is not essential. The example provided is property held on a lease which is an asset if the entity controls the benefits that are expected to flow from the property.

Consistently with SoP/FRS 12, liabilities may arise from either a legal obligation or a constructive obligation.

Equity may be sub-classified in the statement of financial position. For example, in a corporate entity, sub-classifications may include funds contributed by shareholders, retained earnings and gains or losses recognised in other comprehensive income.

Performance

Performance is the relationship of the income and expenses of an entity during a reporting period. FRS 102 permits entities to present performance in a single financial statement (a statement of comprehensive income) or in two financial statements (an income statement and a statement of comprehensive income).

Definitions:

Term defined	FRS 102	Existing Statement of Principles
Income	Income is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity investors.	Gains are increases in ownership interest not resulting from contributions from owners. A footnote indicates that this term incorporates all forms of income and revenue as well as all recognised gains (realised and unrealised) on non-revenue items.
Expenses	Expenses are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity investors.	Losses are decreases in ownership interest not resulting from distributions to owners. A footnote indicates that this term incorporates all forms of expenses, sometimes referred to as revenue expenditure, and all recognised losses (realised and unrealised) on non-revenue items.

The recognition of income and expenses results directly from the recognition and measurement of assets and liabilities.

Consistent with the SoP, FRS 102 confirms that the definition of income encompasses both revenue and gains. Similarly, the definition of expenses in FRS 102 encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

Revenue is income that arises in the course of the ordinary activities of an entity. It is referred to by a variety of names including sales, fees, interest, dividends, royalties and rent. Gains are other items that meet the definition of income but are not revenue.

When gains and losses are recognised in the statement of comprehensive income, they are usually displayed separately because knowledge of them is useful for making economic decisions.

Recognition and measurement of assets, liabilities, income and expenses

Under FRS 102, recognition is a three step process:

- Does the item meet the definition of an asset, liability, equity, income or expense?
- Is it probable that any future economic benefit associated with the item will flow to or from the entity? Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence relating to conditions at the end of the reporting period available when the financial statements are prepared. See further notes below on the subject of ‘probable’.
- Can the cost or value of the item be measured reliably? Note that this may involve estimation and FRS 102 states that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

‘Probable’ is defined in the glossary of FRS 102 as ‘More likely than not’.

In existing UK GAAP, the phrase, ‘more likely than not’ is used in FRS 12 when dealing with provisions and in FRS 19 when dealing with deferred tax assets. On the other hand, the SoP (consistently with FRS 5) asks whether ‘sufficient evidence exists’ that an asset or liability has been created or changed.

The term ‘sufficient evidence’ can permit different probability measures for assets and liabilities and this point is taken up in FRS 12. Provisions are recognised when they are more likely than not to occur. Similarly, an item previously disclosed as a contingent liability will be recognised as a provision if the probability of occurrence increases to become over 50%. On the other hand, contingent assets are only recognised when the realisation of the profit is virtually certain since, at this point, the related asset is not a contingent asset and its recognition is appropriate.

So this would seem to suggest that FRS 102 has adopted an even-handed approach in recognising assets and liabilities. However, this conclusion is then refuted by paragraph 2.38 which states ‘An entity shall not recognise a contingent asset as an asset. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.’

Returning to FRS 102, failure to recognise an item that satisfies the recognition criteria cannot be rectified by disclosure. However, it may be necessary to disclose an item that fails to meet the recognition criteria when knowledge of the item is relevant to the users of the financial statements.

FRS 102 specifies an appropriate measurement basis for many types of assets, liabilities, income and expenses. In Section 2, there is a description of two common measurement bases namely historical cost and fair value. There are no surprises in these descriptions.

Accrual basis

An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. On the accrual basis, items are recognised as assets, liabilities, equity, income or expenses when they satisfy the definitions and recognition criteria for those items.

Other comments on recognition and measurement in financial statements

FRS 102 continues with two sections on recognition and measurement in financial statements. These sections are largely repetitive of what has gone before and do not provide any new difficulties. Interesting quotes are as follows:

- The recognition of income or expense results directly from the recognition and measurement of assets and liabilities.
- Total comprehensive income is the arithmetical difference between income and expenses. It is not a separate element of financial statements, and a separate recognition principle is not needed for it. The definition of total comprehensive income in the glossary is 'The change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions from equity participants (Total comprehensive income is equal to the sum of profit or loss and other comprehensive income).
- Profit or loss is the arithmetical difference between income and expenses other than those items of income and expense that FRS 102 classifies as items of other comprehensive income. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.
- Generally, FRS 102 does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or of liabilities regardless of whether they result from applying the notion commonly referred to as the 'matching concept' for measuring profit or loss.
- At initial recognition, an entity shall measure assets and liabilities at historical cost unless FRS 102 requires initial measurement on another basis such as fair value.
- An entity measures basic financial assets and basic financial liabilities at amortised cost less impairment except for (a) investments in non-convertible preference shares and non-puttable ordinary and preference shares that are publicly traded or whose fair value can otherwise be measured reliably, which are measured at fair value with changes in fair value recognised in profit or loss; and (b) any financial instruments that upon their initial recognition were designated by the entity as at fair value through profit or loss. We will return to this subject and explain these terms fully when we deal with financial instruments in a future update.

- An entity generally measures all other financial assets and financial liabilities at fair value, with changes in fair value recognised in profit or loss, unless FRS 102 requires or permits measurement on another basis such as cost or amortised cost.
- Most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases such that the asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.
- For certain types of non-financial assets, FRS 102 permits or requires measurement at fair value. For example investments in associates and joint ventures, investment property, biological assets and agricultural produce at the point of harvest, property, plant and equipment and intangible assets.
- Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.
- An entity is not permitted to offset assets and liabilities, or income and expenses, unless required or permitted by an FRS.

Section 3: Financial statement presentation (Lecture A423 – 26.44 minutes)

Introduction

FRS 102 uses different terminology for financial statement headings but paragraph 3.22 tells us that 'An entity may use titles for the financial statements other than those used in this FRS as long as they are not misleading'. For example:

- The statement of financial position can still be referred to as balance sheet (which some companies still do under full IFRS) in accordance with The Regulations.
- Where (as is commonly the case in practice) the entity presents two separate statements (Income statement and separate Statement of comprehensive income see below paragraph 5.7) then the first statement can still be called 'Profit and loss account' in accordance with The Regulations.

Fair presentation

This is explained as the faithful representation of the effects of transactions, other events and conditions in accordance with the principles in Section 2. The application of FRS 102, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation of the financial position, financial performance and cash flows of the entity.

Compliance with FRS 102

This requires an explicit and unreserved statement of compliance with FRS 102 in the notes to the financial statements. This statement can only be given if the financial statements comply with all of the requirements of FRS 102. A public benefit entity that applies the 'PBE' prefixed paragraphs is required to make an explicit and unreserved statement that it is a public benefit entity.

This part of Section 3 also deals with the "extremely rare circumstances" when management concludes that compliance with FRS 102 would be so misleading that it would conflict with the objective of financial statements as set out in Section 2. In this case (what we currently call the true and fair view override) FRS 102 sets out the required disclosures as follows:

Disclosures required for fair presentation override:

- That management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows.
- That it has complied with FRS 102 or applicable legislation, except that it has departed from a particular requirement of FRS 102 or applicable legislation to achieve a fair presentation.
- The nature of the departure, including the treatment that FRS 102 or companies legislation would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in Section 2, and the treatment adopted.
- These disclosures are also required when an entity has invoked the fair presentation override in a prior period, and that departure affects the amounts recognised in the financial statements for the current period

These disclosures are similar to those currently required by FRS 18. However, note that the existing requirement to give a description of how the position shown in the financial statements is different as a result of the departure (normally with quantification) is not contained in FRS 102.

Going concern

At a point in time when going concern is considered to be a major issue in financial reporting, the new UK GAAP contains just two paragraphs on this subject. The first paragraph includes the definition:

'An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.'

The impact of this definition is unchanged from the present definition in FRS 18.

FRS 102 requires management, when preparing financial statements, to make an assessment of the entity's ability to continue as a going concern. This compares with the current requirement 'directors should assess whether there are significant doubts about an entity's ability to continue as a going concern'. Perhaps this difference is unimportant since "significant doubts" are mentioned later on in FRS 102 (see below).

The period considered by management in making their assessment must be at least, twelve months from the date when the financial statements are authorised for issue. This is a change from FRED 48 which referred to twelve months from the reporting date.

Disclosures required:

- When management is aware, in making its assessment, of material uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties.
- When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

These disclosures are consistent with the existing requirements of FRS 18 with the exception that there is no explicit mention of the disclosures required in the situation where the period considered by management is inadequate. In my view, should that situation arise under FRS 102, then disclosure would be required anyway since the entity cannot give "an explicit and unreserved statement of compliance with FRS 102".

Frequency of reporting, consistency and comparatives

This section requires the entity to present a complete set of financial statements (including comparative information) at least annually. It also contains disclosure requirements if the reporting date changes such that the reporting period is longer or shorter than a year.

Presentation and classification of items in the financial statements must be consistent from one period to the next unless there is a change of accounting policy or a change in an FRS or FRC Abstract. (This is the first reference to a new animal – the FRC Abstract – not mentioned in FRED 48).There are disclosure requirements (including reclassification of comparative amounts) in the event that the presentation or classification of items in the financial statements is changed.

Comparative information is required for all amounts presented in the current period's financial statements except when FRS 102 permits or requires otherwise. Comparative information is required for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

Materiality and aggregation

An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.

A line item in the financial statements that is not individually material is aggregated with other items either in the financial statements or in the notes. An item that may not warrant separate presentation in the financial statements may warrant separate presentation in the notes.

An entity need not provide a specific disclosure required by FRS 102 if the information is not material.

Complete set of financial statements

A complete set of financial statements consists of:

- A statement of financial position as at the reporting date.
- Either:
    - a single statement of comprehensive income for the reporting period displaying all items of income and expense recognised during the period including those items recognised in determining profit or loss (which is a subtotal in the statement of comprehensive income) and items of other comprehensive income. If there are no items of other comprehensive income then the 'bottom line' of the statement of comprehensive income is labelled 'profit or loss'.

      or

    - a separate income statement and a separate statement of comprehensive income. In this case, the statement of comprehensive income begins with profit or loss and then displays the items of other comprehensive income. If there are no items of other comprehensive income then it is acceptable to present just an income statement.
- A statement of changes in equity for the reporting period. In the circumstance where the only changes to equity during the periods arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy, the entity may present a single statement of income and retained earnings in place of the statement of comprehensive income and statement of changes in equity
- A statement of cash flows for the reporting period.
- Notes, comprising a summary of significant accounting policies and other explanatory information.

Each financial statement must be presented with equal prominence. Different titles for the financial statements may be used as long as they are not misleading

A complete set of financial statements means that the entity must present, as a minimum, two of each of the required financial statements and related notes.

The financial statements and notes should be clearly identified and should be distinguished from other information in the same document. The following information must be displayed prominently and repeated as necessary:

- The name of the reporting entity and any change in its name since the end of the preceding reporting period.
- Whether the financial statements cover the individual entity or a group of entities.
- The date of the end of the reporting period and the period covered by the financial statements.
- The presentation currency.
- The level of rounding, if any, used in presenting amounts in the financial statements.

The following must be disclosed in the notes:

- The legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office).
- A description of the nature of the entity's operations and its principal activities unless this is disclosed in the business review (or similar statement) accompanying the financial statements.

Section 4: Statement of financial position (Lecture A423 – 26.44 minutes)

This section has been changed considerably from the equivalent section in the IFRS for SMEs. This is because accounts prepared using FRS 102 are classified as 'Companies Act accounts' and must therefore comply with the provisions of Part 15 of the CA 2006 (The Act) and with The Regulations.

FRS 102 is not intended to be a one-stop-shop for all accounting and legal requirements, and therefore compliance with FRS 102 alone will be insufficient to ensure compliance with all the disclosure requirements set out in the Act and the Regulations.

Section 4 requires the entity to prepare a balance sheet in accordance with the appropriate schedule of The Regulations. Additional line items, headings and subtotals should be included in the balance sheet when relevant to an understanding of the entity's financial position.

It would seem therefore that the balance sheet of the future will be largely the same as the balance sheet of today and, in fact, may continue to be called the balance sheet. Accordingly, I have not included an example.

Paragraph 4.4A deals with debtors due after more than one year. If the amount is so material in the context of the total net current assets that, in the absence of disclosure of the debtors due after more than one year on the face of the statement of financial position, readers may misinterpret the financial statements, the amount should be disclosed on the face of the statement of financial position within current assets. In most cases it will be satisfactory to disclose the amount due after more than one year in the notes to the financial statements. This is consistent with existing UITF Abstract 4.

In paragraph 4.7, FRS 102 states that an entity shall classify a creditor as due within one year when the entity does not have an unconditional right, at the end of the reporting period, to defer settlement of the creditor for at least twelve months after the reporting date.

For each class of share capital, there should be disclosure of the following either in the balance sheet or in the notes:

- The number of shares issued and fully paid, and issued but not fully paid.
- Par value per share, or that the shares have no par value.
- A reconciliation of the number of shares outstanding at the beginning and at the end of the period. This reconciliation need not be presented for prior periods.
- The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital.
- Shares in the entity held by the entity or by its subsidiaries, associates, or joint ventures.
- Shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts.

An entity without share capital, such as a partnership or trust, should provide equivalent information.

There should also be a description of each reserve within equity – a new requirement to existing UK GAAP users.

Finally, Section 4 brings the concept of assets held for sale and disposal groups into UK GAAP. FRED 32 was published in 2003 as part of the convergence plans of the ASB, However, when IFRS 5: Non-current Assets Held for Sale and Discontinued Operations was published in 2004, the ASB did not proceed with issuing a UK standard. Now FRS 102 contains the following disclosure requirements:

If, at the reporting date, an entity has a binding sale agreement for a major disposal of assets, or a disposal group, the entity shall disclose the following information:

- A description of the asset(s) or the disposal group.
- A description of the facts and circumstances of the sale.

- The carrying amount of the assets or, for a disposal group, the carrying amounts of the underlying assets and liabilities.

So FRS 102, in line with the IFRS for SMEs, requires disclosure of assets held for sale but does not address presentation, recognition and measurement issues so FRS 102 diverges in principle from full IFRS. FRS 102 does some watering down of full IFRS (on assets held for sale) but is stricter than full IFRS on discontinued operations because of constraints imposed by The Regulations.

IFRS for SMEs BC 119 commented on this disclosure only approach referring to cost/ benefit reasons and said that an intention to sell should be viewed as an impairment indicator, and memorandum disclosure should be given.

IFRS 5 issues are effectively dealt with in two places in FRS 102: discontinued operations in paragraph 5.5 of the IFRS for SMEs (but paragraph 5.7D in FRS 102) and non-current assets held for sale in 4.14 of the IFRS for SMEs (and FRS 102).

Section 5: Statement of comprehensive income and income statement (Lecture A423 – 26.44 minutes)

Single statement approach and two statement approach

We have already learned that the statement of performance can be either a single statement of comprehensive income for the reporting period or two separate statements - the income statement and a separate statement of comprehensive income.

In the single-statement approach, the statement of comprehensive income presents all items of income and expense recognised during the period.

In the two-statement approach, the income statement presents all items of income and expense recognised in the period except those that are recognised in total comprehensive income outside of profit or loss as permitted or required by FRS 102.

A change from the single-statement approach to the two-statement approach, or vice versa, is a change in accounting policy.

Section 5 requires the entity to present the items that are required to be included in a profit and loss account in accordance with the appropriate schedule of The Regulations. In the one-statement approach, this information will appear in the statement of comprehensive income. In the two-statement approach, this information will appear in the income statement which will be the profit and loss account in accordance with the Regulations.

Some commentators have suggested that paragraphs 5.2 to 5.7 are back to front and that, as a result, FRS 102 overstates the importance of the single statement approach. The reason for this "bias" in FRS 102 is that it copies the IFRS for SMEs which replicated the drafting in IAS 1. In fact the single statement approach is a rare bird under IFRS in the UK and the two statement approach is very popular with UK listed companies. Also, the two statement approach is easier to align with The Regulations and therefore we can probably conclude that the two statement approach is likely to be more familiar and convenient for users of FRS 102.

FRED 48 contained a list of five types of other comprehensive income recognised as part of total comprehensive income, outside of profit or loss:

- Some gains and losses arising on translating the financial statements of a foreign operation.
- Some actuarial gains and losses.
- Some changes in fair values of hedging instruments.
- Some changes in fair values of investments in subsidiaries, associates and joint ventures.
- Some gains and losses arising on revaluation of property, plant and equipment, intangible assets and heritage assets.

Clearly, in the two statement approach these five items will be included in the separate statement of comprehensive income which starts, if you recall, with profit or loss.

This list has not been reproduced in FRS 102 but continues to be relevant.

Example of the one-statement approach

The following is a very straightforward example of a company that is not part of a group and which has no income from participating interests or other fixed asset investments. At this stage, I have not included any discontinued operations.

AB Limited

Statement of comprehensive income for the year ended 31 December 20X8

	20X8	**20X7**
	£'000	£'000
Turnover	71,645	65,495
Cost of sales	(52,398)	(48,440)
Gross profit	19,247	17,055
Distribution costs	(4,632)	(3,984)
Administrative expenses	(12,531)	(12,040)
Other operating income	2,147	1,980
Interest receivable and similar income	768	454
Interest payable and similar charges	(188)	(225)
Profit on ordinary activities before taxation	4,811	3,240
Tax on profit on ordinary activities	(1,149)	(987)
Profit on ordinary activities after taxation being profit for the financial year	3,662	2,253
Other comprehensive income:		
Actuarial losses on defined benefit pension plans	(964)	(608)
Deferred tax movement relating to actuarial losses	208	118
Total comprehensive income for the year	2,906	1,763

Notice that there is no requirement to include a heading for operating income.

Example of the two-statement approach

The following example uses the same information as the previous example.

AB Limited

Profit and loss account for the year ended 31 December 20X8

	20X8	**20X7**
	£'000	£'000
Turnover	71,645	65,495
Cost of sales	(52,398)	(48,440)
Gross profit	19,247	17,055
Distribution costs	(4,632)	(3,984)
Administrative expenses	(12,531)	(12,040)
Other operating income	2,147	1,980
Interest receivable and similar income	768	454
Interest payable and similar charges	(188)	(225)
Profit on ordinary activities before taxation	4,811	3,240
Tax on profit on ordinary activities	(1,149)	(987)
Profit on ordinary activities after taxation being profit for the financial year	3,662	2,253

Statement of comprehensive income for the year ended 31 December 20X8

	20X8	**20X7**
	£'000	£'000
Profit for the financial year	3,662	2,253
Other comprehensive income:		
Actuarial losses on defined benefit pension plans	(964)	(608)
Deferred tax movement relating to actuarial losses	208	118
Total comprehensive income for the year	2,906	1,763

Further comments applicable to both approaches

Additional line items, headings and subtotals should be included when relevant to an understanding of the entity's financial performance.

When items included in total comprehensive income are material, their nature and amount should be disclosed separately in the statement of comprehensive income (and in the income statement, if presented) or in the notes. (Paragraph 5.9A)

Whichever approach is adopted, prior period adjustments (arising from the correction of material errors or changes in accounting policies) are not included in these statements since prior period adjustments are presented as retrospective adjustments of prior periods. Notice, that we have a difference here from FRS 3 in that FRS 3 requires that the cumulative effect of prior period adjustments should also be noted at the foot of the statement of total recognised gains and losses of the current period.

The following requirements apply to both approaches:

- The entity is required to include line items that present the following amounts for the period:
  a) each of the components of other comprehensive income (excluding amounts in (b)) classified by nature. These may be presented either net of related tax effects or before the related tax effects with one amount shown for the aggregate amount of income tax relating to those components.
  b) its share of the other comprehensive income of associates and jointly controlled entities accounted for by the equity method.
  c) total comprehensive income.
- An entity shall present the following items as allocations of profit or loss and other comprehensive income:
  a) profit or loss for the period attributable to (i) non-controlling interest (ii) owners of the parent. Note that non-controlling interests is the new term for minority interests.
  b) total comprehensive income for the period attributable to (i) non-controlling interest (ii) owners of the parent.
- As a minimum, turnover must be presented on the face of the income statement (or statement of comprehensive income if presented). This is a requirement of The Regulations and has been included in FRS 102. It is not a requirement of full IFRS or IFRS for SMEs.
- As indicated above, FRS 102 does not require disclosure of 'operating profit'. However, if an entity elects to disclose the results of operating activities the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as 'operating'
- An entity shall provide an analysis between continuing operations and discontinued operations of each of the line items on the face of the income

statement (or statement of comprehensive income if presented). This must be done in a columnar format with three columns – continuing operations, discontinued operations and total. There is also a requirement that the income statement (or statement of comprehensive income) presents an amount comprising the total of:

a) the post-tax profit or loss of discontinued operations; and

b) the post-tax gain or loss attributable to the impairment or on the disposal of the assets or disposal groups constituting a discontinued operation.

An example of the columnar format is given in an appendix to Section 5. Notice that the comparatives will also be analysed into three columns.

Disclosures for prior periods have to be re-presented in the financial statements for the current period such that the disclosures of discontinued operations relate to all operations that have been discontinued by the end of the reporting period for the latest period presented.

"Discontinued operation" is defined by FRS 102 as a component of an entity that has been disposed of and:

a) represented a separate major line of business or geographical area of operations;

b) was part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or

c) was a subsidiary acquired exclusively with a view to resale.

The glossary explains that a component of an entity has operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

There is no reference in this definition to timing of the disposal. This is different from FRS 3 where the sale or termination of the discontinued operation could be completed after the balance sheet date as long as the completion was before the earlier of three months after the balance sheet date and the date of approval of the financial statements.

Ordinary activities and extraordinary items

FRS 102 defines ordinary activities as any activities which are undertaken by a reporting entity as part of its business and such related activities in which the reporting entity engages in furtherance of, incidental to, or arising from, these activities. Ordinary activities include any effects on the reporting entity of any event in the various environments in which it operates, including the political, regulatory, economic and geographical environments, irrespective of the frequency or unusual nature of the events.

This definition is virtually identical with the existing definition in FRS 3. Paragraph 5.10A then goes on to describe extraordinary items in the same way as FRS 3.

Notice that FRS 102 does not contain an explicit requirement to show separately on the face of the statement of comprehensive income the "Paragraph 20" exceptional items in FRS 3 (that is profits or losses on sale or termination of an operation; costs of a fundamental reorganisation materially affecting the operation and profits; and losses on disposal of fixed assets). In fact, the term "exceptional items" is not used in FRS 102 at all. Paragraph 43 of The Accounting Council's advice to the FRC to issue FRS 102 comments that the requirements of FRS 3 concerning exceptional items have been included in FRS 102 as a result of "the inclusion of an explicit requirement to disclose material items". Presumably, they are referring to the requirement in Paragraph 5.9A as highlighted above.

This has been an issue under IFRS where, for example, profit on sale of land and buildings is usually taken into operating profit. It would be expected that entities adopting FRS 102 will be greatly influenced by the post-2005 interpretation of IAS 1 by UK listed companies. It will be interesting to see how the requirement to disclose material items will be interpreted in practice.

Other differences from FRS 3

The following requirements of FRS 3 are not included in FRS 102:

- The separate disclosure of the results of acquisitions.
- Disclosure of exceptional items (including the three "paragraph 20" non-operating exceptional items) – but see note above.
- The requirement to disclose that all operations are continuing in the event that there are no discontinued operations.
- The requirement to disclose that all gains and losses are included in the profit and loss account in the event that there are no separate gains and losses to disclose.
- The statement of historical cost profits and losses.

Analysis of expenses

Unless otherwise required by the Regulations, expenses should be analysed based on either the nature of expenses or the function of expenses depending on which presentation is reliable and more relevant.

Analysis by nature of expense means that expenses are aggregated according to their nature (eg depreciation, raw materials and consumables, staff costs etc) rather than being reallocated among various functions within the entity. This method of analysis is consistent with Format 2 for the profit and loss account in The Regulations.

Analysis by function of expense means that expenses are aggregated according to their function as part of, for example, cost of sales, costs of distribution or administrative activities. This analysis is consistent with Format 1 for the profit and loss account in The Regulations.

Section 6: Statement of changes in equity and statement of income and retained earnings ***(Lecture A424 – 8.59 minutes)***

Statement of changes in equity

The statement of changes in equity presents an entity's profit or loss for a reporting period, other comprehensive income for the period, the effects of changes in accounting policies and corrections of material errors recognised in the period, and the amounts of investments by, and dividends and other distributions to, equity investors during the period.

The statement of changes in equity must show:

- Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests.
- For each component of equity, the effects of prior period adjustments.
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:
  i. profit or loss;
  ii. other comprehensive income; and
  iii. the amounts of investments by, and dividends and other distributions to, owners, showing separately issues of shares, purchase of own share transactions, dividends and other distributions to owners, and changes in ownership interests in subsidiaries that do not result in a loss of control.

With respect to (ii) above, the entity must also present (either in the statement of changes in equity or in the notes), for each component of equity, an analysis of other comprehensive income by item.

Example of statement of changes in equity

This example is for a company that is not part of a group.

	Share Capital £'000	Share premium £'000	Profit and loss account £'000	Total £'000
Balance as at 1 January 20x6	786	184	1,985	2,955
Correction of a prior period error			297	297
Restated balance at 1 January 20x6	786	184	2,282	3,252
Total comprehensive income for the year			1,694	1,694
Profit for the year			1,450	1,450
Actuarial gain on defined benefit pension plan net of deferred tax			244	244
Transactions with owners:				
Proceeds from shares issued	124	68		192
Dividends			(580)	(580)
Balance at 31 December 20x6	910	252	3,396	4,558
Balance as at 1 January 20x7	910	252	3,396	4,558
Total comprehensive income for the year			1,110	1,110
Profit for the year			1,427	1,427
Actuarial loss on defined benefit pension plan net of deferred tax			(317)	(317)
Transactions with owners:				
Dividends			(620)	(620)
Balance at 31 December 20x7	910	252	3,886	5,048

Statement of income and retained earnings

This is a simplified statement which is permitted to replace the statement of changes in equity when the only changes to equity during the periods for which financial statements are presented arise from profit or loss, payment of dividends, corrections of prior period material errors, and changes in accounting policy.

The statement of income and retained earnings presents an entity's profit or loss and changes in retained earnings for a reporting period.

The statement of income and retained earnings must present the following items (in addition to the information required by Section 5):

- Retained earnings at the beginning of the reporting period.
- Dividends declared and paid or payable during the period.
- Restatements of retained earnings for corrections of prior period material errors.
- Restatements of retained earnings for changes in accounting policy.
- Retained earnings at the end of the reporting period.

Example of statement of income and retained earnings

For CD Limited, the only changes to equity during 20x8 and 20x7 arise from profit or loss, payment of dividends, corrections of prior period material errors, and changes in accounting policy. In this case, we can present the simplified statement of income and retained earnings instead of the statement of changes in equity.

CD Limited

Statement of income and retained earnings for the year ended 31 December 20X8

	20X8	**20X7 (Restated)**
	£'000	£'000
Turnover	63,605	55,957
Cost of sales	(42,408)	(38,098)
Gross profit	21,197	17,859
Distribution costs	(6,325)	(5,958)
Administrative expenses (20x7: previously stated 8,940)	(11,981)	(11,940)
Other operating income	1,473	1,302
Interest receivable and similar income	358	354
Interest payable and similar charges	(178)	(285)
Profit on ordinary activities before taxation (20x7: previously stated 4,332)	4,544	1,332
Tax on profit on ordinary activities (20x7: previously stated 887)	(1,042)	(287)
Profit on ordinary activities after taxation being profit for the financial year (20x7: previously stated 3,445)	3,502	1,045
Retained earnings at the beginning of the year	12,196	12,751
as previously stated	16,396	14,551
correction of a prior period error	(4,200)	(1,800)
Profit for the financial year (20x7: previously stated 3,445)	3,502	1,045
Dividends	(2,000)	(1,600)
Retained earnings at the end of the year	13,698	12,196

There will also be an explanation of the nature of the prior period error.

Section 7: Statement of cash flows ***(Lecture A424 – 8.59 minutes)***

Introduction

Under FRS 1, cash flows are classified under eight standard headings:

- Net cash inflow from operating activities (using either the direct or the indirect method – see below)
- Returns on investments and servicing of finance
- Taxation
- Capital expenditure and financial investment
- Acquisitions and disposals
- Equity dividends paid
- Management of liquid resources
- Financing

Reconciliations are required between:

- Operating profit and net cash flow from operating activities
- The movement in cash and the movement in net debt.

FRS 102 brings in considerable changes in definitions and in the format of the cash flow statement. Under FRS 102, the statement of cash flows provides information about the changes in cash and cash equivalents of an entity for a reporting period, showing separately changes from operating activities, investing activities and financing activities.

That is, there are only three headings. FRS 102 gives examples of the cash flows to include under each heading and there are no great surprises in the examples provided. However, there is some latitude:

- Interest and dividends paid may be classified as operating cash flows or as financing cash flows.
- Interest and dividends received may be classified as operating cash flows or as investing cash flows.

Whilst on the subject of interest/dividends paid or received, paragraph 7.14 requires an entity to present separately the cash flows from interest and dividends received and paid. Once a policy has been set, the cash flows must be classified consistently from period to period.

I draw attention to the need to present interest and dividends separately to make the point that, in general, FRS 102 is not prescriptive about which cash flows need to be presented separately within the various headings. In fact, the only other cash flows which are required to be disclosed separately are:

- Cash flows arising from income tax which should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. When tax cash flows are allocated over more than one class of activity, the entity is required to disclose the total amount of taxes paid.
- The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units which should be classified as investing activities.
- “Major classes of gross cash receipts and gross cash payments arising from investing and financing activities”. These are the words used in paragraph 7.10 of FRS 102 but, apart from acquisitions and disposals mentioned above, there is no explicit requirement to disclose any particular type of cash flow. In fact, it appears that the major purpose of Paragraph 7.10 is to indicate that net presentation is only permitted in the particular circumstances covered by paragraphs 7.10A to 7.10E. These paragraphs (which are additions to the IFRS for SMEs) cover:
    - Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity for example, rents collected on behalf of, and paid over to, the owners of properties.
    - Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short for example, the purchase and sale of investments.
    - Relaxations available for financial institutions.

Returning to the changes introduced by FRS 102, notice the reference to cash equivalents. Cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.

Bank overdrafts are normally considered financing activities similar to borrowings. However, if they are repayable on demand and form an integral part of an entity’s cash management, bank overdrafts are a component of cash and cash equivalents.

This reference to three months from maturity takes us back to an old concept of the cash flow statement dating from the early 1990’s. It was in 1996 that FRS 1 was amended bringing in the new definition of “cash” as cash in hand and deposits repayable on demand with any qualifying financial institution, less overdrafts from any qualifying financial institution repayable on demand. The amendment explained that deposits are repayable on demand if they can be withdrawn at any time without notice and without penalty or if a maturity or period of notice of not more than 24 hours or one working day has been agreed.

One final point of introduction, as in FRS 1, cash flows from operating activities can be presented using either:

- The indirect method, whereby profit or loss is adjusted for the effects of non-cash transactions, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows; or
- The direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed.

Under FRS 1, it has been very common for entities to adopt the indirect method and it is expected that this approach will continue under FRS 102.

For completeness, and because the direct approach may be unfamiliar to users of these notes, I repeat the details of the direct approach included in FRS 102:

'Under the direct method, net cash flow from operating activities is presented by disclosing information about major classes of gross cash receipts and gross cash payments. Such information may be obtained either:

a) from the accounting records of the entity; or
b) by adjusting sales, cost of sales and other items in the statement of comprehensive income (or the income statement, if presented) for:
    i. changes during the period in inventories and operating receivables and payables;
    ii. other non-cash items; and
    iii. other items for which the cash effects are investing or financing cash flows.'

Case study: converting an FRS 1 cash flow statement into an FRS 102 statement of cash flows

Assuming that FRS 102 is not adopted early, the problem that we will face is to convert the cash flow statement for the year ending 31st December 2014 (prepared under FRS 1) into the comparative year statement of cash flows in the accounts for the year ending 31st December 2015 (prepared under FRS 102). The former ASB issued a case study showing the process required for converting a cash flow statement from the existing FRS 1 format to the new FRS 102 format. They make the point that the purpose of the case study is to illustrate only the format of the cash flow statement prepared in accordance with FRS 102. As a result it has been assumed that there are no other changes arising from the application of FRS 102.

As the basis for their case study, the ASB started with one of the examples in FRS 1. I have started from the same point but I have extended the case study to indicate how the figures in the FRS 1 cash flow statement map to figures in the FRS 102 statement of cash flows. In doing this, I have needed to make some assumptions in order to clarify certain elements of the case study that could be misleading.

My case study ends with a statement of cash flows that complies with FRS 102. However, this statement of compliance needs to be read in conjunction with the comments made in the case study.

Cash flow statement for the year ended 31 December 2014 (prepared under FRS 1)

	Notes	£'000	Map to statement of cash flows prepared under FRS 102
Net cash inflow from operating activities	**1**	**6889**	Shown as cash from operations
Returns on investments and servicing of finance			
Interest received		3011	Now in investing activities
Interest paid		-12	Now in operating activities
Net cash inflow from returns on investments and servicing of finance		**2999**	
Taxation		**-2922**	Now in operating activities
Capital expenditure			
Payments to acquire intangible fixed assets		-71	Now in investing activities
Payments to acquire tangible fixed assets		-1496	Now in investing activities
Receipts from sales of tangible fixed assets		42	Now in investing activities
Capital expenditure		**-1525**	
Equity dividends paid		**-2417**	Now in financing activities
Net cash inflow before use of liquid resources and financing		**3024**	
Management of liquid resources			
Purchase of treasury bills		-650	Now included as part of cash and cash equivalents
Sale of treasury bills		200	
Net cash outflow from management of liquid resources		**-450**	
Financing			
Issue of ordinary share capital		211	Now in financing activities
Repurchase of debenture loan		-149	Now in financing activities
Expenses paid in connection with share issue		-5	Now in financing activities but combined with proceeds from issue of shares
Financing		**57**	
Increase in cash	**2, 3**	**2631**	

Note 1 Reconciliation of operating profit to net cash inflow from operating activities		Training notes
	£'000	
Operating profit	**6022**	This reconciliation could be presented either adjoining the cash flow statement or as a note
Depreciation	899	
Increase in stock	-194	
Increase in debtors	-72	
Increase in creditors	234	
Net cash inflow from operating activities	**6889**	

Note 2 Analysis of changes in net debt	At 1 Jan 2014 £'000	Cash flows £'000	Other changes £'000	At 31 Dec 2014 £'000	Training notes
Cash in hand, at bank	42	847		**889**	These amounts are included in FRS 102 as cash and cash equivalents
Overdrafts	-1784	1784		**0**	
		2631			
Debt due within one year	-149	149	-230	**-230**	
Debt due after one year	-1262		230	**-1032**	
Current asset investments	250	450		**700**	For the purpose of this case study, these amounts are assumed to satisfy the definition of cash equivalents
Total	**-2903**	**3230**	**0**	**327**	

Note 3 Reconciliation of net cash flow to movement in net debt		Training notes
	2014 £'000	
Increase in cash in the period	2631	
Cash to repurchase debenture	149	
Cash used to increase liquid resources	450	
Change in net debt	**3230**	
Net debt at 1 January	-2903	
Net funds at 31 December	**327**	

Statement of cash flows for year ended 31 December 2015 (prepared under FRS 102)

As indicated earlier in these notes, FRS 102 does not generally specify the line items that must appear under each heading in the statement of cash flows. Also, FRS 102 does not contain an example to provide us with guidance in this matter. Therefore, we need to look for guidance to examples produced by the FRC or the IASB. If looking to the IASB for guidance we might choose to look at their training material on IFRS for SMEs or alternatively, we could review the examples in IAS 7.

Whichever of these sources of guidance is selected, it must be said that, in the absence of definitive requirements in FRS 102, preparers are free to determine their own approach. The example below is based on the example provided by the ASB in their staff materials but also includes influences from listed companies following EU-adopted IFRS.

Note that my FRS 102 cash flow statement is different from that provided by the ASB because I have not made the assumptions that a) the tax charge is equal to the tax paid and b) the interest payable and receivable is equal to the interest paid and received.

	2015 £'000	**2014 £'000**	**Training notes**
Cash flows from operating activities			
Profit for the financial year	**x**	**6123**	
Tax charge	x	3046	
Profit before tax	**x**	**9169**	The cash flow statement could start with this line taken directly from the income statement.
Adjustments for:			
Depreciation	x	899	
Interest receivable	x	-3208	Notice that these amounts are the amounts in the income statement and are not necessarily the same as the cash flow figures.
Interest payable	x	15	
Profits or losses on sale of fixed assets	x	46	The profit or loss on sale of fixed assets needs to be removed since cash flows relating to disposal of fixed assets are included in the investing activities
Operating cash flow before working capital changes	**x**	**6921**	
Increase in stock	x	-194	These three adjustments will usually be shown on the fact of the statement of cash flows
Increase in debtors	x	-72	
Increase in creditors	x	234	
Cash from operations	**x**	**6889**	
Interest paid	x	-12	Could be classified as a financing

			cash flow
Income taxes paid	x	-2922	It has been assumed that there are no amounts that can be specifically identified with financing or investing activities
Net cash generated from operating activities	**x**	**3955**	
Cash flows from investing activities			
Proceeds from sale of equipment	x	42	These three items are unchanged but note the different language used to describe them.
Purchases of property plant and equipment	x	-1496	
Purchases of intangible assets	x	-71	
Interest received	X	3011	Could be classified as an operating cash flow
Net cash from investing activities	**x**	**1486**	
Cash flows from financing activities			
Issue of ordinary share capital	x	206	Net of expenses
Repayment of borrowings	x	-149	
Dividends paid	x	-2417	Could be classified as an operating cash flow
Net cash used in financing activities	**x**	**-2360**	
Net increase/decrease in cash equivalents	**x**	**3081**	
Cash and cash equivalents at beginning of year	**x**	**-1492**	In this case study these amounts are the total of cash in hand and at bank, overdrafts and current asset investments
Cash and cash equivalents at end of year	**x**	**1589**	

Other issues concerning statements of cash flows

FRS 102 contains sections on:

- Translation of foreign currency cash flows
- Exclusion of non-cash transactions

- Required disclosures:
  - The components of cash and cash equivalents and a reconciliation of the amounts presented in the statement of cash flows to the equivalent items presented in the statement of financial position. However, an entity is not required to present this reconciliation if the amount of cash and cash equivalents presented in the statement of cash flows is identical to the amount similarly described in the statement of financial position.
  - The amount of significant cash and cash equivalent balances held by the entity that is not available for use by the entity. This should be presented together with a commentary by management.

Note that FRS 102 does not require a reconciliation between the movement in cash and the movement in net debt.

Section 8: Notes to the financial statements (Lecture A425 – 13.06 minutes)

Notes contain information in addition to that presented in the financial statements covered in sections 4 to 7 above. Notes provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements. In addition to the requirements of this section, nearly every other section of FRS 102 requires disclosures that are normally presented in the notes.

The contents of Section 8 of FRS 102 include:

- A requirement, as far as practicable, to present the notes in a systematic manner. Items in the financial statements should be cross-referenced to any related information in the notes.
- A prescribed order for the notes as follows:
  - a statement that the financial statements have been prepared in compliance with FRS 102
  - a summary of significant accounting policies applied
  - supporting information for items presented in the financial statements, in the sequence in which each statement and each line item is presented; and
  - any other disclosures.
- Disclosure of accounting policies to include:
  - the measurement basis (or bases) used in preparing the financial statements
  - the other accounting policies used that are relevant to an understanding of the financial statements.

- Information about judgements (apart from those involving estimations) that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.
- Information about key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of their nature and their carrying amount as at the end of the reporting period.

The final two bullet points are new to existing UK GAAP users and need careful consideration when drafting accounting policies statement. Plenty of practical examples are available under full IFRS since these requirements are identical with those in IAS 1. Also the IFRS training material on IFRS for SMEs provides a number of case study examples.

Section 9: Consolidated and separate financial statements

This section will be covered in future update notes when other matters dealing with group accounts are considered.

Section 10: Accounting policies, estimates and errors (Lecture A425 – 13.06 minutes)

Selection of accounting policies

Accounting policies are defined in the glossary as "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements."

Although much shorter than the definition in FRS 18, there does not appear to be any significant difference between the two definitions.

If an FRS or FRC Abstract specifically addresses a transaction, other event or condition, then the entity is required to apply that FRS or FRC Abstract. This requirement does not apply if the effect of doing so would not be material.

In the absence of an FRS or FRC Abstract that specifically address a transaction, other event or condition then the entity's management is required to use judgement in developing and applying an accounting policy that results in information that is relevant to the economic decision-making needs of users and reliable. It is interesting that the explanation of "reliable" in this context is slightly different from the treatment in Section 2 (above). Here, reliability includes substance over form, prudence and completeness as well as neutrality and faithful representation.

When developing an accounting policy, management refers to the following sources in descending order:

- The requirements and guidance in an FRS or FRC Abstract dealing with similar and related issues.
- Where relevant to the entity, the requirements and guidance in a SORP dealing with similar and related issues.
- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2.

Management may also consider the requirements and guidance in EU-adopted IFRS dealing with similar and related issues.

Accounting policies for similar transactions etc. should be selected and applied consistently. However, this requirement will not apply if an FRS or FRC Abstract specifically requires or permits categorisation of items for which different policies may be appropriate. In this case, an appropriate accounting policy shall be selected and applied consistently to each category

Changes in accounting policies

'An entity shall change an accounting policy only if the change:

(a) is required by an FRS or FRC Abstract; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.' (FRS 102 paragraph 10.8)

Paragraph 10.9 states that the following are not changes in accounting policies:

- the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring
- the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were not material
- a change to the cost model when a reliable measure of fair value is no longer available (or vice versa) for an asset that an FRS or FRC Abstract would otherwise require or permit to be measured at fair value.

Where an FRS or FRC Abstract allows a choice of accounting treatment and an entity changes its previous choice then that is a change in accounting policy.

The initial application of a policy to revalue assets (see Section 17 Property, Plant and Equipment and Section 18 Intangible Assets other than Goodwill) is a change in accounting policy but should be dealt with as a revaluation in accordance with the requirements of Sections 17 and 18 rather than in accordance with the requirements of Section 10.

A change in accounting policy is normally dealt with retrospectively – see paragraph 10.12 below. However, if the change in accounting policy is as a result of a new or revised standard or abstract, then paragraph 10.11 requires the entity to follow the transitional rules (if any) specified in that standard or abstract.

Retrospective application requires the entity to apply the new accounting policy to comparative information for prior periods to the earliest date for which it is practicable, as if the new accounting policy had always been applied.

When it is impracticable to determine the individual-period effects of a change in accounting policy on comparative information for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.

Bearing in mind the different presentation required by FRS 102 (when compared with FRS 3), this paragraph gives broadly the same relief as paragraph 29 of FRS 3.

Disclosures

If the change in accounting policy is as a result of an amendment to an FRS or FRC Abstract, then the required disclosures are:

a) The nature of the change in accounting policy.
b) For the current period and each prior period presented, to the extent practicable, the amount of the adjustment for each financial statement line item affected.
c) The amount of the adjustment relating to periods before those presented, to the extent practicable.
d) An explanation if it is impracticable to determine the amounts to be disclosed in (b) or (c) above.

Financial statements of subsequent periods need not repeat these disclosures.

The disclosures required for a voluntary change in accounting policy are the same but with the addition of the reasons why applying the new accounting policy provides reliable and more relevant information.

Notice that the disclosures above are also required where there is an amendment to an FRS or FRC Abstract that might have an effect on future periods.

Changes in accounting estimates

The term "accounting estimate" is new in UK GAAP but is, of course, familiar to us from ISA 540 where it is defined as 'An approximation of a monetary amount in the absence of a precise means of measurement'.

There is no definition of the term "accounting estimate" in either Section 10 or the glossary. Instead we have the following explanation in paragraph 10.15:

'A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.'

FRS 18 uses the term "Estimation techniques" which it defines as follows:

'The methods adopted by an entity to arrive at estimated monetary amounts, corresponding to the measurement bases selected, for assets, liabilities, gains, losses and changes to shareholders' funds. Estimation techniques implement the measurement aspects of accounting policies. An accounting policy will specify the basis on which an item is to be measured; where there is uncertainty over the monetary amount corresponding to that basis, the amount will be arrived at by using an estimation technique.'

Returning to FRS 102, to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

Otherwise, the effect of a change in an accounting estimate applies, prospectively by including it in profit or loss in the period of the change, if the change affects that period only or the period of the change and future periods, if the change affects both.

Case study examples on changes in accounting estimate

The above paragraph 10.15 is identical with the equivalent paragraph in the IFRS for SMEs. Therefore, we can look for guidance to the case study examples produced by the IASB. I acknowledge the copyright of the IFRS Foundation in the material that follows. Except where stated, I have reproduced the IASB material as originally published. However, for ease of understanding for a UK audience, I have replaced CU by £.

Ex 26 An entity provides warranties at the time of sale to purchasers of its products. On 31 December 20X5 an entity assessed its warranty obligation for products sold before 31 December 20X5 at £100,000. Immediately before the 31 December 20X5 annual financial statements were approved for issue the entity discovered a latent defect in one of its products (ie a defect that was not discoverable by reasonable or customary inspection). As a result of the discovery the entity revised its estimate of its warranty obligation at 31 December 20X5 to £150,000.

This is the determination of an (initial) accounting estimate, not a change in accounting estimate. At 31 December 20X5 the obligation for the warranty provision must be measured at £150,000. The latent defect is a condition that existed at the end of the reporting period and is therefore taken into account in determining the amount of the obligation at the end of the reporting period even though the information was discovered later.

Ex 27 The facts are the same as in example 26. However, in this example, the latent defect was discovered when preparing the interim financial report for the six month period ended 30 June 20X6, after the 31 December 20X5 annual financial statements were approved for issue. In July 20X6 the entity paid £150,000 to transfer the obligation to an independent third party.

The additional £50,000 obligation (not provided for at 31 December 20X5) is a change in accounting estimate for the year ended 31 December 20X6. The warranty obligation (provision) was appropriately measured and reported at £100,000 in the entity's 31 December 20X5 annual financial statements. This estimate was found to be incorrect in 20X6, after the 20X5 financial statements were approved for issue. The £50,000 is recognised as an expense in determining the profit or loss for the six-month period ended 30 June 20X6.

Ex 28 An entity acquired a yacht for £1,000,000 on 1 January 20X1 and appropriately assessed its useful life at 30 years from the date of acquisition with a residual value of £100,000. The entity decided that the straight-line method is the most appropriate method on which to depreciate the yacht.

In 20X9 the entity undertook substantial research into the yachting industry. As a result, at 31 December 20X9 the entity assessed the useful life of the yacht at 20 years from the date of acquisition with a residual value of £500,000. [Editor's note: the original IASB case study said the residual value was nil but this is inconsistent with the answer to Ex 32 therefore I have amended it to £500,000.] It also assessed a fair value for the yacht as at 31 December 20X9 at £800,000. It continued to believe the straight-line method to be the most appropriate method of depreciation for the yacht.

The reassessment of the yacht's useful life and its residual value are changes in accounting estimates. The revised assessments are appropriately made on the basis of new information that arose from research performed in the current reporting period - 20X9.

Ex 32 This example shows the accounting entries for example 28. I have rephrased it slightly when compared with the original.

The original depreciation charge was £30,000 per annum (that is (1,000,000-100,000)/30). So the carrying amount of the yacht at 1 January 20X9 was £760,000 (that is 1,000,000 – 8*30,000).

The remaining depreciable amount of the yacht as a result of the change in estimates is therefore £260,000 (that is £760,000 carrying amount less £500,000 revised residual value). So the annual depreciation charge is £21,667 (that is the depreciable amount £260,000 divided by the remaining useful life of 12 years).

Therefore £21,667 will be deducted in determining profit or loss for the year ended 31 December 20X9 and for each of the next eleven years' remaining useful life of the yacht.

Ex 29 The facts are the same as in example 28. However, the research was undertaken by an independent third party and has been publicly available since late 20X5. Although the entity believed the research to be valid it chose to ignore the research findings until 20X9.

The reassessment in 20X9 of the yacht's useful life and its residual value are not changes in accounting estimates. They represent prior period errors in the entity's financial information since 20X5. The financial statements must be restated to correct the effects of the errors in the periods to which they relate [if material].

Ex 30 An entity has been depreciating its buildings over a 25-year life, which is what is allowed by the entity's national tax laws. In the current year, the tax law is changed to allow depreciation of buildings over 20 years. The entity makes this change for financial reporting purposes and treats it as a change in accounting estimate.

Paragraph 17.18 requires an entity to allocate the depreciable amount of an asset on a systematic basis over its useful life. Unless the useful life of the entity's buildings actually is 25 years, the entity has not been complying properly with paragraph 17.18, which requires the depreciable amount to be allocated over the entire period in which the entity expects to use the asset. Most buildings have useful lives significantly longer than 25 years. If the entity has not been using the correct useful life, it should treat this as the correction of an error by a retrospective restatement. Also, it should allocate the depreciable amount over the useful life, not 25 years or 20 years.

Ex 31 At 31 December 20X1 an entity measured one of its trade debtors at £200,000 (ie £600,000 gross amount less £400,000 provision for doubtful debts). The estimate of the extent of the doubtful debt was appropriately made on the basis of all of the available information.

On 31 December 20X2 the entity received notification from the liquidator of the debtor that it would shortly receive £250,000 in full and final settlement of the debt.

The entity must include £50,000 (£250,000 at 31 December 20X2 less £200,000 at 31 December 20X1) change in accounting estimate as an increase in profit for the year ended 31 December 20X2.

Ex 33 An entity paid a systems developer £50,000 for an on-line system by which its customers could place orders. The entity accounted for the cost of the system as a purchased limited-life intangible asset. The entity estimated that the system would have a five-year life and amortised the cost accordingly. Unfortunately the system never worked as anticipated and customer use declined considerably after the first year because of ongoing system problems resulting in incorrect orders. After two years the entity replaced the custom-developed system with a generic software package available in the market. The entity concluded that the entire £50,000 expenditure was worthless from the beginning and decided to write it off retrospectively, in the year of acquisition, as a correction of an error.

Treating this as a correction of an error is not appropriate. The amortisation in the first two years in which the custom-developed system was used was based on an assessment of future benefits coming from that system. After two years, the assessment of future benefits changed. A prior period error results from failure to take into account information that was available at the time. Until the end of the second year, the best available information was that the system would provide future benefits. Therefore, this is a change of estimate, not a correction of a prior period error.

Disclosures

The entity is required to disclose the nature of any change in an accounting estimate and the effect of the change on assets, liabilities, income and expense for the current period. If it is practicable for the entity to estimate the effect of the change in one or more future periods then those estimates should also be disclosed.

Corrections of prior period errors

Errors are defined in the glossary as:

'Omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

a) was available when financial statements for those periods were authorised for issue; and

b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.'

Paragraph 10.20 explains that such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

To the extent practicable, an entity shall correct a material prior period error retrospectively in the first financial statements authorised for issue after its discovery by:

a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

If it is impracticable to determine the period-specific effects of a material error on comparative information for one or more prior periods presented, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).

Disclosures

The following disclosures are required:

a) the nature of the prior period error;

b) for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected;

c) to the extent practicable, the amount of the correction at the beginning of the earliest prior period presented; and

d) an explanation if it is not practicable to determine the amounts to be disclosed in (b) or (c) above.

Financial statements of subsequent periods need not repeat these disclosures.

These disclosures are broadly the same as those required for changes in accounting policy (see above). As indicated earlier in these notes, the presentation of prior period adjustments is different in FRS 102 from the previous presentation in FRS 3. An example of the new presentation is contained earlier in these notes in the notes dealing with Section 6.

SIMPLER FINANCIAL REPORTING FOR MICRO-ENTITIES (LECTURE A426 – 8.33 MINUTES)

Introduction

The Department for Business, Innovation and Skills (BIS) has published a consultation paper called "Simpler Financial reporting for Micro-entities: The UK'S proposal to implement the Micros Directive".

The Micros Directive provides an exemption for micro-entities from certain financial reporting requirements otherwise applicable to small undertakings. The Micros-Exemption takes the form of a Member State option to exempt micro-entities from certain obligations that may impose unnecessarily onerous administrative burdens.

The Government is seeking to make changes to the Companies Act 2006, and to the accounting regulations made under that Act and under EU law to implement the Micros Directive. It would also make comparable changes to the accounting framework for Limited Liability Partnerships.

The consultation seeks views on the proposed options for implementation of the Micros-Exemption.

What is a micro-entity?

A micro-entity is an undertaking which, on its balance sheet date, does not exceed the limits of two of the following three criteria:

Balance sheet total:	€350,000
Net turnover:	€700,000
Average number of employees during the financial year:	10 (or fewer)

There is no reference to any sort of years' rule in the consultation so perhaps the test for a micro-entity is an annual test.

What exemptions are available?

Micro-entities could choose to prepare an abridged balance sheet and abridged profit and loss account. These abridged accounts would be simpler than the accounts currently prepared for members.

As at present, there would be no need to file the profit and loss account with Companies House.

The only note disclosures required relate to:

- Acquisition of own shares
- Commitments by way of guarantee of any kind

- Advances to directors

There would be no need to recognise accruals or prepayments except for those relating to the cost of raw materials and consumables, value adjustments, staff costs and tax.

Apart from this limited exemption, normal accruals accounting would still apply.

Accounts that are drawn up in accordance with the requirements applicable to micro-entities will be deemed to give a true and fair view of the undertaking's financial position.

What is the government's proposal?

The consultation paper is not explicit as to government plans but the following quotes from the document seem to indicate that the government is likely to introduce all available exemptions into UK law.

- '1.8 The Government is seeking views on how best to implement the Micros-Exemption so as to maximise the benefits to the UK's micro-entities of the flexibilities offered by the Micros Directive.'
- '2.2 The Micros Directive provides a Micros-Exemption from certain EU obligations relating to the preparation and publication of annual financial statements and so eases burdens on the very smallest undertakings. The UK strongly supports the Micros-Exemption, which sets an important precedent in EU legislation. The Micros-Exemption will benefit a significant number of UK companies and the intention is to implement the Micros Directive as soon as possible.'
- '4.1 The Government is minded to implement changes to legislation to enable the smallest UK undertakings to take advantage of the flexibilities offered by the Micros-Exemption.'

The consultation paper indicates that the Government will consider the comments received and announce final proposals in Spring 2013. Subject to parliamentary timetable, the Government will bring forward secondary legislation to give effect to these proposals.

FAQ:CHANGE OF ACCOUNTING REFERENCE DATE (LECTURE A427 – 7.16 MINUTES)

Q: My client, X Ltd had an accounting reference date (ARD) of 31 July. The deadline for filing the accounts for the year ended 31 July 2012 was 30 April 2013. On 29 April 2013, the company gave notice under S392 to shorten its accounting reference period under S392 and the new ARD is 30 July. The deadline for filing the accounts is now (under S442(4)) the later of 30 April 2013 (9 months after 30 July) and 29 July 2013 (3 months after the date of the notice). The company gave notice to shorten its accounting reference period because it was not ready to file accounts and did not wish to suffer a late filing penalty.

The directors of the company have now informed me that the accounts will still not be ready by the new deadline and therefore they intend to give notice again on 28 July 2013 to shorten the period again under S392 – this time to 29 July. They believe that this will extend the deadline by a further three months to 28 October. Incidentally, they tell me that, when they do prepare accounts with the ARD of 29 July they will take the opportunity to prepare the accounts to a day within seven days of the ARD and will actually still prepare accounts to 31 July.

Can they do this? If so, it seems to me that they can avoid filing accounts indefinitely by the repeated use of this ploy.

A: I have heard this question a number of times in the last few months and this seems to be a new scheme that is doing the rounds. If it were really possible to delay filing indefinitely then surely we would all know about it and we would all be taking advantage of this loophole. Let's look at CA 2006.

S 442(4) says" If the relevant accounting reference period is treated as shortened by virtue of a notice given by the company under section 392 (alteration of accounting reference date), the period [allowed for filing accounts] is— (a) that applicable in accordance with the above provisions [that is 9 months from the new ARD], or (b) three months from the date of the notice under that section, whichever last expires.

The directors of X Ltd are therefore correct in that, following their first decision to shorten the period they have bought themselves a period of three extra months to file the accounts.

Now let's look at what happens if they try to shorten the period again.

S 392(4) says "A notice under this section may not be given in respect of a previous accounting reference period if the period for filing accounts and reports for the financial year **determined by reference to that accounting reference period** has already expired."

I have added the bold print because, in my opinion, the period allowed for filing determined by reference to that accounting reference period is 30 April 2013. The deadline of 29 July has been calculated by reference to the date of the notice and is only relevant for the purpose of S442. 29 July is not relevant for the purposes of S392. Accordingly, when they try to give notice under S392 on 28 July they will be too late.

However, I am not a lawyer, and it may well be argued that your client's interpretation follows the letter of the law. So I cannot provide a definitive answer to your question. However, I am sure that the government never intended that a company could extend its year end indefinitely and therefore my belief is that, as professionally qualified accountants, we should not be wasting our time with such schemes.

FAQ: SMALL COMPANY EXEMPTIONS IN A GROUP SITUATION
(LECTURE A428 – 8.01 MINUTES)

P Ltd is preparing accounts for the year ended 31 December 2012. P Ltd has always qualified as a small company. During October 2012, P acquired a subsidiary S Ltd. S Ltd also satisfies the qualifying conditions (size thresholds) to be small and the new P group satisfies the size thresholds to be a small group. Neither P Ltd nor S Ltd are involved in any sort of financial services.

The problem arises from the fact that S Ltd did not qualify as a small company last year since, prior to its acquisition by P Ltd, it was part of an ineligible group.

Q1: Is S Ltd a small company for the financial year ended 31 December 2012?

A1: S384(1) of CA 2006 states that the small companies regime does not apply to a company that is, or was at any time within the financial year to which the accounts relate:

a) a public company,
b) a company that:
    i. is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company, or
    ii. carries on insurance market activity, or
c) a member of an ineligible group.

Since S Ltd was part of an ineligible group until October 2012 then it was part of that group for part of the period ended 31 December 2012.

Therefore S Ltd cannot qualify for the small companies regime.

Q2: In that case, because of the year's rule, can S Ltd be eligible for the small companies regime for the financial year ended 31 December 2013?

A2: It will qualify as small for the year ended 31 December 2013 because the 2 year rule applies to s382 (the thresholds) and not s 384.

Q3: If S Ltd is not small for the financial year ended 31 December 2012, does this mean that P Ltd cannot qualify as the parent of a small group for year ended 31 December 2012? Will P Ltd be required to prepare group accounts? Can P Ltd prepare FRSSE accounts?

A3: It has already been stated that the P group satisfies the qualifying conditions to be small (S383) in the current year. In the previous year, the P group (which consisted at that time only of P Ltd) also satisfied the qualifying conditions. The only potential problem relates to eligibility.

P Ltd is not a plc, nor an entity involved with financial services. Further, P ltd has never been a member of an ineligible group. Therefore, P Ltd is not excluded from the small companies regime. Accordingly, P Ltd is not required to prepare group accounts and can continue to follow the FRSSE.

Q4: Which of the companies require audit for the year ended 31 December 2012?

A4: S Ltd requires an audit since it is not a small company. P Ltd does not require an audit.

Q5: Could S Ltd claim exemption from audit under S479A if P Ltd is prepared to give the guarantee required by S479C?

A5: Yes, in theory, but would this be worth doing? In order to achieve audit exemption for S Ltd, it would be necessary for P Ltd to prepare consolidated accounts and have these audited. If S Ltd is a significant component then there would also be a need for some audit work to be performed on S Ltd. Add to that the implications of the guarantee and it seems that this route would probably not be cost-effective.

FAQ: STATEMENT REQUIRED WHEN AN AUDITOR CEASES TO HOLD OFFICE (LECTURE A429 – 6.29 MINUTES)

Q: An auditor ceases to hold office as a result of the directors resolving that no auditor should be appointed. This occurred during the period for appointing auditors and therefore the auditor reached the end of its term of office and there was no need for the formalities on resignation or removal.

The auditor sends a statement to the company under S519(2) stating that there are no circumstances to bring to the attention of the members or creditors.

Does this statement (of no circumstances) need to be sent to the registrar under S521(1) or does 521(1) only apply when there are circumstances.

A: S521 applies in all situations where an auditor ceases to hold office. Therefore the statement that there are no circumstances to bring to the attention of members or creditors will need to be sent to the registrar.

PROFESSIONAL SCEPTICISM (LECTURE A431 – 19.24 MINUTES)

Extracts from ISA 200

Definition:

Professional scepticism - An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Paragraph 15:

The auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Audit quality inspections

The Audit Quality Review Team of the FRC has recently published inspection reports on two firms. Reports in the accountancy press highlighted the firms' need to "buck up professional scepticism".

Extracts from the areas where firm should pay particular attention in order to enhance audit quality and safeguard auditor independence:

Firm A

- Further emphasise the need for appropriate scepticism by audit teams in relation to key assumptions made by management and other areas in which significant judgment has been applied.

Firm B

- Take further action to ensure that greater professional scepticism is exercised on individual audits.

Details are then provided in the "Principal findings" section of each report. It is difficult to form firm conclusions as to the proportion of audits which contained issues relating to professional scepticism since the same file may be included a number of times under different headings. However, it is clear that the inspectors identified concerns about the level of professional scepticism on well over half of the audits reviewed. Particular areas mentioned are:

- The need to challenge the inputs to management's collective impairment model.
- The need to challenge management in relation to the appropriateness of valuing plant, machinery, land and infrastructure on a fair value basis.
- Failure to challenge appropriately explanations received from management. Examples given were a reallocation of payroll costs that improved reported gross margins and in the lack of a calculation to support a key assumption in the model used by management to assess impairment of goodwill.
- The need for the audit team to show appropriate scepticism when reporting to the Audit Committee on the directors' valuation of a property asset, which was in excess of a third party valuation.
- The need to demonstrate a greater degree of professional scepticism concerning the details of a formal contract for a significant project that was finalised around the year end date where the final signature from the customer was only obtained after the year end. Issues requiring more explanation and challenge were the treatment of an option to extend the contract period and the pricing, especially the treatment of a discount given.
- In relation to additions to intangible assets, insufficient consideration and challenge of the appropriateness of additional payments being treated as capital additions to client relationships, given the requirements of the Accounting Standards.

- Failure to consider and address the impact of the current economic environment, in particular the impact of public spending reviews, in relation to work on going concern.
- Failure to address risks associated with going concern.
- Insufficient sensitivity analysis in a situation where there were losses in the year and a potential deferral of certain creditor payments. A declining growth model had been prepared by the audited entity but no work was performed on this and no consideration was given to the possibility that this scenario would occur.
- Insufficient challenge of management and review of key assumptions in a situation where concerns had been raised, at the planning stage, by the audit team over the lack of a fixed asset register and the potential implications of this. The audit team did note that the concerns were mitigated by a number of factors. Experts were involved in providing estimates of mineral reserve estimates (which were used to calculate the life of the assets for the purposes of depreciation) but there was no evidence that the competence and objectivity of experts, internal and external to the group, had been considered.

Article in Audit & Beyond April 2013

In this article, the writer, Lesley Meall, suggests that auditors may approach audits with a sceptical mind but can fail to demonstrate this in their audit files.

Weaknesses often relate to inadequate documentation of discussions with management, challenges to management assumptions and insufficient audit evidence. The QAD webinar 2012 presents findings from visits the QAD conducted in 2011 and 2012 and, in particular, explains how firms can demonstrate professional scepticism on an audit file.

The webinar is available at bit.ly/VVfKp8. The section on professional scepticism starts at 24:16 and is 10 minutes long.

We use the ideas from the webinar in our practical section below but let's deal first with the topics identified in the article.

Accounting estimates

In order to identify if there is a risk of material misstatement arising from the client's use of accounting estimates, the current audit file or permanent file should set out clearly what estimates are actually being used.

The audit file should:

- Record all of the estimates being used by the entity.
- Identify the level of risk of material misstatement.
- Show exactly what work the auditor has performed as part of the risk assessment process.
- Provide evidence that estimates have been discussed with management.

With respect to the last bullet point, the file should make clear the extent of the discussions: how are estimates made and what are the underlying assumptions? Are there any changes requiring a new estimate?

ISA 540 requires the auditor to review the outcome of any prior period estimate. In circumstances where a prior year review has been performed, QAD reviewers sometimes find that it is poorly documented, with no conclusion reached on the reliability of the method used when considering the risk of material misstatement for this year's balance.

In the light of the continuing problems in this area, I have included a separate section on this subject based on FAQs.

Related parties

This is another area where discussions with management and their proper documentation can help to demonstrate professional scepticism. However, sometimes there is no evidence that related parties have even been identified, let alone discussed either with management or among the audit team.

Sometimes files contain out-of-date lists of directors or make no reference at all to related parties.

Considering fraud

The risk of fraud regarding revenue recognition is assumed to be a significant risk area, but the article reports that this continues to cause problems for some firms. In some cases, the file identifies revenue recognition as a significant area of risk but it is unclear whether sufficient work has been performed in response to the risk. More often, there is a lack of adequate justification on the audit file as to why the risk of fraud regarding revenue recognition has been assessed as low-risk.

Examples given in the article are included in the practical section below.

ISA (UK And Ireland) 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (ISA 240.15)

The Application Material suggests that the discussions may include (amongst other things):

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.

- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.

The article tell us that the file should contain evidence of a fairly robust and wide-ranging discussion on what could potentially occur within the entity.

> Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk. (ISA 240.31)

The risk of management override means that the specified audit procedures set out in paragraph 32 of ISA 240 must be performed on all audits. This means testing the appropriateness of journal entries, reviewing accounting estimates for bias, and evaluating any non-routine or unusual transactions for the risk of fraud.

The QAD are finding that management override is often incorrectly assessed as an area of low risk, and that therefore none of the specified audit procedures are performed. Alternatively, where a risk assessment is correct, the work is often poorly documented or focuses on just one area, usually year-end journals.

Going concern

In the audit of a small entity, there may be little management information to support a going concern assessment. For example, there may be no forecasts and budgets available for review.

However, it is clear from ISA 570 that additional procedures, such as review of cash flow forecasts, are only necessary where the auditor has already identified events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.

Therefore, it is important to record discussions held with the client in a way that demonstrates professional scepticism. This will involve documenting evidence of challenge or corroboration of evidence presented to the audit team.

Conclusion

It can sometimes appear to the QAD as if an audit team has looked for reasons why assumptions can be supported without considering information that may suggest the assumptions are not appropriate. As professional sceptics, audit teams should challenge the information they are given and the evidence that they obtain. This challenge should be demonstrated by clear documentation.

At the end of the audit, the audit team should step back and look at the bigger picture before concluding that the audit work and documentation is complete. The article tells us that this involves asking important questions such as:

- Do the financial statements reflect the substance of what has happened?
- Is the audit evidence sufficient?
- Do we really understand the information presented to us?
- Is there any information on file which appears to be contradictory?

Paragraph A18 in ISA 200 puts it this way:

'Professional scepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the ISAs (UK and Ireland).'

Let's give the final word on this subject to ICAEW vice president Martyn Jones. He says in the Institute's videos on professional scepticism: "This is one of the reasons why auditing is an exciting career. It requires the application of critical thinking in real-life situations, and this shouldn't just happen behind a computer screen in the audit room. It includes walking the floors, communicating effectively with the client's staff and challenging what you are being told."

Practical examples

Example from cold file review	Comments/suggestions
Risk of management override: "The client is well known to us and we are confident that they would not override controls"	It is this sort of comment that clearly demonstrates a lack of scepticism. Recall the quote from ISA 240.14 "setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity."
Risk of fraud: "Fraud is low-risk as there is no previous history of fraud." "Fraud is low risk as the client is longstanding." Quoted from QAD webinar.	Again, a clear indication of lack of scepticism. The fact that there is no previous history of fraud may simply indicate that the auditor has not yet discovered a long-standing fraud. Also, consider the fraud risk factors in Appendix 1 of ISA 240. The very first factor in the list is that there may be an incentive or pressure to commit fraud because financial stability or profitability is threatened by economic conditions.
Presumed significant risk of fraud in revenue recognition: "Revenue recognition deemed to be low risk."	This sort of comment (re revenue recognition) is often made with little, if any, justification. Rather than "deeming" the risk to be low, the audit team meeting should address the question "If I worked at this client and wished to manipulate revenue, then how would I do it." This will then give a focus for the additional work required on this significant risk area. As an aside, I hate to see the word "deemed" on the audit file. It is usually used in situations where the auditor has no real evidence and wishes to avoid performing the appropriate procedures.
Presumed significant risk of fraud in revenue recognition: "Covered by substantive testing."	How does this testing differ from the substantive testing that would normally be performed if revenue recognition was low or medium risk? Will more testing be performed? Will the nature of testing change?
Notes of strategy meeting: "The partner briefed the staff on the risks that are present in this audit"	It is often the case that the so-called discussion among the engagement team becomes a one-way street with information being passed from partner and/or manager to the members of the team. Paragraph A11 in ISA 240 refers to "an exchange of ideas". Brainstorming is the way to step outside preconceptions about the client and this will help in the assessment of risks of material misstatement.

Materiality “Materiality was set as 1% of turnover in line with the firm’s normal methodology. Performance materiality was set as 75% of materiality.”	This is an application of standard methodology without consideration of the particular situation. Also, there is no consideration of the possible need for a lower materiality for particular classes of transactions, account balances or disclosures.
Threats to independence: “I [The audit engagement partner] have acted for the client for 15 years. In my view, rotation is unnecessary because......” Here will follow a variety of reasons/excuses for example: a recent change of manager; the fact that the audit senior is a qualified and experienced person; the file being subject to [the possibility of] cold file review; the client’s wishes; the AEP’s professionalism etc. etc.	This is another area of the file where the auditor finds it useful to “deem”. The AEP can avoid the unwanted outcome of accepting that longevity is a real issue by deeming it to be unnecessary. In my view, any decisions for the AEP to continue should be subject to the approval of the firm’s ethics partner. If the AEP is permitted to continue then there should be a second partner review of all or parts of the file.
Analytical review: “Per client, the reason why selling costs have increased is that an extra salesman has been employed this year. This explanation appears to be reasonable.”	The explanation should be challenged. The auditor should obtain appropriate evidence to corroborate and quantify the explanation. Also, note the common phrase “per client”. Who? When?
Related party debtors: “The amount is owed by another subsidiary of the group and is therefore not overstated.”	The normal principles apply to debtors within the group - has the amount been agreed with the other group company (or their auditor) and is it recoverable?
Accounting estimates: “The method used was consistent with last year and the calculation was performed correctly”	Is the method still appropriate? Was it ever appropriate? What was the outcome of the prior period estimate? What is the estimation uncertainty? Has a sensitivity analysis been performed?

Audit of expenditure: "We gave a list of invoice numbers to Sharon and she gave us photocopies. These are attached to the audit file."	Sharon is always very helpful. She always finds purchase invoices to help out. She is so helpful that she photocopies the invoices for the audit team. Wake up!
Selecting a sample: "We selected a sample of 20 items for testing. Item number J2306 was missing so we tested J2307 instead."	Why was it missing? If the sampled item cannot be found then this is an error.
Impairment test: "I reviewed the test attached at sch x/x and consider it to be reasonable."	The point about this example is that the auditor actually challenged the client about the assumptions made in the calculation of value in use. The client made amendments to the calculations to meet the auditor's objections. The auditor should document on file the nature of the challenges, the discussions and the reasoning behind the conclusions reached. This will demonstrate the operation of professional scepticism. It is common for the auditor to document the resolution of a matter without documenting the steps taken to reach the conclusion.
Going concern: "Discussed with client. Revenues and profits have continued to be good since the year-end."	Who is the client? When did the discussion take place? How did you challenge their assertions? What evidence exists that might support or refute their assertions?

FAQS: ACCOUNTING ESTIMATES (LECTURE A430 – 14.10 MINUTES)

Recording accounting estimates at the planning stage

Q: Have you any suggestions as to an efficient way to record the auditor's knowledge of accounting estimates at the planning stage?

Response: This continues to be a problem area for many firms but recently I performed a file review where the audit team had made a good attempt at meeting the requirements of ISA 540. I have taken their approach and adapted it to provide an example which may provide useful guidance as to how you should record knowledge of accounting estimates. I attach the document as an appendix to these notes.

Accounting estimates under clarified ISAs

This FAQ and those that follow have been taken from the “Auditing and Reporting FAQ Library” compiled by the technical team at SWAT UK.

Q: A client has a policy for valuation of stock whereby stock older than 2 years is written down to nil, and stock older than a year is written down by 50%.

Are these accounting estimates?"

Response: Yes, this is estimating the net realisable value of stock based on the age of that stock. You will therefore need to do some work (as you would have done previously) on the reasonableness of this approach.

You will need to address the specific requirements that apply in the clarified ISA 540 in respect of estimates, in particular the requirements to review the outcome of estimates made in the previous year as part of the planning and to review all estimates for bias towards the end of the fieldwork.

Audit work on warranty provision

Q: We have a client who has had a material warranty provision in the accounts for several years.

Since the introduction of the Clarified ISAs we have been undertaking significantly more work (and obtaining supporting documentation) to challenge the warranty provision made by management. In the case of this client, their calculations make sense and the reasons behind the provision seem reasonable.

My issue is more with looking retrospectively at the prior year figures and justifying the provision, as the actual costs incurred on work covered by the warranties for the last few financial years has been significantly less than the provision in the accounts each year.

The client is adamant that their provision is reasonable, and if anything could be higher. Where do we stand on this, as I don't think there is much more audit work that can be carried out?"

Response: I am assuming that the warranty provision is based on a percentage of the sales and that this has been set at a particular level for a number of years. You have then looked at actual costs of warranty work and this indicates that a lower provision should be made. If the actual costs have been lower for a number of years then this does suggest that the provision is too high. How does the client justify the larger figure? Are you capturing all relevant costs? Have all costs been incurred in the period you looked at?

If you are capturing all relevant costs, the actual costs have been lower than the provision for a few years and you believe that the provision is overstated then this should be recorded as an unadjusted error. You should then assess the materiality of this error as you would any other.

In addition you should also consider bias in estimates. Are there any other provisions that are overstated? These overstated amounts may not be material individually, but when taken together may indicate that the accounts contain a material error.

Significant risk - controls re management override

Q: I have been asked what sort of control could be linked to the significant (fraud-related) risk of management override of controls and, if the conclusion is that, by default there cannot be one, then what is the effect on the audit?"

Response: I do not think that it is possible to have a management control that addresses the risk of override of controls by management. The argument is that whatever the system in place, management can override it. This is my interpretation of ISA 240.31 which states:

“Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.”

The response to that risk is then set out in ISA 240.32 which specifies procedures to consider:

- The appropriateness of journal entries
- Review of accounting estimates for bias
- Review of significant transactions outside the normal course of business

These procedures should be included as standard tests in all audits. However, if there are specific concerns in relation to a particular client these risks should be identified separately and an appropriate response to risk should be designed.

SUMMARY OF DEVELOPMENTS

The following are extracts from press releases issued by the FRC over the last three months.

FRC issues supplementary guidance for client asset auditors addressing the use of Third Party Administrators (TPAs)

The FRC has today issued Bulletin 3 "Providing Assurance on Client Assets to the Financial Services Authority (Supplement addressing the use of Third Party Administrators)".

The purpose of this Bulletin is to supplement the guidance contained in Bulletin 2011/2 for CASS auditors providing assurance to the FSA on client assets where the firm has outsourced certain services or functions to a TPA.

The Bulletin:

- Outlines the models commonly used by firms when outsourcing to TPAs;
- Highlights particular aspects of outsourcing on which CASS auditors should consider focussing; and
- Provides guidance on some common issues arising in relation to CASS audits where firms have outsourced functions to TPAs.

The outsourcing of functions to a Third Party Administrator is widely acknowledged as being a difficult area for both regulated firms and CASS auditors. This Supplement addresses the risk that CASS auditors may not fully understand the extent of their responsibilities to report on the regulated firm's position under the FSA's CASS Rules when the firm outsources functions to a TPA.

13 March 2013

Describing the application of FRS 101 and 102 in auditor's reports

Certain entities are now able to apply either:

- FRS 101 "The reduced disclosure framework"; or
- FRS 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland" in the preparation of their financial statements.

Section 495(2) of the Companies Act 2006 (CA 2006) requires, among other things, that the auditor's report must include an introduction identifying the annual accounts that are the subject of the audit and the financial reporting framework that has been applied in their preparation. Section 495(3) of CA 2006 further requires the auditor to state whether the financial statements have been properly prepared in accordance with the financial reporting framework.

In UK auditor’s reports, the expression “United Kingdom Generally Accepted Accounting Practice” is used to describe a financial reporting framework consisting of, applicable law and United Kingdom Accounting Standards.

As adoption of the requirements of either FRS 101 or FRS 102 does not constitute use of a different financial reporting framework there is no effect on the expression of the auditor’s opinion required by Section 495(3) of CA 2006. This opinion is generally expressed as “the financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice”.

However, it is suggested that, in order for the introductory paragraph to make clear which UK accounting standards have been used in the preparation of the accounts, the final sentence of the introductory paragraph of an auditor’s report read as follows:

“The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice), including [FRS 101 “Reduced Disclosure Framework”] [FRS 102 “The Financial Reporting Standard applicable in the UK and Republic of Ireland”]. The square bracketed wording should be included as applicable.

15 March 2013

APPENDIX: ACCOUNTING ESTIMATES REGISTER

ZZZ Limited - Year ended 31 December 2012 - Accounting estimates

Accounting estimate	How the client makes estimate	Prior year charge or balance	Outcome of prior year estimate	Degree of estimation uncertainty	Is it a significant risk?	Audit approach planned in response to risk
Depreciation	Depreciation is calculated on an annual straight line basis using zero residual value and standard asset lives based on category.	Charge £150K	There are a number of fully written down assets that are still in use implying that useful lives are set too low.	Low	No	Usual audit test – recalculate depreciation for a sample of assets. Discuss with client whether useful lives should be reconsidered
Stock NRV	Stock used as spares is written down monthly on a straight line basis with an estimated UEL of 3 years – 50% is written off in year one, with 25% in the next two years.	Charge to write cost down to NRV £700K	No information as to actual lives of spare parts or their NRV.	High	Yes	Agree calculation of write down. Review accounts of competitor organisations. When this was last done three years ago it was discovered that there was no common treatment with some companies writing off stocks as they are supplied and others taking a write down. Some stocks are leased to customers. A detailed discussion was conducted two years ago as to whether these should be capitalised. Challenge the client to justify the current rate of write down based on competitors' methods and actual experience of life of stock. Ensure the methods employed are adequately described in the notes to the accounts.
Bad debts	Review trade debtors ledger and assess the probable recoverability of the o/s debts at the year end.	Balance £640K	Only a small part (£74K) of the provision has been used in the current year.	High	Yes	Review after date receipts up to the date of signing to ensure that the balance is reasonable. Challenge the client on the apparent over-provision in last year's accounts.
Warranty Provisions	Standard percentage of turnover. Client proposes to increase percentage from 1.4% of turnover in previous years to 1.9% of turnover in current year	Balance £850K	Client does not keep records of expenditure related to warranties	High	Yes	Review correspondence with customers to identify the apparent level of warranty claims. Challenge the client to demonstrate why (in the absence of detailed figures) it is considered appropriate to increase the standard percentage.