ACCOUNTING AND AUDIT UPDATE

Tolley®CPD

December 2013

Disclaimer

Tolley CPD takes every care when preparing this material. However, no responsibility can be accepted for any losses arising to any person acting or refraining from acting as a result of the material contained in these notes.

All rights reserved. No part of these notes may be reproduced or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of Tolley CPD.

Tolley® Tax intelligence from LexisNexis®

TABLE OF CONTENTS

FRS 102: TOP TEN THINGS TO THINK ABOUT NOW! (LECTURE A444 – 25.47 MINUTES) 4
Which Standards will you apply? 4
Preparing directors and accountants for the impact of FRS 102 5
The expense of transition 6
Mind the GAAP – small companies are different 6
The impact on the accounts from the users' view point 7
Fixed Assets – cost or deemed cost? 8
Arrange valuations 8
Is your accounts preparation software up to the job? 9
Tax implications and iXBRL Tagging 9
Choices for subsidiaries 9

FRS 102: THE KEY DIFFERENCES (LECTURE A445 – 16.17 MINUTES) 11
Terminology changes 11
Changes to accounting practice 12

THE FRSSE (LECTURE A446 – 9.04 MINUTES) 26
Does the FRSSE have a future? 26
Consequential amendments 26

FRS 102 SECTION 16: INVESTMENT PROPERTY (LECTURE A447 – 13.34 MINUTES) 31
Requirements under current UK GAAP 31
Requirements under FRS 102 31

FRS 102 SECTION 17: PROPERTY, PLANT AND EQUIPMENT (LECTURE A448 – 13.06 MINUTES) 33
Initial recognition 33
Components of 'cost' 34
Subsequent measurement 34
Depreciation 35

FRS 102 SECTION 18: INTANGIBLE ASSETS OTHER THAN GOODWILL (LECTURE A449 – 10.11 MINUTES) 36
Scope 36
Definition 36
Recognition criteria 36
Internally generated intangible assets 37
Research and development costs 38
Amortisation 40
Review of estimates 41
Disclosures for intangible assets 41

FRS 102 SECTION 20: LEASES (LECTURE A450 – 12.10 MINUTES) 44
Leases beyond the scope of Section 20 44
Finance and operating leases 44
Determining the amounts in a finance lease 46
Subsequent measurement – finance leases 46
Subsequent measurement - operating leases 47
Lessor accounting – finance leases 47
Lessor accounting – operating leases 48
Disclosures – finance leases (lessee's financial statements) 49
Disclosures – operating leases (lessee's financial statements) 50

Disclosures – finance leases (lessor's financial statements) 50
Disclosures – operating leases (lessor's financial statements) 51
Leasing – the future? 51

FRS 102 SECTION 24: GOVERNMENT GRANTS (LECTURE A451 – 7.17 MINUTES) 52
Recognition and measurement 52
The performance model 53
The accrual model 53
Disclosures 55

CASH ACCOUNTING FOR SMALL UNINCORPORATED BUSINESSES (LECTURE A452 – 10.25 MINUTES) 56
Optional regime (but, once in; stay in) 56
Excluded persons 57
Entry and exit thresholds 57
Cash basis profits and losses 59

ASSURANCE REVIEW ENGAGEMENTS (LECTURE A453 – 6.29 MINUTES) 61
Compliance with ethical standards 62
Quality control 62
Acceptance and continuance of client relationships 62
Liability limitation and risk management 63
Going concern 64

ISA 230 *AUDIT DOCUMENTATION* (LECTURE A454 – 7.30 MINUTES) 65
Definitions 65
Illustration of audit documentation preparation 66
How much is the right amount of audit documentation? 67
Audit documentation after the auditor's report has been issued 67
Assembly of the audit file 68

AUDIT FAQS (LECTURE A455 – 19.07 MINUTES) 69

SUMMARY OF DEVELOPMENTS 75
FRC responds to Competition Commission's Provisional Decision on Remedies 75
FRC consults on strategic report guidance 76
UK and US regulators agree to continue arrangements for cooperation on cross-border supervision of audit firms 76
FRC to enable the electronic filing of accounts based on its new financial reporting standards 77
FRC to consult on executive remuneration 77
FRC publishes Corporate Reporting Review Annual Report 78
FRC publishes Financial Reporting Lab report on Reporting of Audit Committees 78

FRS 102: TOP TEN THINGS TO THINK ABOUT NOW! (LECTURE A444 – 25.47 MINUTES)

The implementation of FRS 102 is mandatory for periods commencing 1st January 2015 but that is not as far away as you would think. A year end of 31st December 2015, will typically have a transition date of 1st January 2014.

So, what do company directors, users of financial statements, auditors and accountants need to know about FRS 102 now?

Which Standards will you apply?

There are many choices that can be made upon adoption of new UK GAAP but typically:

- small companies will continue to apply FRSSE;
- listed groups will continue to apply full EU-adopted IFRS; and
- medium-sized and large companies will tend to adopt FRS 102 (see point 10, for other options, particularly for subsidiary companies).

Even taking this oversimplified view it will not be straightforward to determine which entities need to prepare for transition to FRS 102. At the time of writing, for a company to be classified as small it needs to meet two out of three of the following criteria:

	£
Balance Sheet	3.26M
Turnover	6.5M
Employees	50

New European Union directives, finalised in July 2013, permit this threshold to increase to:

	€	£ (approx.)
Balance Sheet	5.5M	5.4M
Turnover	12M	10.8M

(The Sterling equivalent is calculated using the same method that BIS used for the Micro Company accounting exemption thresholds).

At the time of writing, BIS have yet to announce how they intend to respond to this opportunity to widen the availability of small company exemptions. The whispers in the accounting community together with BIS's previous enthusiasm for accounting deregulation suggest that some increase in the thresholds is likely.

What all this means is that some companies do not currently know if they have the option of using the FRSSE (2015) instead of FRS 102. Hopefully BIS will make an announcement in the near future to give some certainty and clarity in this matter, but in the meantime some companies seem to be in a no-mans-land and advising such companies is difficult.

Preparing directors and accountants for the impact of FRS 102

One of the first things that needs to be understood is when and how transition occurs. Whilst the first mandatory period of adoption is for periods commencing 1st January 2015, the date of transition is much earlier.

Transition date is the first day of the earliest period of comparatives presented in the transition financial statements. So for a 31st December 2015 year end the transition date is 1st January 2014. An entity with a 31st December 2015 year end, who extended their previous accounting period could have a transition date as early as 1st July 2013!

It should go without saying that management of every entity applying FRS 102 should already have identified their date of transition. Yet it is possible that many might have never come across the notion of a transition date. It is important because there might be things to do before that date. Assets and liabilities may require measuring or remeasuring, decisions might need be made and most importantly, opportunities might be missed!

In short, the word needs to be spread.

One final point, mandatory adoption might be from periods commencing 1st December 2015 but early adoption of FRS 102 is permitted from periods ending 31st December 2012. As a general rule this is to be avoided. Do you want to be the first person to go through transition, use the accounting software and iXBRL tag the accounts? If it can be avoided, no thanks! However, if a new company starts up and will be required to apply FRS 102 very shortly afterwards, early adoption does make some sense because you will avoid the need to go through transition. So, early adoption might suit some companies, but are there that many that will be medium-sized or large so early in their life?

The expense of transition

The financial statements might look a little different under FRS 102 and certain assets and liabilities are measured and recognised differently but the FRS 102 revolution starts with ***transition***!

First time adoption of FRS 102 is like adopting no other Standard that most accountants have seen! Unless, that is, you are familiar with first time adoption of IFRS under IFRS 1. In that case the subject of transition needs no introduction. First time adoption of IFRS 1, tends to leave scars on accountants that are slow to heal!

In short, first time adoption requires:

- the determination of a transition date;
- the re-measurement of all assets and liabilities at the transitions date, and perhaps the recognition or derecognition of certain assets and liabilities;
- the identification of prohibited restatements such as accounting estimates;
- the selection of one or more of seventeen exemptions available in the process; and
- the preparation and presentation of reconciliations and disclosures.

This is often time-consuming and sometimes, very time-consuming indeed. It usually takes days of extra time and sometimes weeks. This statement is not sensationalist it is merely factual. Ignore the workload of transition at your peril! Most companies will rely upon their accountants to help with this process and resulting additional fees of £5,000 to £10,000 will be commonplace. Everyone needs to be prepared for this.

The firm of accountants asked to help with transition will often, also be the firm's auditors. This will nearly always create significant threats to the auditors' independence, which will require safeguards to be applied and possibly the auditors might have to refuse elements of the engagement as being incompatible with being independent auditors.

Mind the GAAP – small companies are different

In 2015, small companies will have never have had it so good! As well as avoiding the onerous process of transition they will not have comply with some of the more challenging accounting requirements of FRS 102, such as:

- The fair valuing of investments in shares where a reliable valuation is possible.
- The fair value through profit and loss account approach to investment properties.
- Changes to the definition of investment properties where a group company is the tenant.
- The withdrawal of the option to use contract rates in foreign currency transactions.
- The requirement to value derivatives at fair value through profit and loss.
- The timing differences plus approach to deferred tax (if you have not come across this, don't ask!).

This is not meant to be an exhaustive list of the differences between FRS 102 and the FRSSE 2015, indeed it is just a few of the more major ones.

The point is that FRS 102 and FRSSE 2015 are different in a way that will not be familiar in the UK.

The relationship between the previous UK GAAP and the FRSSE 2008 is very different to this. It can be summed up as, the accounting is the same but small companies have reduced disclosure. That is not the case with FRS 102. The accounting is not the same and the disclosure might sometimes be reduced for small companies but it is also sometimes just different rather than reduced.

Why is all this important? Firstly, users of financial statements need to understand that there is no longer the same comparability between the financial statements of small companies and medium-sized and large companies. Or to put it another way, comparisons might require considerable thought and will need relevant adjustments.

Secondly, many in the profession believe that this difference is not sustainable and the FRSSE should be withdrawn and be replaced by FRS 102 in some form or other. Will the FRSSE still be around in five years' time?

The impact on the accounts from the users' view point

Comparing existing UK GAAP to FRS 102 is like a gigantic *spot the difference* competition. To begin with the two look similar with some obvious differences, but the longer that you spend looking the more differences you identify. After some time you start to realise that they are not half as similar as you thought they were as you continue to identify further subtle differences.

This is the experience that all directors, users and accountants will have over the next few years. What at first looks familiar is in fact very different in many ways.

There are also a number of choices for the preparers of financial statements to make. Such as, are the primary statements called the profit and loss account, balance sheet and cash flow statement, or the income statement, statement of financial position and statement of cash flows? Indeed there is a plethora of IFRS terminology in FRS 102; revenue not turnover; inventory not stock; property, plant and equipment not fixed assets; etc.

The choices are often between familiar names and presentations or different ways of doing things. It is tempting to opt for the familiar so as to reassure the users that nothing has changed. However, perhaps is it better to be more up front about the change and to opt to use the IFRS terminology, where possible, in order to underline the change not hide it?

Beyond terminology, FRS 102 contains a number of different approaches to the measurement and recognition of assets and liabilities. For examples look at the previous section. These will take some time to get used to

Fixed Assets – cost or deemed cost?

There are some accounting opportunities when adopting FRS 102 for the first time. One of the main ones is the option to bring in property, plant and equipment at deemed cost rather than book value, at the date of transition.

This opportunity might be used in a number of possible ways:

- A company could revalue, at transition, a property that has never previously been revalued. Previously, the company might have wanted to revalue, but the on-going commitment to regularly revalue the property, deterred them from doing so. Revaluing at transition does not mean that they need to adopt a policy of regular revaluation, although they could do if they chose to.

- A company who already has a policy of regular revaluation of their property, but wishes that they had not, could recognise the property at fair value at transition and then abandon that policy, leaving the property at the deemed cost at transition indefinitely.

- A company that has previously revalued their property, but wishes that they had not, could bring the property in at cost.

- All of this could also apply to any other category of property, plant and machinery. A group of assets that have previously been over-depreciated with a £1 net book value could be recognised at deemed cost (i.e. fair value) instead.

However, companies cannot ‘cherry pick’ the assets that benefit from this option. The whole category of assets must be recognised at deemed cost.

Arrange valuations

One of the reasons that preparing for FRS 102 transition is so important is that certain assets and liabilities may be recognised on the balance sheet for the first time, such as:

- Interest rate swaps

- Forwards contracts for the purchase or sale of foreign currency

- Forwards contracts for the purchase or sale of commodities

- Holiday pay accruals

- Intangible assets that are not separable from the entity

- Deferred tax liabilities under the new timing differences plus model, including, provisions for revaluations, fair value adjustments on acquisitions and unremitted earnings form subsidiaries

Other assets that might already be recognised on the balance sheet might be measured differently such as investments in shares, goodwill and fixed assets measured at deemed cost.

Where new valuations are needed companies might need to put new arrangements in place to obtain them. It might be possible to produce valuations retrospectively, several years after the transition date, but it is essential to give it some though now.

Is your accounts preparation software up to the job?

One stakeholder with a massive part to play is the accounts preparation software industry. A good FRS 102 template and a good disclosure checklist will be a Godsend as it will make the process of first time adoption more efficient and help with compliance.

Accountants should be talking to their software suppliers to make sure that the software is going to meet their needs and that it will be available on time.

Tax implications and iXBRL Tagging

There will, inevitably be tax implications upon adopting FRS 102. The taxable profit is based upon the accounting profit so changes to the way assets, liabilities, revenues and expenses are measured and recognised will have an effect.

HMRC will of course have views on the tax effects of these changes and some of the changes are likely to be contentious. Some thought needs to be given now, to accounting treatments that have a tax effect. Entities might need to consider the impact of changes to the tax charge on their future cash flows.

Also, the prior period adjustments necessitated by transition need to be properly accounted for, for tax purposes.

One high profile area that some have identified as a tax planning opportunity is the timing of revenue recognised on contracts for services. UITF Abstract 40, which addresses this subject, will be withdrawn and some point out, quite correctly, that FRS 102 is less specific than that Abstract when it comes to recognising revenue.

However, FRS 102 is less specific than a lot of standards, it is only 225 pages long! Its principles-based approach to revenue is similar to UITF 40, so if you fancy writing back all that revenue recognisable under contracts for services, best of luck!

Another big issue arises from the fact that, HMRC have required electronic submission of corporation tax returns for the last few years, which requires iXBRL tagging. Financial statements prepared under FRS 102 and FRS 101 should be tagged using the IFRS taxonomy. Best of luck with that to!

Choices for subsidiaries

A UK subsidiary of an IFRS adopting holding company will often have the choice of adopting IFRS, FRS 101 or FRS 102. If they are small they are also eligible for the FRSSE 2015!

Subsidiaries should be talking to their holding companies now, about which options are best. Here is a summary of these options with the pro's and con's:

- **IFRS** – will always be a good choice for IFRS-adopting groups, but the disclosures can be onerous.

- **FRS 101** (reduced disclosure regime) – also a very good option for IFRS-adopting groups, maybe the best even. IFRS recognition and measurement treatments, but with simplified disclosures. Accountants should approach FRS 101 with some caution, because potentially in FRS 101 lurks another learning curve to be climbed in addition to FRS 102.

- **FRS 102** – a serviceable option for IFRS-adopting groups. The recognition and measurement requirements are IFRS with some tweaks, so there could still be adjustments on consolidation, but not many. FRS 102 is the only realistic option for FRS 102 adopting parent companies.

- **FRSSE 2015** (where applicable) – keeps life simple for the subsidiary! The parent might not be so happy if they adopt IFRS because there could be a myriad of adjustments on consolidation. Even FRS 102-adopting groups might be unhappy with the FRSSE option for the same reasons.

Of course do not forget that the fist-time adoption procedures for each of these options are different!

FRS 102: THE KEY DIFFERENCES (LECTURE A445 – 16.17 MINUTES)

It has always been the intention by the Financial Reporting Council (FRC) (and the former Accounting Standards Board (ASB)) that the UK and Republic of Ireland would report under an international-based financial reporting framework and in light of this intention, the FRC was conscious to ensure that UK GAAP was aligned as far as possible to EU-adopted IFRS. Why was this a deliberate act on the part of the former ASB? It was done so that there were no significant deviations from EU-adopted IFRS and hence a new UK GAAP would be more or less aligned to its predecessor.

Financial reporting has evolved considerably over the years and new accounting practices have been developed. For example, the area of financial instruments has been subjected to extreme scrutiny over the recent years (due in part to the economic recession). However, the ways in which entities account for financial instruments can be very different across sectors and even to this day, much work is still being done to further enhance and improve the ways in which such instruments are accounted for and disclosed within financial statements. The development of FRS 102 certainly does not draw a line under financial instruments – indeed it is intended that these will be revisited very soon by the Accounting Council.

Notwithstanding the fact that the FRC have tried, as far as possible, to align existing UK GAAP to FRS 102, with a new financial reporting regime (which FRS 102 is) comes a new way of dealing with certain items within the financial statements as well as a change in the way certain items are disclosed.

Terminology changes

FRS 102 is based on the IFRS for SMEs which is based on full IFRS and therefore FRS 102 does adopt the use of international-based terminology. Many students will be familiar with the terminology used in FRS 102 as they, themselves, will more than likely be examined on IFRS in their financial reporting exams. However, some in the profession may not be familiar with the terminology and may, at first glance, appear to be very Americanised. However, the good news is that the 'traditional' terminology (balance sheet, profit and loss account etc.) will probably stay around for some time as these titles are derived from Regulations. Indeed, paragraph 3.22 to FRS 102 also allows flexibility in the titles given to the primary financial statements, provided the titles are not misleading (which 'balance sheet' would not be!).

Appendix III to FRS 102 contains a very useful analysis of the terminology differences contained in FRS 102 versus the terminology used in Companies Act 2006 and is reproduced as follows:

Companies Act 2006	FRS 102
Accounting reference date	Reporting date
Accounts	Financial statements
Associated undertaking	Associate
Balance sheet	Statement of financial position
Capital and reserves	Equity
Cash at bank and in hand	Cash
Debtors	Trade receivables
Diminution in value (of assets)	Impairment
Financial year	Reporting period
Group (accounts)	Consolidated (financial statements)
IAS	EU-adopted IFRS
Individual (accounts)	Individual (financial statements)
Interest payable and similar charges	Finance costs
Interest receivable and similar income	Finance income/investment income
Minority interest	Non-controlling interest
Net realisable value (of any current asset)	Estimated selling price less costs to complete and sell
Parent undertaking	Parent
Profit and loss account	Income statement (under the two-statement approach) Part of the statement of comprehensive income (under the single-statement approach)
Related undertakings	Subsidiaries, associates and joint ventures
Stocks	Inventories
Subsidiary undertaking	Subsidiary
Tangible assets	Includes: property, plant and equipment; Investment property
Trade creditors	Trade payables

Changes to accounting practice

As mentioned above, the introduction of a new financial reporting regime will bring with it some changes to the way in which items are treated and disclosed within the financial statements. There are some notable changes in the following areas:

- Accounting policies and errors
- Cash flow statement
- Consolidated financial statements
- Deferred tax
- Defined benefit pension plans
- Employee benefits
- Fair value accounting
- Financial instruments
- Fixed assets
- Goodwill and intangible assets

- Investment properties
- Leases
- Prior period adjustments
- Revenue recognition
- Stock valuations

Accounting policies and errors

FRS 102 deals with accounting policies in Section 10. Paragraph 10.4 tells preparers of financial statements that where FRS 102 does not specifically address a transaction or other event or condition, management must develop and apply an accounting policy that is:

- **Relevant** – information is relevant to aid the decision-making process of the users.

- **Reliable** – will result in the financial statements faithfully representing the financial position, performance and cash flows. In addition, the policy must also reflect the economic substance of the transaction(s)/event(s)/condition(s) rather than reflecting the legal form. To achieve reliability, the policy adopted must be neutral, prudent and complete in all material respects.

FRS 18 *Accounting Policies* is very similar but in some cases the end result and the overall impact on profit or loss would not necessarily be the same.

Under FRS 3 *Reporting Financial Performance* the correction of errors is done by way of a prior-period adjustment where the error is *fundamental*. The word *fundamental* in FRS 3 is taken to mean that the error is so significant that it destroys the truth and fairness of the financial statements. Under Section 10 an error is corrected by way of a prior-period adjustment when it is considered *material* hence there may be more errors corrected by way of a prior-period adjustment under FRS 102 than under FRS 3.

Cash flow statement

FRS 1 *Cash Flow Statements* requires cash flows to be classified under several different types of heading such as Operating activities, Dividends, Taxation, Return on investment and servicing of finance etc. FRS 102 deals with the cash flow statement (or statement of cash flows) under Section 7. Under this section, the numerous classifications seen in FRS 1 are reduced considerably to only three possible cash flow classifications:

- Operating activities;
- Investing activities; and
- Financing activities.

Operating activities are the day-to-day revenue-producing activities that are not investing or financing activities. This category is essentially a 'default' category, encompassing all cash flows that do not fall within investing or financing classifications. Paragraph 7.4 outlines examples of what it considers cash flows from operating activities, including:

(a) Cash receipts from the sale of goods and the rendering of services;

(b) Cash receipts from royalties, fees, commissions and other revenue;

(c) Cash payments to suppliers for goods and services;

(d) Cash payments to and on behalf of employees;

(e) Cash payments or refunds of income tax, unless they can be specifically identified with financing and investing activities;

(f) Cash receipts and payments from investments, loans and other contracts held for dealing or trading purposes, which are similar to inventory acquired specifically for resale; and

(g) Cash advances and loans made to other parties by financial institutions.

Example

A company makes a payment of corporation tax on 30 November 2013. Under FRS 1 this cash flow would be included within the 'Taxation' classification in the cash flow statement. Under FRS 102, this payment would be included in the 'Operating activities' as follows:

Cash flows from operating activities			
		£'000	£'000
Profit from operations			X
Adjustments for:			
	Depreciation	X	
	Gain on sale of property, plant and equipment	(X)	
		X	
Increase in stock		(X)	
Increase in trade debtors		(X)	
Increase in trade creditors		X	
Cash generated from operations		X	
Interest paid		(X)	
Corporation tax paid		(X)	
Net cash flows from operating activities		X	

Investing activities are those activities that involve the acquisition and disposal of long-term assets – for example monies used for the purchase of fixed assets as well as sales proceeds from the disposal of fixed assets. Paragraph 7.5 gives examples of what it considers to be cash flows arising from investing activities:

(a) Cash payments to acquire property, plant and equipment (including self-constructed property, plant and equipment), intangible assets and other long-term assets. These payments include those related to capitalised development costs and self-constructed property, plant and equipment;

(b) Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments classified as cash equivalents or held for dealing or trading);

(d) Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments classified as cash equivalents or held for dealing or trading);

(e) Cash advances and loans made to other parties (except those made by financial institutions);

(f) Cash receipts from the repayment of advances and loans made to other parties;

(g) Cash payments for futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the payments are classified as financing activities; and

(h) Cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the receipts are classified as financing activities.

Financing activities are those activities that change the equity and borrowing composition of a company.

Example

A company undertakes a rights issue in the year issuing one share for every five held. The proceeds of the share issue amount to £20,000 and in addition, the company's bankers agree to a loan amounting to £50,000 in order to fund additional working capital requirements.

The above cash flows will be considered financing cash flows for the purposes of the company's cash flow statement.

Paragraph 7.6 gives the following examples of what it considers to be financing cash flows:

(a) Cash proceeds from issuing shares or other equity instruments;
(b) Cash payments to owners to acquire or redeem the entity's shares;
(c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;
(d) Cash repayments of amounts borrowed; and
(e) Cash payments by a lessee for the reducing of the outstanding liability relating to a finance lease.

Consolidated financial statements

FRS 102 deals with consolidated financial statements in Section 9 *Consolidated and Separate Financial Statements*. There are few significant changes from old UK GAAP, although, where subsidiaries are held for resale, FRS 102 generally allows an accounting policy choice relating to measurement which is at cost less impairment provisions, or at fair value. These elements of the investment portfolio must also be excluded and measured at fair value which will result in more subsidiaries being excluded under FRS 102.

Deferred taxation

There are some significant changes to the scope of deferred tax and the concept of deferred tax is dealt with in Section 29 *Income Tax*. Deferred tax has been more aligned to its international counterpart standard, IAS 12 *Income Tax* and whilst there are similarities in comparison to FRS 19 *Deferred Tax*, Section 29 recognises additional circumstances in which deferred tax issues can arise. In current UK GAAP, deferred tax is calculated using the 'timing difference' approach which focuses on when transactions are recognised in the profit and loss account (income statement). The (now defunct) Accounting Standards Board (ASB) had concerns that the timing difference approach was resulting in companies reporting disproportionate levels of deferred tax and in FRED 44 the ASB changed the method of recognising deferred tax from the timing difference approach to the 'temporary difference' approach so that the UK and Republic of Ireland standard was in line with IAS 12.

The temporary difference approach focuses on the balance sheet (statement of financial position) as opposed to the profit and loss account and this would have resulted in far more levels of deferred tax being recognised. After an element of outcry from various commentators, the ASB acknowledged that it was not realistic for the UK and Republic of Ireland to use the temporary difference approach in the calculation of deferred tax but also acknowledged that the concept had to be brought in line with IAS 12 (as the UK was essentially going to report under an international-based framework).

FRS 102 now uses the concept of a timing difference 'plus' approach. The timing difference plus approach gives rise to three additional circumstances when deferred tax issues are triggered:

(a) Revaluations of non-monetary assets, including investment property;

(b) Fair values on business combinations; and

(c) Unremitted earnings on overseas subsidiaries or associates.

As a result of the above, financial reporting under FRS 102 will see more deferred tax provisions being recognised (particularly where companies use the revaluation model for non-monetary assets).

Under FRS 19, reporting entities also have the option of discounting deferred tax balances to present day values. The reality is that hardly any firms discount deferred tax balances to present day values and FRS 102 actually prohibits the practice so this is a difference that is likely to go largely unnoticed in the UK and Republic of Ireland.

Defined benefit pension plans

Section 28 *Employee Benefits* deals with defined benefit pension plans (commonly referred to as 'final salary pension schemes' or 'final salary plans'). Paragraph 28.18 to FRS 102 provides a number of simplifications where the valuation basis (the Projected Unit Credit Method) would require undue cost or effort. Section 28 does not require the use of an independent actuary to provide a valuation as FRS 17 *Retirement Benefits* does. However, reporting entities must have the ability to be able to measure the obligation under the defined benefit pension plan without undue cost or effort. As a consequence, unless the reporting entity employs an actuary or the preparer of the financial statements is themselves an actuary, the reporting entity is still going to have to use the services of an independent actuary so as to be able to include the defined benefit pension plan on the balance sheet and include the relevant disclosure notes.

Another change from FRS 17 is the net interest on the net defined benefit plan liability is calculated as a single item by multiplying the net defined benefit plan's liability by the discount rate used to determine the present value of the plan's liabilities. Under FRS 17, a calculation of an expected return on plan assets and an interest cost relating to the plan's liabilities would have been made and this revised approach in Section 28 may have a potential impact on earnings.

Employee benefits

In addition to defined benefit pension plans (see above), Section 28 also deals with employee benefits. The main difference where employee benefits are concerned is that reporting entities will now have to make provisions for short-term employee benefits that have been accrued by the employee, but where the reporting entity will pay the employee in the subsequent financial year. Realistically, reporting entities do not do this in current UK GAAP as there is no specific requirement to recognise short-term employee benefits. Interestingly, FRS 12 *Provisions, Contingent Liabilities and Contingent Assets* does make reference to an example of unpaid holiday pay at the year-end meeting the definition of a provision, so technically reporting entities should have made such provisions. This new introduction into Section 28 is going to cause problems for larger companies where the information about short-term employee benefits accrued but not paid is not centrally available.

Fair value accounting

There are a couple of fundamental changes inherent in FRS 102 relating to the increased use of fair value accounting and the number of accounting policy choices that are available. In addition, practitioners and company accountants must consider the impact of fair value accounting as there are several areas of the financial statements that are likely to be affected:

- Biological assets (living animals and plants) can be measured using fair values (where such values can be obtained reliably). Fluctuations in those fair values are taken to profit or loss. It is important that the reporting entity applies such policies consistently to each class of biological asset and its related agricultural produce.

- Business combinations where intangible assets are acquired and whose values can be reliably measured need to be separate from goodwill at acquisition.

- Financial instruments (such as derivatives) must be carried at fair value with changes in such fair value being taken to profit or loss at each reporting date. Derivatives are only one example of such financial instruments, but they can also include interest rate swaps/options, forward contracts, commodity contracts, investments in non-convertible and non-puttable shares and certain debt instruments.

- Investments can be held in the separate financial statements at cost less impairment, or at fair value, with fluctuations in fair value being passed through a revaluation reserve account within equity, or in certain circumstances through profit or loss. Parent companies may also opt for recognising gains and losses through profit or loss but it is important that the accounting policy choice is applied consistently.

- Property, plant and equipment can be measured using the revaluation model or the depreciated historic cost model. On transition to FRS 102, a reporting entity could also use fair value as 'deemed cost' on transition, and then choose to carry those assets under the cost model going forward.

Financial instruments

FRS 102 splits financial instruments into two component elements: 'Basic Financial Instruments' and 'Other Financial Instruments Issues'. Current UK GAAP deals with financial instruments in FRS 25 *Financial Instruments: Presentation*, FRS 26 *Financial Instruments: Recognition and Measurement* and FRS 29 *Financial Instruments: Disclosures*.

'Basic' financial instruments include items such as trade debtors, trade creditors and straightforward bank loans. These are measured (usually) at amortised cost, with certain types being measured at cost or fair value. Most debtors and creditors that are classified as current assets or current liabilities will still be measured at the undiscounted amount of the cash value expected to be received or paid.

'Other' financial instruments will include instruments such as foreign exchange forward contracts and loans that have complex terms attached to them. Under FRS 102, these will all be measured at fair value at each balance sheet date with movements recognised within profit or loss. The key difference here is that under current UK GAAP, many of these instruments would not be recognised on the balance sheet, but merely disclosed.

Fixed assets

FRS 15 *Tangible Fixed Assets* goes into a lot of detail concerning the capitalisation criteria relating to subsequent expenditure. As a general rule, FRS 15 requires subsequent expenditure to be written off to profit or loss, unless the expenditure:

(a) Provides an enhancement of the economic benefits of the asset in excess of the previously assessed standard of performance.

(b) Relates to a component of a tangible asset that has been treated separately for depreciation purposes which was replaced or restored.

(c) Relates to a major inspection or overhaul of the tangible fixed asset that restores the economic benefits of the asset(s) that had been used up by the entity and that have already been reflected within the depreciation charge.

Fixed assets are dealt with in FRS 102 in Section 17 *Property, Plant and Equipment* and specifically paragraph 17.15 deals with subsequent expenditure. The key difference in FRS 102 is that paragraph 17.15 merely states that day-to-day servicing of property, plant and equipment must be recognised in profit or loss in the periods in which the costs are incurred. Financial statement preparers are therefore directed to the *Concepts and Pervasive Principles* in Section 2 of FRS 102 to determine whether any subsequent expenditure does, in fact, meet the definition and recognition criteria of an asset outlined in paragraphs 2.15(a) and 2.27(a) and (b) to FRS 102.

Paragraph 17.15 also deals with the issue relating to 'spare parts and servicing equipment'. FRS 15 does not deal with such equipment and therefore many reporting entities carry such equipment within their stocks with recognition taking place as and when such parts/equipment are used in the business. Section 17 at paragraph 17.5 requires 'major' spare parts and stand-by equipment to be included within the cost of the fixed asset(s) to which the equipment relates when the business is expected to use them for more than one accounting period. Therefore, the accounting treatment under FRS 102 will mean that the cost of major spare parts/servicing equipment will be recognised within the depreciation charge rather than in profit or loss through consumption of stock (i.e. cost of sales).

The cost of fixed assets that are acquired under deferred payment arrangements (i.e. deferred beyond normal credit terms) is the present value of all future payments calculated in accordance with paragraph 17.13 to FRS 102. Such issues are not specifically covered in FRS 15 and therefore potentially result in the value of assets capitalised in the balance sheet being understated, hence giving rise to a lower depreciation charge and lower losses or higher profits. FRS 102 does now address this issue and therefore the net book value of fixed assets accounted for in accordance with paragraph 17.13 will be higher and there will be a consequential increase in the depreciation charge.

Goodwill and intangible assets

Section 18 *Intangible Assets* only deals with intangible assets but NOT goodwill (goodwill is dealt with in Section 19 *Business Combinations and Goodwill*). The most notable change that is going to affect preparers of financial statements under FRS 102 is in relation to the prescribed maximum life. Currently FRS 10 *Goodwill and Intangible Assets* presumes a maximum useful life of 20 years, with an option to rebut this presumption if a longer (or indefinite) life can be justified. Under FRS 102, intangible assets and goodwill will always have a finite life and if no reliable estimate can be made by management, the useful life is deemed to be a maximum of FIVE years.

Investment properties

SSAP 19 *Accounting for Investment Properties* requires an investment property to be carried in the balance sheet (statement of financial position) at its market value, with any changes in market value being recognised through a revaluation reserve account within equity and reported via the statement of total recognised gains and losses.

The key change in FRS 102 is the withdrawal of the revaluation reserve account. Section 16 *Investment Property* at paragraph 16.7 requires all changes in the fair value of an investment property to be recognised in profit or loss. The upshot of this treatment is that reported profit or loss would be different than would otherwise have been the case under SSAP 19 (although there would be no tax effect until the asset was sold).

A key point to note where this accounting treatment is concerned is that any fair value gains that are reported in profit or loss are **NOT** distributable as a dividend to shareholders because there is no actual gain realised.

Section 16 also requires fair values to be obtained for investment properties when obtaining such values can be done without ‘undue cost or effort’. SSAP 19 does not make this exception. If obtaining fair values does result in undue cost or effort, the entity accounts for such investment property in accordance with Section 17 *Property, Plant and Equipment* until a reliable measure of fair value becomes available. In reality, the entity would commission a surveyor to undertake the fair value exercise and therefore it is difficult to see how obtaining such fair values would result in undue cost or effort.

Accounting for fair value gains and losses in investment property is markedly different under FRS 102 than current SSAP 19. While accounting standards do not give specific reasoning behind their methodologies, investment property is not subjected to depreciation or impairment testing because they are valued at fair value at each reporting date, hence any changes in fair value are taken directly to profit or loss.

An entity’s interest in a property that is held under a lease and classified as an investment property is to be accounted for as a finance lease regardless of whether the lease may have been accounted for as an operating lease if it was in the scope of Section 20 *Leases*. In this respect, the asset is recognised at the *lower* of the fair value of the property and the present value of the minimum lease payments with an equivalent amount being recognised as a liability (in other words like any other type of finance lease).

Leasing

SSAP 21 *Accounting for Leases and Hire Purchase Contracts* sets out a specific numeric benchmark within the Guidance Notes to SSAP 21 (paragraph 22). This benchmark is where the minimum lease payments equates to 90% or more of the fair value of the asset being leased.

The classification in Section 20 *Leases* does not specifically refer to a numeric benchmark, but the equivalent is within the term 'substantially all'. Section 20 also cites examples of the various situations that individually, or in combination, would give rise to a lease being classified as a finance lease. These classifications are derived from IAS 17 *Leases* and are as follows:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term.

(b) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.

(c) The lease term is for the major part of the economic life of the asset, even if title is not transferred at the end of the lease.

(d) At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

(e) The leased asset is of such a specialised nature that only the lessee can use them without major modifications.

In addition, Section 20 also cites three further examples when a lease could be a finance lease:

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

(b) Gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease).

(c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent (usually coined a 'peppercorn' rent).

The key theme in Section 20 is on **judgement**. Correct judgement should be exercised by the company in determining whether a lease is a finance or an operating lease.

The classification criteria is based around the *risks and rewards* of ownership of the associated asset and which party retains those risks and rewards. There are a number of factors that can determine whether risks and rewards have, or have not, been transferred from the lessor to the lessee and therefore in recognition of this, paragraph 20.7 acknowledges that the examples cited above will not be conclusive in every respect and consideration must be given to other indicators that risks and rewards may (or may not) have been transferred from lessor to lessee, thus more judgement is needed in this very subjective area.

There are instances when lessees may receive an incentive payment to take up a lease. Paragraph 20.15 does not make reference to the effect of incentive payments relating to operating leases. UITF 28 *Operating Lease Incentives* at paragraph 8 states that any incentive should be allocated to match the effect of the increased rentals in later periods so that the financial statements reflect the true effective rental for premises – in other words, an incentive is not recognised immediately, but is instead included in profit or loss in the periods to which the benefits of the incentive are received.

Whilst on the subject of leases, the International Accounting Standards Board (IASB) is due to issue a new standard on leases in 2014 or 2015 and this new standard will radically change the way in which leases are accounted for. Whilst this new standard will only affect the larger companies who report under EU-adopted IFRS, there is large scope for the UK and Republic of Ireland to follow suit because the changes are quite radical, so it is important that accountants are aware of the developments at the IASB.

Essentially the new IFRS on leasing will exonerate many existing operating leases and treat them as finance leases and therefore recognising such leases on the balance sheet (statement of financial position). This new standard has the prime objective of minimising opportunities for off-balance sheet finance and will be based on a 'right of use' concept. Only very short leases (those with terms of less than 12 months) will qualify for classification as an operating lease. This issue is covered in more detail further in the notes.

Prior period adjustments

Section 10 *Accounting Policies, Estimates and Errors* deals with the issue relating to prior period adjustments and there is a notable difference between Section 10 and FRS 3 *Reporting Financial Performance*. Paragraph 10.21 in FRS 102 requires an entity to correct a 'material' prior period error *retrospectively* in the first financial statements which are authorised for issue after discovery of the error by way of a prior period adjustment.

FRS 3, on the other hand, at paragraph 63, requires the correction of *fundamental* errors. Fundamental errors are those which are so significant that they destroy the true and fair view of the financial statements as well as the validity of those financial statements.

The terms 'material' and 'fundamental' could be interpreted differently among accountants, but they amount to more or less the same thing. This interpretation aspect could well mean that more errors are corrected by way of a prior period adjustment.

It is to be noted that the way in which an error is corrected through a prior period adjustment is still the same as before (i.e. by restating the previous year's financial statements and then restating the balance on opening reserves).

Revenue recognition

There are slight variations in the wording relating to the measurement of revenue compared to that of UITF 40 (Application Note G) to FRS 5 *Reporting the Substance of Transactions*. Application Note G at paragraph G4 states that a seller recognises revenue under an exchange transaction with a customer when, and to the extent that, it obtains the *'right to consideration'* in exchange for its performance.

FRS 102, is slightly more relaxed in its wording and refers to revenue being the fair value of the consideration *'received or receivable'*.

This subtle difference in wording could potentially result in later recognition of profit which would result in a potentially different tax treatment as the tax treatment would follow the accounting treatment, although it has to be acknowledge that HMRC would be interested in the way this interpretation has been applied in the financial statements.

In addition, paragraph 23.15 refers to a 'specific' and a 'significant' act. When a specific act is much more significant than any other act, the entity will postpone revenue recognition until the significant act is executed. Application Note G to FRS 5 is much more prohibitive in that it requires revenue to be recognised in line with performance (references such as 'passing a milestone' or the occurrence of a 'critical event' are cited) as well as earning the right to consideration, hence there is the possibility that some entities could interpret the wording in such a way so as to delay recognising profit. Again, this would also have an effect on the tax implications as the tax treatment would follow the accounting treatment.

Paragraph 23.16 to FRS 102 says that if an entity cannot estimate the outcome of a service contract, then it should only recognise revenue to the extent of the expenses recognised which are recoverable. In contrast, paragraph 10 to SSAP 9 *Stocks and Long-Term Contracts* says that where the outcome of a long-term contract cannot be assessed with reasonable certainty, no profit should be reflected in the profit and loss account and suggests showing, as turnover, a proportion of the total contract value using a zero estimate of profit.

Stock valuations

SSAP 9 *Stocks and Long-Term Contracts* permits stock to be valued using the 'last-in first-out (LIFO)' cost-flow assumption method. Whilst this method is permissible in SSAP 9, the standard itself does not favour its use over the other permissible methods, such as first-in first-out (FIFO) or weighted-average cost (AVCO). This is acknowledged in paragraph 39 to SSAP 9 where the standard explains that the use of the LIFO method can result in the reporting of assets at amounts that bear little relationship to recent costs. In light of this, SSAP 9 requires the directors to have justifiable circumstances when applying the use of the LIFO method.

The use of the LIFO cost methodology was outlawed in IAS 2 *Inventories* in 2003 and FRS 102 at paragraph 13.18 follows the same stance as its international counterpart and IFRS for SMEs and therefore reporting entities will no longer be permitted to use LIFO as a cost-flow assumption.

THE FRSSE (LECTURE A446 – 9.04 MINUTES)

Does the FRSSE have a future?

The good news is that there are no immediate plans by the FRC to withdraw the use of the FRSSE. However, given that the FRSSE is based on current UK GAAP (FRSs/SSAPs/UITFs) which are essentially being withdrawn, there will undoubtedly have to be further amendments made to the FRSSE in the future in order that there are no significant variations between mainstream UK GAAP and the FRSSE. There may also have to be further changes to the FRSSE given the EU's decision earlier in 2013 on the issue of micro-entities and reduced disclosures. However, at the time of writing, it was unclear as to the extent of these changes. Such issues will be covered in further course material.

Consequential amendments

As a result of the issuance of FRS 102, there have been consequential amendments to the FRSSE (effective April 2008) and therefore the Accounting Council of the FRC decided to issue another version of the FRSSE, being the FRSSE (effective January 2015) which becomes mandatory for accounting periods commencing on or after 1 January 2015, with earlier adoption permissible.

Status of the FRSSE

The changes to the status of the FRSSE can be summarised in bullet points as follows:

- The status of the FRSSE becomes FRSSE (effective January 2015) and paragraph 1 is also amended to remove inapplicable text.

- Paragraph 2 of the FRSSE is amended to include reference to FRS 100 *Application of Financial Reporting Requirements* and to remove references to old UK GAAP.

- Paragraph 4 is deleted and a new paragraph is inserted as follows:

  'The significant differences between this version of the FRSSE (effective January 2015) and the FRSSE (effective April 2008) are in respect of the revised reporting framework introduced into the UK effective January 2015. As part of the revised reporting framework, the FRC has withdrawn extant Financial Reporting Standards and Urgent Issues Task Force (UITF) Abstracts. It has made consequential amendments to the FRSSE where it previously referred to standards or Abstracts that are now withdrawn.

- Paragraph 5 is amended in respect of transactions and events not covered by the FRSSE. It is amended so that entities must first have regard to their own existing accounting policies. It is then amended to guide users to FRS 102 in developing a new accounting policy.

- Paragraph 5A is inserted which refers to public benefit entities.

- Paragraph 6 is amended to include reference to FRS 102 and to remove reference to the Accounting Standards Board and amend this to the Financial Reporting Council.

- Paragraph 10 is amended requiring entities not eligible to use the FRSSE to report under EU-adopted IFRS, apply FRS 101 *Reduced Disclosure Framework* in the individual financial statements of qualifying entities, or apply FRS 102 in accordance with the requirements of FRS 100. A footnote has also been included in paragraph 10 that refers to company law in the Republic of Ireland requiring certain companies to prepare Companies Act accounts using a financial reporting framework based on accounting standards, other than those issued by the FRC.

- Paragraph 11 is amended to remove reference to the first issuance of the FRSSE in November 1997 and also to make reference to FRS 102 and SORPS.

Main body of the FRSSE

The main body of the FRSSE has been amended as follows:

- Paragraph 2.6 is amended to refer to the FRSSE (effective January 2015).

- The footnote to paragraph 2.6 is amended to include provisions *applicable* rather than *relating* to small companies and amendments are made to change the effective date to January 2015.

- Paragraph 6.13 is amended to make reference to capitalised goodwill and intangible assets having a finite useful life and amending the economic useful life of goodwill and intangible assets that cannot be assigned a reliable estimated useful life from 20 years to five years.

- Paragraph 6.45 is amended to remove the suggestion of obsolescence or fall in demand for a product (this is because the FRSSE (effective January 2015 now contains specific requirements for entities to carry out an impairment test (see below)).

- Paragraph 6.45A to C are inserted which read as follows:

  6.45A

  At each reporting date an assessment shall be carried out of whether there is any indication that an asset should be written down (i.e. whether its carrying amount is more than its recoverable amount). If any such indication exists, the recoverable amount of the asset shall be estimated. If there is no indication that an asset should be written down, it is not necessary to estimate the recoverable amount.

6.45B

In assessing whether there is any indication that an asset should be written down, the following might be considered:

(a) During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

(b) Significant changes with an adverse effect on an asset, or the entity, have taken place during the accounting period, or will take place in the near future, (for example external factors such as technological, market, economic or legal changes or internal factors such as the asset becoming idle, or plans to dispose of an asset before the previously expected date).

(c) Market interest rates have increased during the period, and those increases are likely to affect the asset's recoverable amount.

(d) Evidence is available of obsolescence or physical damage of an asset.

(e) Evidence is available from internal reporting that indicates that operating results or cash flows from the use of the asset are, or will be, worse than expected.

6.45C

If there is an indication that an asset should be written down, this may indicate that the entity should review the remaining useful economic life, the depreciation method or the residual value of the asset and adjust it in accordance with paragraph 6.40 even if no loss is recognised for writing down the asset.

- Paragraph 15.7 is amended to include a paragraph (d) which says that related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly-owned by such a member, does not require a related party disclosure note.

- Paragraph 16.2 is amended to make reference to paragraph 5 of the *Status of the FRSSE* and various text relating to old FRSs is deleted.

- Paragraphs 19.1 and 20.1 are amended to change the effect date to January 2015.

Part C 'Definitions' – amendments

The Definitions contained in Part C have been amended as follows:

- The definitions of 'close family' are amended and now include the person's children, spouse or domestic partner; children of that person's spouse or domestic partner and dependents of that person or that person's spouse or domestic partner.

- The definition of 'key management personnel' is inserted.

- The definition of 'public benefit entities' is inserted.

- The current definition of a related party is deleted and replaced with the following: *'A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred as the 'reporting entity')*.

  (a) A person or a close member of that person's family is related to a reporting entity if that person:
  - *(i) has control or join control over the reporting entity;*
  - *(ii) has significant influence over the reporting entity; or*

  (b) is a member of the ***key management personnel*** *of the reporting entity or of a parent of the reporting entity. An entity is related to a reporting entity if any of the following conditions applies:*
  - *(i) The entity and the reporting entity are members of the same group (which means the parent, subsidiary and fellow subsidiary is related to the others).*
  - *(ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture or a member of a group of which the other entity is a member).*
  - *(iii) Both entities are joint ventures of the same entity.*
  - *(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.*
  - *(v) The entity is a retirement benefit scheme for the benefit of the employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity itself is such a scheme, the sponsoring employers are also related to the reporting entity.*
  - *(vi) The entity is controlled or jointly controlled by a person identified in (a).*
  - *(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).*

- The final sentence in paragraph 35 to Appendix IV *Development of the FRSSE* has been deleted. Appendix V to the FRSSE (effective April 2008) has also been deleted in full.

- Paragraphs 38 and 39 to Appendix IV of the FRSSE (effective January 2015) have been renumbered paragraphs 41 and 42 and new paragraphs 38, 39 and 40 have been included as follows:

The FRSSE (effective January 2015)

38. *In November 2012 the FRC amended the FRSSE as a consequence of the significant changes that were made to UK and Republic of Ireland financial reporting standards at this date. In November 2012 the FRC revised extant Financial Reporting Standards, withdrawing its existing financial reporting standards and supplementary literature from 1 January 2015 and replacing them with revised financial reporting requirements, based on International Financial Reporting Standards (for example, IFRS for SMEs was used as a basis for FRS 102 The Financial Reporting Standards applicable in the United Kingdom and Republic of Ireland). The FRSSE (effective April 2008) was amended as a consequence of these changes.*

39. *The consequential amendments to the FRSSE were to update references in the FRSSE (effective April 2008) to accounting standards that were withdrawn or for greater consistency with legislation. In addition, the FRC explained that where an entity applying the FRSSE undertakes a new transaction for which it has no existing accounting policy it should have regard to FRS 102, not as a mandatory document, but as a means of establishing current practice. The FRC removed the reference to the accounting standards applicable to consolidated financial statements because the general requirements in the FRSSE for developing accounting policies for transactions or events that are not dealt with in the FRSSE are equally applicable to consolidated financial statements.*

40. *The FRC made two further amendments to the FRSSE:*

    (a) *It introduced a requirement which is consistent with EU Directives, that 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 five years.*

    (b) *It clarified that an entity hall assess annually whether there is any indication that an asset should be written down. This will assist entities applying the existing requirement for fixed assets and goodwill to be carried at no more than their recoverable amount.*

    These amendments relate to applying existing company law requirements.

- Paragraphs 41 and 42 have been amended to remove reference to UITF Abstracts and to replace the word ‘Board’ with ‘FRC’ and to remove references to old UK GAAP standards and include reference to FRS 102.

- Paragraph 42 has also been amended to make reference to FRS 102 and remove reference to ‘auditors’, the ‘Board’ and citation of an example relating to marking to market fixed interest instruments.

FRS 102 SECTION 16: INVESTMENT PROPERTY (LECTURE A447 – 13.34 MINUTES)

Many clients (including those that report under the FRSSE (effective April 2008)) hold investment property on the balance sheet. Those companies that are not eligible to use the FRSSE (effective April 2008) will account for investment property under SSAP 19 *Accounting for Investment Properties*.

Requirements under current UK GAAP

Under SSAP 19 (and the FRSSE (effective April 2008)), reporting entities that hold investment properties are required to carry such properties at their open market value (SSAP 19 para 6). Any changes in market value are taken to the revaluation reserve within the statement of total recognised gains and losses, unless a deficit (or the reversal of a deficit) on an individual investment property is expected to be permanent. In such cases, permanent diminutions in value are taken to the profit and loss account in the period the diminution in value occurs. The revaluation of investment property accords with the alternative accounting rules which require such amounts to be taken to the revaluation reserve.

Requirements under FRS 102

Under FRS 102 (Section 16 *Investment Property*), any changes in the fair value of investment property are taken directly to profit or loss as illustrated in the following example which compares the accounting treatment currently in SSAP 19 and the accounting treatment in Section 16:

Example

Company A Limited has a property on its balance sheet that meets the recognition criteria of an investment property, both in SSAP 19 and paragraph 16.2 of FRS 102. On 1 January 2015 the carrying value of this property was £300,000 and on 31 December 2015 an independent valuation was carried out which revealed the open market value of this property was now £310,000.

<u>SSAP 19 treatment</u>

Under the provisions in SSAP 19 there will be a debit to the investment property of £10,000 to uplift the investment property's carrying value from £300,000 to £310,000. The credit will be reported in the statement of total recognised gains and losses through the revaluation reserve account, hence no impact on the profit and loss account in this example.

<u>Section 16 treatment</u>

The revaluation of the investment property accords with the fair value accounting rules and will be reported in profit or loss as follows:

DR carrying value of investment property	£10,000
CR profit and loss	£10,000

Being fair value uplift in the value of investment property

In the example above, under Section 16, we will see a direct impact on the profit and loss account because paragraph 16.7 in FRS 102 requires changes in fair value to be recognised in profit or loss. However, what is important to emphasise is that the revaluation gain will not be a realised profit available for distribution to shareholders. The staff guidance on investment property acknowledged that reporting entities could choose to transfer gains and losses arising from the fluctuation of open market values for investment property to a non-distributable reserve, however, technically this is incorrect and is therefore not advisable. Paragraph 16.7 is clear – changes in the fair value of investment property is to be recognised in profit or loss.

The treatment in Section 16 is consistent with international accounting standards; specifically IAS 40 *Investment Property*. The reason that IAS 40 and Section 16 does not require the use of a revaluation reserve account is because investment property is not depreciated, nor subjected to an annual impairment test. Instead all valuation changes are reported within profit or loss for the period. Many accountants appear to disagree with this treatment with some accusing the proposed treatment as destroying the function of the profit and loss account by reporting unrealised gains. Again, it is important to emphasise that revaluation gains on investment property that go through profit and loss will not be distributable because the fair value of the investment property is not readily convertible to cash.

FRS 102 SECTION 17: PROPERTY, PLANT AND EQUIPMENT (LECTURE A448 – 13.06 MINUTES)

Section 17 to FRS 102 *Property, Plant and Equipment* is currently dealt with in FRS 15 *Tangible Fixed Assets* and there are some notable differences between the two. Section 17 deals with PPE that:

- are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- are expected to be used for more than one period.

Initial recognition

The recognition criteria under FRS 102 has remained unchanged from current practice and a client can recognise PPE if (and only if):

- it is probable that future economic benefits associated with the item will flow to the entity; and
- the cost of the item can be measured reliably.

Paragraph 17.5 to FRS 102 deals with 'spare parts and servicing equipment'. This particular paragraph acknowledges that such items are usually carried in the financial statements in inventory (stock) with recognition taking place as and when such parts/equipment are used in the business (usually via cost of sales). Paragraph 17.5 requires 'major' spare parts and stand-by equipment to be included within the cost of the fixed asset(s) to which it/they relate(s) when the client is expected to use them for more than one year. The paragraph also goes on to require that if the spare parts and servicing equipment are only able to be used in connection with an item of PPE, then they are considered PPE.

In the past there has also been an element of confusion as to the correct accounting treatment for parts of items of PPE (for example the roof on a building) and whether to capitalise the cost of these replacement parts or to expense them as repairs and renewals expenditure. Paragraph 17.6 to FRS 102 says that a reporting entity can add such costs to the carrying amount of an item of PPE provided that the replacement part is expected to provide incremental future benefits to the entity.

Where 'major components' of an item of PPE have significantly different patterns of consumption, the client must allocate the initial cost of the asset to its major components and then depreciate them separately over its useful economic life.

Example

An entity acquires a new property which consists of both land and buildings.

Land and buildings are considered to be separable assets (land usually has an indefinite life whereas buildings have a limited life). As such paragraph 17.8 to FRS 102 requires both component parts to be accounted for separately regardless of the fact that they are acquired together.

Components of 'cost'

On initial recognition of an item of PPE that satisfies the recognition criteria, the reporting entity will initially account for the item at cost. For the purposes of Section 17, cost will include:

- The purchase price (to include legal/brokerage fees, non-recoverable taxes and net of trade discounts and rebates);
- Costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of being operated in the manner intended;
- The initial estimate of dismantling and removing the item and restoring the site on which it is located; and
- Borrowing costs.

Costs such as advertising and general administrative costs are not to be assigned to the cost of an item of PPE.

Subsequent measurement

As with FRS 15, once the item of PPE has been recognised at cost, it can then be subsequently measured using the 'cost' model or the 'revaluation' model. There is no change to current accounting practice in this respect and all assets in the same class are subjected to the same subsequent measurement (whether it be cost or revaluation).

Example

A company has an item of machinery that is very specialist to their specific business and for which there is no market-based evidence of its fair value as the machine is rarely sold but the directors wish to carry this machine in the balance sheet using the revaluation model.

In situations such as these, paragraph 17.15C says that the fair value will usually be determined by appraisal and directs users to paragraph 11.27 and 11.32 (Section 11 is *Basic Financial Instruments*) which will provide further guidance on determining fair value. If circumstances are such that there is no market-based evidence of fair value because of the machine's specialist nature, then paragraph 17.15D says that the entity may need to estimate fair value using an income or depreciated replacement cost approach.

Where items are carried at revaluation, the same accounting principles contained in FRS 15 will apply in that an increase in an asset's carrying amount due to revaluation will be recognised in equity (usually as 'revaluation surplus') and reported through other comprehensive income. In the case that a revaluation decrease was previously recognised in respect of that asset, the increase in fair value will go to the profit and loss account to the extent that it reverses a previous revaluation decrease.

Revaluation losses will be taken to the revaluation reserve account in equity and reported in other comprehensive income to the extent of any previous revaluation gains accumulated in equity. This is the same as under FRS 15 but this practice is not the same for investment properties accounted for under Section 16 *Investment Property* which requires all fair value gains and losses in respect of such property to be taken to profit or loss.

Depreciation

Section 16 continues to recognise the straight-line method, diminishing balance (commonly referred to as 'reducing balance') method and an alternative method based on usage and cites the use of the 'units of production' method.

Example

A company has undertaken a review of the entity's pattern of consumption of various items of plant used in its manufacturing process and concludes that the depreciation rate is too accelerated and so changes from a five-year straight-line method of depreciating its plant and machinery to a ten-year method.

A change in depreciation method is applied going forward, hence there is no retrospective application of the new depreciation policy as it is considered a change in estimation technique, not a change in accounting policy and the entity will account for such to comply with the requirements in paragraphs 10.15 to 10.18 (Section 10 is *Accounting Policies, Estimates and Errors*).

Example

A company produces washing powder and has four brands, EcoWash, BriteWash, CleanWash and ColorFriendly. It has four items of machinery that deal with the production of each brand and all the machinery used in the production of the washing powder are depreciated under the 'units of production' method. The company has a year-end of 31 October each year. In the current financial year, the company has not produced any of its BriteWash brand because of a surplus of this product that it is trying to sell. The financial accountant has not put through any depreciation charges on the plant and machinery used to manufacture this product and the financial controller is disputing this non-depreciation.

Paragraph 17.20 to FRS 102 acknowledges that depreciation does not cease when the asset becomes idle or retired from active use unless the asset is fully depreciated. However, paragraph 17.20 does confirm that under the usage methods of depreciation, the depreciation charge can be zero while there is no production.

FRS 102 SECTION 18: INTANGIBLE ASSETS OTHER THAN GOODWILL (LECTURE A449 – 10.11 MINUTES)

Scope

Whilst goodwill IS an intangible asset, the concept is dealt with in Section 19 *Business Combinations and Goodwill* hence Section 18 only specifically applies to all other intangible assets. It is also worth mentioning that Section 18 does not apply to intangible assets held by an entity for sale in the ordinary course of business. Such concepts are dealt with in Section 13 *Inventories* and Section 23 *Revenue*.

Section 18 does not apply to:

(a) Financial assets (Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* deals with these);

(b) Heritage assets (Section 34 *Specialised Activities* deals with these); or

(c) Mineral rights and mineral reserves (Section 34 *Specialised Activities* deals with these).

Definition

An intangible asset is an identifiable asset which does not possess a physical form (it is invisible – or 'cannot be kicked!'). The key word in this definition is 'identifiable'. An intangible asset qualifies for recognition when it is identifiable and this is when:

(a) It is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

(b) It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Recognition criteria

The recognition criteria is essentially more, or less, the same as the recognition criteria for a tangible asset. An entity shall recognise an intangible asset as an asset if, and only if:

(a) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) The cost or value of the asset can be measured reliably.

In order to get an understanding of the 'future economic benefits', paragraph 18.5 requires management to assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the **useful life** of the asset.

Internally generated intangible assets

One of the most problematic areas of intangible assets in real-life relates to the issue of internally-generated intangible assets because management often want them to be capitalised on the balance sheet.

Example

A company manufactures washing power under the brand name of EcoWash and has been in operation for several years. The directors of the company feel that this brand is widely recognised and would like to capitalise it as an intangible asset in the balance sheet.

Paragraph 18.8C would prohibit this treatment on the grounds that the brand is internally generated.

A reporting entity cannot recognise expenditure on the following items as an intangible asset, but must instead write them off as an expense in the profit and loss account:

(a) Internally generated brands, logo, publishing titles, customer lists and items similar in substance.

(b) Start-up activities (i.e. start-up costs), which include establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (i.e. pre-opening costs) and expenditure for starting new operations or launching new products or processes (i.e. pre-operating costs).

(c) Training activities.

(d) Advertising and promotional activities (unless it meets the definition of inventories held for distribution at no or nominal consideration) (see paragraph 13.4A).

(e) Relocating or reorganising part or all of an entity.

(f) Internally generated goodwill

Research and development costs

Reporting entities must write off all research expenditure directly to the profit and loss account. This is because in the research phase of an internal project, the entity cannot demonstrate that an intangible asset will generate probable future economic benefits. Examples of research activities are:

(a) Activities aimed at obtaining new knowledge.

(b) The search for, evaluation and final selection of, applications of research findings and other knowledge;

(c) The search for alternatives for materials, devices, products, processes, systems or services.

(d) The formulation, design, evaluation and final selection of possible alternatives for new or improved material, devices, projects, processes, systems or services.

Once the research phase has been completed, the internal project may well move on to the development phase. Development expenditure can only be recognised as an intangible asset on the balance sheet if the company can demonstrate ALL of the following:

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) Its intention to complete the intangible asset and use or sell it.

(c) Its ability to use or sell the intangible asset.

(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Paragraph 18.8J gives some useful examples of development activities which are:

(a) The design, construction and testing of pre-production or pre-use prototypes and models.

(b) The design of tools, jigs, moulds and dies involving new technology.

(c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.

(d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Initial measurement

When expenditure qualifies for recognition as an intangible asset, the reporting entity must first measure it at its cost. The cost is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria. In the case of a separate acquisition, 'cost' will comprise:

(a) The purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

(b) Any directly attributable cost of preparing the asset for its intended use.

Examples of 'directly attributable costs' are cited in paragraph 18.10B which are:

(a) Costs of materials and services used or consumed in generating the intangible asset;

(b) Costs of employee benefits (as defined in Section 28 *Employee Benefits*) arising from the generation of the intangible asset;

(c) Fees to register a legal right; and

(d) Amortisation of patents and licenses that are used to generate the intangible asset.

Example

A company has recognised costs in relation to the development of an intangible asset in its profit and loss account in the previous financial year. The directors have decided that these costs should now be recognised as part of the cost of the intangible and are proposing to reallocate these expenses to intangible assets in the current year's financial statements.

The directors cannot reclassify previously recognised expenses. Paragraph 18.17 to FRS 102 will prohibit this treatment – it is clear in that expenditure on an intangible item that was initially recognised as an expense shall not be recognised at a later date as part of the cost of an asset.

Measurement after initial recognition

There are two permissible methods in Section 18 for measurement after initial recognition:

- Cost model; and
- Revaluation model.

Under the cost model, the entity measures intangible assets at cost less any accumulated amortisation and impairment losses.

Under the revaluation model, the intangible asset is carried at a revalued amount, which is the asset's fair value at the date of revaluation less any subsequent accumulated amortisation and subsequent accumulated impairment losses. A key point here is that the revaluation model can only be used where there is an **active market**. The reality is that few intangible assets will be part of an active market (where frequent transactions are evidenced and hence a price can be obtained) and therefore in practice the cost model will be the most frequently used method of measurement after initial recognition.

It is also worth pointing out that the revaluation model is only used AFTER the asset has been initially recognised at cost.

Reporting gains and losses on a revalued intangible asset

Any revaluation gains in respect of an intangible asset will be recognised in other comprehensive income and accumulated in equity (using a revaluation reserve account). Gains can be recognised in profit or loss, but only to the extent that the gain reverses a revaluation decrease of the same asset previously recognised in profit or loss.

Revaluation losses are recognised in other comprehensive income to the extent of any previously recognised gains and accumulated in equity. Where losses exceed the accumulated revaluation gains, any further losses are recognised in profit or loss.

Amortisation

All intangible assets that fall within the scope of Section 18 are considered to have a finite useful life. Where management are unable to make a reliable estimate of the useful life of an intangible asset, the useful economic life will not exceed five years (this is a significant reduction from 20 years that is currently the presumption in FRS 10).

The depreciable amount of the intangible asset will be allocated to profit or loss on a systematic basis over the asset's useful life and amortisation is to commence when the intangible asset is available for use (in other words when it is in the location and condition necessary for it to be usable in the manner intended by management). Conversely, amortisation will cease when the asset is derecognised.

The straight-line method of amortisation is the benchmark treatment in Section 18 unless the entity can demonstrate that an alternative amortisation method accurately reflects the entity's consumption of the intangible asset.

Example

An entity acquires an intangible asset on 1 January 2014. Management have calculated the depreciable amount by assuming a residual value of £5,000. There is no commitment by a third party to acquire the intangible asset at the end of its useful life, nor is there an active market for the asset.

Paragraph 18.23 assumes a residual value for an intangible asset as being **zero** unless:

(a) There is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) There is an active market for the asset and:

(i) residual value can be determined by reference to that market; and

(ii) it is probable that such a market will exist at the end of the asset's useful life.

Therefore management should assume a residual value of zero when calculating depreciable amount for amortisation purposes.

Review of estimates

If the intangible asset is showing indicators of impairment since the most recent annual reporting date, the company shall review previous estimates of residual value and useful economic life. Where current expectations differ, management should amend the residual value, amortisation method or useful life as appropriate. Where such changes are made these are considered to be changes in accounting estimate and will be applied *prospectively* (i.e. no prior year adjustment will be made as there is no change in accounting policy).

Disclosures for intangible assets

The following are to be disclosed for each class of intangible assets:

(a) The useful lives or the amortisation rates used and the reasons for choosing those periods;

(b) The amortisation methods used;

(c) The gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the reporting period;

(d) The line item(s) in the statement of comprehensive income (or in the income statement, if presented) in which any amortisation of intangible assets is included; and

(e) A reconciliation of the carrying amount at the beginning and end of the reporting period showing separately:

   (i) additions, indicating separately those from internal development and those acquired separately;

   (ii) disposals;

   (iii) acquisitions through business combinations;

   (iv) revaluations;

   (v) amortisation;

   (vi) impairment losses; and

   (vii) other changes.

This reconciliation need not be presented for prior periods.

In addition, reporting entities should also disclose:

(a) A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.

(b) For intangible asset acquired by way of a grant and initially recognised at fair value:
   (i) the fair value initially recognised for these assets; and
   (ii) their carrying amounts.

(c) The existence and carrying amounts of intangible assets to which the entity has restricted title or that are pledged as security for liabilities; and

(d) The amount of contractual commitments for the acquisition of intangible assets.

An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period (i.e. the amount of expenditure incurred internally on research and development that has not been capitalised as an intangible asset or as part of the cost of another asset that meets the recognition criteria in this FRS).

If intangible assets are accounted for at revaluated amounts, an entity shall disclose the following:

(a) The effective date of the revaluation;

(b) Whether an independent valuer was involved;

(c) The methods and significant assumptions applied in estimating the assets' fair values; and

(d) For each revalued class of intangible assets, the carrying amount that would have been recognised had the asset been carried under the cost model.

FRS 102 SECTION 20: LEASES (LECTURE A450 – 12.10 MINUTES)

One of the most topical debates at the moment (certainly among the International Accounting Standards Board (IASB)) is the issue of leasing. Leases have always posed a problem for the accountancy profession because of their subjective nature and the ability to manipulate leasing transactions to achieve a desired outcome (commonly referred to in the profession as 'off balance sheet finance'). This section take a look at leasing in the context of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and also takes a brief look at the IASB's proposals that may affect UK and Republic of Ireland companies in the future.

Leases beyond the scope of Section 20

Leasing is dealt with in FRS 102 in Section 20 *Leases*. At the outset this particular section confirms that it does not deal with the following types of leasing transactions:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (see Section 34 *Specialised Activities*);
- Licensing agreements for such items has motion picture films, video recordings, plays, manuscripts, patents and copyrights (see Section 18 *Intangible Assets other than Goodwill*);
- Measurement of property, plant and equipment held by lessees that is accounted for as investment property and measurement of investment property provided by lessors under operating leases (see Section 16 *Investment Property*);
- Measurement of biological assets held by lessees under finance leases and biological assets provided by lessors under operating leases (see Section 34); and
- Leases that could lead to a loss to the lessor or the lessee as a result of non-typical contractual terms.

Finance and operating leases

Section 20 still determines the classification of a lease in much the same way as SSAP 21 *Accounting for Leases and Hire Purchase Contracts*. The overarching principle in the determination of whether a lease is financing or operating is considered in light of the substance of the arrangement – in other words looking at who bears the risks and rewards of ownership of the asset subjected to the lease.

When, substantially, all the risks and rewards incidental to ownership of the asset are transferred from the lessor to the lessee, this will give rise to a finance lease. The asset will appear on the company's balance sheet (statement of financial position) together with a corresponding finance lease creditor. Where the risks and rewards of ownership remain with the lessor, the lease is classified as an operating lease and rentals are charged to profit or loss as incurred. This is the same accounting treatment as we currently see in SSAP 21 (and the FRSSE (effective April 2008)).

The Guidance Notes to SSAP 21 contain a 90% test whereby should the present value of the minimum lease payments that the lessee is required to pay equate to 90% or more of the fair value of the leased asset then this will give rise to a finance lease. However, Section 20 does not contain any 90% benchmark that we currently see in SSAP 21; instead it offers five examples of situations that individually, or in combination, would normally lead to a lease being classified as a finance lease, and a further three indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease. The first five are as follows:

- The lease transfers ownership of the asset to the lessee by the end of the lease term;

- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

- The lease term is for the major part of the economic life of the asset even if title is not transferred;

- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

- The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

You may note that the fourth bullet point above refers to the term 'substantially all'. This is the term that has essentially replaced the 90% test contained in SSAP 21, hence more judgement will be needed on the part of the accountant.

The three additional indicators of situations that could also lead to classification of a lease as a finance lease are as follows:

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

- Gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

It is important to understand that the situations above are not exhaustive and this is reflected in the wording in paragraph 20.7 that confirms that all of the above situations are not always conclusive. The key to determining the correct lease classification will all depend on whether the risks and rewards of ownership have transferred to the lessee or remain with the lessor at the inception of the lease. Paragraph 20.8 says that lease classification is made at the inception of the lease and the classification is not changed during the term of the lease (i.e. from operating to finance or vice versa) unless the lessee and the lessor agree to a change in the provisions of the lease (other than simply renewing the lease). Where such provisions are changed, the lease classification is then re-evaluated.

Determining the amounts in a finance lease

Once a lease has been determined as a finance lease, on initial recognition Section 20 would require a lessee to recognise its rights of use of that asset as an asset at an amount equivalent to the fair value of the leased asset or, if lower, the present value of the minimum lease payments which are determined at the start of the lease. Where a client incurs costs that are directly attributable in negotiating and arranging a lease, these costs are added to the amount recognised as an asset.

Example

Company A Ltd enters into a finance lease with Company B Ltd. Company A is trying to work out whether the present value of the minimum lease payments at the commencement of the lease are higher or lower than the fair value of the leased asset but is unsure which rate to use to discount the minimum lease payments down to present day values.

Paragraph 20.10 to FRS 102 says that the present value of the minimum lease payments shall be calculated using the interest rate implicit in the lease. If this cannot be determined, the lessee's incremental borrowing rate will be used instead.

Subsequent measurement – finance leases

After initial recognition, paragraph 20.11 to FRS 102 requires a lessee to split the minimum lease payments between the capital element of the lease and the interest cost (as currently done in SSAP 21 and the FRSSE). However, the reduction in the outstanding liability is calculated using the *'effective interest method'* The effective interest method is a method of calculating the amortised cost of either a financial asset or a financial liability (or a group of financial assets and liabilities) and therefore allocating the interest component of the lease payments over the relevant period. Under the effective interest method:

- The amortised cost of the finance lease liability is the present value of future payments discounted at the effective interest rate; and

- The interest expense in a period is equivalent to the carrying amount of the liability at the beginning of a period multiplied by the effective interest rate for the period.

For the purposes of this calculation, the *effective interest rate* is the rate that exactly discounts the future payments through the expected life of the lease.

In addition, the lessee must depreciate the leased asset over the shorter of the lease term and its useful economic life and at the end of each reporting period assess whether an asset leased under a finance lease is impaired. There is no change to how we depreciate such assets under SSAP 21.

Subsequent measurement - operating leases

These will essentially follow the same accounting treatment as SSAP 21 which is that the lessee will recognise payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense over the lease term on a straight-line basis, unless:

- Another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis; or

- The payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. However, if payments to the lessor vary because of factors other than general inflation, then this condition is not met.

If a lessee receives a lease incentive, this is accounted for as a reduction to the expense over the lease term on a straight-line basis, unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset.

Lessor accounting – finance leases

Lessors recognise assets that are subject to finance leases in their balance sheet (statement of financial position) as a receivable (a debtor) at an amount that is equal to the net investment in the lease (which is the gross investment in the lease, but discounted at the interest rate implicit in the lease). The gross investment is the total of:

- The minimum lease payments receivable by the lessor under the finance lease; and
- Any unguaranteed residual value accruing to the lessor.

Finance income is recognised in profit or loss based on a pattern that reflects a constant periodic rate of return on the lessor's net investment in the finance lease.

Example

A lessor has recognised a finance lease as a receivable, calculated using the gross investment in the lease and discounted at the interest rate implicit in the lease. A year later it is clear that the unguaranteed residual value which was used to calculate the gross investment in the lease has changed quite significantly due to technological advances.

Where there is an indication that the estimated unguaranteed residual value used in the calculation of the gross investment in the lease has changed significantly, paragraph 20.19 says that the income allocation over the lease term shall be revised, and any reduction in respect of amounts accrued is recognised immediately in profit or loss.

Manufacturer or dealer lessors

Where lessors are manufacturers or dealers, a finance lease can give rise to two types of income:

- A profit or loss resulting from outright sale of the asset; and
- Finance income over the period of the lease.

Revenue recognised at the outset of a lease by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor (calculated using the market rate of interest) is lower than the fair value of the asset, this is used as the revenue figure.

The cost of sale recognised at the outset of a lease is the cost (or carrying amount if different) of the leased asset *less* the present value of the unguaranteed residual value.

The difference between the revenue and the cost of sale is clearly the selling profit. However, where a manufacturer or dealer lessor enters into an operating lease, it will not recognise any profit on sale because it is not the equivalent of a sale.

Lessor accounting – operating leases

Assets which are subject to operating leases are recognised in the lessor's balance sheet (statement of financial position) depending on the nature of the asset and income arising from the lease is recognised in the lessor's profit and loss account on a straight-line basis over the life of the lease. There are two exceptions to the straight-line basis of income recognition, which apply to when:

- Another systematic basis is representative of the time pattern of the lessee's benefit from the leased asset, even if the receipt of payments is not on that basis; or

- The payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary according to factors other than inflation, then this condition is not met.

Costs associated with operating leases from the standpoint of the lessor are dealt with as follows:

Cost of lease incentives

These are recognised as a reduction to the income recognised over the lease term on a straight-line basis unless another systematic basis is representative of the time pattern over which the lessor's benefit from the leased asset is diminished.

Costs

Costs incurred with earning the lease income (paragraph 20.26 cites depreciation as such a cost) are recognised as expenses and the depreciation policy of such assets will be consistent with the lessor's normal depreciation policy for similar assets.

Incidental costs of negotiating and arranging the operating lease

These are added to the cost of the leased asset and recognised as an expense in profit or loss over the lease term on the same basis as the lease income.

Disclosures – finance leases (lessee's financial statements)

Paragraph 20.13 says that a lessee shall make the following disclosures for finance leases:

- For each class of asset, the net carrying amount at the end of the reporting period;

- The total of future minimum lease payments at the end of the reporting period, for each of the following periods:

    - not later than one year;
    - later than one year and not later than five years; and
    - later than five years; and

- A general description of the lessee's significant leasing arrangements including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.

Also, the requirements for disclosure concerning assets in accordance with Section 17 *Property, Plant and Equipment* and Section 27 *Impairment of Assets* also apply to lessees for assets leased under finance leases.

Disclosures – operating leases (lessee's financial statements)

Paragraph 20.16 requires the following disclosures for operating leases:

- The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years; and
- Lease payments recognised as an expense.

Disclosures – finance leases (lessor's financial statements)

Paragraph 20.23 requires the following disclosures for finance leases in a lessor's financial statements:

- A reconciliation between the gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period. In addition, a lessor shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period, for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years;
- Unearned finance income;
- The unguaranteed residual values accruing to the benefit of the lessor;
- The accumulated allowance for uncollectible minimum lease payments receivable;
- Contingent rents recognised as income in the period; and
- A general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.

Disclosures – operating leases (lessor's financial statements)

Paragraph 20.30 requires the following disclosures for operating leases in the lessor's financial statements:

- The future minimum lease payments under non-cancellable operating leases for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years;
- Total contingent rents recognised as income; and
- A general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, and restrictions imposed by lease arrangements.

In addition, paragraph 20.31 requires disclosures about assets in accordance with Section 17 *Property, Plant and Equipment* and Section 27 *Impairment of Assets* for assets provided under operating leases.

Leasing – the future?

The International Accounting Standards Board (IASB) are planning to revise the way that leases are accounted for. In a nutshell, the vast majority of leases (those with terms longer than 12 months) will all fall to be classed as finance leases with only a minority of leases being classified as operating leases. The objective here is to combat the problem of off-balance sheet finance and these proposals have certainly not been without controversy. The IASB have said that, despite the risks and rewards of ownership (which currently decipher whether a lease is finance or operating), it is the 'rights of use' that should determine lease classification. The IASB have looked at lease classification in the context of the *Conceptual Framework for Financial Statements* and concluded that an asset subject to an operating will meet the definition of an asset because the lessee has the right to use the asset and enjoy economic benefits generated from that use. On the flip side it also meets the definition of a liability because the lessee has obligations to pay the lessor lease rentals, hence should appear on the face of the balance sheet.

These proposals are very controversial at present and are likely to affect retailers, airlines and transport companies who all make most use of operating leases.

These proposals are due to be redeliberated in the final quarter of 2013 before the IASB decide on whether to issue a new standard in 2014. There is the possibility that the UK could adopt the same accounting treatment in the future if the IASB go ahead with the proposals, so accountants should be made aware of them.

FRS 102 SECTION 24: GOVERNMENT GRANTS (LECTURE A451 – 7.17 MINUTES)

FRS 102 deals with government grants in Section 24 *Government Grants* and whilst some of the concepts are largely the same as in current SSAP 4 *Accounting for government grants*, FRS 102 introduces the 'performance model' which is not available under SSAP 4. There are also some additional accounting issues relating to government grants that should be considered by firms of accountants.

Section 24 itself is a very short section and defines a 'government grant' as:

'...assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity'.

It is worth mentioning that the ways in which government grants are accounted for has been the subject of much debate over the years and the UK's Financial Reporting Council have intimated that they will revisit this area in the future with the objective of overhauling the ways in which grants are accounted for.

Section 24 does not deal with government assistance provided to an entity in the form of benefits which are available in determining taxable profit (or loss), or are determined or limited on the basis of income tax liability. Section 24 defines 'government assistance' as:

'...action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under specified criteria'.

Examples of such assistance are tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates and users are directed to Section 29 *Income Tax* for issues pertaining to taxation.

Recognition and measurement

Before a grant (which also includes non-monetary grants) can be recognised in an entity's financial statements, there must be reasonable assurance that:

- The entity will comply with the conditions attaching to them; and
- The grants will be received.

The term 'reasonable assurance' is not defined in FRS 102, although it should be taken to mean the same as *probable* which is defined in the Glossary to FRS 102 as *'more likely than not'*.

Grants will be initially recognised at the fair value of the asset received (or receivable) to comply with paragraph 24.5 and if any of the grant becomes repayable, the reporting entity must recognise a liability at the point in time the repayment meets the definition of a liability.

The performance model

Under the provisions in SSAP 4, only the accrual model is permitted for the recognition of grants. However, FRS 102 introduces a new concept of the 'performance model' which is not recognised in either SSAP 4, or the international equivalent, IAS 20.

If an entity adopts the performance model it recognises grants as follows:

- A grant is recognised in income when the grant proceeds are received (or receivable) provided that the terms of the grant do not impose future performance-related conditions*.
- If the terms of a grant do impose performance-related conditions* on the recipient, the grant is only recognised in income when the performance-related conditions* are met.
- Any grants that are received before the revenue recognition criteria are met are recognised in the entity's financial statements as a liability.

*performance-related conditions are defined in the Glossary as *'A condition that requires the performance of a particular level of service or units of output to be delivered, with payment of, or entitlement to, the resources conditional on that performance*.'

The accrual model

This is probably the most familiar model to UK and Republic of Ireland accountants and FRS 102 requires grants accounted for under the accrual model to be classified as a grant relating to revenue (revenue-based grant) or a grant relating to assets (capital-based grants). There are four methods of accounting for grants under the accrual model, depending on whether they are revenue- or capital-based grants:

- Grants relating to revenue are recognised in profit and loss on a systematic basis over the periods in which the entity recognises the related costs for which the grant is intended to compensate.
- Grants that are received in respect of expenses or losses already incurred by the entity are recognised in profit and loss in the period when the grant becomes receivable.
- Capital-based grants are recognised in profit and loss on a systematic basis over the useful economic life of the asset (usually to match the associated depreciation charge).
- Grants relating to an asset which are deferred are recognised as a liability (deferred income) and are not deducted from the carrying value of an asset.

The final bullet point addresses an issue that was not explicitly dealt with in SSAP 4. SSAP 4 offers a choice of accounting for a capital-based grant (as does IAS 20). Under SSAP 4 an entity can either recognise the deferred portion of the grant within liabilities as deferred income, or it can offset the grant against the cost of the related asset. If the reporting entity were to choose the latter accounting method, the grant would be recognised within profit or loss by way of reduced depreciation charges (as the cost-base used to calculate depreciable amount would be lower). However, the issue here is that Companies Act 2006 prohibits such treatment (although as I have previously reported, entities that do not apply the Companies Act 2006 when preparing their financial statements (sole traders and partnerships for example) may well be able to offset grants against the cost of asset to which the grant relates). This is illustrated as follows:

Example

A company purchases a new machine for £100,000 (funded out of cash) and the directors have assessed the useful economic life (UEL) to be five years with a nil residual value at the end of this UEL. The company's accounting policy in respect of depreciation is to charge a full year in the year of acquisition and none in the year of disposal and the company received a government grant in respect of this machine for £30,000. The grant has been recorded as follows:

DR cash at bank	£30,000
CR plant and machinery	£30,000

Being receipt of capital-based government grant

The annual depreciation charge would therefore be calculated as:

Cost £100,000 less government grant £30,000 = Depreciable amount of £70,000

The depreciation charge would be £70,000 / five years = £14,000 per annum.

Under the provisions in FRS 102, paragraph 24.5G prohibits the above treatment relating to government grants, so the following would occur:

New machine
Cost = £100,000
Depreciation = £100,000 / five years = £20,000 per annum

Government grant
£30,000 released over five years = £6,000 per annum

Net effect on profit and loss account

Depreciation charge	£20,000
Government grant released	(£6,000)
Overall net charge to P&L	£14,000

Effect on balance sheet

Deferred income within 1 year	£6,000
Deferred income more than 1 year	£18,000

So you can see that there is no overall difference on the charge to the profit and loss account (the P&L is still taking an overall hit of £14,000), it is just that FRS 102 (and Companies Act 2006) requires all amounts to be shown gross and not netted off.

Disclosures

The disclosures required in respect of government grants are as follows:

- The accounting policy adopted for grants in accordance with paragraph 24.4;
- The nature and amounts of grants recognised in the financial statements;
- Unfulfilled conditions and other contingencies attaching to grants that have been recognised in income; and
- An indication of other forms of government assistance from which the entity has directly benefited.

CASH ACCOUNTING FOR SMALL UNINCORPORATED BUSINESSES (LECTURE A452 – 10.25 MINUTES)

Legislation is introduced in Finance Act 2013 so that **eligible unincorporated small businesses** are able to elect to use **cash accounting** as the basis of their self-assessment tax return(s). This will, of course, be instead of using generally accepted accounting practice (GAAP) that is employed at the moment.

The measures take effect from the tax year 2013/14. However, current year basis rules continue to apply. As such, if a trader with a 30 April 2013 year end is eligible to and does elect to use cash accounting for 2013/14; this will impact on the business records from 1 May 2012.

Optional regime (but, once in; stay in)

The cash basis is optional and eligible businesses may consider whether or not to elect to use it. If an election is made, it has effect for the tax year for which it is made (but not earlier than 2013/14) **and for every subsequent year** until one or more of the following applies:

- The trader becomes an excluded person (see below);
- The business exceeded the exit threshold (see below) in the previous tax year and does not have cash basis receipts of less than the entry threshold (see below) in the current tax year; or
- There is a change of circumstances relating to the trade which makes it more appropriate to use accruals accounting **and** the person elects to do so. *The updated technical note for this area gives examples of such changes as being a business that:*
    - *is expanding and wishes to claim more than £500 interest deductions.*
    - *wishes to claim sideways loss relief.*
    - *decides to register for VAT.*

Even if a business leaves the cash accounting regime, it is still able to join it again in the future, subject of course to meeting the eligibility criteria at that time.

It still appears the Government will look to encourage the use of the cash basis as the effective default for those new businesses which do not need to use accruals accounting for business purposes.

The rules that provide for the election have been added in new section 25A to the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005).

Excluded persons

Regardless of the size of the business, the following persons are specifically prohibited from making a claim to use cash accounting. A person is excluded if they are:

- A company;
- A partnership with a corporate partner;
- A limited liability partnership; or
- A Lloyds underwriter.

An otherwise eligible sole trader or partnership is also excluded if:

- A herd basis election has effect in relation to the tax year;
- A claim for averaging of fluctuating profits (farmers and creative artists) has been made in relation to the tax year;
- Business Premises Renovation Allowances have been claimed in the 7 years prior to the basis period for the tax year;
- Research and Development Capital Allowances have been claimed prior to the basis period for the tax year, in relation to an asset still owned; or
- A mineral extraction trade is carried on.

Entry and exit thresholds

Businesses that are not excluded (essentially sole traders and partnerships) are eligible to make the s25A election for a tax year if their cash basis receipts for the basis period do not exceed specified entry and exit thresholds.

Entry threshold

A person (that is not otherwise excluded) may elect to use the cash basis if their aggregate 'cash basis receipts' of all trades, professions and vocations carried on during the basis period do not exceed the "relevant maximum".

The relevant maximum is usually the **VAT registration threshold that applied as at the end of the tax year in question**. This must be pro-rated down for a basis period that is less than 12 months in length.

Universal credit recipients

UC claimants may elect to use the cash basis if their **sole trade** cash basis receipts for the year do not exceed **twice the amount** of the VAT registration threshold that applied as at the end of the tax year in question (again, pro-rated down for a short basis period).

Exit threshold

All businesses must stop using the cash basis **the tax year after** their cash basis receipts for a tax year exceed **twice the amount of the VAT threshold** (pro-rated for short basis periods), unless receipts fall back below the entry limits.

Example

Clarissa is not a UC claimant. She prepares accounts to 5 April each year. In her year to 5 April 2014 she has cash basis receipts of £60,000 and so elects to use cash accounting.

Over the subsequent years, there are no changes of circumstances, relating to her trade.

For the purposes of this example, we will assume that the VAT registration threshold is £79,000 throughout.

Her future cash basis receipts and accounting requirements are as follows:

- 2013/14 - £60,000 – *Elects to use cash accounting*
- 2014/15 - £80,000 – *Must remain in cash accounting**
- 2015/16 - £160,000 – *Must remain in cash accounting**
- 2016/17 - £40,000 – *Must remain in cash accounting**
- 2017/18 - £160,000 – *Must remain in cash accounting**
- 2018/19 - £80,000 – *Must leave cash accounting and revert to GAAP.*

** In each of these years following the initial 2013/14 election to use cash accounting, Clarissa does not become an excluded person (unless she, say, incorporates) or generate a level of cash basis receipts that require her to leave cash accounting. Therefore, she must continue to use the cash basis **unless** there is a "change in her commercial circumstances" **and** she chooses to revert to accruals accounting.*

Indeed, in this example there is likely to be a significant change in her commercial circumstances through a requirement to register for VAT that, depending on the nature of her supplies, is likely to arise in 2014/15 or 2015/16.

Cash basis profits and losses

The taxable business profits under the cash basis are the total amount of receipts less the total payments of allowable expenses, subject to adjustments required or allowed by tax law.

Section 34 of ITTOIA 2005 continues to apply. This prohibits deductions for expenses not incurred wholly and exclusively for the purposes of the trade and losses not connected with or arising out of the trade.

Indeed, unless otherwise specified by law, ITTOIA 2005 continues to apply as normal.

Key points to note are as follows:

- If the trader is VAT registered, they can choose whether to record their business income and expenditure (in their business records and their self-assessment tax return) gross or net or VAT. If they choose to record all transactions gross of VAT for cash accounting purposes, the VAT payments to/from HMRC are included as cash expenditure / income.

- Only business proportions of income and expenditure should be included.

- Generally, there is no distinction between revenue and capital expenditure. As long as the capital expenditure constitutes plant and machinery within Part 2 of CAA 2001 a deduction is given as normal when the expenditure is incurred. However, cars are specifically excluded from this treatment and are subject to different rules (see later).

  No deduction is given for items that do not constitute plant and machinery, for example; land and buildings.

- As such, generally, persons using cash accounting are not entitled to claim plant and machinery capital allowances.

- However, if expenditure is incurred on a car, the trader can choose between claiming plant and machinery capital allowances or claiming mileage allowances.

- Partners could find that their personal relief for qualifying loan interest is blocked, if the partnership opts for cash accounting.

- Other interest is usually deductible as a trading expense although there is a limit of £500 per annum.

- Losses computed while cash accounting cannot be sideways relieved against other income and capital gains relief is prohibited. All the trader can do is carry the loss forward against profits of the same trade.

- Special rules apply when changing between basis:

  - Chapter 17 of ITTOIA 2005 applies and so an amount of 'adjustment income' or 'adjustment expenditure' is computed to counteract any duplication or omission of income or expenditure. Adjustment income is not assessable to Class 4 NIC.

  - If adjustment income arises when moving *from* cash accounting to accruals accounting, it will be equally spread over 6 years, unless the taxpayer elects to accelerate the charge.

  - Any unrelieved tax written down value in the plant and machinery pool is deducted from profits when moving to cash accounting; but only to the extent that the assets in question would have been deductible under cash accounting (and so, in particular, not cars!).

- Limited guidance has been published here: https://www.gov.uk/simpler-income-tax-cash-basis. With regard to record keeping, this simply says:

  'You must keep records of business income received and business expenses paid. Depending on what you use simplified expenses for, you need to record business miles for vehicles, hours you work at home and how many people live on your business premises over the year.'

- Different rules are still proposed for self-employed universal credit claimants who will be required to prepare monthly cash accounts.

(Finance Act 2013 section 17 and Schedule 4)

ASSURANCE REVIEW ENGAGEMENTS (LECTURE A453 – 6.29 MINUTES)

In October 2013, the ICAEW published TECH09/13AAF *Assurance Review Engagements on Historical Financial Statements*. This Technical Release was published in light of the sheer number of audit exempt companies that are now in existence since audit exemption was introduced in 1993. The Technical Release is designed to be a companion to the International Standard for Review Engagements (ISRE) 2400 which was revised in 2012 (it is to be noted that the revised ISRE 2400 comes into effect for reviews of financial statements for periods ending on or after 31 December 2013.

The objective of a review engagement is for the accountant to obtain a degree of assurance that the financial statements comply with an applicable financial reporting framework and give a true and fair view as well as obtaining assurance that management is aware of its responsibilities for producing the financial statements.
In order to achieve this objective, the accountant will undertake a comprehensive review of all the material areas within the financial statements, whilst being alert to factors that may increase the risk of material misstatement, or be non-compliant, such as:

- The nature of the client's business and its organisational structures
- The incidence of fraud
- Non-compliance with laws and regulations
- Undisclosed related party transactions
- Going concern problems
- Post balance sheet events
- Accounting estimates
- Suitability of accounting policies
- Significant, unusual or complex transactions or events

A review engagement is not as rigorous as an audit engagement, and therefore the levels of assurance in a review engagement are less (limited assurance, rather than reasonable assurance, are given in review engagements in the form of a conclusion). There are generally four types of review engagement that are available:

1. A compilation engagement where the reporting accountant is engaged to prepare the financial statements from accounting records provided by the directors.

2. Agree-upon procedures, the outcome of which are contained in a report of factual findings relating to the tests carried out.

3. An assurance review engagement, which provides limited assurance on financial statements in accordance with ISRE 2400 (revised).

4. An audit carried out in accordance with the UK and Ireland International Standards on Auditing, the output of which is an expression on the truth and fairness of the financial statements by the auditor which is in the form of reasonable assurance (an opinion). The opinion is not absolute due to inherent limitations of the audit, but is still regarded as the highest form of assurance.

Compliance with ethical standards

The practitioner undertaking the review engagement is mandated to comply with a Code of Ethics. Ethical principles which apply to practitioners' professional responsibilities include:

(a) Independence;
(b) Integrity;
(c) Objectivity;
(d) Professional competence and due care;
(e) Confidentiality;
(f) Professional behaviour; and
(g) Technical standards.

Quality control

As is the case with all types of engagement, there has to be an element of quality control at firm level and the engagement level quality control requirements contained within ISRE 2400 assume that the firm will comply with the requirements in ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*. For UK and Republic of Ireland practitioners undertaking review engagements, the FRC's ISQC (UK and Ireland) 1 will apply and should also be read in conjunction with the FRC's *Statement of Scope and Authority of Audit and Assurance Pronouncements*.

Acceptance and continuance of client relationships

As is the case with audit engagements, before acceptance and re-acceptance of an assignment, the accountant must consider whether the applicable financial reporting framework for which the work will be undertaken is acceptable and in the UK, these are:

- UK GAAP: current UK GAAP, FRS 102 and the FRSSE (effective April 2008) or (effective January 2015;

- EU-adopted IFRS; or

- FRS 101 *Reduced Disclosure Framework.*

The accountant must ensure that management both acknowledges and understands its responsibilities and this is usually acknowledged in an engagement letter (TECH 09/13 AAF) contains an illustrative extracts to include in an engagement letter in Appendix 1.

Example

A client has requested a professional accountant to undertake a review engagement in accordance with ISRE 2400. The client is a trust and the accounts for which the trust has prepared do not have to comply with any of the above applicable financial reporting frameworks, but do have to follow accepted accounting principles. The professional accountant is unsure whether this is acceptable.

The principles in ISRE 2400 can be applied to a set of financial statements which do not necessarily comply with a recognised GAAP in the UK, but do have to follow accepted accounting principles. However, the professional accountant must satisfy themselves that the accounting policies disclosed in the financial statements provide sufficient information as to the accounting basis and policies the client has adopted as well as ensuring that there is sufficient information disclosed within the financial statements for the purpose of the users of the financial statements. In dealing with such a review engagement, the professional accountant's report will also need to be amended accordingly.

If, on the other hand, the accountant concludes that the use of ISRE 2400 is not appropriate, they may consider the use of other types of engagement, such as an agreed-upon procedures engagement.

Liability limitation and risk management

The overarching objective of any kind of assurance review is to enhance the credibility of the information contained in the report and third parties often seek to place reliance on the financial statements (particularly those which have been audited).

In an assurance engagement, there could be multiple individual parties who will have access to the financial statements which will contain the assurance report. In a situation when all the parties to the financial statements can be identified, it may be the accountant seeks to manage their risk by way of a tri-partite or multi-partite engagement contract which would accept that the accountants owes a duty of care not only to the client, but also to the other interested parties and include limitation of liability where appropriate.

TECH 09/13 AAF does acknowledge that ISRE 2400 does not require any such contract and that this approach is only effective if all the third parties are party to the contract as well as the fact that it could prove to be time-consuming to negotiate if there are several third parties.

Many assurance reports contain the use of a Bannerman paragraph or something similar in an attempt to limit the accountant's liability, such a paragraph is worded typically as follows:

This report is made solely to the Company's directors, as a body, in accordance with the terms of our engagement letter dated [insert date]. Our review has been undertaken so that we may state to the company's directors those matters we have agreed with them in our engagement letter and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's directors as a body for our work, for this report or the conclusions we have formed.'

There is, however, no substitute to minimising the accountant's exposure to risk than good practice. This includes:

- Ensuring team members understand the requirements of ISRE 2400 and guidance issued by professional bodies (such as TECH 09/13 AAF).
- Ensuring work is adequately documented, supervised and reviewed.
- Ensuring the scope of the engagement is clearly communicated to the client and the responsibilities of management and the reviewing firm are established and fully understood.
- Ensuring the assurance report is appropriately worded.

Going concern

Likewise with auditor's reports, ISRE 2400 at paragraph 87 requires the accountant to make use of an 'emphasis of matter' paragraph where the accountant considers going concern to be a matter of such importance that it is fundamental to the users' understanding of the financial statements (such as where there is material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern).

ISA 230 *AUDIT DOCUMENTATION* (LECTURE A454 – 7.30 MINUTES)

A frequent criticism from many file reviewers is the lack of audit documentation on file for the material areas of the financial statements. In the absence of sufficient documentation representing audit evidence or complementing audit evidence on file, it is often difficult for file reviewers to conclude that procedures have been carried out. When an auditor holds a discussion with the client, for whatever reason, the most frequently missed point by the auditor is DOCUMENTING that discussion. Auditors should always keep in mind that 'inquiry' is a method of gathering audit evidence in ISA (UK and Ireland) 500 *Audit Evidence* (although inquiry, alone, will often be insufficient evidence – inquiry usually complements alternative audit evidence).

Definitions

ISA (UK and Ireland) 230 defines audit documentation as follows:

'The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used).'

Paragraph 8 to ISA (UK and Ireland) 230 says that the auditor shall prepare audit documentation which is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

(a) The nature, timing and extent of the audit procedures performed to comply with the ISAs (UK and Ireland) and applicable legal and regulatory requirements;

(b) The results of the audit procedures performed, and the audit evidence obtained; and

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

The paragraph then goes on to say that in documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

(a) The identifying characteristics of the specific items or matters tested;

(b) Who performed the audit work and the date such work was completed;

(c) Who reviewed the audit work performed and the date and extent of such review.

Illustration of audit documentation preparation

Every audit firm will have their own sort of 'house style' when it comes to audit documentation. The key is to ensure that there is adequate documentation on file to support the audit opinion (in other words every audit file should 'tell a story' which is how the auditor has arrived at their audit opinion in each material area of the financial statements).

Example of a typical audit file working paper

Client:	ABC Industries Ltd	**Prepared by:**AB
Subject:	Health and Safety – Notes of Discussion	**Date:** 02.11.2013
File Ref:	C4	**Reviewed by:** CD
Year-End:	30 September 2013	**Date:** 20.11.2013

Objective

The objective of the meeting was to confirm whether, or not, the company has complied with its obligations under Health and Safety legislation. Health and Safety legislation has been deemed as a central law and regulation for ABC Industries Ltd and any breach of such legislation would have going concern issues for the client.

Work performed

We held a discussion with Lucas Stevens, the Managing Director, on 2 November 2013 to discuss the company's compliance with Health and Safety legislation. Lucas Stevens provided me with a copy of the latest Health and Safety inspection which was undertaken on 1 June 2013 (refer to schedule C5). This report confirms that the company's Health and Safety procedures are sufficient and that they have complied with all Health and Safety legislation. Lucas Stevens confirmed that they have three internal Health and Safety specialists as well as an external Health and Safety specialist who monitors, on a regular basis, the company's compliance with Health and Safety issues.

Lucas Stevens also confirmed that the entity takes Health and Safety very seriously and any employees who breach Health and Safety are taken through the company's disciplinary process.

Results and evaluation

See schedule C5 for the results of the Health and Safety inspection undertaken by the external Health and Safety consultant. I have also obtained copies of the internal Health and Safety review which was undertaken on 20 September 2013 (see schedule C6). There was no indication of any breach of Health and Safety legislation.

Conclusion

Based on the other audit evidence obtained and the results of the discussion above, which are consistent with the other audit evidence, I am satisfied that no breaches of Health and Safety legislation have occurred.

Preparing adequate audit documentation will also help to serve compliance with other ISAs, for example:

- Planning documentation will help to comply with ISA (UK and Ireland) 315 *Identifying and assessing risks of material misstatement through understanding the entity and its environment*;

- The auditor's report will confirm compliance with ISA (UK and Ireland) 700 *The independent auditor's report on financial statements*;

- Having a letter of engagement on file prior to the commencement of the audit will help to comply with the provisions in ISA (UK and Ireland) 210 *Agreeing the terms of audit engagements*.

How much is the right amount of audit documentation?

ISA (UK and Ireland) 230 does not specify a 'benchmark' when it comes to the amount of audit documentation on file that would be considered sufficient and appropriate. The form, content and extent of audit documentation would all depend on varying degrees of factors and the Application and other explanatory material at paragraph A2 outlines these factors as follows:

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The audit methodology and tools used.

Audit documentation after the auditor's report has been issued

In rare situations, transactions or events may come to light which will mean that the auditor may have to perform new, or additional, audit procedures or draw new conclusions after the date of the auditor's report. This could occur, for example, if a subsequent event comes to light (such as a fraud) that the auditor was not previously aware and where the audit procedures had not discovered such a transaction(s) or event(s). In these cases, it is important that the auditor documents:

(a) The circumstances encountered;

(b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

(c) When and by whom the resulting changes to audit documentation were made and reviewed.

Assembly of the audit file

In real life audit practice, audit files are not completed as soon as the audit fieldwork has drawn to a close. There are many ‘behind the scenes’ activities that must be undertaken once the detailed audit evidence has been obtained, such as assembling the audit file, dealing with the completion side of the audit, audit engagement partner review and analytical procedures.

However, once the completion side of the audit has been completed, the audit clearance meeting has taken place and the auditor’s report and financial statements have been approved, paragraph 14 to ISA (UK and Ireland) 230 says that the auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor’s report. ISQC (UK and Ireland) 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements* in the Application and other explanatory material at paragraph A54 says:

‘Law or regulation may prescribe the time limit by which the assembly of final engagement files for specific types of engagement is to be completed. Where no such time limits are prescribed in law or regulation, paragraph 45 requires the firm to establish time limits that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit would ordinary not be more than 60 days after the date of the auditor’s report.’

Once the final audit file has been assembled, the auditor must not delete or discard audit documentation of any nature before the end of its retention period. However, circumstances may come to light which may mean that the auditor finds it necessary to modify existing audit documentation, or add new audit documentation, after the assembly of the audit file has been completed. Paragraph 16 to ISA (UK and Ireland) 230 says that regardless of the nature of the modifications or additions, the auditor shall document:

(a) The specific reasons for making them; and

(b) When and by whom they were made and reviewed.

AUDIT FAQS (LECTURE A455 – 19.07 MINUTES)

This section of the notes is based on an article (FAQs) that appeared in *Audit and Beyond* in October 2013. The article was written by John Selwood, a chartered accountant, writer and independent training consultant.

Are companies required to disclose transactions with directors in the financial statements? The directors of one of my audits have refused to disclosure a very large loan from a director stating that the Companies Act no longer requires this disclosure. How should I respond?

The directors are correct in identifying that the Companies Act 1985 requirement to disclosure contracts in which directors have an interest has been withdrawn. The Companies Act 2006, S413, instead requires disclosure of advances, credits and guarantees to directors. The Act does not require disclosures of loans from directors to the company.

However, Accounting Standards require disclosure of related party transactions. The directors are clearly related parties so provided that the loan is material then it should be disclosed. Whilst there are detailed differences in the disclosure requirements in FRSSE 2008, FRS 8 and IAS 24, they all require disclosure relating to this transaction. So this loan should be disclosed in the accounts, in one form or another, regardless of the accounting framework being followed.

As the auditor you should request that the company makes the appropriate disclosures in the accounts otherwise you have to consider the impact on your audit report and the possibility of a qualified opinion based upon disagreement.

More importantly you should revisit your audit risk assessment. The directors' reluctance to disclose this loan should make you alert to the possibility of fraud relating to this transaction. Additionally, could this indicate that other similar issues might have been concealed by management?

Following on from the previous question, is there a Companies Act 2006 requirement to disclose directors loans to the company in small company abbreviated accounts? Is the answer different if the loan is from the company to the director?

These questions have arisen time and time again over the past five years, since the Companies Act 2006 came into force. This makes them no easier to deal with!

Loans from directors to the company are related party transactions and as such are not required to be disclosed in the small company abbreviated accounts.

Companies Act 2006 S413 does require disclosure of advances, credits and guarantees in favour of any director, in the company's individual accounts. However, there is no explicit requirement in the Act to include these disclosures in the small company abbreviated accounts. Previously ICAEW has suggested that this lack of clarity in the Act, coupled with the fact that the disclosure that S413 replaced did go in the small company abbreviated accounts, means that disclosure should continue to be made.

This is very much now the 'received wisdom' on the issue. Software suppliers and Companies House templates all encourage the disclosure of directors' loans etc. in the small company abbreviated accounts.

Having said that, in my view, it is hard to say that abbreviated accounts excluding S413 loan disclosures do not comply with the Act.

I am currently auditing a company with very poor trading results that is being supported by its parent company. This support over the past few years has resulted in very large sums being advanced to the company by the parent and this support will be needed for the foreseeable future. As the company cannot survive without continued heavy support I have asked the directors to include extensive disclosures on going concern and I have informed them of my intention to include an added emphasis paragraph in my report, regarding the going concern position. The directors are unhappy with this and believe that the letter of support from the parent should be enough. What should I do?

You are right to be nervous of relying solely on a letter of support. In the recent legal case of *Re Simon Carves Ltd sub nom Carillion Construction Ltd v Hussain and others* the judge referred to the letter of support as '*little more than worthless scraps of paper*' and he said that it had only been prepared to support the use of the going concern basis in the financial statements. The judge went on to say that the holding company is unlikely to have made such a major financial commitment so flippantly. The judge made no comment on the audit!

Auditors should take note of this and regard the letter of support as part of the evidence rather than the beginning, middle and end of the audit evidence. The auditor should consider evidence that supports the holding company's intentions such as:

- business plans;
- past history; and
- anything that would support the magnitude and nature of the support pledged and a real commitment to supporting the subsidiary.

The holding company's ability to offer the support should also be considered and a review of the holding company's financial statements and other relevant records is almost mandatory.

Coming back to the specifics of your question, your request to include relevant going concern disclosure and your intention to include a going concern added emphasis paragraph in your audit report sound perfectly reasonable. In any event you clearly need more evidence to support the going concern basis than a letter of support.

A new holding company has offered very significant support but has not provided a letter of support. Management of the subsidiary do not want to push the issue because they are concerned about offending the directors of the holding company who have given their word to support the subsidiary. As auditor, what should I do?

Whilst, having a letter of support is not persuasive audit evidence regarding going concern, not having a letter of support is a real worry.

The fact that the directors of the subsidiary are reluctant to push for a more formal confirmation of support could indicate that they lack confidence in the holding company. Perhaps the directors know that a letter of support will not be forthcoming.

As auditor you should remind the directors of the subsidiary of their obligation to consider the appropriateness of the going concern basis for the preparation of the financial statements. It is their duty as directors to seek out confirmation of the holding company's support.

Without a letter of support you will have to carefully scrutinise the directors disclosure in the accounts to ensure that is appropriate given the audit evidence available and you will have to consider the impact on your audit report.

It seems to me that many companies will not be able to cope with all of the changes in FRS 102 without assistance from their external accountant, who will in many cases be their auditor too. Can auditors provide services to help with the transition to the new UK GAAP?

This is likely to be a very hot topic over the next few years and the more that you think about it, the more issues present themselves. In answering this question all I can do is highlight the big issues.

New UK GAAP and FRS 102

The new UK GAAP applies from periods commencing 1 January 2015 (early adoption is permitted) and comes in different forms:

- *The Financial Reporting Standard for Smaller Entities* (effective January 2015) – obviously for small entities;
- *FRS 101 Reduced Disclosure Framework* (November 2012) Disclosure exemptions from EU-adopted IFRS for qualifying entities – for members of groups adopting IFRS;
- FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (March 2013) – applies to medium sized and large, unlisted entities.

The nature of the accountancy services that an auditor might be asked to provide will depend upon the standard adopted and just as importantly whether the GAAP adopted prior to the change was UK GAAP or IFRS. Transition provisions in these standards can be onerous.

The most likely transition scenario, in the UK, is FRSSE 2008 to FRSSE 2015. This is likely to represent a relatively small change and assisting with this is unlikely to create ethical problems other than the management threat arising from assisting with the re-estimation of the useful life of goodwill. In any event, most of these entities will be audit exempt due to their size.

The transition that auditors are most likely to see is UK GAAP to FRS 102. Providing accountancy services related to this transition undoubtedly will present threats to independence, some of them potentially significant.

Auditors providing valuations

In Ethical Standard 5 *Non-audit services provided to audited entities* (Revised December 2010, updated December 2011) paragraph 77 states that:

‘The audit firm shall not undertake an engagement to provide a valuation to:

(a) an audited entity that is a listed company or a significant affiliate of such an entity, where the valuation would have a material effect on the listed company’s financial statements, either separately or in aggregate with other valuations provided; or

(b) any other audited entity, where the valuation would both involve a significant degree of subjective judgment and have a material effect on the financial statements either separately or in aggregate with other valuations provided.’

There will be few listed entities adopting FRS 102. As you would expect the provision of valuations, by auditors, to listed entities is very restricted.

To summarise the position for unlisted entities, auditors cannot provide valuations that are both material in the financial statements and involve subjectivity. When adopting FRS 102 there are a number of areas where valuations might be required, such as:

- valuation at fair value (FV) of investments in shares;
- the reassessment of the FV of assets acquired in previous acquisitions, particularly intangible assets;
- provisions for deferred tax liabilities, previously unrecognized;
- uplifts in the value of fixed assets to deemed cost; and
- valuation at FV of derivatives, such as interest rate swaps and foreign exchange or commodities forward contracts.

Some of these valuations are more likely to be material or involve more subjectivity than others. Auditors need to think very carefully before accepting an engagement to assist with transition and consider exactly what might be involved. Valuations of shares in private companies are likely to involve too much subjectivity for an auditor to be able to assist.

Threats and safeguards

On the other hand, calculating deferred tax provisions might be acceptable, if appropriate safeguards are in place. Where auditors are able to provide non-audit services to assist with transition to FRS 102, careful thought will always need to be given to the nature of these safeguards. The necessary safeguards can only be properly determined once the threats to independence have been identified.

Typically these threats to independence will be self-review and management threats. They can be robustly addressed by ensuring separate staff and partners, who do not form part of the audit team, provide the accountancy services. But it is important to note that no safeguard will be sufficient to address threats from providing valuations that are both material and involve subjectivity.

Self-interest threats might also arise if the fees for the FRS 102 related accountancy services are significant - and given the required transition process, they could be. Making another partner responsible for the provision of the non-audit services tends to be a good safeguard in these situations.

Having said all of this, every situation is different and the auditors' own professional judgement needs to be applied to the situation.

Informed management

Another potential problem for auditors is that non-audit services may only be provided where there is informed management. In previous years the auditors might have identified informed management, however, informed management is not constant and it depends upon what management are required to be informed about.

Transition to FRS 102 is very complex for some companies and management may need significantly more informing than they did in previous years. This is vital to ensure that the auditor is not making decisions that are properly those of management.

Small Companies and PASE

An interesting point to note is that PASE, the *Provisions Available for Smaller Entities* (Revised 2010), is unlikely to apply because small companies will tend to not adopt FRS 102. However, if the audited entity is small, PASE might be of some use because it permits the provision of non-audit services without the application of safeguards to protect against the self-review threats. Self-review threats will be an issue with FRS 102 adoption. But other important threats will also tend to be present, such as the management threat, and PASE offers no such similar relief for these.

After transition to FRS 102

Providing assistance with transition is not the end of these ethical issues. In a number of areas ongoing valuation services will be required, such as for the fair value of investments in shares and derivatives. If auditors are to provide these valuations they will always have to consider their materiality and the subjectivity in making them.

Other than this, providing accountancy services to entities adopting FRS 102 will be business as usual. Auditors will continue to identify informed management and assess the threats to independence and apply appropriate safeguards.

SUMMARY OF DEVELOPMENTS

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

12 August 2013

FRC responds to Competition Commission's Provisional Decision on Remedies

The FRC has welcomed the withdrawal of some earlier proposals such as mandatory rotation of audit firms, compulsory joint audit, and a role for the FRC in the appointment of auditors; it is however concerned that five yearly audit tendering will not achieve the stated aim of promoting competition in the audit market.

FRC CEO Stephen Haddrill said:

'The FRC supports the objectives that the Commission is seeking to achieve through the remedies it has proposed. Nevertheless, our response includes a number of comments and suggestions (below) particularly in relation to the remit of the FRC's Audit Quality Review programme, and the five year retendering period which need more careful consideration. In particular, we are concerned that tendering on a five year basis will involve additional costs and risks to companies and firms.'

Mandatory tendering

The FRC is concerned that a five-year tendering interval will not be taken seriously by companies or firms and may result in a 'sham' process which will undermine the serious approach already being shown to ten-year retendering introduced in updates to the UK Corporate Governance Code in 2012.

Audit quality review (AQR)

A concern raised by the FRC in respect of extending the AQR reporting to include all FTSE 350 companies every five years as well as increasing the remit to include firms auditing ten or more public interest entities was that it may undermine the FRC's current risk-based approach to the selection of audits for inspection. The FRC has expressed a wish to consider how to address this and other matters such as the additional funding which would be need for a larger investigation remit during its consideration of the Commission's eventual recommendation.

Enhanced shareholder engagement

The FRC is keen to encourage enhanced shareholder engagement with companies relating to audit issues. In light of this, the FRC is willing to consider amendments to the Corporate Governance Code, including the remedies proposed by the Commission, to support its own recent changes already made to enhance audit committee reporting.

FRC consults on strategic report guidance

15 August 2013

The FRC issued a consultation document, *Guidance on the Strategic Report* which relates to applying the requirements for the strategic report in the recently issued Companies Act 2006 (Strategic Repot and Directors' Report) Regulations 2013.

Companies are encouraged to experiment and be innovative in the way that they draft their annual reports and should present narrative information in a way that allows a 'story to be told' to investors in a concise and clear manner and which links to information in a fair, balanced and understandable way.

Melanie McLaren, Executive Director, Codes and Standards, said:

'Whilst the new regulations represent a relatively modest change to the existing legal requirements, we hope that our proposed guidance will act as a catalyst for companies to publish more relevant narrative reports, facilitating communication and engagement with investors. Investors tell us that they want information to be forward-looking and focussed on strategy and the business model; highlighting relationships and interdependencies between information presented in different parts of the annual report, and with an emphasis on materiality and conciseness.

The guidance builds on the changes made to the UK Corporate Governance Code in October 2012, requiring annual reports to be fair, balanced and understandable. Along with our project on establishing a framework for disclosure, the guidance is aimed at "cutting clutter" and improving relevance of corporate reporting to investors. In drafting the guidance we have borne in mind developments in integrated thinking and reporting.'

Feedback on the draft guidance is required by 15 November 2013.

UK and US regulators agree to continue arrangements for cooperation on cross-border supervision of audit firms

22 August 2013

The FRC and the Public Company Accounting Oversight Board of the United States (PCAOB) have agreed to continue their cooperation agreement following recent European Commission Decisions which permit such agreements until 31 July 2016.

The Statement of Protocol between the FRC and PCAOB allows for effective cooperation between the two organisations as well as allowing joint work on inspections and the exchange of (otherwise confidential) information against the background of an audit market which is increasingly global in nature.
Paul George, Executive Director of the Conduct Committee and co-signatory of the Statement of Protocol, said:

'The FRC and the PCAOB have developed an excellent working relationship in recent years, which has provided the basis for increasing confidence in one another's regulation of major audit firm.'

FRC to enable the electronic filing of accounts based on its new financial reporting standards

26 September 2013

The FRC announced a project which will improve the quality of electronic tagging of accounts. Following transfer of responsibility to the FRC, the XBRL tagging convention – taxonomies – will be updated to reflect the new financial reporting standards (FRS 100, 101 and 102) for the UK and Ireland and will be introduced by the FRC in March 2014.

In recognition of the fact that UK companies already have to submit their accounts to HMRC in XBRL format (and many voluntarily choose to do so when submitting accounts to Companies House), updating the XBRL tagging conventions will enable companies to continue doing so after they have adopted the new UK accounting standards.

Melanie McLaren, Executive Director, Codes and Standards, said:

'Improved tagging of corporate reports enhances investors' ability to compare and analyse. The FRC sees e-enablement of financial communication and reporting as an extension of its standard setting.'

FRC to consult on executive remuneration

2 October 2013

The FRC has published a consultation on whether to amend the UK Corporate Governance Code in order to address a number of issues relating to executive remuneration, specifically three proposals:

- Clawback arrangements;
- Whether non-executive directors who are also executive directors in other companies should sit on the remuneration committee; and
- What actions companies may take if they fail to obtain at least a substantial majority in support of a resolution on remuneration.

FRC Chairman, Baroness Hogg, commented:

'The Government's new legislation underlines the importance of Boards and investors engaging on directors' remuneration. The FRC is undertaking this consultation to understand if there is a case for changes to the Code.

There is no presumption on the FRC's part as to the outcome. All interested parties will have an opportunity to make their views known before we reach a final decision.' If changes to the Code are ultimately proposed, they will be subject to consultation in the first quarter of 2014. The new Code would then apply to accounting periods commencing on or after 1 October 2014.

FRC publishes Corporate Reporting Review Annual Report

17 October 2013

The FRC has published the *Corporate Reporting Review (CRR) Annual Report for 2013*. This report covers reviews conducted in the year to 31 March 2013. The findings conclude that while corporate reporting by larger companies remains at a good level, smaller listed or quoted companies suffer from a lack of sufficient or appropriate resource. In light of these findings, the FRC will consider actions that serve to strengthen reporting in this area as part of the 2014/15 work plan.

The CRR's assessment was based on a review of 264 sets of financial statements selected from the full range of companies within the FRC's remit. Of this sample, 91 companies were subsequently approached for further information or explanation. The users' of a company's accounts should be able to understand the company's key messages and the CRR was disappointed that a few boards followed the initiative shown by some who, in 2012, were required to review their accounts to ensure that key messages were highlighted and supported with relevant, concise disclosures.

Richard Fleck, Chairman of the FRC's Conduct Committee, said:

'We operate in an environment where reputation is enhanced by transparency and openness supports integrity. It is important that boards are willing to hold open and constructive dialogue with investors and respond well to suggestions for improvements to the quality of their reports.'

FRC publishes Financial Reporting Lab report on Reporting of Audit Committees

24 October 2013

The FRC's Financial Reporting Lab has published its report on *Reporting of Audit Committees* which provides insight from companies and investors on the effective approaches to audit committee reporting, including the content and the way in which the information is presented. There were 19 companies and 25 investor and analyst organisations which took part in the project.

The UK Corporate Governance Code was revised in October 2012 and the revisions included introducing requirements for audit committees to describe, in more detail, the work that they undertake. The revised Code calls for descriptions of the significant issues considered by audit committees in relation to the financial statements and:

(a) How they were addressed;
(b) How the audit committee assessed the effectiveness of the external audit process; and
(c) The audit committee's approach to appointing the auditor and safeguarding the objectivity and independence relative to the use of non-audit services.

The study found that investors are keen to gain an understanding of the issues that have been the subject of the audit committee's focus for the year. The report also gives the following examples of what investors are looking for:

- Demonstrate ownership and accountability by personalising their report
- Ensure reports are specific to their company and current year's activities
- Describe in detail actions taken rather than just the functions they serve
- Depict their specific activities during the year and their purpose, using active, descriptive language
- Disclose judgements made for the year, and the sources of assurance and other evidence used to satisfy themselves of the appropriateness of the conclusion
- Consider their audience in describing issues and their context

Director of the Financial Reporting Lab, Sue Harding, said:

'Investors have told us that they will pay more attention to audit committee reports if they provided more meaningful information. This report sets out clearly how audit committee members can make their reports do just that. Audit committee reports should form part of the conversation between companies and investors building confidence in this important area of governance and showing how it contributes to good financial reporting.'