ACCOUNTING AND AUDIT UPDATE

Tolley® CPD

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FRS 102: THE FINANCIAL REPORTING STANDARD APPLICABLE IN THE UK AND REPUBLIC OF IRELAND (LECTURE A432 – 22.05 MINUTES)

Reminder

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. Early adoption must be disclosed.

[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. The FRC issued further observations on this subject on 2 August 2013 indicating that in considering whether a current SORP conflicts with FRS 102 an entity should have regard to the overall effect in practice. In particular an entity should consider whether or not the recognition and measurement requirements of FRS 102 are consistent with a current SORP. For example if a current SORP is silent on a topic, accounting policies determined in accordance with FRS 102 should not conflict with the current SORP. Similarly if a current SORP uses different terminology to express the same recognition and measurement concepts as required by FRS 102, compliance with FRS 102 should not automatically lead to non-compliance with that SORP. In relation to disclosure requirements, where a SORP requires specific disclosures that are not required by FRS 102, additional disclosure can be provided in addition to that required by FRS 102 in order to meet both requirements.]

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.

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 covered most of those chapters in our previous update.

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 deal with transition and the necessary reconciliations in these update notes.

FRS 102 SECTION 35: TRANSITION

Transitional arrangements in FRS 100, FRS 101 and FRS 102

As a result of the choices included in FRS 100, there are a number of possible transitions that may occur. These are summarised in the table below.

Existing framework:	**Transition to:**	**Transitional rules contained in:**
Existing UK GAAP	EU-adopted IFRS	IFRS 1 First-time Adoption of International Financial Reporting Standards as adopted by the EU
Existing UK GAAP	FRS 101	Paragraphs 6 to 33 of IFRS 1 as adopted by the EU including the relevant appendices. References to IFRSs in IFRS 1 are interpreted to mean EU-adopted IFRS as amended in accordance with paragraph 5(b) of FRS 101
EU-adopted IFRS	FRS 101	See notes re FRS 101 in the update notes for 2013 Quarter 1

Existing UK GAAP or EU-adopted IFRS	FRS 102	FRS 102: Section 35 – covered in detail below
Existing UK GAAP (not FRSSE)	FRSSE	FRSSE: Section 19 – these transitional arrangements are long-standing and refer to the now-forbidden practice (since 1999) of eliminating goodwill against reserves and the changes arising from FRS 15 (March 2000) relating to fixed assets. No new transitional provisions were introduced into FRSSE (2015). See further comment below.

The main part of our notes today is concerned with transition to FRS 102. This subject is covered in Section 35 of FRS 102 and the same principles apply whether transition is from FRSSE, existing UK full standards or EU-adopted IFRS.

We will also consider the following transitions:

- From FRSSE (2008) to FRSSE (2015)
- From FRSSE (2008) to FRS 102
- From FRSSE (2015) to FRS 102
- From existing UK GAAP to FRSSE (2008) or FRSSE (2015)
- From FRS 102 to FRSSE (2015)

Note, for the purposes of these notes, references to UK GAAP (or existing UK GAAP) should be interpreted as meaning the complete set of current FRSs, SSAPs and UITF Abstracts. FRS 102, FRSSE (2008) and FRSSE (2015) are referred to individually.

First time adoption of FRS 102

Adoption of the new framework is mandatory for accounting periods commencing on or after 1 January 2015. Transition to FRS 102 is dealt with in Section 35 and this section applies to the first financial statements in which the entity makes an explicit and unreserved statement of compliance with FRS 102. FRS 102.3.3 requires such a statement to appear in each set of financial statements prepared under FRS 102. An example of this disclosure would be:

> These financial statements have been prepared in accordance with the provisions of FRS 102 [as the applicable accounting standard under the Companies Act 2006].
>
> Adoption of this standard in the first year has required the following changes of accounting policy which have been reflected in prior period adjustments as noted below.

The text in the square brackets discloses compliance with SI 410 Reg 4(2), although this could be interpreted from the reference to FRS 102.

The second paragraph would only be relevant in the first period the standard is adopted.

For many UK companies (typically those following existing SSAPs, FRSs etc) first time adoption will occur within 12 months of December 2015. However, Section 35 will continue to be relevant in the longer term if there is a change of circumstances for example where an entity previously following FRSSE exceeds the thresholds and needs to switch to FRS 102.

Transition date

The transition date is the beginning of the earliest period for which the entity presents comparative information. In the UK this will be the start of the previous period as generally only one year is shown as comparative information.

Throughout these notes I will refer to an example entity X Ltd that will adopt FRS 102 for the first time when preparing its accounts for the year ended 31 December 2015. Previously X Ltd followed existing UK GAAP. The transition date for X Ltd is 1 January 2014.

Paragraph 7 of Section 35 requires the entity to prepare an opening statement of position as of the date of transition which recognises and measure all assets and liabilities in accordance with the requirements of FRS 102. Similarly the entity must not recognise items as assets or liabilities if FRS 102 does not permit such recognition. It may be surprising to note that there is no requirement for this statement to be presented, as such, in the financial statements.

There are a number of assets and liabilities that will be measured differently under FRS 102 – for example, investments currently held at cost may need to be fair valued and deferred tax will need to be recognised on a property that has been revalued.

Example: X Ltd has revalued a property under FRS 15 and has included the gain in a revaluation reserve. No deferred tax was provided on the revaluation since the conditions in FRS 19 were not met. Section 29 of FRS 102 requires deferred tax to be recognised in respect of all timing differences unless the differences are permanent. This means that, if an asset is revalued then there is a timing difference between the recognition of the gain and when a tax liability in respect of the profit would arise. This would include the property revalued by X Ltd. Therefore X Ltd will need to account for the deferred tax at the transition date.

For X Ltd, the change may be viewed as simply transferring the tax element from the revaluation reserve to deferred tax. SI 410 Sch 1 Reg 35 permits transfers to and from the revaluation reserve in respect of taxation credited or debited to the reserve. Note also that FRS 102.35.8 permits the prior period adjustment to be recognised "if appropriate, in another category of equity" rather than retained earnings.

If X Ltd had capitalised the revaluation reserve by the issue of shares to members then, in this situation there may not have been sufficient amounts in the reserve in respect of the deferred tax and therefore retained earnings would need to be used.

An example of an asset or liability that will be recognised for the first time under FRS 102 is a forward foreign exchange contract.

Example: X Ltd entered into a forward foreign exchange (FFX) contract on 12 November 2013 to purchase 220,000 euros at 1.1 euros to the £ on 12 February 2014. Since X Ltd has never adopted FRS 26, the contract was not recognised in the balance sheet at 31 December 2013 as prepared under UK GAAP.

For the purposes of the opening statement of position at 1 January 2014, it will be necessary to recognise the FFX contract at fair value.

We will cover the detail of this topic in a future course but, for the sake of this example, let us assume that X Ltd has established (by discussion with the company's bank) that the FFX contract is an asset at1 January 2013 with a fair value of £20,000.

For most companies, it is highly likely that the accounting policies used in the opening statement of financial position (at 1 January 2014) under FRS 102 will differ from those that it used at the same date under existing UK GAAP. FRS 102.35.13 requires the entity's first financial statements prepared using FRS 102 to include a description of the nature of each change in accounting policy.

Any adjustments that are necessary as a result of changes in accounting policies should be recognised directly in retained earnings (or, if appropriate, another category of equity) at the date of transition because these adjustments arise from transactions, other events or conditions that occurred before the date of transition to FRS 102 (FRS 102.35.8).

The amounts originally presented (under existing UK GAAP) in the balance sheet of X Ltd at 31 December 2014 will need to be restated in order to become the comparative year in the statement of financial position (under FRS 102) for December 2015. There will be a similar impact on the other statements required under FRS 102, namely the statement of comprehensive income, statement of changes in equity, statement of cash flows and supporting notes.

In order to make the transition process more straightforward, FRS 102 includes lists of prohibitions (in paragraph 35.9) and exemptions (in paragraph 35.10). The date of transition has an impact on the exemptions that may be available. For example, for acquisitions prior to the transition date the requirements of section 19 do not need to be applied. Acquisitions after this date would not be covered by the exemption in Section 35. See example later in these notes.

From a practical perspective there may be a number of problems when preparing the first set of accounts under FRS 102. Software packages normally carry forward the balances from the previous year to the current period. In the first FRS 102 accounts opening balances will need to be amended for both the comparative year and the current year. Also the comparatives appearing in the balance sheet and the statement of comprehensive income for the year ended 31 December 2015 may differ considerably from the figures as previously stated in the accounts for the year ended 31 December 2014. Software developers may (or may not) provide a simple solution to this problem although presumably they encountered the same problems with IFRS 1 when listed companies moved from UK GAAP to IFRS in 2005.

The directors of all entities need to plan the transition to FRS 102 so that appropriate decisions can be made and information gathered before the transition date. For X Ltd, this means that they will need to consider transition well before 1 January 2014.

Disclosures

102.35.12 requires an entity to explain how the transition from its previous financial reporting framework to FRS 102 affected its reported financial position and financial performance. This requires a description of the nature of each change in accounting policy and the following reconciliations:

- Reconciliations of its equity determined in accordance with its previous financial reporting framework to its equity determined in accordance with FRS 102 for the date of transition to FRS 102 and the end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework.
- A reconciliation of the profit or loss determined in accordance with its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined in accordance with FRS 102 for the same period.

Example: In its financial statements for the year ended 31 December 2015, X Ltd will need to present two reconciliations of its equity determined in accordance with existing UK GAAP to its equity determined in accordance with FRS 102. The reconciliations are required at 1 January 2014 and 31 December 2014.

X Ltd is also required to present a reconciliation of the profit or loss determined in accordance with existing UK GAAP for the year ended 31 December 2014 to its profit or loss for the same period determined in accordance with FRS 102.

Examples of these reconciliations are provided later in these notes.

There is no illustration in FRS 102 of how this information should be presented. For example, should the requirement of 102.35.12 be met by a reconciliation of each item presented on a line by line basis or could this be satisfied by reference to the major categories of assets and liabilities, i.e. fixed asset, current assets, etc. Arguably a reconciliation of the net asset and profit/loss position would satisfy the requirement. There is no requirement to include a reconciliation of all the matters presented on a line by line basis.

Later on in these notes we will look at two example formats based on the examples provided by the ASB when they set out to explain the requirements of FRED 48. These examples should be treated with caution as it is expected that the FRC will update them in due course.

First year

For entities that did not present financial statements in the previous period there is a requirement in FRS 102.35.15 for this fact to be disclosed. This is not an issue for existing entities but new entities will need to ensure this specific disclosure requirement is met.

Differences between existing UK GAAP and FRS 102

It is not possible to cover today all of the differences between existing UK GAAP and FRS 102. Rather, we will consider these differences in detail in future update notes. However, I will need to refer to some detailed differences in order to provide examples of the impact of Section 35.

When retrospective restatement is prohibited

There are five areas where retrospective adjustments to previous transactions are not permitted on transition. These are covered in FRS 102.35.9 and dealt with below.

Derecognition of financial assets and financial liabilities

Financial assets and liabilities derecognised under an entity’s previous accounting framework before the date of transition shall not be recognised upon adoption of FRS 102.

Conversely, for financial assets and liabilities that would have been derecognised under FRS 102 in a transaction that took place before the date of transition, but that were not derecognised under an entity’s previous accounting framework, an entity may choose to derecognise them on transition or to continue to recognise them until disposed of or settled.

The ASB comments in their staff materials that this is most likely to have relevance for financial institutions. The examples presented by the IASB in their training material on Section 35 of the IFRS for SMEs cover the situation where the entity's previous accounting framework dealt with factoring differently from the IFRS for SMEs. In the first example, the entity has derecognised debtors that have been sold to a bank even though the bank has recourse to the entity for debtors outstanding more than 120 days. Derecognition would not be permitted under the IFRS for SMEs because not all of the risks and benefits have been transferred to the bank. Despite this difference, retrospective adjustment of the debtors balance is not permitted and there is no need for the entity to reinstate the debtors at transition date.

This example does not carry over for use in the UK since an entity following FRS 5 should already be applying the same principles as FRS 102 in the area of factoring. However, the example does help us to understand the purpose of the prohibition which brings a common-sense approach to bear.

Hedge accounting

An entity shall not change its hedge accounting before the date of transition to FRS 102 for hedging relationships that no longer exist at the date of transition. For hedging relationships that exist at the date of transition, the entity shall follow the hedge accounting requirements of Section 12, including the requirements for discontinuing hedge accounting for hedging relationships that do not meet the conditions of Section 12.

The ASB comments in their staff training materials that this prohibition is only relevant for those entities that previously adopted FRS 26. This is true with respect to the first sentence since other entities will not have used hedge accounting prior to the introduction of FRS 102.

However, the more interesting situation is that dealt with by the second sentence where it would appear that an entity that has not used hedge accounting before will be required to consider hedges that may exist at the transition date. I use the words "it would appear" because, despite the wording of Section 35 of FRS 102, hedge accounting is always optional since an entity that does not wish to employ hedge accounting need not bother to try to meet the conditions for hedge accounting.

We will cover hedge accounting in a future set of update notes but suffice it to say at this stage that hedge accounting can only be used from the point that documentation and systems are in place. It is probably unlikely that an entity preparing their first set of accounts under FRS 102 for the year ended 31 December 2015 will already have such documentation and systems in place before 1 January 2014.

Accounting estimates

No further explanation is given in FRS 102 however we do have examples provided by both the ASB and the IASB.

The principle involved here is that accounting estimates are based on information available at the time when financial statements for the period were authorised for issue. Later information that reveals that the estimates were not accurate does not mean that the original accounts contained errors. Therefore, changes in accounting estimates are dealt with prospectively and are not corrected by a prior period adjustment. If this is the general principle applying to accounting estimates, it would be illogical to amend estimates made prior to the date of transition purely because of the availability of new information that only became available later.

Example (Based on Example 5 provided by the ASB staff materials):

At 31 December 2013 X Ltd had a significant debtor balance of £100K. The directors of X Ltd were concerned about the credit risk of the debtor and made a provision of £50K, ie for 50 per cent of the balance. During the following year, in the summer of 2014, the debtor collapsed and is currently being liquidated. As a consequence X Ltd no longer considers it will collect any of the outstanding debt.

When X Ltd prepares the transition date balance sheet as of 1 January 2014, hindsight shows that its accounting estimate made on 31 December 2013 was incorrect. However, it does not make any adjustment to the provision since FRS 102.35.9(c) prohibits retrospective adjustments to correct accounting estimates.

Note that the ASB add the comment to the above example that it is also possible that the amount of provision that would have been recognised in accordance with FRS 102 would have differed, not only because of the effect of hindsight, but because the requirements of draft FRS 102 paragraphs 11.21 to 11.25 could have led to a different value for the impairment loss to be recognised (based on the information available at 31 December 2013). We will consider this point in future update notes when we deal with Section 11.

Discontinued operations

Once again the standard does not contain any further comment. However, the crux of this matter is the change in definition that has occurred between FRS 3 and FRS 102.

Example: In its accounts for the year ended 31 December 2014, X Ltd showed amounts relating to a discontinued operation. The sale of the operation was completed in February 2015 before the date on which the financial statements for the year ended 31 December 2014 were approved.

Applying the rules of FRS 102, this operation would not count as discontinued at 31 December 2014 since FRS 102 defines a discontinued operation as “a component of an entity that **has** been disposed of” (my emphasis).

As a result of the prohibition on retrospective amendment, this operation will continue to be treated as discontinued in the year-ended 31 December 2014.

When preparing accounts under FRS 102 for the year-ended 31 December 2015, there will be no discontinued operations in the year to 31 December 2015 (assuming that no further operations have been discontinued). The comparatives will report the operation as discontinued in the year to December 2014.

Measuring non-controlling interests (minority interests)

The requirements:

i. to allocate profit or loss and total comprehensive income between non-controlling interest and owners of the parent;

ii. for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

iii. for accounting for a loss of control over a subsidiary

shall be applied prospectively from the date of transition to FRS 102 (or from such earlier date as FRS 102 is applied to restate business combinations – see paragraph 35.10(a) dealt with below).

Exemptions from the requirement to recognise or re-measure assets and liabilities on transition

Section 35.10 of FRS 102 lists 17 exemptions as a result of which an entity may choose not to re-measure particular assets and liabilities in its statement of financial position at transition date. Note once again the importance of the date of transition. Transactions falling after this date will not be covered by the exemptions. This may mean that transactions appearing in the final set of accounts prepared under UK GAAP (31 December 2014 for X Ltd) may need to be restated when 2014 appears as the comparative year for the first FRS 102 accounts.

There are a number of ways that I could present the 17 exemptions. I could simply make a list in the order of FRS 102 from (a) to (s) omitting (e) and (h). However, I think that it might be more helpful if I group the exemptions differently from the way they are presented in the FRS. I have retained the reference letters from FRS 102 in case you wish to go back to the original document.

Dormant companies

A company within the Companies Act definition of a dormant company may elect to retain its accounting policies for reported assets, liabilities and equity at the date of transition to FRS 102 until there is any change to those balances or the company undertakes any new transactions. (Exemption (m) in 102.35.10)

Note that dormant companies are required to adopt FRS 102 at the same time as any other company. Since there is no need to change policies at transition date then there should be no need for any of the usual reconciliations. Presumably, it would be sensible to make a statement in the accounting policies section that advantage has been taken of this exemption.

However, if it is intended that the dormant company might cease to be dormant at some future date then it might be better to adopt policies in accordance with FRS 102 immediately on transition. There are two reasons for this. Firstly, the other exemptions in 35.10 are only available when preparing the first financial statements that conform to FRS 102. For example, if a dormant company owns a property that they wish to restate at deemed cost (see below) then this needs to be done at the transition date. [If this results in a change in the valuation then this will, of course, mean that the company is no longer dormant.] Secondly, if an accounting policy needs to be changed at some later date then it may be more difficult to obtain the information needed to perform a prior period adjustment at that later date than it is now.

Entities within groups or with investments in associates or joint ventures

Business combinations, including group reconstructions (Exemption (a))

A first-time adopter may elect not to apply Section 19 Business Combinations and Goodwill to business combinations that were effected before the date of transition to FRS 102.

This is a very useful exemption without which all past business combinations would need to be re-examined and, if necessary retrospectively restated.

The exemption goes on to say that, if a first-time adopter restates any business combination to comply with Section 19, it shall restate all later business combinations. If a first time adopter does not apply Section 19 retrospectively, the first-time adopter shall recognise and measure all its assets and liabilities acquired or assumed in a past business combination at the date of transition to FRS 102 in accordance with paragraphs 35.7 to 35.9 or if applicable, with paragraphs 35.10(b) to (r) except for:

(i) intangible assets other than goodwill – intangible assets subsumed within goodwill shall not be separately recognised; and

(ii) goodwill – no adjustment shall be made to the carrying value of goodwill.

Example: Suppose that X Ltd made an acquisition in 2013. Existing UK GAAP was applied to this acquisition in the accounts for the year-ended 31 December 2013. It was considered that a life of 10 years was appropriate for the goodwill arising. On adoption of FRS 102 at December 2015, X Ltd is not required to apply FRS 102 Section 19 to that transaction. Therefore the fair values attributed under existing UK GAAP can be retained. In order to retain the original estimate in respect of the useful life of goodwill it is necessary to consider whether 10 years is a reliable estimate since 102.19.23a states that, if an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall not exceed five years.

Some commentators are suggesting that the original life of 10 years can be carried forward without question but I am basing my answer on the staff materials provided by the ASB.

[Another possibility that arises at this point is that the management of X Ltd, when reviewing the life of goodwill for the adoption of FRS 102, decide that there is no strong evidence for a life of 10 years and so, on transition, they decide to adopt a life of 5 years. Is this a correction of an accounting estimate which can be made prospectively or does this mean that the original estimate of useful life was an error? If the original estimate was an error then the error needs to be corrected by a prior period adjustment as required by 102.35.14:

“If an entity becomes aware of errors made under its previous financial reporting framework, the reconciliations required by paragraphs 35.13(b) and (c) shall, to the extent practicable, distinguish the correction of those errors from changes in accounting policies.”

In my view, the original estimate was probably not an error. FRS 10 accepts that the useful economic life of goodwill will usually be uncertain (paragraph 21). It goes on to say that “this uncertainty does not in itself form grounds for treating a useful economic life as indefinite or for adopting a 20-year period by default. Where, for example, the useful economic life of goodwill or an intangible asset is expected to be less than 20 years, the FRS requires an estimate of the useful economic life to be made”. Paragraph 22 adds the comment that “Whilst uncertainty forms grounds for estimating the useful economic life on a prudent basis, it does not form grounds for choosing a life that is unrealistically short.”

It is interesting that FRS 10 was at pains to point out that there was no such thing as a default life. By contrast, It seems that many commentators are already expecting that FRS 102 will lead to five years becoming the default life for goodwill. Indeed, FRS 102.19.25(g) requires disclosure, in the period when the acquisition occurs, of “the useful life of goodwill, and if this exceeds five years, supporting reasons for this”.]

Returning to our example, if the acquisition had been made in 2014 this would be after the transition date. Therefore in the original accounts for the period ending 31 December 2014 the requirements of existing UK GAAP would be applied. The estimated life of goodwill might again be (say) 10 years. On adoption of FRS 102 at December 2015, the fair values attributed under UK GAAP would need to be reviewed for any adjustments that may be required by FRS 102. If it is considered that the 10 year life is a reliable estimate then this can continue to be used. If not then the life would need to be reduced to five years. Any adjustments would affect both the reconciliation of equity at 31 December 2014 and the reconciliation of profit for the year-ended 31 December 2014.

Exemption (a) only applies to goodwill. Other intangible assets are covered in section 18 from which there is no exemption. Therefore if X Ltd has an intangible asset separate from goodwill that arose in a previous acquisition then the requirements of section 18 would apply. The inclusion of other intangibles in an acquisition is not often encountered in practice and for this reason this aspect may impact only a small number of entities.

Public benefit entity combinations (Exemption (q))

A first-time adopter may elect not to apply paragraphs PBE34.75 to PBE34.86 relating to public benefit entity combinations to combinations that were effected before the date of transition to FRS 102. However, if on first-time adoption a public benefit entity restates any entity combination to comply with this section, it shall restate all later entity combinations.

Individual and separate financial statements (Exemption (f))

When an entity prepares individual or separate financial statements, paragraphs 9.26, 14.4 and 15.9 require the entity to account for its investments in subsidiaries, associates, and jointly controlled entities either at cost less impairment or at fair value.

If a first-time adopter measures such an investment at cost, it shall measure that investment at one of the following amounts in its individual or separate opening statement of financial position, as appropriate, prepared in accordance with FRS 102:

(i) cost determined in accordance with Section 9 Consolidated and Separate Financial Statements, Section 14 Investments in Associates or Section 15 Investments in Joint Ventures; or

(ii) deemed cost, which shall be the carrying amount at the date of transition as determined under the entity's previous GAAP.

We would not expect this exemption to be relevant since in most situations UK entities will already account for these investments at cost less impairment. However, FRS 9 (and the Regulations to CA 2006) do permit the inclusion of associates and joint ventures at a valuation. Therefore if X Ltd has included an associate or joint venture in the UK GAAP accounts at 31 December 2013 at a valuation then this valuation could be included as deemed cost in the FRS 102 statement of position at 1 January 2014.

Assets and liabilities of subsidiaries, associates and joint ventures (Exemption (r))

If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall in its financial statements measure its assets and liabilities at either

(i) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to FRS 102, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary; or

(ii) the carrying amounts required by the rest of FRS 102, based on the subsidiary's date of transition to FRS 102.

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation (and equity accounting) adjustments and for the effects of the business combination in which the entity acquired the subsidiary (or transaction in which it acquired the associate or joint venture). Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

Exemptions relating to fixed assets

Measurement at deemed cost

Exemptions (c) and (d) apply to property, plant and equipment and investment property. The exemptions also apply to intangible assets that meet the recognition criteria and the criteria for revaluation in Section 18. Consistently with existing FRS 10, FRS 102 states that an intangible asset can only be revalued (to fair value) if the fair value can be determined by reference to an active market.

Any of the above items can be measured on the date of transition to FRS at deemed cost. Deemed cost can be fair value (Exemption (c)) or a previous GAAP revaluation at, or before, the date of transition (Exemption (d)). Recall that, as mentioned in our earlier example, it will be necessary to account for deferred tax where a fixed asset has been measured at deemed cost.

Notice that the decision concerning deemed cost is made separately for each item within the above categories. There is no requirement for a consistent approach.

Example: X Ltd adopted a policy of revaluation for freehold properties at 31 December 2000 following the issue of FRS 15. They owned one property at that date. This property had cost £50,000 when it was purchased many years before. In 2000, the property was revalued to £1.2m. In 2008, the directors decided that the policy of revaluation was onerous and the costs of complying outweighed the benefits of the policy. However, the auditor pointed out that the only way to change the policy of revaluation was to restate the property at cost. The directors decided with reluctance to continue with the policy of revaluation. At 31 December 2013, the property was considered to have a value of £1.65m and this amount was included in the balance sheet at that date.

FRS 102 gives the directors the option to revert to a policy of cost while retaining the latest valuation in the balance sheet prepared under existing UK GAAP at 31 December 2013. The value shown in the UK GAAP accounts at 31 December 2013 (£1.65m) can be used as deemed cost in the FRS 102 opening balance sheet at 1 January 2014. This value is, in accordance with the general principles of FRS 102 subject to an impairment test but that should not create any problems for X Ltd. Notice that the use of the term “deemed cost” does not remove the need to retain a revaluation reserve. In order to comply with company law the revaluation reserve would be retained and the excess depreciation would continue to be offset against it.

Alternatively, the directors still have the choice to return to the original cost figure of £50,000 in which case the revaluation reserve can also be dispensed with.

X Ltd also own some very expensive machinery which they have previously carried at cost. The directors wanted to revalue this machinery in 2008 but were put off by the requirements of FRS 15. FRS 102 offers the directors a one-off chance to restate the value of the machinery without getting caught on the treadmill of a policy of revaluation. There are two ways they could achieve this:

Either: Adopt a policy of revaluation for this machinery in the UK GAAP accounts at 31 December 2013. As in the freehold property example discussed above, the value shown in the UK GAAP accounts at 31 December 2013 can be used as deemed cost in the FRS 102 opening balance sheet at 1 January 2014. In order to adopt this approach the directors would need to make the appropriate decision (and valuation) before the December 2013 accounts are issued.

Or: Include the machinery at fair value in the opening statement of position at 1 January 2014. This decision (and calculation) could be delayed until the preparation of the first FRS 102 accounts in 2016.

For the purpose of the example reconciliations below I have assumed that the directors have chosen to adopt the second approach. The increase in value of property plant and equipment is £47K.

Decommissioning liabilities included in the cost of property, plant and equipment (Exemption (l))

Paragraph 17.10(c) states that the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. A first-time adopter may elect to measure this component of the cost of an item of property, plant and equipment at the date of transition to FRS 102, rather than on the date(s) when the obligation initially arose.

One of the bullet points in paragraph 10 of FRS 15 gives as an example of a directly attributable cost “the estimated cost of dismantling and removing the asset and restoring the site to the extent that it is recognised as a provision under FRS 12”.

Therefore entities following existing UK GAAP should already be capitalising such costs. Therefore this exemption seems to be superfluous.

However, what if an entity has never included decommissioning costs within fixed assets? Is this exemption giving the entity a fresh start? Or is the failure to follow FRS 15 an error in which case the entity will need to follow Paragraph 14 of Section 35 which says:

“If an entity becomes aware of errors made under its previous financial reporting framework, the reconciliations required by paragraphs 35.13(b) and (c) shall, to the extent practicable, distinguish the correction of those errors from changes in accounting policies.”

Extractive activities (Exemption (j))

A first-time adopter that under a previous GAAP accounted for exploration and development costs for oil and gas properties in the development or production phases, in cost centres that included all properties in a large geographical area may elect to measure oil and gas assets at the date of transition to this FRS on the following basis:

i. Exploration and evaluation assets at the amount determined under the entity's previous GAAP.

ii. Assets in the development or production phases at the amount determined for the cost centre under the entity's previous GAAP. The entity shall allocate this amount to the cost centre's underlying assets pro rata using reserve volumes or reserve values as of that date.

These amounts are subject to an impairment test at the date of transition.

This exemption only applies in this particular industry and is not considered further in these notes.

Borrowing costs (Exemption (o))

An entity electing to adopt an accounting policy of capitalising borrowing costs as part of the cost of a qualifying asset may elect to treat the date of transition to FRS 102 as the date on which capitalisation commences.

I have included this exemption under the heading of fixed assets but the capitalisation of borrowing costs is not restricted to fixed assets. The definition of a qualifying asset in FRS 102 is:

An asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following may be qualifying assets:

(a) inventories;

(b) manufacturing plants;

(c) power generation facilities;

(d) intangible assets; and

(e) investment properties.

Financial assets, and inventories that are produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

Exemption (o) is a sensible approach since it may be difficult to find the information for the retrospective application of a new policy to capitalise borrowing costs.

Example based on example 4 provided by the former ASB

Z Ltd started to construct a new building during 2013. Under FRS 15, Z Ltd has an accounting policy not to capitalise finance costs (although FRS 15 permits capitalisation as an accounting policy choice). Accordingly, when a similar building had been constructed back in 2002 and 2003 no finance costs had been included in the cost of the property.

As at 31 December 2013, Z Ltd had capitalised costs of £750K and estimated that it still had approximately nine months of construction work ahead. Finance costs that could have been capitalised, had Z Ltd had a policy of capitalisation, amounted to £20K.

During 2014 Z Ltd completed construction of the building. The total cost to be capitalised in accordance with FRS 102 (excluding borrowing costs) is £2.4m. Qualifying borrowing costs calculated in accordance with FRS 102 relating to the project as a whole are £80K.

On adoption of FRS 102, the directors of Z Ltd review the company's accounting policies and decide that they will now elect to capitalise borrowing costs in accordance with FRS 102 Section 25. In accordance with FRS 102 paragraph 35.10(o) they decide to capitalise borrowing costs prospectively from 1 January 2014. As a result, no adjustment is made to the transition balance sheet, and the £20K previously written off is not capitalised, but £60K of borrowing costs are capitalised.

Note that, if the directors had decided to capitalise finance costs retrospectively then it would have been necessary to establish and capitalise the borrowing costs incurred on the property constructed in 2002/3.

Deferred development costs as a deemed cost (Exemption (n))

A first-time adopter may elect to measure the carrying amount at the date of transition to FRS 102 for development costs deferred in accordance with SSAP 13 as its deemed cost at that date.

Without this exemption it would be necessary to re-examine all past projects to test whether they should be capitalised or not under the new rules of FRS 102. We will examine the differences between SSAP 13 and FRS 102 in a future set of notes but notice in passing that FRS 102 requires that, where an entity adopts a policy of capitalising development expenditure then that policy must be applied consistently to all development expenditure.

Exemptions relating to leases

Arrangements containing a lease (Exemption (k))

A first-time adopter may elect to determine whether an arrangement existing at the date of transition to FRS 102 contains a lease (see paragraph 20.3A) on the basis of facts and circumstances existing at that date, rather than when the arrangement was entered into.

Lease incentives (Exemption (p))

A first-time adopter is not required to apply paragraphs 20.15A and 20.25A to lease incentives provided the term of the lease commenced before the date of transition to FRS 102. The first-time adopter shall continue to recognise any residual benefit or cost associated with these lease incentives on the same basis as that applied at the date of transition to this FRS.

X Ltd entered into a 20 year lease on 1 January 2012. The lease provided for periodic reviews every 5 years whereby the rental can be adjusted to the prevailing market rate. Under UITF 28, the incentive is spread over 5 years whereas under FRS 102, the benefit is spread over 20 years. X Ltd may choose whether to continue to recognise the lease incentive over 5 years or whether to apply FRS 102 retrospectively.

Share-based payment transactions

Under exemption (b), a first-time adopter is not required to apply Section 26 Share-based Payment to equity instruments that were granted before the date of transition to FRS 102, or to liabilities arising from share-based payment transactions that were settled before the date of transition to FRS 102. Except that a first-time adopter previously applying FRS 20 or IFRS 2 shall, in relation to equity instruments that were granted before the date of transition to FRS 102, apply either FRS 20/IFRS 2 (as applicable) or Section 26 of FRS 102 at the date of transition.

This exemption should not be relevant to entities transitioning from existing UK GAAP who should already be applying FRS 20. However, this would be a useful exemption for an entity transitioning from FRSSE. Notice that an entity may continue to apply FRSSE for a number of years after 2015 before it decides (or is required) to switch over to FRS 102. The exemption will still apply to the entity as a first time adopter irrespective of when transition occurs.

Financial instruments

Compound financial instruments (Exemption (g))

Paragraph 22.13 requires an entity to split a compound financial instrument into its liability and equity components at the date of issue. A first-time adopter need not separate those two components if the liability component is not outstanding at the date of transition to FRS 102.

This exemption should not be relevant to entities transitioning from existing UK GAAP who should already be applying FRS 25.

Designation of previously recognised financial instruments (exemption (s))

FRS 102 permits a financial instrument (provided it meets certain criteria) to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss. Despite this, an entity is permitted to designate, at the date of transition to FRS 102, any financial asset or financial liability at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 11.14(b) at that date. We will consider these criteria in future notes.

Service concession arrangements – accounting by operators

FRS 102 defines a service concession agreement as an arrangement whereby a public sector body or a public benefit entity (the grantor) contracts with a private sector entity (the operator) to construct (or upgrade), operate and maintain infrastructure assets for a specified period of time (the concession period).

Exemption (i) states that a first-time adopter is not required to apply the accounting requirements contained in FRS 102 for service concession arrangements to those arrangements entered into before the date of transition. If this exemption is taken then service concession arrangements entered into before the date of transition must continue to be accounted for using the same accounting policies being applied at the date of transition.

Examples of the reconciliations required by FRS 102

FRS 102 does not specify a format for the reconciliations required by 102.35.13 and there is no illustration in FRS 102 of how this information could or should be presented The staff materials produced by the former ASB gave two example formats. The following reconciliations for X Ltd are based on the ASB examples and, as usual, assume the transition date is 1 January 2014.

The items included in the reconciliation are derived from the examples presented earlier in these notes. The reconciliations are included in these notes to provide examples of how the reconciliations might be presented. These reconciliations are not intended to cover all adjustments that might be required in practice.

Example A: Reconciliation format 1

		Reconciliation of capital and reserves					
		At 1 January 2014			**At 31 December 2014**		
	Notes	As previously stated (£'000)	Effect of transition (£'000)	FRS 102 as restated (£'000)	As previously stated (£'000)	Effect of transition (£'000)	FRS 102 as restated (£'000)
Fixed assets	1,2	4,756	47	4,803	4,738	38	4,776
Current assets	3	4,588	20	4,608	4,902	15	4,917
Creditors: amounts falling due within one year		(3,573)		(3,573)	(3,418)		(3,418)
Net current assets		1,015	20	1,035	1,484	15	1,499
Total assets less current liabilities		5,771	67	5,838	6,222	53	6,275
Creditors: amounts falling due after more than one year		(1,450)		(1,450)	(1,450)		(1,450)
Provisions for liabilities	4	(356)	(108)	(464)	(344)	(106)	(450)
Net assets		3,965	(41)	3,924	4,428	(53)	4,375
Capital and reserves	2,3,4	3,965	47+20-108	3,924	4,428	38+15-106	4,375

		Reconciliation of profit for the year		
		Year ended 31 December 2014		
	Notes	As previously stated (£'000)	Effect of transition (£'000)	FRS 102 (as restated) (£'000)
Turnover		8,414		8,414
Cost of sales	2	(5,418)	(9)	(5,427)
Gross profit		2,996	(9)	2,987
Administrative expenses	3	(2,385)	(5)	(2,390)
Other operating income		7		7
Operating profit		618	(14)	604
Interest receivable and similar income		18		18
Interest payable and similar charges		(42)		(42)
Taxation	4	(131)	2	(129)
Profit on ordinary activities after taxation and for the financial year		463	(12)	451

Notes to reconciliations

1 Fixed assets – freehold property

Under previous UK GAAP, in accordance with the choice provided by FRS 15, the company adopted a policy of revaluation for freehold property. In the balance sheet at 31 December 2013, freehold property was included at a valuation of £1,650K.

On transition to FRS 102, the directors have chosen to adopt a policy of recognising property, plant and equipment at cost less depreciation. In accordance with the exemption provided by paragraph 10(d) of FRS 102, the directors have elected to use the previous valuation of freehold property as its deemed cost on the date of transition.

This has no impact on the balance sheet at the date of transition (31 December 2013) or the balance sheet at 31 December 2014.

2 Fixed assets – plant and equipment

Under previous UK GAAP, all tangible fixed assets (other than freehold property) were valued at cost less depreciation.

On transition to FRS 102, the directors have chosen to adopt a policy of recognising property, plant and equipment at cost less depreciation. In accordance with the exemption provided by paragraph 10(c) of FRS 102, the directors have elected to measure the Steinway machines at their fair value on the date of transition and this fair value is the deemed cost of those machines at the date of transition. The impact of this change is to increase fixed assets and reserves by £47K in the balance sheet at the date of transition. The impact on the financial statements for the year ended 31 December 2014 is to increase fixed assets and reserves by £38K and depreciation included in cost of sales by £9K.

3 Current assets and creditors falling due within one year

The company was not within the scope of FRS 26 'Financial instruments: recognition and measurement' and did not apply it voluntarily. As a result derivative financial instruments were not recognised on the balance sheet under previous UK GAAP. Instead the effects of the derivative financial instruments were recognised in profit or loss when the instruments were settled.

Under FRS 102, derivative financial instruments are recognised as a financial asset or a financial liability, at fair value, when an entity becomes party to the contractual provisions of the instrument. The derivative financial instruments are foreign exchange forward contracts.

The impact of the change in accounting policy for these derivative contracts is to increase current assets and reserves by £20K in the balance sheet at the date of transition. The impact on the financial statements for the year ended 31 December 2014 is to increase current assets and reserves by £15K and to increase administrative costs by £5K.

4 Deferred taxation

Under previous UK GAAP, in accordance with the choice provided by FRS 15, the company adopted a policy of revaluation for freehold property. The gain on revaluation was included in a revaluation reserve. No deferred tax was provided on the revaluation since the conditions in FRS 19 were not met.

FRS 102 requires deferred tax to be recognised in respect of all timing differences unless the differences are permanent. This means that, if an asset is revalued then there is a timing difference between the recognition of the gain and when a tax liability in respect of the profit would arise. Therefore an adjustment is required to recognise the deferred tax at the transition date. The revaluation of the Steinway machines has also led to the need to restate deferred tax. The impact of these changes is to increase provisions and reduce reserves by £108K in the balance sheet for 1 January 2014 and £106K in the balance sheet for 31 December 2014. The tax charge for the year ended 31 December 2014 is reduced by £2K.

Example B: Reconciliation format 2

Reconciliation of capital and reserves	**Notes**	**At 1 January 2014 (£'000)**	**At 31 December 2014 (£'000)**
Capital and reserves (as previously stated)		3,965	4,428
Restatement of Steinway machines at deemed cost	2	47	38
Recognition of derivative financial instruments	3	20	15
Deferred tax on revalued assets	4	(108)	(106)
Capital and reserves (as restated)		3,924	4,375

Reconciliation of profit for the year	**Note**		**Year ended 31 December 2014 (£'000)**
Profit on ordinary activities after taxation and for the financial year (as previously stated)			463
Additional depreciation on Steinway machines net of deferred tax	2		(7)
Recognition of derivative financial instruments	3		(5)
Profit on ordinary activities after taxation and for the financial year (as restated)			451

Notes to reconciliations

As before

OTHER TRANSITIONS THAT MAY OCCUR

From FRSSE (2008) to FRSSE (2015)

FRS 100.11 states that entities transitioning to the FRSSE apply the transitional arrangements set out in the FRSSE. In practice this may be difficult as there are no specific transitional provisions in the FRSSE, either 2008 or 2015 (based on changes listed in FRS 100).

The FRSSE does include transitional provisions in section 19 but these are related to previous changes since the FRSSE was first introduced in 1997. They deal with the following matters:

- Elimination of goodwill against reserves

- Revaluation of fixed assets prior to 2000
- Separation of fixed assets applicable in 2000

FRS 100 indicates no amendment to the above, nor does it add any additional provisions.

FRS 102 includes transitional provisions which have the effect of reducing the impact of changing from one framework to the other. Such transitional provisions do not exist for transition from FRSSE (2008) to FRSSE (2015).

The main differences between FRSSE (2008) and FRSSE (2015) are:

- Life of intangibles presumed not to exceed 5 years
- Impairment reviews – the requirement for an annual assessment of whether there is any indication of impairment
- Related party definitions

On this basis an entity adopting FRSSE (2015) from FRSSE (2008) would make the necessary adjustments in the first year, and to comparatives if relevant. Therefore, for an entity with a December year end, the first period under FRSSE (2015) (assuming no early adoption) would be 31 December 2015. If a change of accounting policy is required then the opening balance of reserves needs to be adjusted for the change. The comparatives also need to be adjusted so that the results are on the same basis as the current period.

If, on application of FRSSE (2015), a FRSSE entity reduces the life of goodwill from 20 years to 5 years, is this a change in policy, a change in estimate or the correction of a prior period error? See further notes below on this subject.

The change in respect of related parties may give rise to the need to disclose corresponding amounts, which were not disclosed in the previous period. This is because of the change to the definition of a related party. Certain parties that fell outside the previous definition may fall within the new definition. Identifying this change in advance would allow the data to be extracted. For example, if the entity has a 31 December period end and it is identified that a new related party relationship will exist for 2015. The data could be extracted in 2014 in advance of its disclosure the following year.

Life of an intangible asset

FRSSE (2015) Para 6.13: Capitalised goodwill and intangible assets shall be considered to have a finite useful life, and shall be depreciated on a straight-line (or more appropriate) basis over their useful economic lives. If an entity is unable to make a reliable estimate of the useful life of goodwill or intangible assets, the life shall be presumed not to exceed 5 years.

FRSSE (2008) Para 6.13: Capitalised goodwill and intangible assets shall be depreciated on a straight-line (or more appropriate) basis over their useful economic lives which shall not exceed 20 years.

Therefore, it is likely that under FRSSE (2008) a longer life may have been used. Provided a reliable estimate can be made the previous estimate can continue to be used.

Are the requirements of FRSSE (2015) more onerous than those of 2008?

FRSSE (2015) (as FRS 102) provides no insight in to what may constitute a reliable estimate. In estimating the useful life under FRSSE (2008) the factors that were considered would also be relevant in making a reliable estimate under FRSSE (2015).

Where the useful life was previously estimated at more than five years, and this cannot be justified as a reliable estimate, there will need to be a change in the first year under the new requirements. In my opinion, this is not a change in accounting estimate since the only change that has occurred is a change in the (presumed) maximum life. This should not affect the estimate of life if that estimate was well founded.

So is this a change in accounting policy? If the directors were simply basing the life on the maximum permitted by the standard then I would suggest that there is a change in policy. On the other hand, if no attempt has been made to place a realistic estimate on the useful life of goodwill then I think that we have the correction of an error. Whether we decide there has been a change in policy or whether there is a need to correct an error made in a prior period, the change must be reflected retrospectively. A prior period adjustment will be required on transition to FRSSE (2015).

Example

Z Ltd, year end 31 December, acquired the business of an unincorporated trade in August 2010. The goodwill arising on the acquisition was £500,000. The life was estimated as 10 years, full charge in year of acquisition. The company is using FRSSE (2008) and adopts the new framework when mandatory.

FRSSE 2008						
Year	**2010**	**2011**	**2012**	**2013**	**2014**	
Cost	500,000	500,000	500,000	500,000	500,000	
Amortisation						
B/fwd	-	50,000	100,000	150,000	200,000	
Charge	50,000	50,000	50,000	50,000	50,000	
C/fwd	50,000	100,000	150,000	200,000	250,000	
NBV	450,000	400,000	350,000	300,000	250,000	
FRSSE 2015						
Year					**2014**	**2015**
Cost					500,000	500,000
Amortisation						
B/fwd					200,000	500,000
Change of policy					200,000	
Charge					100,000	
C/fwd					500,000	500,000
NBV					-	-

In the example the change of policy (or correction of error) would be accounted for by increasing the amortisation b/fwd and adjusting reserves.

From FRSSE (2008) to FRS 102

Currently the measurement differences between FRSSE (2008) and UK GAAP are restricted to a limited number of areas. In many instances the result under the FRSSE is identical to that under the full standards.

As a result of this, matters noted above in respect of transition from UK GAAP to FRS 102 would also apply to transition from FRSSE (2008) to FRS 102.

From FRSSE (2015) to FRS 102

As mentioned above, the measurement differences between FRSSE (2008) and UK GAAP are restricted to a limited number of areas. In many instances the result under the FRSSE is identical to that under the full standards. Entities currently changing from the FRSSE to the full UK standards would need to address those changes but the change is unlikely to incur substantial time and expense.

The differences between FRSSE (2015) and FRS 102 are substantial and entities are likely to incur increased costs should they wish or need to follow this transition. This normally arises when the entity is no longer able to use the FRSSE due to it no longer fulfilling the requirements for small under CA 2006. If this situation is expected to arise then prior planning would be essential as the measurement and disclosure differences will require changes to accounting policies and the comparative information in the first year.

However, the transition from FRSSE (2015) to FRS 102 is the first time adoption of FRS 102 and so all of the exemptions in FRS 102 would apply. The notes presented earlier in respect of transition from UK GAAP to FRS 102 would therefore be relevant to this transition.

From existing UK GAAP to FRSSE (2008) or FRSSE (2015)

Currently, some entities eligible to use the FRSSE do not do so preferring to use full UK GAAP. In these circumstances there are likely to be some advantages in adopting FRSSE (2015) as opposed to FRS 102. This would avoid implementing some of the more onerous requirements contained in FRS 102.

Under FRS 100 an entity must follow the new framework from 1 January 2015. FRS 100.4 indicates that the GAAP used prior to implementation does not affect the application of the framework. Therefore an entity currently using the full Standards could adopt FRSSE (2015) from the implementation date. There is no requirement to have been using FRSSE (2008), prior to implementation, to be able to use FRSSE (2015). On this basis there is little to be gained in changing from UK GAAP to FRSSE (2008) and then to FRSSE (2015).

The differences between UK GAAP and FRSSE (2008) are concentrated in certain areas. The differences between FRSSE (2008) and FRSSE (2015) are largely encompassed in three areas; life of intangibles, impairment reviews, and related party definitions.

The FRSSE is only available to entities which satisfy the definition of small under the Companies Act 2006. A footnote to FRS 100 indicates that in measuring the turnover and balance sheet total the requirements of the FRSSE should be applied and not those of either FRS 102 or FRS 101.

The following considerations would apply:

- The issues arising in respect of goodwill would be the same as those discussed above in transitioning from FRSSE (2008) to FRSSE (2015).
- The definition of a related party is the same under FRSSE (2015) as the current FRS 8. Therefore no additional information of disclosures would be required.
- Similarly, the new requirement in FRSSE (2015) to consider impairment indicators is very similar to that in FRS 11 so no new issues would arise.
- Certain disclosures currently required under UK GAAP could be removed if the FRSSE is adopted.
- Certain measurement differences would have to be considered, e.g. equity settled share based transactions – but this would again be a simplification.

From FRS 102 to FRSSE (2015)

This transition will only arise after the introduction of the new regime and is likely to give rise to a significant number of issues. As noted above the measurement differences between current UK GAAP and FRSSE (2008) are minimal. The measurement differences between FRS 102 and FRSSE (2015) are numerous and significant. There is also the additional consideration of an entity using the exemptions in FRS 102 that are not available to entities using FRSSE (2015) and the impact this may have on such a transition.

Further, if the entity switches to FRSSE (2015) because it becomes small, it will need to switch back to FRS 102 if it ceases to be small. Would this be a second instance of first time adoption of FRS 102? Or would the exemptions on first time adoption be unavailable on second time adoption?

At the moment, entities on the borderline between small and medium-sized can switch, almost seamlessly, between FRSSE and the full standards. This will not be easy in the future. I suspect that the adoption of FRS 102 will be regarded as a one-way street. Entities will not consider reverting to FRSSE after adopting FRS 102.

THE COMPANIES ACT 2006 (STRATEGIC REPORT AND DIRECTORS' REPORT) REGULATIONS 2013 (LECTURE 433 – 9.31 MINUTES)

Introduction

These Regulations have effect in respect of financial years ending on or after 30th September 2013. The regulations amend CA 2006 by the introduction of a new chapter – "Chapter 4A Strategic report" placed before Chapter 5 Directors' report. The regulations require all companies other than those entitled to the small companies exemption to prepare a strategic report.

(A company is entitled to the small companies exemption in relation to the strategic report if it is entitled to prepare accounts for the year in accordance with the small companies regime, or it would be so entitled but for being or having been a member of an ineligible group. This is the same as the small companies exemption concerning the directors' report which is contained in S415A of CA 2006.)

The strategic report must be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company.

The strategic report replaces the business review and therefore the obvious first impact of these regulations is that S417 dealing with the business review will no longer exist. However, for medium-sized companies there is very little difference between the requirements of S414C and the existing requirements under S417. I have repeated these requirements in the first sub-section below since they are frequently dealt with badly in practice. For quoted companies, the strategic report repeats most of the existing requirements and adds some new requirements. The requirements for quoted companies over and above those for other companies are listed below.

There are some changes affecting all companies including small companies and these are covered in the final sub-section below.

The FRC has recently issued a consultation on strategic report guidance with a deadline for response of November 2013.

The strategic report for medium-sized companies

The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).

The strategic report must contain a fair review of the company's business, and a description of the principal risks and uncertainties facing the company. The review required is a balanced and comprehensive analysis of the development and performance of the company's business during the financial year, and the position of the company's business at the end of that year, consistent with the size and complexity of the business.

The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include analysis using financial key performance indicators. "Key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.

As at present, the report must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

In relation to a group strategic report, references to the company have effect as if they were references to the undertakings included in the consolidation.

Nothing in S414C requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

All of the above are identical to the existing requirements of S417.

S414C(11) adds the comment that the strategic report may also contain such of the matters otherwise required by regulations made under section 416(4) to be disclosed in the directors' report as the directors consider are of strategic importance to the company.

This sub-section raises the question as to whether companies required to prepare a strategic report might be able to dispense with a directors' report. However, these hopes are dashed by the amendment to schedule 7 of the accounts regulations for large and medium-sized companies which says in paragraph 1A:

"Where a company has chosen in accordance with section 414C(11) to set out in the company's strategic report information required by this Schedule to be contained in the directors' report it shall state in the directors' report that it has done so and in respect of which information it has done so."

The strategic report for large companies

Large companies must meet all of the requirements for medium-sized companies as shown above. In addition, the analysis using key performance indicators must include non-financial key performance indicators, including information relating to environmental matters and employee matters.

The strategic report for quoted companies

Quoted companies must meet all of the requirements for large and medium-sized companies as shown above. They must also meet the following requirements.

Requirements that are largely unchanged from the requirements in the existing business review

The strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:

(a) the main trends and factors likely to affect the future development, performance and position of the company's business, and

(b) information about:

(i) environmental matters (including the impact of the company's business on the environment),

(ii) the company's employees, and

(iii) social, community and **human rights** issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies.

If the report does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii), it must state which of those kinds of information it does not contain.

The bold type above indicates a new requirement.

There is no longer a requirement to give information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.

New requirements

The strategic report must include

a) a description of the company's strategy,

b) a description of the company's business model,

c) a breakdown showing at the end of the financial year:

i. the number of persons of each sex who were directors of the company;

ii. the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph (i)); and

iii. the number of persons of each sex who were employees of the company.

"Senior manager" means a person who is an employee of the company and has responsibility for planning, directing or controlling the activities of the company, or a strategically significant part of the company.

In relation to a group strategic report, the reference to the company in subsection (c)(i) is to the parent company; and the breakdown required by subsection (c)(ii) must include the number of persons of each sex who were the directors of the undertakings included in the consolidation.

Other changes affecting the directors' report

With effect from financial years ending on or after 30th September, the directors' report need no longer state:

- The principal activities of the company in the course of the year. Note, however, that paragraph 3.24 of FRS 102 requires disclosure of 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.
- The difference between balance sheet value and market value of land.
- The amount of charitable donations.
- The disclosures required where a company purchases its own shares except in the situation where the company is a public company.
- The policy and practice on payment of creditors

Quoted companies will be required to present new disclosures concerning greenhouse gas emissions.

Summary financial statements

There will no longer be an option to provide summary financial statements. Rather there will be an option to provide a strategic report with supplementary material. The supplementary material must:

a) contain a statement that the strategic report is only part of the company's annual accounts and reports;

b) state how a person entitled to them can obtain a full copy of the company's annual accounts and reports;

c) state whether the auditor's report on the annual accounts was unqualified or qualified and, if it was qualified, set out the report in full together with any further material needed to understand the qualification;

d) state whether, in that report, the auditor's statement under section 496 (whether strategic report and directors' report consistent with the accounts) was unqualified or qualified and, if it was qualified, set out the qualified statement in full together with any further material needed to understand the qualification;

e) in the case of a quoted company, contain a copy of that part of the directors' remuneration report which sets out the single total figure table in respect of the company's directors' remuneration in accordance with the requirements of Schedule 8 to the Large and Medium-sized Companies (Accounts and Reports) Regulations 2008 (S.I. 2008/410).

Note that e) above refers to the changed requirements for disclosure of directors' remuneration. These only affect quoted companies and apply to years ended on or after 30 September 2013.

There are a number of fairly obvious consequential amendments arising from the new strategic report and one of these is alluded to in (d) above. S496 has been amended to read:

"The auditor must state in his report on the company's annual accounts whether in his opinion the information given in the strategic report (if any) and the directors' report for the financial year for which the accounts are prepared is consistent with those accounts."

EU ADOPTS NEW ACCOUNTING DIRECTIVE (LECTURE A434 – 16.42 MINUTES)

On 1 July 2013, after a legislative process spanning some 18 months, a new EU accounting directive finally passed into European law. This will replace both the 4th and the 7th directives which have been in place since 1978 and 1983 respectively. The key aim of the new legislation is simplification of small company financial statements.

The impact of the new directive on small UK companies is currently unclear. It will be necessary for the UK government to consult before any concrete steps are taken. However one change that may occur quite quickly is an increase in the thresholds for small companies. The new directive gives the thresholds as fewer than 50 employees, a turnover of not more than €8m and/or a balance sheet total of not more than €4m. These limits are the same as those currently used in the UK. However, member states are now permitted to use thresholds for turnover of up to €12m and a balance sheet total of up to €6m

The directive reduces and limits the amount of information that small companies will have to provide in their financial statements - notably in the notes to the financial statements. The EC says that financial statements notes (for small companies) will include between 8 and 13 items as opposed to between 14 and 24 notes (or more in some cases) as is the case at the moment.

The use of the word “limits” above refers to the so-called maximum harmonisation approach such that member states are not permitted to require additional disclosures. How this will play out and the impact on the FRSSE remains to be seen.

There is an option within the directive which permits member states to allow small companies to prepare abridged balance sheets and profit and loss accounts. This is a term that we have recently encountered in the context of the micro-company and so we wait to see what the UK government does with this option. Interestingly, it is reported that small companies will still be entitled to provide more information, or additional financial statements (such as a cash flow statement) should they so wish. Presumably this means that the individual entity can provide extra information but the member state government is not permitted to mandate additional disclosures.

SIMPLER FINANCIAL REPORTING FOR MICRO-ENTITIES

On 9 September, the government published its response to the consultation concerning the accounts of micro-entities. This indicates that micro-entities will be able to prepare and publish much reduced financial statements. They will be able to draw up an abridged balance sheet and profit and loss account with fewer notes. The government is not, however, going ahead with the earlier suggestion that micro-entities would be permitted to prepare accounts that did not follow in all respects the usual accruals principle. Accordingly, all small companies (micro or otherwise) will continue to follow the same recognition and measurement rules.

The BIS press release states that the changes will come into force as soon as possible, and will apply to financial years ending on, or after, 30 September 2013 and related accounts filed on, or after, the date on which the changes come into force.

We will cover this topic fully once the regulations have been published. It is expected that the FRC will issue an exposure draft of amendments to FRSSE shortly.

PURCHASE OF OWN SHARES (LECTURE A435 – 3.51 MINUTES)

These notes are adapted from an article written by John Major and published on the website of SWATUK Ltd

A number of changes have been made to the legal requirements in the Companies Act 2006 in respect of purchase of own shares. These changes came into force on 30 April 2013.

Previously, where a limited company purchased its own shares, the shares had to be paid for on purchase. This requirement has been removed where the company is purchasing the shares for the purposes of an employees' share scheme. This allows the company to pay for the shares by instalments in this situation.

The requirement that a limited company may only purchase its own shares out of distributable reserves (or out of a fresh issue of shares) has been changed to enable the company to use cash to finance the purchase, without having to identify it as distributable reserves, up to the value of the lower of £15,000 or 5% of the share capital.

The previous requirement for a purchase of own shares out of reserves to be authorised by a special resolution (a 75% majority) has been changed to authorisation by an ordinary resolution (majority exceeding 50%).

New sections have been included which reduce the requirements concerning payment out of capital and for registration of resolution and documents where the purchase of own shares is for the purposes of an employees' share scheme. This amendment reduces the requirement to a statement by the directors that the company is solvent and a special resolution by the shareholders.

Another change brought in by the SI is that any limited company may now purchase its own shares and hold them in treasury. Previously, only listed companies were permitted to hold treasury shares.

The title of the Statutory Instrument 2013 No 999 that sets out these changes is The Companies Act 2006 (Amendment of Part 18) Regulations 2013 and it can be accessed at:

http://www.legislation.gov.uk/uksi/2013/999/contents/made

PRACTICE ASSURANCE 2012 (LECTURE A436 – 11.10 MINUTES)

These notes are adapted from an article written by David Norris and published on the SWATUK website.

Introduction

The ICAEW has recently published a summary of its findings from practice assurance visits in 2012. The full document can be downloaded from:

http://www.icaew.com/~/media/Files/Members/practice-centre/practice-assurance/practice-assurance-highlights-2012.pdf

Scope

In 2012 the QAD introduced desktop reviews for some firms that had already had a PA review and completed 529 by the end of the year. See www.icaew.com/practiceassurance for more information on how these work.

Frequency

In 2012, the frequency of the reviews was changed from six to eight years for smaller firms and masterclasses were introduced. Nine masterclasses were run in 2012, and they have said that they are planning 10 for 2013. See www.icaew.com/practiceassurance for more information.

In this report the QAD said they wanted to focus on their reviews of sole practitioners and smaller practices. Out of 13,000 practitioners and firms; 70% are run by sole practitioners and about 50% of all firms have a gross practice income of less than £75,000 per year.

Overall results

Of the 1,930 firms subject to a Practice Assurance review in 2012, only 6% resulted in a report to the Practice Assurance Committee (PAC), and only 2% were referred to the Professional Conduct Department (PCD) for further investigation. 17 reports were written in 2012 because firms hadn't actioned the points they promised to do following a previous visit.

The areas of compliance with the Practice Assurance Standards that repeatedly come top of the agenda for the PAC are summarised below.

Frequently identified findings

Anti-money laundering

Most firms have appropriate procedures for obtaining ID for a new client, but often carry out the same checks regardless of the risk. The risks of a potential client must be documented and the checks carried out must be proportionate to that risk. You need to be able to explain to the ICAEW as your supervisor how you've carried out this risk assessment.

You also have to keep that risk assessment up to date, so you need a process or a trigger to remind you to re-visit the information you have about your client to see if anything has changed.

Quick questions:

- Do I have a copy of the CCAB guidance (icaew.com/regulations)?
- Do I have documented procedures?
- Do my staff and subcontractors understand what the procedures are?
- Can I demonstrate how I have assessed the risk of new and existing clients?
- Have I done a compliance review including a file review?

Clients' money

Last year, about 2,000 firms informed the ICAEW that they handled clients' money and, of those, 1,400 had three or fewer principals. Most of the findings in this area are about the firm's compliance activities, rather than unethical activities.

Remember that, if you are a sole practitioner, you must tell the ICAEW the name of your client money alternate who will need access to your bank account.

Quick questions:

- Do I need a clients' money account? What about tax refunds or payroll?
- Have I got the right bank trust letters to hand?
- Have I reconciled the accounts at least every five weeks and followed up the reconciling items?
- Have I held any amounts over £10,000 for more than 30 days? Do I need a designated account?
- Have I done a compliance review?

Terms of engagement

The QAD believes that the best way to engage with your client is through an engagement letter which clearly sets out the scope of the engagement. Even without this, as a minimum, you must tell your clients in writing about the basis on which you charge your fees and their right to complain to ICAEW. Helpsheets on engagement letters can be found at www.icaew.com/practicehelpsheets. Are your engagement letters up to date?

Firms also have to provide clients with certain information about their professional indemnity insurer (PII) to comply with the Provision of Services Regulations 2009. You can find a helpsheet PAS1/HS22 on this at www.icaew.com/practicehelpsheets

Quality of financial statements

The QAD commented that they often find disclosure errors in the accounts they review. As these are a matter of public record, it is important that quality control procedures spot errors before they go out.

The QAD states that there is no substitute for continuing professional development (CPD) and, with the forthcoming end of all SSAP's and FRS's and the new FRS 102, this will be even more important. Using specialist software or a good checklist can be a sound investment. For a list of the common accounting and disclosure issues visit www.icaew.com/paguidance

Quick questions:

- Is my software up to date?
- Do I check accounts before they go out?
- Do I and my staff need an update course?

And a few other things

- Have I registered with the Information Commissioner to comply with the Data Protection Act 1998?
- How secure is my clients' data?
- Does my firm need procedures to address the Bribery Act 2010?
- Have I done the right CPD? Reflect, act, assess the impact and declare?

The QAD says that firms that carry out a regular Practice Assurance compliance review have fewer findings from their reviews than firms that don't do one. The helpsheet, PAS4/HS01, includes a detailed compliance review checklist which can be tailored to meet the individual needs of the practice; visit www.icaew.com/practicehelpsheets

AUDIT MONITORING 2012 (LECTURE A437 – 24.00 MINUTES)

Introduction

The ICAEW has recently published a summary of its findings from audit visits in 2012. The full document can be downloaded from:

http://www.icaew.com/~/media/Files/Technical/Audit-and-assurance/audit/working-in-the-regulated-area-of-audit/audit-monitoring-2012.pdf

Scope

In 2012 the QAD visited around 700 firms (out of a total of 3,700, in line with a target of reviewing every firm in a 5 to 6 year period), and reviewed 1,230 audits, including 46 AIM and Plus companies and 216 charities. From these files, the general results were as follows:

- 20% Satisfactory
- 50% Generally acceptable but a small number of improvements needed
- 20% Some improvements needed
- 10% Significant improvements required

They say that firms have invested significantly in training, have updated their procedures for clarified ISAs and, increasingly, smaller firms are engaging training organisations and other specialists to supplement their own audit compliance resources. Nevertheless, some firms need to make significant improvements to their audit work, both in the underlying audit evidence and in the documentation of work done and key judgements.

With the increase in the number of requirements, some firms have voiced their concerns about spending too much time in the audit room completing detailed checklists at the expense of getting out and 'kicking the tyres'. The QAD says that firms need to keep sight of the key risks and make sure they obtain sufficient and appropriate evidence… and document it!

Audit evidence

Audits that need some or significant improvement generally lack audit evidence in one or more key areas. The report gives a brief comment on those areas and we have summarised these comments below. The QAD then provide what they refer to as "Top tips" which are incorporated in these notes.

Revenue

Detailed tests do not cover the correct assertion, particularly over completeness. Firms sometimes focus solely on the main income stream and do not adequately cover other streams which may be material. Completeness tests should start from outside the accounting system.

Firms may use substantive analytical review to audit revenue but do not always apply all the necessary steps in ISA 520. This includes the requirement to set appropriate expectations and thresholds.

There is confusion between substantive analytical review and the higher level analytical review procedures undertaken at the preliminary and completion stages of the audit. There is no point in trying to use substantive analytical review when it's unlikely to provide sufficient evidence - detailed testing may be more effective and easier and quicker to do.

Stock

If stock is material, attendance at the stock count is required unless impracticable; inconvenience or cost are not acceptable reasons for not attending.

Where tests of existence are performed other than at the year end, then it is necessary to test the period between the date of the tests and the year end.

Sometimes there are tests of cost but not net realisable value or vice versa. Tests must cover all relevant assertions. There is a need for professional scepticism when assessing stock provisions and net realisable value in the current economic climate.

Asset valuations/impairment

This is another area where the auditor should demonstrate professional scepticism by a robust assessment of the judgements made by management. In practice, there is often insufficient consideration of the valuation of properties and the life/value of goodwill.

A particular issue mentioned by the QAD is that auditors sometimes accept valuations made by third party experts without assessing their skills and objectivity, and without evaluating the significant assumptions used and the accuracy of source data. Remember that the ISAs differentiate between a management's expert (dealt with in ISA 500.8) and an auditor's expert (dealt with in ISA 620).

Impairment tests are not always performed even if the business is loss-making. The QAD also finds flaws in the way that the 'recoverable amount' and cash-generating units are determined when management performs impairment tests.

Going concern

For Going Concern, some firms are not obtaining information from directors, not testing the assumptions behind the information and/or not confirming if the directors really have looked forward 12 months from the date of approval of the accounts.

Documentation

Good documentation protects firms; it isn't just about satisfying the regulator!

The QAD lists reasons why significant weaknesses occur:

- Important information is known to partners or staff but not recorded.
- Audit evidence through accounts preparation work is not properly identified or recorded.
- At firms using electronic systems, all or part of an audit section is missed from the archived audit file.
- Discussions with the client, key audit judgements and the reasoning behind them are not always properly recorded.

A good final review of the audit file should pick up any significant holes in documentation, so the QAD concludes that sometimes the review process has not been effective.

Risk assessment

Good risk assessment is key to a good audit file and firms need to demonstrate that they go through the relevant processes, particularly in the areas of fraud and internal controls.

Fraud may be considered but the consideration is not always documented. In particular, there is often no record on file of a discussion with management.

The audit team meeting should address the possibility of fraud.

Appropriate tests must be devised to address the deemed significant risk of management override and the presumed significant risk of fraud in revenue recognition.

Firms should remember an understanding of controls is required, even if the audit is purely substantive. Controls relevant to the audit (eg, those relating to key transaction streams) should be identified and documented. Their design should be considered and the file should include confirmation that these controls have been implemented (eg, by a walkthrough test).

Other ISA requirements

Clarified ISAs introduced some new requirements covering accounting estimates and the audit file must show how the firm considered the risks in these areas and concluded that the assumptions were reasonable. Some firms are not identifying significant estimates at the planning stage and do not always take all the appropriate steps to check their reasonableness.

Clarified ISAs also introduced a requirement for auditors to establish a full record of related parties in addition to covering the completeness and disclosure of related party transactions. Firms may be confident they know who the related parties are but audit files often do not contain a full list. The QAD reports they sometimes find transactions with related parties that should have been disclosed but were not.

The QAD often raises points for improvement in the area of group audits, especially about the level and timing of the firm's input into work done by component auditors. See FAQs on group audits later in these notes.

The report comments that the QAD has raised a range of points relating to other ISAs and this confirms a need for firms to familiarise themselves more closely with the requirements by reading the text of the ISAs (in conjunction with the guidance in their audit system) and not try to rely on checklists in isolation as sometimes appears to be the case.

Ethical standards

The QAD continues to raise issues relating to independence and ethics but they range in seriousness. Non-audit services must be identified and safeguards identified. For example, if the firm is providing accountancy services, is there a self-review threat, or is the work so extensive that there is a management threat? Only by identifying and classifying the threat can the firm decide what safeguards may be appropriate, or at the extreme, whether it's appropriate to continue as auditor.

[Editor: I would add to the above the need to ensure that the safeguards are operated.]

Family, staff or other connections with audit clients are sometimes accepted without sufficient thought. Examples the QAD has seen include a subcontractor being a director of an audit client and the audit partner's daughter being a director of an audit client. Firms should ask themselves if the situation would pass the newspaper test: if a problem were to hit the press, would the connection stand up to public scrutiny?

In 2012 the QAD found a number of issues surrounding trustee shareholdings. They recommend that the firm clearly documents the risks and the matching safeguards and refers to Audit News 52. Consultation with either ICAEW or other appropriate organisation might also be helpful.

Cold file reviews

Cold file reviews (reviews of completed audit engagements) are key to effective self-regulation by firms. Around 60% of firms that were the subject of a detailed report to the Audit Registration Committee (ARC) in 2012 had ineffective cold file reviews.

Firms must also ensure that following the cold review process, there is a mechanism for ensuring that appropriate action is taken to address the findings.

ISQC1 states that a cold file review should not be carried out by someone involved in the audit. Where a firm does not have enough experienced staff to conduct independent cold file reviews they should engage an external cold file reviewer at least every third year while continuing to conduct (internal) cold file reviews in the intervening years.

Visit outcomes

Overall quality remains very similar to that found in 2011 although clearly a different population of firms was visited.

- Visits closed without follow-up action 71%
- Some further follow-up action 20%
- Detailed report to Audit Registration Committee (ARC) 9%

The table below sets out ARC action in 2012:

- Registration withdrawn 17
- Firms where conditions and restrictions were imposed 40
- Firms where conditions were imposed 20
- Voluntary withdrawal accepted after adverse QAD visit 6

The regulatory penalties that the ARC imposes are reported in economia each month.

The following points are those that the ARC views most seriously:

- Failure to meet the criteria for eligibility to be a registered auditor;
- Misleading statements on the annual return, for example, firms saying that they had completed audit compliance reviews when this was not the case;
- Independence issues not identified or not properly considered by firms;
- Failure to comply with the conditions imposed by the ARC;
- Failure to deliver on assurances given to the ARC; and
- Signing of audit reports by a person who was not a responsible individual.

AUDITED ENTITY USES AN INVESTMENT MANAGER AS A SERVICE ORGANISATION (LECTURE A438 – 10.11 MINUTES)

The problem and a possible solution

I have frequently criticised firms for a failure to audit investments properly where those investments are under the control of an investment manager. The response that I get from firms varies but often they comment that they are uncertain as to the work that should be performed.

The classic error made by auditors is that they rely on the statement received from the investment manager. This is, of course, useless since Paragraph A26(c) of ISA 402 says:

"If the user entity does not maintain independent records, information obtained in confirmations from the service organisation is merely a statement of what is reflected in the records maintained by the service organisation. Therefore, such confirmations do not, taken alone, constitute reliable audit evidence."

Auditors have adopted various responses to this problem. The common response is to obtain a Type 2 report on the investment manager. However, this does not solve the problems. One point that auditors fail to grasp is that the type 2 report only refers to the operational effectiveness of controls and gives no substantive evidence concerning the existence and ownership of the investments.

The most recent response I came across was that the auditor asked the client to maintain their own record of the investment transactions so that they could establish their own measure of the shareholdings at the end of the year. The auditor believed that this would then make the situation equivalent to the confirmation from a bank of a bank balance. However, this was also useless as audit evidence since the client's records were produced using contract notes sent by the investment manager. Any half-competent crook can manage consistency between a set of (false) contract notes and a (false) year-end statement.

In my view, the answer lies in Paragraph A26(c) of ISA 402 which says:

"For example, when multiple service organisations are used, such as an investment manager and a custodian, and these service organisations maintain independent records, the user auditor may confirm balances with these organisations in order to compare this information with the independent records of the user entity."

Therefore, the auditor needs to obtain a separate confirmation from the custodian as distinct from the investment manager. This may seem confusing since the investment managers may be called AB (Investment Managers) Ltd whereas the custodian is called AB (Nominees) Ltd but I think the answer to the auditor's problem can be found in this separate confirmation.

In practice, the investment manager wants to offer a seamless service to their client (the user entity) and therefore wishes to present information to the user entity about both share holdings and valuation. The investment manager may see no need to provide a separate confirmation from AB (Nominees) Ltd. However, the auditor needs a separate confirmation from the custodian direct to the auditor and the audited entity needs to be asked to facilitate the provision of that confirmation.

Some people might say that, if AB is a crook, then AB (Investment Managers) Ltd and AB (Nominees) Ltd might well be colluding to defraud the client. However, this separation of management from custodianship is an FCA requirement so the FCA sees this separation as a protection for the consumer. It is unfortunate that the CASS auditor's return to the FCA is not publicly available – although, hopefully, we can trust the FCA to ensure that all custodians do obtain such an assurance opinion every year.

One other suggestion is that, for those auditors who are wedded to their Type 2 reports then make sure that the report covers the separate activities of the custodian.

Case study

This is an extension to a case study presented in the quarterly notes in December 2012. The new material is highlighted in bold and deals with the problem of ownership.

The Tracey Foundation was established to support scientific research by an individual who upon their death left a significant legacy to continue the charitable works. The trustees have invested £10M with the investment managers Creighton-Ward.

How should the auditor approach this element of the audit?

Firstly, the auditor needs to establish how this affects the financial statements. The year-end valuation of the investments is presented in the balance sheet at the valuation produced by Creighton-Ward. In this regard the auditors need to consider the impact of management's expert.

The gain/loss on investments and investment income presented in the SOFA may also be obtained from figures produced by Creighton-Ward.

Also, the record of investments held by the investment managers needs to be considered. In all likelihood an element of the charity's internal control has been outsourced to a service organisation.

The auditor should:

- Through discussions with the trustees of the Tracey Foundation and Creighton-Ward, establish an understanding of the internal controls in relation to holding and recording investments and recognising income, gains and losses. The internal controls might be present in both the charity and the investment fund manager. Remember that the auditor should understand the design and implementation of internal controls.

- Assess the risks of error based upon their understanding of the internal controls and other relevant factors. The audit tests are then designed in response to these risks.

- Consider whether it might be possible to rely upon internal controls within Creighton-Ward. This might be possible if the appropriate reports on internal control are available from the investment fund manager's auditor. These reports are often known as type 2 reports. In practice this is rarely an option.

- In the absence of a control based approach, develop a suitable substantive approach. Gains/losses can be audited using tests of detail, vouching income from expectations formed based on external data on dividends declared etc.

- Subject the year-end report of the investment manager to tests of detail. In all likelihood sampling will be used to confirm existence and valuation. Note that, regardless of the reputation of Creighton-Ward, some audit evidence is required.

- **Ownership and rights/obligations should be tested by writing to the custodian and requesting confirmation direct to the auditor of:**

    - **Investment ownership i.e. held by the custodian on behalf of the charity, which should be the beneficial owner; and**

    - **The absence of any charges, liens etc.**

Comments on case study:

1. In my opinion, the auditor should regard the investment manager, Creighton-Ward (CW), as equivalent to an in-house department of the Tracey Foundation (TF). In this case, the auditor ceases to regard CW as a third party and it doesn't matter whether or not they are given the title of "management's expert". There seems to be little point in obtaining a Type 1 or Type 2 report on CW since sufficient information about the system of internal controls may be obtained from TF. A suitable Type 2 report would however permit a reduction in the sample sizes for the test described in 2.

2. The auditor subjects the year-end report of CW to tests of detail in exactly the same way as a report prepared by an internal investments department. For quoted investments, the valuation of the items selected for testing can be confirmed to publicly available information. If there are unquoted investments then the basis of the Trustee's valuation would need to be considered.

3. I would want to confirm that the custodian is a genuine organisation by checking to FCA data. It would be worth trying to obtain a Type 1 or Type 2 report on the custodian.

4. Some suggest that a further test should be performed of ownership of investments as follows. For the items selected from the year-end report, establish (from an independent information source) the date that dividends were paid by the investee companies. Confirm that those dividends have been credited by the investment manager to the charity's account without undue delay. This test is designed to identify fictitious items on the list of investments since, in the absence of an investment, there will be no dividends received. I doubt the value of this test since the fraudulent investment manager can easily credit fictitious dividends to hide the non-existence of the fictitious investments. However, I am told that fraudsters will often fail in this sort of detail and therefore the test may be worth doing.

FAQS ON GROUP AUDITS (LECTURE A439 – 15.55 MINUTES)

This section of the notes is based on an article (FAQs) that appeared in Audit and Beyond in March 2012. The article was written by Richard Gillin who is director, national accounting and audit, at Deloitte. I have used Richard's questions but the answers provided are my own. I am including these FAQs because of the ongoing problems in this area identified by the QAD.

Q. Can I accept an appointment as a group auditor when my company does not audit many (or any) of the group components?

A. Yes you can. Rather flippantly it might be said that a firm has to be found to perform the group audit so why should it not be your firm. The key is whether you are happy with the work of the component auditors. Paragraph 19 of ISA 600 requires the group engagement team to obtain an understanding of the following:

- Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.

- The component auditor's professional competence.

- Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.

- Whether the component auditor operates in a regulatory environment that actively oversees auditors.

If a component auditor does not meet the independence requirements relevant to the group audit, or the group engagement team has serious concerns about the other matters listed above then paragraph 20 requires the group engagement team to obtain sufficient appropriate audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component.

Note that there is no difference between using a network firm and an unrelated firm as a component auditor as ISA 600 does not distinguish between network and non-network firms.

Q. What happens when component auditors' documentation is not published in English?

A. The group auditor has to obtain sufficient appropriate audit evidence to issue an opinion on the group accounts. If the group auditor cannot understand the correspondence received from the component auditor then it will be necessary for the key documents to be produced in English.

Q. Do I need to review the component auditors' files?

A. Paragraph 42 of ISA 600 states:

"The group engagement team shall evaluate the component auditor's communication (see paragraph 41). The group engagement team shall:

(a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and

(b) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation."

This might mean that it is unnecessary to review other parts of the component auditor's file. This decision will be influenced by the group auditor's assessment of risk and the significance of the component. Paragraph 43 also envisages that the group engagement team might conclude that the work of the component auditor is insufficient. In this case, additional procedures must be performed, either by the component auditor or by the group engagement team.

Q. I want to review the component auditors' files. Can I insist they give me access?

A. The Companies Act 2006 requires auditors of UK subsidiaries to provide such information and explanations as the group auditor thinks necessary for the performance of their duties as group auditor (s499).

However this does not apply to overseas subsidiaries. Section 500 of the Act requires a parent company, if requested by the group auditor, to obtain information from the auditor of a subsidiary. But, as they are outside of the UK, the Act cannot force them to do anything.

Note that, neither s499 nor s500 applies to components other than subsidiaries (for example, joint ventures and associates). Also, “Information and explanations” does not necessarily include a copy audit file.

In situations where a component auditor is not obliged to co-operate, Richard Gillin suggests that it may be possible to enter into a hold harmless agreement with them. The group auditor can still rely on the component auditors’ work – just at their own risk. He points out that ISA 600 requires the group auditor to take sole responsibility for the group audit opinion anyway.

Q. The QAD are critical about the level and timing of the group auditor’s input into work done by component auditors. What is the requirement concerning risk assessments?

A. Paragraph 30 of ISA 600 states:

“If a component auditor performs an audit of the financial information of a significant component, the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements. The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but at a minimum shall include:

(a) Discussing with the component auditor or component management those of the component's business activities that are significant to the group;

(b) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and

(c) Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.”

Richard Gillin suggests that this can be achieved by:

- Arranging a call with the component auditor so that they can participate in the group audit team’s discussion of risk including consideration of fraud risk and related parties.
- Obtaining a copy of the component auditor’s audit plan. If this covers both the identification of significant risks and the planned response, it will also assist with the requirement in paragraph 31 of ISA 600 to evaluate the appropriateness of the response to identified significant risks.

Doing this at the planning stage will avoid late surprises for the group auditor and group management.

AMENDMENTS TO ISA (UK AND IRELAND) 700 – AUDIT REPORTS
(LECTURE A440 – 4.47 MINUTES)

For audits of financial statements for periods commencing on or after 1 October 2012, there will be more information needed in the auditor's report for those entities that are required to apply the UK Corporate Governance Code.

The new requirements are found in paragraph 19A. The auditor's report shall:

- Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.

- Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole.

- Provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement disclosed in accordance with (a) and was influenced by the auditor's application of materiality disclosed in accordance with (b).

With respect to the first bullet point, how will auditors decide which risks to report? Will it be the risks assessed as significant? Will the auditor need to rank all assessed risks in order of their effect and then report the top 5 or 10? Or will it be the case, as some commentators are suggesting that all assessed risks will be reported?

The Application Material indicates that the explanation relating to materiality might include area materialities, performance materiality, significant revisions made during the audit, the threshold for reporting unadjusted differences to the audit committee and significant qualitative considerations relating to the auditor's evaluation of materiality.

Moving on to the final bullet point, the content of the overview of the scope of the audit is tailored to the particular circumstances of the audit and how the scope was influenced by the auditor's application of materiality and addressed the assessed risks of material misstatement described in the auditor's report. The Application Material suggests, inter alia, that the summary might also include, for example, the coverage achieved of revenue, total assets and profit before tax.

Paragraph 19B contains requirements designed to make the new information useful to users of the financial statements.

The FRC has issued an example of an auditor's report which complies with the revised standard. However, this merely indicates the format of the report showing where the new information would be placed. Presumably the FRC has decided that it would be unwise to provide more detailed examples as such examples might lead to standardised wording.

It should be noted that the IASB has issued an exposure draft of proposed amendments to a number of auditing standards that affect the auditor's report. This ED has similarities to the recent changes introduced in the UK. The interesting question is whether and to what extent the changes currently being introduced by auditors of listed companies in the UK might, in due course, apply to auditors of other entities.

OTHER AUDITING FAQS (LECTURE A441 – 10.40 MINUTES)

Taking over an audit when the previous auditors have not completed audit resignation procedures

Question: During the year there has been a management buy-out of a subsidiary from a large group. We have been appointed as auditors.

XYZ, the previous auditors, have not replied to a couple of letters seeking professional clearance. What should be done?

XYZ's letter of resignation as auditors has not been filed at Companies House. What should be done?

Does this firm have right of access to XYZ's audit working papers?"

Response: Even though management might want to appoint your firm as auditors, they cannot do so until the previous firm have resigned or been removed from office.

The company should write to XYZ requesting the letter that they are required to give under s516 CA 2006 when resigning as auditors. It is the company's responsibility to file this at Companies House. If XYZ were to say that they are not resigning but are being removed from office then the procedures in s510 - 513 must be followed (more complicated and time consuming).

Since the auditor is ceasing to hold office before the end of his term of office, it will also be necessary to complete the formalities in s522 and s523.

Following their resignation (or removal from office) you should send your "clearance" letter to XYZ again. You should add a final paragraph saying that if they do not reply you will treat this as being that they have no matters to bring to your attention. Send this letter by recorded delivery and keep a record on file.

You do have the right of access to information from XYZ. If they fail to give you access to information you consider you require then you should consider reporting them to their supervisory body.

Access to work of another firm of auditors

Question: Following completion of the 2012 audit for X Ltd, we lost the client to another firm for 2013 as the client was considering listing overseas.

However, the client would now like to come back to us for 2013, mainly for cost reasons. The new auditors had done some work for 2013 but have now resigned as the client asked them to stop working. The statement of circumstances did not refer to any circumstances connected with their resignation. Can we obtain access to the work already undertaken by the other firm under the Companies Act even though they never reported as auditors?

Response: The wording in Regulation 3.09 refers to audit work undertaken by a registered auditor. It does not make any reference to the need for an audit report to have been issued. Regulation 3.09 suggests therefore that you should still have access to the other firm's work notwithstanding that they did not complete the engagement.

Limitation of liability on pension scheme audits

Question: Our pro-forma engagement letter for the audit of a pension scheme does not have a limitation of liability paragraph. Are we able to limit our liability on the pension schemes we audit or are there any rules in any pension scheme legislation/other legislation which restrict this?

Response: It is (and always has been) permissible to limit your liability in respect of the audit of entities other than companies.

Historically the Companies Act did not allow such limitation for companies and this tended to be carried over to other audits as well. Limitation of liability is permitted under CA 2006 but, whilst it is permitted, it is complicated and most firms do not bother. For this reason limitation of liability clauses are not often included in sample engagement letters – be they for audits of companies or non-company entities.

Limitation of liability is possible for pension scheme audits. However, drafting clauses that would be effective is a different matter. The ICAEW have a couple of help sheets dealing with limitation of liability and these may give you some ideas if you wanted to do this.

Director of audit client refusing to sign letter of representation

Question: The sole director of an audit client is refusing to sign the letter of representation. He says that we should perform whatever work is necessary rather than ask him to do our work for us. Can we perform alternative procedures to make the letter of representation unnecessary? What impact does his refusal have on the auditor's report?

Response: This scenario is addressed in ISA 580.19. This states:

"19 If management does not provide one or more of the requested written representations, the auditor shall:

(a) Discuss the matter with management;

(b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with ISA (UK and Ireland) 705, having regard to the requirement in paragraph 20 of this ISA (UK and Ireland)."

You therefore need to discuss the issue with the director, explain why the letter is needed and try and establish why they will not sign. Various possibilities can be identified.

Firstly, the director may be prepared to sign a letter that contains those representations required by ISAs. However, the director is not prepared to provide additional representations where (in the words of ISA 580.13) the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

I have some sympathy with this view and it may be possible to gather alternative evidence in certain situations. However, it may be that you are merely asking the director to confirm in writing those representations which were previously given orally. In that case, refusal to confirm a representation in writing would certainly put the auditor on alert and may even cause a breakdown in the relationship between the two parties.

Secondly, the client might refuse to provide any representations. Paragraph 20 of ISA 580 requires the auditor to disclaim an opinion on the financial statements if management does not provide the written representations required by paragraphs 10 and 11 or if the auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 10 and 11 are not reliable.

The representations required by paragraphs 10 and 11 deal with management's responsibilities i.e.:

- Management has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation.
- Management has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement.
- All transactions have been recorded and are reflected in the financial statements.

Finally, faced with paragraph 20 of ISA 580, the director may decide to provide representations concerning responsibilities while still refusing the other compulsory representations required by other ISAs (dealing with, e.g., laws and regulations, related parties, subsequent events etc.).

Now the auditor will need to consider each requirement in turn to decide whether there is a need for a separate qualified opinion with respect to each separate missing representation. It is probably more likely that the auditor would disclaim an opinion. In this case, in response to paragraph 21 of ISA 705, the auditor describes in the basis for modification paragraph all of the individual matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof. Under the heading of matters on which the auditor is required to report by exception, the following words will be used:

"Arising from the limitation of our work referred to above, we have not obtained all the information and explanations that we considered necessary for the purpose of our audit."

It is to be hoped that the client, when faced with the additional costs resulting from their refusal, might withdraw their opposition to signing the letter of representation.

SUMMARY OF DEVELOPMENTS

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

FRC publishes Audit Quality Inspections Annual Report 2012/13

The key highlights of this year's report are:

- An improvement in the overall standard of audit work, especially in the audits of FTSE 350 companies. 59% of audits inspected (46% 2011/12) were categorised as good or acceptable with limited improvements required. 79% of FTSE 350 audits inspected (55% 2011/12) were in these top bands.
- This improvement is not uniformly spread across all the firms and types of entities: 15% of audits (10% 2011/12) were assessed as requiring significant improvement; of which 87 % (63% 2011/12) were for audits of entities outside the FTSE 350.
- The inspections found that, while progress has been made, firms need to maintain and in some cases reinforce their efforts on professional scepticism.

Paul George, Executive Director Conduct said:

"Audit makes a vital contribution to investor confidence in financial statements. We are pleased to see in this year's results that firms' efforts to address our concerns on professional scepticism are bearing fruit, particularly in the FTSE 350. It is important that further improvements are more uniformly and consistently achieved across all entities and by all firms."

Key messages from the report include:

- Focus on audit quality - firms should ensure that audit efficiencies are not achieved at the expense of audit quality.

- Improving professional scepticism - while recognising the progress that has been made in embedding the exercise of professional scepticism in audit work, further improvements are needed, particularly in smaller audits.

- Improving audit quality in the financial services sector - firms should strengthen their testing in respect of loan loss provisioning and general IT controls.

- Group auditors need to ensure they are sufficiently involved in all stages of the work of component auditors.

- Enhancing auditor independence and ethical issues - firms should reconsider the adequacy of their independence and ethics procedures and the training they provide to staff at all levels. Auditor independence is also important for audit committees to consider and in particular when putting their audit out to tender.

- Ensuring high quality internal monitoring - firms should reconsider the robustness of their internal monitoring processes and the extent to which they contribute to an improvement in overall audit judgments.

Included in this year's inspection report is a focus on those companies where the substantive operations and general, financial and corporate management are in a different country to that of the auditor. These companies, where the majority of the audit work is often performed by component auditors, pose risks to the audit. When auditing such companies firms should recognise the risks inherent in such arrangements and ensure they have sufficient involvement in the audit work of component auditors to enable the engagement partner to lead and control the audit as a whole.

29 May 2013

Going concern guidance *(Lecture A443 – 5.29 minutes)*

In January the FRC consulted on how best to implement Lord Sharman's proposals on going concern. The FRC is pleased with the considered responses/feedback to its recent Consultation Paper Implementing the Recommendations of the Sharman Panel – Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland).The majority of respondents supported the principles behind the recommendations advocated by Lord Sharman's report, "Going Concern and Liquidity Risks: Lessons For Companies and Auditors". The FRC therefore encourages all companies to consider and abide by the principles.

In terms of the development of guidance in support of the principles the FRC has decided to take up a number of proposals and will:

- Issue separate, simplified guidance for SMEs. As was anticipated in the consultation questions, feedback has been that recommendations for SMEs could be more proportionate.

- Make a clearer distinction as to the meaning of going concern in the context meant by the Sharman panel. The feedback highlighted that the use of going concern to describe both the specific assessment required when preparing the financial statements, and the broader assessment of the risks affecting a company's viability, was confusing. The FRC will consult on whether changes to the UK Corporate Governance Code are needed to make the distinction clearer; if so, they will take effect in October 2014.

- Make a clearer link between the assessment of business viability risks and the broader risk assessment that should form part of a company's normal risk management and reporting processes. FRC will consider this in the development of the Code and related guidance on risk management and internal control.

Melanie McLaren, Executive Director Codes & Standards said:

"We believe going concern guidance information is crucial for all investors and are pleased respondents confirmed this in principle. We have listened to all the views expressed on the details of our proposals and are now able to prepare more appropriate proposals for all businesses large and small. "

The FRC expects to issue further consultation documents in the Autumn covering SMEs, proposed changes to the Code, and integrated going concern and risk management Code guidance.

06 June 2013

FRC prohibits the use of internal audit staff on the external audit team

The FRC today introduces a measure that creates a clearer division of responsibility between internal and external audit teams to safeguard against conflicts of interest. By prohibiting auditors from using internal audit staff as "direct assistance" members of the audit team, the FRC is seeking further to ensure the independence of the external auditor and promote greater confidence in the integrity of the audit for investors.

The prohibition comes into effect for audits of financial statements for periods ending on or after 15 June 2014.

Nick Land, FRC Board member and chairman of the Audit and Assurance Council, said:

"Prohibiting direct assistance supports stakeholders' expectation that external auditors should be free from threats to their independence. In determining the effective date of the prohibition, the FRC has taken into consideration that planning the use of the work of internal auditors may take place early in the financial period being reported on."

In February 2013, the FRC confirmed that it would adopt the revised international auditing standards on the external auditor's use of work carried out by internal audit.

In doing so, it also announced that it was minded to go beyond the international standard, and prohibit the direct use of internal audit staff on the external audit team, to enhance the principle of auditor independence.

The feedback to the consultation suggested that there could be logistical issues for audits that have already begun when the prohibition comes into effect. To remedy this, the FRC concluded that the prohibition should be applied prospectively and the implementation date reflects this.

Other revisions to the FRC's auditing and ethical standards to reflect the revised international auditing standards on the external auditor's use of work carried out by internal audit will also have the same effective date.

19 June 2013

FRC highlights the audit risks of housing associations

The Financial Reporting Council (FRC) has today issued a proposed revised version of its practice note on 'The Audit of Housing Associations in the United Kingdom'.

The proposed practice note reflects:

- Changes to the environment in which Housing Associations operate:
    - Pressures on public expenditure which have led to welfare reforms and lower grant funding and revenue support for Associations;
    - Changes in the pattern of financing which have resulted in a migration away from bank debt to the bond market; and
    - Various pressures on Housing Associations to diversify from not for profit to commercial operations and into more complex corporate structures.
- Regulatory developments, including where regulators assess Associations' financial viability, which are likely to be a useful source of audit evidence.

Nick Land, FRC Board member and Chairman of its Audit and Assurance Council said,

"UK Housing Associations provide some 3 million homes and have attracted in excess of £50 billion in bank and capital finance. This economically important sector of the UK economy has its own particular business and audit risks which auditors need to be aware of and respond to, when undertaking engagements in the sector."

25 July 2013

FRC updates guidance for the audit of financial instruments

The FRC today issues updated guidance for audits of entities of all sizes that may be subject to the risks associated with using financial instruments. The guidance aims to enhance investor confidence in the depth and reliability of the audit.

Nick Land, FRC Board member and chairman of the Audit and Assurance Council, said,

“Financial instruments is an area of financial reporting involving complex issues, which came under particular focus in the financial crisis. This new update is intended to assist auditors in understanding the nature of, and risks associated with, financial instruments, the different valuation techniques and types of controls that may be used by entities in relation to them, and identifies the important audit considerations.”

The FRC previously issued updated guidance for auditors in 2009 and consulted on the updated guidance in October 2012. The updated guidance is given in Practice Note 23, Special Considerations in Auditing Financial Instruments, and reflects the clarified International Standards on Auditing (ISAs) (UK and Ireland) and guidance issued by the International Auditing and Assurance Standards Board (IAASB) in its International Auditing Practice Note (IAPN) 1000. The final updated guidance is substantially unchanged from that consulted upon.

25 July 2013

FRC proposes updates to UK GAAP for insurance

The FRC has today issued a draft new UK accounting standard for insurance (FRED 49: Draft FRS 103 Insurance Contracts).The proposals rationalise existing UK accounting provisions for insurance rather than establishing new requirements. They build on the current global standard while enabling UK insurance accounting practices to be retained.

Draft FRS 103 follows on from the 2012 Discussion Paper ‘Insurance Accounting - Mind the UK GAAP’ and applies to those entities applying FRS 102 that have insurance contracts; life and general insurers including mutuals and non-listed subsidiaries of listed entities. The draft Implementation Guidance accompanying draft FRS 103 is drawn from the existing FRS 27 Life Assurance and the ABI’s Statement of Recommended Practice. The FRC expects little change in accounting by entities within their scope.

Other entities which are not regulated insurance businesses but which have contracts meeting the definition of insurance will need to apply certain aspects of draft FRS 103.

Roger Marshall, Chair of the FRC’s Accounting Council said:

“The FRC aims to provide succinct financial reporting standards, which have consistency with international accounting standards unless an alternative is clearly better; reflect up-to-date thinking and developments in the way entities operate and the transactions they undertake; and balance consistent principles with practical solutions. We believe that draft FRS 103 and its accompanying Implementation Guidance does this by consolidating several standards and pieces of guidance for insurance contracts. At the same time we have been mindful of the importance of not imposing multiple changes in accounting and reporting for insurers in quick succession."

The FRC is issuing the draft now so that it can be finalised in time for the wider mandatory implementation of UK GAAP by 1 January 2015.

The FRC stresses that these developments are distinct from the IASB's current proposals on insurance contract accounting. The FRC will only consider international developments and their potential adoption in UK GAAP when there is much more certainty about the outcome of the IASB's work.

29 July 2013

FRC issues FRED 50 **(LectureA442 – 8.52 minutes)**

The FRC has today issued a financial reporting exposure draft FRED 50 containing Draft FRC Abstract 1 Residential Management Companies' Financial Statements (draft FRC Abstract 1) and consequential amendments to the FRSSE.

The FRED sets out how residential management companies should recognise transactions with third party suppliers in their financial statements when discharging their duties to manage and arrange maintenance of a property. The FRED reflects that residential management companies act as principals (not agents) in such transactions.

Aligned with the implementation of the new UK GAAP standard FRS 102, the proposed effective date of draft FRC Abstract 1 and the consequential amendments to the FRSSE is applicable for accounting periods beginning on or after 1 January 2015 with early adoption permitted.

The FRC are inviting comments to be received by 11 November 2013.

Accordingly, UITF Information Sheet 92 containing UITF Draft Abstract 49 Residential Management Companies' Financial Statements, which was issued by the FRC in May 2012, is withdrawn.

5 August 2013