# ACCOUNTING AND AUDIT UPDATE

**Tolley®CPD**

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## FRS 102: DEFERRED TAXATION (Lecture A456 – 16.26 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* takes mandatory effect for accounting periods commencing on or after 1 January 2015 (although earlier adoption is permissible). The new Generally Accepted Accounting Practice (GAAP) is considered to be one of the most significant changes UK GAAP has seen in the last 40 years. Auditors and accountants must get to grips, sooner rather than later, with the new accounting practices inherent in FRS 102 as well as understanding how reporting entities will be affected once the new UK GAAP becomes effective.

Potentially, one of the most unpopular concepts in the world of financial reporting is the issue of deferred tax. Deferred tax has been criticised over the years by practitioners who have largely questioned its relevance in the context of certain clients – particularly companies at the smaller end of the scale. Notwithstanding the varying degree of opinions concerning deferred tax, the concept is still with us in FRS 102 and to a certain extent comes back with a vengeance (see later in the notes).

The overarching principle underlying deferred tax is the recognition of future tax consequences of transactions and events in the current year's financial statements. It is acknowledged that most transactions and events that have been recorded in a client's financial statements will have some form of tax consequence and the main example that illustrates this principle is the acquisition of an asset which is deductible for tax purposes in the current and subsequent accounting periods (by way of capital allowances). The future tax consequences of transactions and events cannot be ignored because whatever happens in the future, the reporting entity will have to pay more or less tax than it would have done had those transactions or events not taken place. As a result, it is necessary to recognise the tax effects of all income and expenditure, assets and liabilities, gains and losses in the period in which they are recognised themselves and not in the period in which they form part of the tax computation. It is this matching concept that gives rise to both current and deferred tax.

In current UK GAAP, taxation issues are covered in two standards – that of FRS 16 *Current Tax* and FRS 19 *Deferred Tax*. Aspects concerning taxation are also found in FRS 17 *Retirement Benefits* at paragraphs 71 and 72 which deal with tax relief on a company's pension contributions and the attribution of the tax effects to the profit and loss account and statement of total recognised gains and losses.

FRS 102 deals with taxation at Section 29 *Income Tax*. The scope paragraph of Section 29 confirms that income tax (for the purposes of FRS 102) includes all domestic and foreign taxes which are based on taxable profit. It then goes on to include taxes such as withholding taxes payable by a subsidiary, associate or joint venture within its scope.

Unlike FRS 16 and FRS 19, Section 29 combines the requirements of both current and deferred taxes and the Section recognises that current tax is payable (or refundable) in respect of the taxable profit (or taxable loss) in respect of the current reporting period or past reporting periods. The scope section in Section 29 takes the same stance as current FRS 19 in respect of deferred tax in that it acknowledges that deferred tax represents the future tax consequences of transactions and events recognised in the entity's financial statements of both the current and previous accounting periods.

When a business combination takes place (business combinations are dealt with in Section 19 *Business Combinations and Goodwill*), the Section also requires deferred tax to be recognised in respect of assets and liabilities recognised as a result of the business combination. In respect of assets, it is all assets but NOT goodwill.

Section 29 is a relatively short section which spans just over four pages; however, the concepts that the Section deals with in relation to taxes can be extremely complex. In addition, Section 29 also brings in the issues relating to Value Added Tax (VAT) which, again, is currently dealt with in a separate standard, namely SSAP 5 *Accounting for Value Added Tax*.

## *Current tax*

Section 29 deals with current tax in addition to deferred tax and clearly current tax is the simplest form of tax to account for. Paragraph 29.3 requires a reporting entity to recognise a current tax liability in respect of corporation tax payable for the current and previous accounting periods. This will, in almost all cases, be based on the company's taxable profit for the financial year. The Glossary to FRS 102 defines 'taxable profit (tax loss)' as:

*'The profit (loss) for a* ***reporting period*** *upon which income taxes are payable or recoverable, determined in accordance with the rules established by the taxation authorities. Taxable profit equals taxable income less amounts deductible from taxable income.'*

Conversely, in respect of taxable losses, a company may be due a refund from HM Revenue and Customs (HMRC) and if this is the case, the company will be required to recognise a current tax asset in respect of such. All amounts relating to tax are required to be measured using the tax rates and laws that have been enacted, or substantively enacted, by the balance sheet date.

## *Deferred tax*

Deferred tax has long since been a topical issue within the accountancy profession and the objectives of deferred tax are twofold:

- To ensure that the future tax consequences of past transactions and events are recognised as assets or liabilities within a reporting entity's financial statements; and
- To disclose any additional special circumstance that may have an effect on future tax charges.

It is important at the outset to acknowledge that the accounting for deferred tax could have been a whole lot worse according to the previous Exposure Drafts issued by the (now defunct) Accounting Standards Board (ASB). The previous Exposure Drafts were based on the International Accounting Standards Board's *IFRS for SMEs* and looked at deferred tax from a 'temporary difference' approach. In the UK, accountants have been used to dealing with deferred tax from a 'timing difference' approach and the differences between the two are significant. The temporary difference approach focuses on the balance sheet so, for example, a deferred tax liability would arise if the carrying value of an asset was greater than its tax base (tax written down value) or if the carrying value of a liability is less than its tax base.

Timing differences, on the other hand, focus on the profit and loss account and are differences between a company's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in the financial statements. A typical scenario would be where an asset qualifies for HMRC's *Annual Investment Allowance* in the year of acquisition, but that same asset is being depreciated over three years using the straight-line method of depreciation.

## Example – timing difference giving rise to a deferred tax liability

Company A Limited purchases an item of machinery for use in its production process amounting to £20,000. This item of machinery qualifies for HMRC's *Annual Investment Allowance* at a rate of 100%. The company's accounting policy in respect of manufacturing plant and machinery is to charge a full year's depreciation in the year of acquisition with no depreciation being charged in the year of disposal. The directors of Company A have assessed the new machine's useful economic life to be five years with a residual value of £nil at the end of this five-year period. Company A is preparing financial statements to 31 March 2014 and financial statement extracts in respect of this new machine are as follows:

| | £ |
|---|---|
| Cost | 20,000 |
| Depreciation (£20,000 ÷ 5 years) | (4,000) |
| Net book value | 16,000 |

The directors have taken advantage of HMRC's *Annual Investment Allowance* and the same machine will therefore have a tax written down value at 31 March 2014 of £nil. A difference, therefore, arises between the net book value per the financial statements and the tax written down value of the machine amounting to £16,000. This difference will trigger a deferred tax liability because there will be a future tax consequence for the company. The company has made a cash flow saving in the year of acquisition by claiming HMRC's *Annual Investment Allowance* – this allowance will not be available in the next accounting period for that same asset and therefore the tax liability will be higher. Assuming the company pays tax at 20%, the deferred tax liability to be recognised will be £3,200 (£16,000 x 20%).

Timing differences are said to originate when a transaction is first reflected in the financial statements, but is not yet reflected in the tax computation, or vice versa. Timing differences will then reverse when, over time, the transaction is reflected in the financial statements or in the tax computation either wholly, or in part. None of these concepts are new to accountants and paragraph 29.6 to Section 29 does require deferred tax to be recognised in respect of all timing differences at the balance sheet date. Paragraph 29.6 goes on to define a timing difference slightly differently than FRS 19 does as follows:

*'Timing differences are differences between taxable profits and* ***total comprehensive income*** *as stated in the financial statements that arise from the inclusion of* ***income*** *and* ***expenses*** *in tax assessments in periods different from those in which they are recognised in the financial statements.'*

This definition is essentially saying that a timing difference will arise when an item is included in the tax computation in the current accounting period but the same transaction has been recognised in the financial statements in a different period.

There are some points in Section 29 that practitioners and companies will need to be aware of:

- Tax losses that are carried forward to the next accounting period that essentially give rise to a deferred tax asset must only be recognised to the extent that it is probable that they will be recovered against the reversal of deferred tax liabilities. Like the outgoing FRS 19, the default presumption is that the mere existence of tax losses is taken as strong evidence that there may not be other future taxable profits against which the unutilised tax losses can be relieved. There should be evidence to the contrary that the company will be able to utilise deferred tax assets (for example, the awarding of a lucrative contract in the next financial year).

- Paragraph 29.8 says that deferred tax is to be recognised in an entity's financial statements in respect of tax allowances for the cost of a fixed asset when these are received before, or after, the depreciation of the fixed asset is recognised in profit or loss. If, and when, the company has met all the conditions imposed by HMRC for retaining the capital allowances, deferred tax is then reversed.

- When a reporting entity has a subsidiary, associate, branch or an interest in a joint venture, it must recognise deferred tax when income or expenses from these sources have been recognised in the financial statements but will subsequently be included in the tax computation in a future period. There are *two* exceptions to this rule:

  - Where the reporting entity has control over the reversal of the timing difference; and
  - There is probability that reversal of the timing difference will not take place in the foreseeable future.

- Paragraph 29.9 gives an example of a situation where there are undistributed profits in a subsidiary, associate, branch or interest in a joint venture.

## *Timing difference 'plus'*

The previously exposed FRED 44 required deferred tax to be computed using a temporary difference approach. This was because the ASB wanted deferred tax calculations to be more aligned to the *IFRS for SMEs* which is based on full IAS 12 *Income Taxes*. There was a certain element of outcry by the profession on this approach by the ASB and, in fairness, the ASB did take on board the critics and required this area of the FRED to be redrafted. However, whilst the ASB did agree to redraft the section on deferred tax, they also acknowledged that the revised accounting issues concerning deferred tax should result in a deferred tax answer that would be very similar to that calculated under *IFRS for SMEs*. The product of this redrafting was the concept of the timing difference plus approach.

The 'plus' part builds on the existing timing difference approach that many accountants are familiar with, but the objective of brining in the plus part was so that the calculation of deferred tax would be the same in many (but not all) cases as that under IAS 12. It achieves this by extinguishing the fewer exceptions that are currently incorporated in FRS 19. A typical example of this is in respect of fixed assets that are subjected to the revaluation model as permitted in Section 17 *Property, Plant and Equipment*. Under FRS 19, paragraph 14, no deferred tax is recognised on a revaluation gain in respect of a non-monetary asset that is subjected to the revaluation model unless the client has:

- Entered into a binding agreement to sell the revalued asset(s); and
- Recognised the gains and losses expected to arise on the sale.

Paragraph 29.15 in Section 29 to FRS 102 outlaws this exception and now requires deferred tax in respect of non-depreciable property whose value is measured using the revaluation model to be measured using the tax rates and allowances that apply to the sale of the asset.

**Example – deferred tax on investment property**

Company A Limited has a year-end of 31 December 2015. On this date it had an investment property on its balance sheet with a carrying value of £100,000. An independent valuation agency has confirmed that the open market value of this property has risen to £110,000.

Paragraph 16.7 to FRS 102 requires fair value gains and losses arising on investment property to be reported in profit or loss. The entries in the books of Company A Ltd will therefore be:

| | | |
|---|---|---|
| DR | Investment property | £10,000 |
| CR | Profit and loss | £10,000 |

*Being fair value uplift in valuation of investment property*

Deferred tax on this revaluation would then be recognised as the adjustment to fair value affects profit. Assuming Company A Ltd will pay tax at 20% in that financial year, the deferred tax recognised will be £2,000 (£10,000 x 20%).

The rates of tax to be used in the calculation of deferred tax balances will be those tax rates and allowances that apply to the sale of the asset.

In addition to non-monetary assets that have been subjected to the revaluation model (or which are carried at fair value at each reporting date) giving rise to additional deferred tax consideration, FRS 102 also brings in the following additional situations that will trigger deferred tax considerations:

- Where a business combination has taken place; and
- Unremitted earnings on overseas subsidiaries or associates.

Paragraph 29.11 says that when the tax base of an asset acquired in a business combination (not goodwill) is less than the value at which it is recognised in the acquirer's financial statements, a deferred tax liability is recognised which represents the additional tax that will be paid in the future. On the flip side, when the tax base of an asset is more than the amount recognised for the asset in the financial statements, a deferred tax asset is recognised to represent the additional tax that will be avoided in respect of that difference. A deferred tax asset or liability is recognised for the additional tax the company will either avoid or pay due to the difference in value at which a liability is recognised and the amount that is assessed to be owed to HMRC. Amounts attributed to goodwill are adjusted by the amount of deferred tax recognised (see later in the notes).

## *Permanent and temporary differences*

In almost all cases, a company's taxable profit will not be the same as its accounting profit due to the adjustments that need to be made to accounting profit to take account of tax legislation. These 'adjustments' can be categorised into 'permanent' differences and 'temporary' differences and these concepts have been carried over into FRS 102. The term 'permanent differences' means that certain types of income in the financial statements are not taxable and certain types of expenditure are not tax deductible. Timing differences, however, arise from items that are either taxable or tax deductible but in periods that differ from those in which they are dealt with in the financial statements.

There may be occasions when timing differences arise and then reverse, but are never actually reflected in the tax computation. A classic example of this would be a provision for bad debts that is included in the financial statements in one year and then written back in the next as the provision has been deemed unnecessary. Other examples of timing differences are:

- Accelerated capital allowances in respect of fixed assets;
- Accrued pension liabilities in the financial statements which are granted tax relief when they are paid at a later date; and
- Intra-group profits in stock which are unrealised at group level and then reversed on consolidation.

Deferred tax is never provided for in respect of permanent differences.

### *Measurement of deferred tax*

The measurement of deferred tax is similar to current FRS 19 in that paragraph 29.12 requires a reporting entity to measure a deferred tax liability or asset using the tax rates and laws that have been enacted, or substantively enacted, at the balance sheet date and which are expected to apply to the reversal of the timing differences. There are some other requirements that practitioners need to be aware of:

- If different tax rates apply to different levels of taxable profit, deferred tax is measured using an average rate(s) that have been enacted or substantively enacted at the balance sheet date and that will apply to the taxable profit or loss of the periods in which the company expects the deferred tax asset or liability to be realised or settled.
- Paragraph 29.14 recognises that in some jurisdictions, taxes are payable at higher or lower rates should all, or part, of the profit or profit and loss reserves be paid out as a dividend to shareholders. This paragraph requires an entity to measure current and deferred taxes using the rates applicable to the profits that are eligible to be distributed as a dividend until the entity recognises a liability to pay a dividend. When a liability to pay a dividend is recognised in the financial statements, the entity recognises a current or deferred tax liability/asset and the associated tax expense/income.
- Deferred tax recognised in respect of assets carried under the revaluation model are measured using the tax rates that apply when the asset is sold.
- For investment property measured at fair value, deferred tax is measured using the tax rates that apply when the asset is sold.

A final point to note where measurement issues are concerned (which will largely go unnoticed) is that FRS 102 prohibits a company from discounting deferred tax balances to present day values. The reality is that hardly anyone discounts deferred tax balances for the time value of money and so this new requirement is not going to be fundamental.

### *Deferred tax in business combinations*

One of the additional situations which will give rise to deferred tax considerations under the timing difference plus approach is the area of business combinations. For clarity the term ‘business combinations’ is referred to in current UK GAAP as an ‘acquisition’. Paragraph 29.11 to FRS 102 says:

*‘When the amount that can be deducted for tax for an asset (other than goodwill) that is recognised in a business combination is less (more) than the value at which it is recognised, a deferred tax liability (asset) shall be recognised for the additional tax that will be paid (avoided) in respect of that difference. Similarly, a deferred tax asset (liability) shall be recognised for the additional tax that will be avoided (paid) because of a difference between the value at which a liability is recognised and the amount that will be assessed for tax. The amount attributed to goodwill shall be adjusted by the amount of deferred tax recognised.’*

In a group context, all members of the group should follow uniform accounting policies for the purposes of preparing the consolidated financial statements. This requirement will more than likely trigger various adjustments to be made at consolidation level – for example if a parent has an overseas subsidiary that has not followed group accounting policies due to local legislation or local GAAP requirements. In such situations this will result in additional timing differences in the consolidated financial statements for which deferred tax should be recognised.

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

Company A acquires 100% of the net assets of Company B for a purchase consideration of £1.1 million all of which was funded out of cash. Company B has a valuable customer list which was not recognised on B's balance sheet as it failed to meet the recognition criteria for an intangible asset due to the fact that it was internally generated. Tax relief has been obtained by Company B for the expenditure it incurred in creating the customer list.

At the acquisition date, the customer list was valued at £150,000 and the fair value of the other assets in the acquisition amount to £600,000. Company A pays tax at a rate of 20%.

The difference between the tax base of the asset (which is £nil because tax relief has already been granted by HMRC in respect of the expenditure) and the fair value of the intangible asset of £150,000 gives rise to a deferred tax liability of £30,000 (£150,000 x 20%). The amount attributed to goodwill is adjusted by this deferred tax balance which is calculated as follows:

| | £ |
|---|---|
| Cost of business combination | 1,100,000 |
| Fair value of customer list | (150,000) |
| Fair value of other net assets in the combination | (600,000) |
| Deferred tax | 30,000 |
| Goodwill | 380,000 |

If it is assumed that the customer list has an expected useful life of five years, then in the consolidated financial statements it will be amortised at an annual rate of £30,000 (£150,000 ÷ 5 years). The deferred tax liability will be released to the consolidated income statement (consolidated profit and loss account) over a five-year period, hence £6,000 (£30,000 ÷ 5 years).

## *Deferred tax assets*

Deferred tax liabilities are inherently more common than deferred tax assets. This is largely due to the fact that Section 29 takes a very pessimistic approach (as does FRS 19) where deferred tax assets are concerned. In practice, the most common event that will (potentially) trigger a deferred tax asset is when a company makes a loss and therefore has unutilised tax losses to carry forward which may be offset against future profits that the company generates. For the purposes of Section 29, a pessimistic approach must be adopted by the accountant to comply with paragraph 29.7 which says:

*'Unrelieved tax losses and other **deferred tax assets** shall be recognised only to the extent that it is **probable** that they will be recovered against the reversal of **deferred tax liabilities** or other future taxable profits (the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved).'*

The final sentence in brackets is the 'pessimistic' approach adopted by Section 29. When a company makes a loss which turns into a taxable loss, the default presumption under FRS 102 is that the company will never return to profit and evidence to the contrary must be obtained by the accountant BEFORE recognising any deferred tax assets. This underlying concept in Section 29 is because assets cannot be carried in an entity's balance sheet at any more than recoverable amount and so the pessimistic approach is adopted so as to reduce the scope for reporting entities from inappropriately recognising deferred tax assets that may never be used.

**Example – recognition of a deferred tax asset**

Company A Limited has been established for many years but during the recent economic difficulties has seen a steady decline in turnover and profits. The financial statements for the year-ended 31 December 2015 have shown a significant loss (both for financial reporting and for tax purposes) amounting to £100,000. This loss has arisen as a result of reduced gross profit margins due to supplier price rises which have not been passed on to customers and redundancy costs which have occurred during the year. The financial statements have been completed to draft stage but have not yet been approved by the directors. Company A Ltd pays corporation tax at a rate of 20%.

On 2 January 2016 it was confirmed that the company was awarded a five-year contract to supply goods and services to a large, blue-chip company. This contract was awarded following a rigorous tendering process because the contract is highly lucrative due to the demands that will be required of the successful applicant and the fact that the applicant will have to supply goods on a 'just-in-time' basis. The contract is expected to become operational in the summer of 2016.

The awarding of the contract is evidence that the company will generate suitable taxable profits in the year for which a deferred tax asset can be utilised. On this basis, Company A Ltd would be able to recognise a deferred tax asset of £20,000 (£100,000 x 20%).

## *Defined benefit pension schemes*

UK tax legislation states that a company obtains tax relief on pension contributions usually in the period in which the contributions are paid, as opposed to when the contributions are recognised in profit or loss. Therefore, where there is a difference between the pension contributions recognised in profit or loss and the contributions that have actually been paid, this will give rise to a timing difference for the purposes of deferred taxation.

Under a defined benefit pension scheme, there are various components of the scheme that are reported in profit or loss, such as:

- Current service cost;
- Past service cost;
- Gains or losses on curtailments and settlements;
- Interest cost; and
- Expected return on plan assets.

Certain items in a defined benefit pension scheme are also reported in other comprehensive income (i.e. actuarial gains and losses). Because of the nature of these schemes, the way such costs are accounted for will often result in tax relief being granted by HMRC for the actual contributions paid by the company but also deferred tax on the timing differences that arise between the contributions paid and the costs recognised in profit or loss. A further complication arises in deferred tax because some of the deferred tax attributable to the timing differences may have to be split between the component recognised in profit or loss and the component that is to be recognised in other comprehensive income.

**Example – deferred tax in a defined benefit pension scheme**

A company based in the UK operates a defined benefit pension scheme for its staff. Actuarial information has been obtained as follows:

| | £ |
|---|---|
| Opening scheme liability | (200,000) |
| Contributions paid into the scheme | 80,000 |
| Past service cost | (20,000) |
| Interest cost | (70,000) |
| Expected return on plan assets | 20,000 |
| Actuarial loss | (20,000) |
| Closing scheme liability | (210,000) |

The company pays corporation tax at a rate of 20%. The deferred tax asset is calculated as follows:

| | Deficit | Tax Relief | Deferred Tax Asset |
|---|---|---|---|
| | £ | £ | £ |
| Opening deficit | (200,000) | | 40,000 |
| Contributions paid | 80,000 | (16,000) | |
| Charges to P&L | (70,000) | 14,000 | |
| Actuarial loss (OCI) | (20,000) | 2,000 | 2,000 |

| | | | |
|---|---|---|---|
| Balance c/fwd | (210,000) | - | 42,000 |

The profit and loss account charge is made up of the past service cost of £20,000, the interest cost of £70,000 less the expected return on plan assets of £20,000. Tax relief will be granted by HMRC on the contributions paid and this is allocated to the profit and loss account charge. The difference between the contributions paid and the profit and loss charge of £10,000 (£80,000 less £70,000) is allocated against the actuarial loss which is reported in other comprehensive income.

## FRS 102: SECTION 11 BASIC FINANCIAL INSTRUMENTS (Lecture A457 – 25.50 minutes)

Financial instruments are a big part of every business. Items such as trade debtors, trade creditors, cash balances, share capital, loans and overdrafts are all financial instruments and therefore the phrase 'financial instruments' should not be assumed to just apply to larger corporations as they apply to all business entities.

FRS 102 deals with financial instruments in Section 11 *Basic Financial Instruments* as well as in Section 12 *Other Financial Instruments Issues*. This course will look at Section 11 and Section 12 will be covered in the Quarter 2 update.

The ways in which financial instruments are accounted for have evolved considerably over the years as businesses enter into more complex financial instrument arrangements due to the diversity of business practices. Generally, basic financial instruments are dealt with using historical cost, although there are certain limited exceptions (for example, certain investments in shares which are carried at market value).

FRS 102 introduces new terminology which accountants who have clients falling under its scope need an awareness of, such as 'amortised cost' and 'effective interest' and these issues will be looked at later in the course.

FRS 102 does give a fairly comprehensive list of what it considers to be *basic* financial instruments which fall within its scope including:

- Cash;
- Demand and fixed-term deposits when the entity is the depositor (e.g. bank accounts);
- Commercial paper and commercial bills held;
- Accounts receivable and payable (trade debtors and trade creditors);
- Accounts payable in a foreign currency;
- Loans from banks and other third parties;
- Loans to subsidiaries, associates or joint ventures;
- Bonds, and similar debt instruments;
- Investments in non-convertible preference shares and non-puttable ordinary and preference shares; and
- Commitments to receive a loan and commitments to make a loan to another entity that cannot be settled net in cash.

Section 11 does NOT apply to the following:

- Investments in subsidiaries, associates and joint ventures that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Investments in Joint Ventures*.
- Financial instruments that meet the definition of an entity's own equity and the equity component of compound financial instruments issued by the reporting

entity that contain both a liability and an equity component. Section 22 *Liabilities and Equity* deals with these instruments.
- Leases to which Section 20 *Leases* applies.
- Employers' rights and obligations under employee benefit plans. Section 29 *Employee Benefits* applies here (although paragraphs 11.27 to 11.32 in Section 22 do apply in determining the fair value of plan assets).
- Financial instruments, contracts and obligations under a share-based payment plan (and contracts that fall within the scope of paragraph 12.5 to FRS 102). Section 26 *Share-based Payment* applies.
- Insurance contracts (including reinsurance contracts) that the entity issues and reinsurance contracts that the entity holds (these are dealt with in FRS 103 *Insurance Contracts*).
- Financial instruments issued by an entity with a discretionary participation feature (again, FRS 103 applies).

As mentioned earlier, where basic financial instruments are concerned, these are generally accounted for at cost. However, if the entity has investments in shares where such shares are publicly traded, or where the fair values of such shares can otherwise be measured reliably, these should be measured using fair values. For the purposes of Section 11, the following are NOT basic financial instruments:

- Convertible preference shares; and
- Puttable shares that give the holder the right or option to require the company to buy back the shares.

FRS 102 is quite flexible where financial instruments are concerned and offers an accounting policy choice of the following:

- To account for financial instruments using Section 11 and Section 12 of FRS 102; or
- EU-adopted IAS 39 *Financial Instruments: Recognition and Measurement* including the disclosure requirements contained within Section 11 and Section 12; or
- IFRS 9 *Financial Instruments* and/or IAS 39 (as amended following the publication of IFRS 9) including the disclosure requirements contained within Section 11 and Section 12.

The reality is that most entities falling under the scope of FRS 102 will choose to account for financial instruments using the first bullet point due to the inherent complexities within IAS 39 and IFRS 9.

## *Initial recognition of financial assets and liabilities*

Financial assets and liabilities should only be recognised when the entity becomes a party to the contractual provisions of the instrument. When the entity does meet this recognition criteria, the financial asset or liability should be recognised at its transaction price. The transaction price includes all transaction costs with the exception of the initial measurement of financial assets and liabilities that are measured at fair value through profit or loss.

**Example – investment in shares**

Company A invests in the equity shares of Company B plc (a listed company recognised on the London Stock Exchange) and Company C Limited (an unlisted privately-owned medium-sized entity).

Company B plc
The investment in Company B should initially be accounted for at cost, excluding transaction costs. The transaction costs should be recognised immediately in profit or loss. Subsequently the investment should be accounted for at fair value through profit or loss.

Company C Ltd
The investment in Company C Ltd should be initially recorded at cost, including transaction costs. In contrast to Company B, it will not be possible to obtain a reliable fair value at subsequent reporting dates.

Paragraph 11.13 refers to the situations when an arrangement constitutes a financing transaction. This paragraph says that a financing transaction may take place in connection with the sale of goods or services where payment is deferred beyond normal business terms, or is financed at a rate of interest that is not market rate. When these situations present themselves, the entity must measure the financial asset or liability at the present value of the future payments which are discounted at a market rate of interest for a similar debt instrument.

**Example – loan made to an entity**

Company A has seen rapid expansion over the last few months and has approached its bank for a working capital loan to which the bank has agreed. The loan is to be repaid over a five-year period and the monthly instalments will include a mix of principal and interest.

The loan is clearly a financing transaction and therefore should be recognised initially at the present value of the proceeds from the loan receivable including interest payments and repayments of principal from the bank.

In the above example, this was assumed to be a commercial loan with normal interest rates being charged by the bank to Company A. Had the loan been from a source other than the bank with a favourable rate of interest being charged to Company A (i.e. not a market interest rate), the loan would need to be recognised in the financial statements at the present value of the future payments discounted using a MARKET rate of interest for a similar debt instrument.

Paragraph 11.13 gives some useful examples of financial assets and financial liabilities and how they should be accounted for which are reproduced below:

Financial assets

1. For a long-term loan made to another entity, a receivable is recognised at the present value of cash receivable (including interest payments and repayment of principal) from that entity.

2. For goods sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that entity, which is normally the invoice price.

3. For an item sold to a customer on two-years interest-free credit, a receivable is recognised at the current cash sale price for that item (in financing transactions conducted on an arm's length basis the cash sales price would normally approximate to the present value). If the current cash sale price is not known, it may be estimated as the present value of the cash receivable discounted using the **prevailing market rate(s)** of interest for a similar receivable.

4. For a cash purchase of another entity's ordinary shares, the investment is recognised at the amount of cash paid to acquire the shares.

Financial liabilities

1. For a loan received from a bank, a payable is recognised initially at the present value of cash payable to the bank (e.g. including interest payments and repayment of principal).

2. For goods purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier, which is normally the invoice price.

### *Subsequent measurement*

For the purpose of subsequent measurement, it is important to understand certain technical jargon contained in FRS 102 which is defined as follows:

***Amortised cost*** is defined as the net of the following four amounts:

1. The amount at which the financial asset or financial liability is measured at initial recognition;
2. *Minus* any repayments of principal;
3. *Plus or minus* the cumulative amortisation using the effective interest rate method (see below) of any difference between the amount at initial recognition and the maturity amount; or
4. *Minus* – in the case of a financial asset – any reduction for impairment or uncollectibility.

The ***effective interest method*** is a method of:

- Calculating the *amortised cost* of a financial asset or a financial liability (the carrying amount in the statement of financial position (balance sheet)); and
- Allocating the interest income or interest expense over the relevant period on an actuarial basis using the *effective interest rate*.

The ***amortised cost*** of a financial asset (liability) is the present value of future cash receipts (payments) discounted at the effective interest rate.

The ***effective interest rate*** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument (or, where appropriate, a shorter period), to the carrying amount of the asset or liability.

'Simple' financial instruments such as trade debtors, trade creditors, bank loans and deposits are measured at amortised cost using the effective interest method. Debt instruments classified as current assets or current liabilities are subsequently measured at the undiscounted amount of the cash or other consideration to be paid or received, net of impairment.

For arrangements which are classified as financing arrangements, the debt instrument is measured at the present value of the future payments. These are discounted at a market rate of interest for a similar debt instrument.

**Example – effective interest method**

A company borrows £120,000 over a five-year period and incurs transaction costs amounting to £10,000, giving net proceeds of £110,000. Interest is fixed at an amount of £7,200 per annum and the loan is to be repaid at the end of the five-year period at a premium of £13,500 (i.e. £133,500).

Total finance costs are £36,000 interest, £13,500 debt premium and transaction costs of £10,000 = £59,500. The effective rate of interest that discounts these payments to the initial loan proceeds of £110,000 is approximately 10% (in real life a computer program would be used to calculate the effective interest rate). However, for the purposes of this example, 10% has been used and the figure of £13,064* is essentially a balancing figure.

| Year | Opening amortised cost | Finance cost | Cash flow | Closing amortised cost |
|---|---|---|---|---|
| | £ | £ | £ | £ |
| 1 | 110,000 | 11,000 | 7,200 | 113,800 |
| 2 | 113,800 | 11,380 | 7,200 | 117,980 |
| 3 | 117,980 | 11,798 | 7,200 | 122,578 |
| 4 | 122,578 | 12,258 | 7,200 | 127,636 |
| 5 | 127,636 | 13,064* | 7,200 | 133,500 |
| | | 59,500 | 36,000 | |

## *Impairment issues*

As with most other assets, a reporting entity must assess their financial assets to establish whether there are any indicators of impairment. If there is objective evidence of impairment, the financial asset should be written down to recoverable amount by recognising an impairment loss. Paragraph 22 to Section 22 gives some useful indicators that a financial asset may be impaired:

(a) Significant financial difficulty of the issuer or obligor;
(b) A breach of contract, such as a default or delinquency in interest or principal payments;
(c) The creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider;
(d) It has become **probable** that the debtor will enter bankruptcy or other financial reorganisation; and
(e) Observable data indicating that there has been a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions.

Other factors may also be significant changes which have an adverse effect in the environments in which the issuer of the financial instrument operates, such as:

- Technological environment;
- Market environment;
- Economic environment; and
- Legal environment.

**Example – impairment of a financial asset**

A company purchases a debt instrument for £10,000 which is to be settled on maturity at a premium of £2,500 (i.e. £12,500) over a five-year period. The coupon rate of interest is 4.7% with interest of £590 being payable annually. The amortisation table in respect of the debt instrument is shown below:

| Year | Opening amortised cost | Finance cost | Cash flow | Closing amortised cost |
|---|---|---|---|---|
| | £ | £ | £ | £ |
| 1 | 10,000 | 1,000 | 590 | 10,410 |
| 2 | 10,410 | 1,040 | 590 | 10,860 |
| 3 | 10,860 | 1,090 | 590 | 11,360 |
| 4 | 11,360 | 1,130 | 590 | 11,900 |
| 5 | 11,900 | 1,190 | 13,090* | - |

*£12,500 + £590

At the end of year 2, the amortised cost of the debt instrument is £10,860 and on this date the company concludes that the debt instrument has become impaired and no further interest payments will be paid on the debt. The capital elements of the payments will continue to be paid.

The company calculates that the present value of the principal repayment in three years' time is £9,391 (£12,500 ÷ $1.1^3$).

The company will recognise an impairment loss of £1,469 (£10,860 less £9,391).

Paragraph 11.25 outlines the measurement of an impairment loss relating to a financial instrument measured at cost or amortised cost.

Financial instrument measured at amortised cost

The impairment loss is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. When a financial instrument has a variable interest rate, the discount rate for measuring the impairment loss is the current effective interest rate determined under the contract.

Financial instrument measured at cost less impairment

The impairment loss is the difference between the asset's carrying amount and the best estimate (which will necessarily be an approximation) of the amount (which could be zero) that the entity would receive for the asset if it were to be sold at the reporting date.

Reversal of impairment

Reversals of previously recognised impairment losses can be recognised if the reduction in the previous impairment loss can be related objectively to an event occurring after the impairment was recognised. Paragraph 11.26 gives the example of an improvement in the debtor's credit rating). However, care must be taken because the reversal of the previous impairment loss CANNOT result in a carrying amount of the financial asset (net of any allowances) that exceeds what the carrying amount would have been had the impairment not been recognised.

**Example – reversal of an impairment loss**

In the previous year, a company had written down a financial asset for impairment. Prior to the write-down the financial asset was carried in the statement of financial position (balance sheet) at an amount of £11,000 and was written down to £8,000. In the current financial year, the debtor's credit rating was significantly upgraded and the entity is proposing to reverse the whole impairment loss of £3,000 on the basis of this improved credit rating. Had the instrument not been written down at the end of the previous year it would have been carried in the balance sheet at an amount of £10,000.

The maximum amount of the impairment reversal that the entity can recognise is £2,000. This is because paragraph 11.26 says that any reversal shall not result in a carrying amount of the financial asset (net of any allowance account) that exceeds what the carrying amount would have been had the impairment not previously been recognised. Had no impairment been recognised, the instrument would have been carried in the balance sheet at £10,000 but it was written down to £8,000. To reverse the entire £3,000 would result in the instrument being carried at £11,000 which is £1,000 more than it would have otherwise been carried at had no impairment loss been recognised.

### *Investments in Shares*

Many companies invest in shares in other entities – either listed investments or unlisted investments. Section 11 says that investments in non-convertible preference shares and non-puttable ordinary shares or preference shares are to be measured at fair value if those shares are traded on a public market (i.e. a stock market) OR if their fair value can otherwise be measured reliably. Other investments are recognised at cost less impairment.

Section 11 uses a fair value hierarchy to estimate the fair value of shares at paragraph 11.27 which says:

(a) The best evidence of fair value is a quoted price for an identical asset in an **active market**. Quoted in active market in this context means quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted price is usually the current bid price.

(b) When quoted prices are unavailable, the price of a recent transaction for an identical asset provides evidence of fair value as long as there has not been a significant change in economic circumstances or a significant lapse of time since the transaction took place. If the entity can demonstrate that the last transaction price is not a good estimate of fair value (e.g. because it reflects the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted.

(c) If the market value for the asset is not active and recent transactions of an identical asset on their own are not a good estimate of fair value, an entity estimates the fair value by using a valuation technique. The objective of using a valuation technique is to estimate what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations.

Valuation techniques where there is no active market include:

- Recent arm's length market transactions for an identical asset between knowledgeable, willing parties (if available);
- Reference to the current fair value of another asset that is substantially the same as the asset being measured;
- Discounted cash flow analysis; and
- Option pricing models.

For investments where the fair value cannot be measured reliably, these should be carried at cost less impairment.

### *Derecognition of financial assets*

There are strict derecognition criteria laid down in Section 11 which essentially focus on the risks and rewards of ownership of financial assets. Paragraph 11.33 says that a financial asset should be derecognised in an entity's financial statements if any one of the following situations apply:

- The contractual rights to the cash flows from the financial assets expire or are settled (e.g. a receipt of cash in settlement of the amount owing on a trade debtor); or

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

- The entity has retained some significant risks and rewards of ownership but has transferred control of the asset to another party who:

    - Has the practical ability to sell the asset in its entirety to another third party; and
    - Is able to exercise that ability unilaterally, and without needing to impose additional restrictions on the transfer.

- In such cases, the entity should:

    - Derecognise the asset; and
    - Recognise separately any rights and obligations retained or created in the transfer.

**Example – sales ledger sold to a finance house**

A company sells its sales ledger on to a finance house. The terms of the sale say that the company has no responsibility for slow or non-payment of debts by its customers and that on collection the company must remit all monies collected on a prompt basis. The sales proceeds are less than the par value of the debtors and the finance house pays a market rate for the collection/statement service.

The company has rescinded all risks and rewards of ownership of the sales ledger to the finance house and therefore must derecognise the value of the trade debtors. No liability is recognised to the finance house in respect of the sales proceeds, but a liability is recognised to the finance house in respect of cash collected from debtors but not yet paid over.

As the proceeds from the sale of the sales ledger are less than the face value of the debtors, a loss is recognised in the income statement (profit and loss account) which represents the difference between the carrying amount of the trade debtors at the time of sale and the proceeds received from the sale.

A reporting entity can only derecognise a financial asset when, essentially, the risks and rewards associated with the financial asset have been transferred (see the criterion for derecognition above). There may be situations when a company receives consideration for a financial asset, but still retains significant risks and rewards associated with that asset. In such cases the financial asset will not qualify for derecognition.

**Example – risks and rewards retained**

A company sells its sales ledger to a finance house for less than the par value of the trade debtors. The company collects monies from its debtors and then remits these funds to the finance house on a prompt basis. The terms of the sale make provision for the company to buy back any debtors which fall in arrears for more than 120 days.

In this example, the company has retained the significant risk of slow or non-payment. The company will not remove the trade debtors from its balance sheet because of this retention of risk and the proceeds from the finance house will be treated as a liability (a loan).

## *Derecognition of financial liabilities*

Paragraph 11.36 to FRS 102 requires a reporting entity to derecognise a financial liability (or part thereof) only when it is extinguished. This means that the obligation specific in the financial liability is discharged, cancelled or expires. Any difference that arises between the carrying amount of the financial liability and the consideration paid (which also includes any non-cash assets transferred as part of the consideration, or liabilities assumed) is recognised in profit or loss.

The offsetting of financial assets against financial liabilities can only be undertaken in two situations, when the entity:

- Currently has a legally enforceable right to set off the recognised amounts; and
- Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

## *Disclosure requirements for basic financial instruments*

Section 11 outlines the disclosure requirements for complex, as well as basic, financial instruments. This course only considers the requirements for basic financial instruments (Quarter 2 will consider more complex financial instruments).

<u>Accounting policy</u>

Paragraph 11.40 requires the measurement basis (or bases) used for financial instruments and the other accounting policies that are used for financial instruments which are deemed to be relevant to an understanding of the financial statements.

**Example – accounting policy (extract)**

Financial instruments

Financial assets and financial liabilities are recognised on the balance sheet when the entity becomes party to the contractual provisions of the financial instrument.

Trade debtors and trade creditors are initially measured at fair value. Subsequent to initial valuation, they are carried at amortised cost using the effective interest method less amounts in respect of impairment losses.

Bank loans are initially recognised at fair value less directly attributable transaction costs. Subsequent to initial recognition, loans are stated at amortised cost with any difference between cost and redemption value being recognised in profit or loss using the effective interest method.

Investments in equity shares which are publicly traded or where the fair value of the shares can otherwise be measured reliably are initially measured at fair value with transaction costs being recognised in profit or loss. The investments are subsequently remeasured in the balance sheet at fair value with changes in fair value being recognised in profit or loss.

Investments in equity shares which are not publicly traded and where the fair value of the shares cannot be measured reliably are initially measured at cost, including transaction costs. The investment is not remeasured except where impairment has been identified.

Carrying amount

The carrying amount for each of the following categories of financial assets and financial liabilities should be disclosed either on the face of the balance sheet or in the notes:

- Financial assets measured at fair value through profit or loss;
- Financial assets that are debt instruments measured at amortised cost;
- Financial assets that are equity instruments measured at cost less impairment;
- Financial liabilities that are measured at amortised cost; and
- Loan commitments measured at cost less impairment.

Financial assets measured at fair value

Reporting entities must disclose the basis for determining fair value (e.g. quoted market price in an active market or by way of a valuation technique). If a valuation technique is adopted, the assumptions applied in determining fair value should also be disclosed.

Transfers of financial assets that do not qualify for derecognition

When the entity has transferred financial assets but retains some element of risks and rewards associated with the asset that mean the asset does not qualify for derecognition, the following should be disclosed:

- The nature of the assets;
- The nature of the risks and rewards of ownership to which the entity remains exposed; and
- The carrying amounts of the assets and any associated liabilities that the entity continues to recognise.

Assets pledged as collateral

In situations where a reporting entity has pledged financial assets as collateral for liabilities (or contingent liabilities), disclosure is required of:

- The carrying amounts of the financial assets pledged as collateral; and
- The terms and conditions relating to the pledge.

Defaults and loan breaches

If, by the reporting date, there has been a breach in the terms of loans payable (such as default of principal, interest, sinking fund or redemption terms) which has not been remedied, the following disclosures must be made:

- Details of that breach or default;
- The carrying amount of the related loans payable at the reporting date; and
- Whether the breach or default was remedied, or the terms of the loan payable were renegotiated, before the financial statements were authorised for issue.

Income, expenses, gains and losses

A reporting entity must disclose income, expenses, gains or losses (which also includes changes in fair value) recognised on the following:

- Financial assets measured at fair value through profit or loss;
- Financial liabilities measured at fair value through profit or loss;
- Financial assets measured at amortised cost; and
- Financial liabilities measured at amortised cost.

Total interest income and total interest expense

This disclosure only applies to financial instruments which are NOT carried at fair value through profit or loss and disclosure is required of total interest income and total interest expense which is calculated using the effective interest method.

Impairment losses

Disclosure is required of the amount of any impairment loss for each class of financial asset.

## FRS 102: SECTION 30 FOREIGN CURRENCY TRANSLATION (Lecture A458 6.57 minutes)

Foreign currency issues are dealt with in FRS 102 at Section 30 *Foreign Currency Translation*. The Scope section of Section 30 recognises that an entity can conduct foreign activities in three ways:

- Undertaking transactions in foreign currencies;
- Possess foreign operations; or
- Present its financial statements in a foreign currency.

For the purposes of Section 30, a 'foreign operation' is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

### *Functional currency*

Reporting entities are required to identify their 'functional currency'. Paragraph 30.2 says that an entity's functional currency is the currency of the primary economic environment in which the entity operates. For example, the functional currency of a company based in the UK will be pound sterling. For clarity, paragraph 30.3 outlines some important factors when considering the functional currency of an entity, it says:

*'The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends* ***cash****. Therefore, the following are the most important factors an entity considers in determining its functional currency:*

*(a) the currency:*

*(i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and*

*(ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services; and*

*(b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).'*

In addition, the currency in which funds from financing activities are generated will also have a bearing on an entity's functional currency as well as the currency in which receipts from operating activities (the day-to-day, revenue-producing activities of the entity) are usually retained. A change in functional currency can only take place if there is a change to the underlying transactions, events and conditions which are pertinent to the entity. This could arise, for example, where there is a change of currency (for example if the UK decided to adopt the Euro).

In a group situation, it is not uncommon for a foreign subsidiary to be a member of a group and paragraph 30.5 outlines various additional factors that are to be considered in determining the functional currency of a foreign operation which will then lead to the conclusion as to whether the functional currency is the same as that of the parent:

(a) Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy.

(b) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

(c) Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

## *Accounting for individual foreign currency transactions*

A company may enter into a foreign exchange transaction with an overseas supplier whereby the transaction will be denominated in a foreign currency and will be settled in a foreign currency. Examples include:

- Purchase or sale of goods or services whose price is denominated in a foreign currency;
- Borrowing or lending of funds when the amounts payable or receivable are denominated in a foreign currency; and
- Acquisition or disposal of assets, or incurring or settling of liabilities, denominated in a foreign currency.

On initial recognition, the transaction is accounted for using the rate of exchange prevailing on the date of the transaction. This applies whether or not the transaction is covered by a forward foreign currency contract (which is different than the choice offered in SSAP 20 at paragraph 46 where an entity can record the transaction at the rate of exchange on the date of the transaction or the rate specified in the contract).

**Example – purchase of goods from an overseas supplier**

A company based in the UK buys a batch of chemicals from its supplier based in Austria. The cost of the chemicals is €180,000 and the spot rate on the date of the transaction is £1 = €1.45. The company does not have credit facilities with this supplier.

The invoice will be translated into sterling at the exchange rate prevailing at the date of the transaction, i.e. £124,138 (€180,000 ÷ 1.45) and this is the amount that will be recorded in the supplier's purchase ledger.

It may be the case that payment is made in accordance with agreed credit terms and, using the example above, if it is assumed that the company has a four-week credit period and settles the invoice on time, but the exchange rate has moved to £1 = €1.65 there will be an exchange difference of £15,047 ((€180,000 ÷ 1.65) - £124,138). This has arisen because the exchange rate has moved from the date the transaction was entered into to the date the transaction was settled and the £15,047 would be recognised as a gain on exchange in profit or loss.

Note: if the payment was made AFTER the year-end, the gain would be recorded in the subsequent year's financial statements. No exchange rate differences are accrued or prepaid which relate to settlement of foreign currency transactions after the reporting date.

## *Net investment in a foreign operation*

Reporting entities could have a monetary item that is receivable from, or payable to, a foreign operation. If the settlement of such amounts is not planned or likely to occur in the foreseeable future, such transactions will form part of an entity's net investment in that foreign operation. Please note, such monetary items may include long-term debtors or loans but they DO NOT include trade debtors or trade creditors.

Any exchange differences that arise on a monetary item which forms part of a reporting entity's net investment in a foreign operation is recorded in profit or loss in the individual financial statements of the reporting entity or the individual financial statements of the foreign operation (as appropriate). However, if consolidated financial statements are prepared where the foreign operation is a subsidiary, such exchange differences are recognised in other comprehensive income and accumulated within equity and are NOT recognised in profit or loss when the parent disposes of the net investment.

## *Presentation currency*

The term 'presentation currency' is the currency in which the financial statements are presented. FRS 102 does acknowledge in paragraph 30.17 that an entity may present its financial statement in any currency (or currencies).

**Example – presentation currency**

TopCo Limited is the parent of a number of subsidiaries which operate throughout Germany, Spain and France, however the majority of the group's turnover and profits are generated in the United Kingdom.

As most of the group's turnover and profits are generated in the United Kingdom, TopCo Ltd chooses to present its consolidated financial statements in Great British Pounds.

The above example is not conclusive in the UK and it might well be that a UK group has a large number of overseas subsidiaries that trade in different currencies. If, say, 80% of a group's profit is generated by European subsidiaries whose functional currency is the Euro, (despite the fact that the group has other functional currencies such as US Dollars and Canadian Dollars), it may adopt the Euro as its presentation currency for the purpose of consolidated financial statements.

In situations where an entity's presentation currency differs from the entity's functional currency, the entity must translate its items of income and expense and financial position into the presentation currency. This is achieved as follows:

- Assets and liabilities for each **statement of financial position** presented (i.e. including comparatives) shall be translated at the closing rate* at the date of that statement of financial position;

- Income and expenses for each **statement of comprehensive income** (i.e. including comparatives) shall be translated at the exchange rates at the dates of the transactions; and
- All resulting exchange differences shall be recognised in other comprehensive income.

*The closing rate is defined as the spot rate of exchange as at the end of the reporting period.

Paragraph 30.19 does recognise that for practical reasons, an entity may use average rates of exchange, particularly to translate income and expense items. Care must be taken where average rates of exchange are employed because the paragraph does also recognise that where exchange rates have fluctuated significantly, the use of an average rate of exchange for a period will be inappropriate.

**Example – foreign subsidiary which is not wholly-owned**

TopCo Limited owns 80% of ForeignCo Inc and has accumulated exchange differences which have been recognised in other comprehensive income.

In the consolidated financial statements, exchange differences that relate to a foreign operation which is not wholly-owned and which are attributable to the non-controlling interests (minority interests) are allocated to, and recognised as part of, non-controlling interests within the consolidated balance sheet.

## *Consolidated goodwill*

If a group acquires a foreign subsidiary, any goodwill which arises on the acquisition of the subsidiary is treated as an asset of the foreign operation. Any fair value adjustments to the carrying amount of assets and liabilities arising on the acquisition of a foreign operation are treated as assets and liabilities of the foreign operation. Assets and liabilities for each statement of financial position presented (which must also include the comparatives) should be translated from the functional currency to the presentation currency at the closing exchange rate at the reporting date.

A key difference to note in comparison to SSAP 20 *Foreign Currency Translation* is that SSAP 20 regards consolidated goodwill as an asset of the parent company and not the subsidiary.

## *Disclosure requirements*

The following are required to be disclosed for foreign currency transactions:

(a) The amount of exchange differences recognised in profit or loss during the period, except for those arising on **financial instruments** measured at fair value through profit or loss in accordance with Sections 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*.

(b) The amount of exchange differences arising during the period and classified in equity at the end of the reporting period.

In addition, reporting entities must also disclose:

- The currency in which the financial statements are presented.  When the presentation currency is different from the functional currency, an entity shall state that fact and shall disclose the functional currency and the reason for using a different presentation currency.
- When there is a change in the functional currency of either the reporting entity or a significant foreign operation, the entity shall disclose that fact and the reason for the change in functional currency.

## THE MICRO-ENTITIES LEGISLATION (Lecture A459 – 17.29 minutes)

Legislation was introduced on 1 December 2013 in the form of SI 2013/3008 *The Small Companies (Micro-Entities' Accounts) Regulations 2013* which was introduced by the European Union with the objective of reducing costs for small businesses. The legislation is effective for financial years ending on or after 30 September 2013 where the company's financial statements are filed with the Registrar of Companies (Companies House) on or after 1 December 2013.

Under the new legislation, a company can qualify as a micro-entity if it meets at least two of the following three conditions:

- Turnover is not more than £632,000
- Gross assets (balance sheet total) is not more than £316,000
- Average number of employees does not exceed 10

The two-year rule that applies in determining whether a company qualifies as small also applies to micro-entities; namely that where a company meets, or ceases to meet, the qualifying conditions, qualification as a micro-entity only arises if it occurs in two consecutive years.

For the purposes of a small company that has a shortened reporting period (for example, if it is new start-up business), the turnover figure must be adjusted proportionately as in the following example:

**Example – short accounting period**

A company has a year-end date of 31 December 2013 and has been trading since 1 April 2013 (i.e. a nine-month accounting period). In this case the company will use 9/12 x £632,000 to determine whether the entity qualifies as a micro-entity.

Companies that are members of a group must take care when applying the criteria to determine whether they, individually, may qualify as a micro-entity. For parent companies, a company will qualify as a micro-entity in the financial year only if:

- The company qualifies as a micro-entity in that year;
- The group headed up by the company qualifies as a small group (as defined in Companies Act 2006 at section 383(2) to (7)); and
- The company has not voluntarily elected to prepare consolidated financial statements.

Care must be taken when applying the above because the exemptions that are available under the micro-entities regime will NOT be available for subsidiary companies that are included in the consolidated financial statements for the year. In addition, the micro-entities regime is not currently available for use by Limited Liability Partnerships, nor:

- Investment undertakings;
- Financial holding undertakings;
- Credit institutions;
- Insurance undertakings; or
- Charities.

The balance sheet must also include a statement that the accounts have been prepared in accordance with the micro-entity provisions, as opposed to the provisions applicable to companies subject to the small companies' regime.

## *FRED 52: Draft Amendments to the Financial Reporting Standard for Smaller Entities (effective April 2008)*

At the end of 2013, the Financial Reporting Council (FRC) issued FRED 52 which outlined amendments to the FRSSE (effective April 2008) which reflect the new micro-entities' legislation. The FRED is open for comment until 12 February 2014 and in addition to the reduced disclosure requirements for micro-entities, the FRED proposes to (for micro-entities only):

- Withdraw the use of the revaluation model for tangible fixed assets.
- Withdraw the choice to measure fixed asset investments at market value.
- Require micro-entities to account for investment properties using paragraphs 6.19 to 6.26 in the FRSSE as opposed to the specific accounting requirements for investment properties within the FRSSE at paragraphs 6.50 to 6.53 (i.e. micro-entities will be accounting for investment properties under the normal fixed asset rules rather than using fair value).

It was noted in the third bullet that the FRED did not contain any transitional provisions relating to micro-entities that may have investment properties on their balance sheets. There is no indication within FRED 52 as to whether such entities will be required to use the latest valuation as deemed cost, or whether such entities would be expected to restate carrying amounts to depreciated historic cost (which could prove very problematic in some instances, particularly where investment property has been held on the balance sheet for several years). It is hoped that the FRC will offer some transitional guidance in its final publication of the FRSSE for micro-entities.

## *True and fair concept*

The requirement to prepare financial statements that give a true and fair view has been enshrined in companies' legislation for many years. Under the micro-entities' regime, such entities will only be required to disclose minimal amounts of information at the foot of the balance sheet. Financial statements prepared under this regime are 'deemed' to give a true and fair view and many commentators argue that the deeming provision is inappropriate because the extent to which the disclosures have been significantly reduced are along the same lines as the abbreviated financial statements (abbreviated financial statements are not intended to give a true and fair view). Some commentators argue that micro-entity financial statements will fail to give a true and fair view in light of the absence of disclosures which are considered to be material in nature, such as:

- Directors' remuneration and other benefits in kind;
- Related party transactions;
- Post balance sheet events; and
- Going concern disclosures.

Whilst the micro-entities' regime brings with it a host of significant disclosure reductions, additional disclosures may be needed in the directors' report of a micro-entity relating to political and charitable donation and/or the company's policy on disabled employees where (in the rare circumstance) the average number of employees exceeds 250.

### *Format of the financial statements*

The formats required for the abridged accounts are set out in the statutory instrument. There is a choice of two formats for the balance sheet, but only one for the profit and loss account which is based on the present Format 2; all of the Formats are shorter than those presently in the Companies Act.

FRED 52 outlines the structure of the balance sheet and profit and loss account for a micro-entity which is outlined below:

<u>Format 1 balance sheet</u>

A. Called up share capital

B. Fixed assets

C. Current assets

D. Prepayments and accrued income

E. Creditors due within one year

F. Net current assets (liabilities)

G. Total assets less current liabilities

H. Creditors due after more than one year

I. Provisions for liabilities

J. Accruals and deferred income

K. Capital and reserves

<u>Format 2 balance sheet</u>

Assets:

Called up share capital not paid

Fixed assets

Current assets

Prepayments and accrued income

Liabilities:

Capital and reserves

Provisions for liabilities

Creditors (those due within one year and more than one year are separated)

Accruals and deferred income

Profit and loss account

A. Turnover

B. Other income

C. Cost of raw materials and consumables

D. Staff costs

E. Depreciation and other amounts written off assets

F. Other charges

G. Tax

H. Profit or los

Notes to the financial statements

These will consist of:

- Guarantees and other financial commitments; and
- Directors' benefits: advances, credits and guarantees.

## *Filing requirements*

Micro-entities can file the 'full' micro-entity financial statements with Companies House but the concept of 'abbreviated financial statements' will not apply to the micro-entities' regime. Alternatively, a micro-entity could exercise the option in s444(1)(a) CA 2006 and file just the balance sheet (i.e. no directors' report and profit and loss account) but the notes which will be at the bottom of the balance sheet must also be filed with the Registrar of Companies.

### *Concluding remarks on micro-entities*

Many accountants in the profession welcome the reduced disclosure requirements and feedback so far does seem to indicate that opinions on this regime are polarised. Some in the profession argue that the reduced disclosures are too much and will (potentially) result in more enquiries into corporation tax returns by HMRC as well as the potential for a company's credit-rating to be eroded by financiers and banks who may not be able to see the 'full picture' of a micro-entity. With that in mind, some in the profession are arguing that there will not be any cost-savings due to the potential for non-statutory information to be provided to external parties (such as HMRC and banks) who may require more information relating to the financial affairs of a micro-entity, over and above that required to be disclosed in legislation.

At the time of writing, the way forward by the FRC was not absolutely certain and hopefully more clarification will be incorporated in course material for quarters two and three, but for now it is simply a case of 'watch this space'.

## DRAFT CHARITY SORP 2015 (Lecture A460 – 23.18 minutes)

Changes in UK Generally Accepted Accounting Practice (UK GAAP) prompted a review of the Charities SORP. A new Exposure Draft SORP has been issued by the Charity Commission and the Office of the Scottish Charity Regulator for comment. At the time of writing the period for comment has closed.

Implementation of the SORP is intended to be for periods commencing 1 January 2015 onwards in line with FRS 102. Early adoption of FRS 102 is permitted but it will only possible for a charity to early adopt once the regulations are in place.

The draft SORP can be accessed from the microsite charitysorp.org. The microsite is being developed to support a number of features:

- A PDF copy of the SORP;
- An interactive SORP with hyperlinks;
- The option to select individual modules of the SORP;
- Two helpsheets comparing SORP 2005 with the Exposure Draft SORP; and
- The history of the development of the SORP.

Whilst there is extensive guidance in the new SORP for charities preparing their accounts under FRS 102 or the FRSSE, it is not a stand-alone document and needs to be read in conjunction with the relevant accounting standard.

The SORP sets out the form and content of the trustees' annual report and the three primary accounting statements:

- A balance sheet modelled on company reporting;
- A statement of financial activities (SoFA); and
- A statement of cash flows.

A 'think-small-first approach' in drafting the new SORP has been adopted. It is in a modular format with the scope and application section followed by 14 core modules that are intended to be read by all charities preparing their accounts on an accruals basis. A further 15 modules deal with particular transactions and structures, for example grant making, group accounts and mergers.

### *Main differences in the new SORP and points to note*

The following is a summary of the main changes from the previous SORP and other areas of interest. This is not intended to provide an exhaustive analysis of the changes but more of an overview for planning purposes.

All references to 'the SORP' refer to the draft SORP 2015.

Trustees' annual report

The helpsheet makes the point that the trustees' annual report is intended to provide information relevant to a charity's stakeholders and for the charity to tell its own story in a balanced manner. Nothing has changed in this regard.

One significant change to the SORP is that the requirements are now separated between larger charities and smaller charities, in line with the 'think small first' approach. Larger charities are considered to be those required to have a statutory audit by charity law or company legislation. Many 'larger charities' will therefore be small under the Companies Act and will be eligible to apply the FRSSE. This is likely to catch out at a least a few charities!

*Going concern* – the SORP now requires the trustees' report to include the nature of any uncertainties relating to going concern. The implication in the SORP is that if there are no uncertainties then no disclosure is required. Realistically the funding of many charities is annual and this disclosure will often be required in these situations. This change is in response to the FRC's going concern guidance. Note: there are also new requirements relating to going concern disclosure in the notes to the accounts (see below) which will need to be integrated with the trustees report disclosure, to avoid excessive duplication.

*Public benefit* - the SORP includes for the first time the legal requirements for all charities to explain those activities undertaken to further the charity's purposes for the public benefit and confirm that they have had regard to the Charity Commission's guidance on public benefit. However, public benefit considerations will not be restricted to objectives and activities but will also be considered in respect of achievements and performance. All charities will need to *'identify the difference the charity's work has made to its beneficiaries and, if practicable, explain any wider benefits to society as a whole.'*

*Reserves policy* – the absence of a reserves policy must now be disclosed and reasons given.

*Risk management* – in line with company law, larger charities are now required to make risk management disclosures. This is a difficult area where the FRC have previously reported that many large companies struggle to comply. It is likely that charities will need to work hard at this.

*Trustees' names concession* – the concession for charities with over 50 trustees has been dropped and now all trustees have to be named.

Statement of Financial Activities (SoFA)

The SoFA continues but with some changes to the headings which are intended to make the presentation simpler and adopt a 'plain English' approach.

Also, FRS 102 creates very significant changes for entities with financial instruments, and these include investments. The SORP has responded by changing the presentation of investment gains and losses. FRS 102 requires investment gains and losses to be accounted for at fair value through profit and loss.

The previous SORP showed these after 'net incoming/outgoing resources' and the new SORP now requires investment gains and losses to be presented in the 'income and expenditure account' before that total. The SORP recommends inserting a new subtotal 'net incoming/resources expended before investment gains/losses' to help identify a charity's income and expenditure before the impact of any investment gains and losses.

The helpsheet that compares the SORP 2005 to the draft SORP lists the changes to the other headings as follows:

Income

- The main heading 'incoming resources' is renamed 'income and endowments'.
- 'Voluntary income' is renamed 'income from donations'.
- 'Incoming resources from charitable activities' is renamed income 'earned from charitable activities'.
- 'Activities for generating funds' is renamed 'income earned from other activities.
- 'Investment income' is combined with 'other income' unless it is material in which case it is separately presented on the face of the SoFA.

Expenditure

- The main heading 'resources expended' is renamed 'expenditure'.
- 'Costs of generating voluntary income', 'fundraising trading: cost of goods sold and other costs' and 'investment management costs' are all combined in a new heading 'cost of raising funds'.
- 'Charitable activities' is renamed 'expenditure on charitable activities'.
- The heading of 'governance costs' is dropped altogether with these costs being a treated as a separate component of support costs for allocation across the other expenditure headings.
- 'Other resources expended' is renamed 'other expenditure'.

<u>Balance sheet (The Statement of Financial Position)</u>

The Companies Act formats continue to be used.

Cash flow statement

Note that all charities adopting FRS 102 will be required to present a cash flow statement. Previously adopters of FRS 1 *Cash Flow Statements* could benefit from a small company exemption – this is not present in FRS 102. The group exemption will no longer be available to charitable subsidiaries, either. Indeed the whole of the group reduced disclosure framework, in FRS 102, is unavailable to charities. Note that it could be applied by group members in charitable groups that are not themselves charities.

FRS 102 makes a number of changes to the format of the cash flow statement. The number of headings reduces to three:

- Cashflow from operating activities;
- Cashflow from investing activities; and
- Cashflow from financing activities.

There is also a change to the principle of what represents cash flows, and it now includes cash equivalents. This might broaden the scope of what cash is for many charities, as cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

Disclosures

The disclosures required now differ based on the size of charity and whether the accounts are prepared in accordance with the FRSSE or with FRS 102.

Accounting policies and definitions

There are a number of other changes for charities in the SORP, which are driven by changes to FRS 102. However, charities may continue to adopt the extant version of the FRSSE. The FRSSE 2015 has the following to say about its status:

*'For transactions or events not dealt with in the FRSSE, smaller entities should first have regard to their own existing accounting policies. Where an entity applying the FRSSE undertakes a new transaction not dealt with in the FRSSE for which it has no existing policy, in developing a new policy it should have regard to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland not as a mandatory document, but as a means of establishing current practice.'*

This reinforces the point that the FRSSE-adopting charities will, to a very large extent, continue to adopt their previous FRSSE compliant accounting policies. The FRSSE 2015 is changed very little when compared with the FRSSE 2008. The areas of change include a shortening of the life of goodwill for many entities and a change to the definition of related parties to align it with that used in FRS 102 and FRS 8 *Accounting Policies*.

**However**, some changes affect **all charities**, and accounts preparers will have to be vigilant to identify the changes for small companies, such as going concern disclosures, see below.

**Editor's note:** The future of the FRSSE 2015 is uncertain and many commentators (and standard setters) are of the view that FRSSE needs to move towards being an FRS 102 'Lite'. This would greatly change the impact of new UK GAAP for small charities. Events are moving fast, watch this space,

The major changes for FRS 102-adopting charities are:

Going concern

Note, that this change effects all charities including those adopting the FRSSE 2015.

Section 3.40 of the SORP states:

*'All charities must explain if there are material uncertainties related to events or conditions that cast significant doubt on the charity's ability to continue as a going concern. In making their explanation, charities should provide:*

- *a brief explanation as to those factors that support the conclusion that the charity is a going concern; and*
- *a balanced, proportionate and clear disclosure of any uncertainties or liquidity risks that makes the going concern assumption doubtful or inappropriate.'*

3.41 continues:

*'Where there are no material uncertainties about the charity's ability to continue, this should be stated.'*

This disclosure requirement is above and beyond the requirements of FRS 102 because it requires disclosure whether or not there are any uncertainties to disclose. A statement of why the charity is a going concern will always be required.

Income from donated goods, services, and facilities including volunteers

This was a major talking point when FRS 102 was developed. Most charities were very resistant to recognising these sorts of assets/income, for both practical and reporting reasons.

The SORP reflects the FRS 102 requirement that, where practicable, income from the receipt of donated goods intended for resale is recognised at the time of receipt at fair value and that income from donated goods for distribution be similarly recognised as income at fair value at the time of receipt.

The compromise is that the SORP says that where it is impracticable to fair value the donated goods on receipt then they should be recognised as income when they are sold or distributed. This is different from the SORP 2005 approach which recognised the inherent practical problems of fair valuing goods upon receipt so did not require it.

**Editor's note**: In practice charity shops will not recognise goods as income on receipt. These goods commonly consist of clothes, books, toys, household goods etc. and it is not usually practicable to value them. However, if a charity worker is lucky enough to find Whister's Mother on the doorstep then recognition would usually be practicable. Practicability, has to be judged by both considering the inherent difficulty of performing a reliable valuation and the importance of valuing the income in question

The contribution of volunteers will not be included as income in the charity's financial statements. However, an indication of the scale of their contribution will be required in a note to the accounts, including, for example, the number of volunteers or full time equivalents.

Related parties

The definition of a related party has been brought into line with definition in FRS 102, which is also identical to the definition in FRS 8 *Related Parties*. The SORP has its own extended definition of related parties that is thought to be more appropriate to charities.

A significant point, worthy of note is the extension of the definition relating to employees of the charity. Which now includes any person who is:

- an officer, agent or employee of the charity (draft SORP Glossary, Related Party C2); or
- a person who is a member of the key management personnel of the reporting charity or a close family member of that person's family (draft SORP Glossary, Related Party C7).

SORP 2005 stated that a related party includes *'any officer, agent or employee of the charity having authority or responsibility for directing or controlling the major activities or resources of the charity'*, instead. The broadening of this is clear, as more junior employees are now brought within the scope of related parties.

Income recognition

The Charity SORP micro-site is virtually silent on the subject of income recognition but many commentators have identified some significant issues in this area.

Income will need to be recognised when all of the following criteria are met:

- Entitlement – control over the rights or other access to the economic benefit has passed to the charity;

- Probable – it is more likely than not that the economic benefits will flow to the charity; and
- Measurement – the monetary value or amount of the income and the costs to complete the transactions can be measured reliably.

This is important because one of the income recognition criteria is moving from 'virtually certain' to 'probable'. This could possible accelerate the recognition of income in charities.

For example, a charity is informed in writing that a wealthy benefactor has promised to donate £100,000. The recognition criteria of virtual certainty would general be met only once the donation is received. 'Probable' means more likely than not and might require earlier recognition. Some commentators have pointed out that this is hardly prudent!

Grant Income

FRS 102 introduces an interesting accounting policy choice on government grants. Under that standard entities can either use the performance model or the accrual model. The SORP does not give this choice for charities and does not permit the use of the accrual model even for government grants.

The performance model will require the grant to be recognised as soon as the grant is received or receivable where there are no performance-related conditions. This is in line with current practice and the main impact is likely to be the changing income recognition from virtually certain to probable.

Financial instruments

This is probably the most major change in UK GAAP, but only for those entitles that hold certain financial instruments, which are typically the ones described as 'non-basic' by FRS 102, such as derivatives. Indeed charities have always had to account for certain investments at market value under the SORP so the practical impact is lessened on charities compared to other entities who previously had the option of holding these investments at cost.

FRS 102 requires that investments in shares must be remeasured at fair value through profit and loss if the shares are publicly trade or whose fair value can otherwise be reliably measured.

There is some heated debate in the profession about how far this goes. Charities with investments in small private companies will need to consider whether the fair values of the shares can be measured reliably. If they decide that they can, then they need to give some thought to what evidence their auditor might require to support the valuation!

Post-employment benefits

The big issue for charities in FRS 102 is the requirement to include the liabilities arising from multi-employer defined benefit pension schemes on the balance sheet, to the extent that the charity has agreed to fund deficits relating to past service. Previously these will generally have been accounted for as defined contribution schemes.

The SORP will also require a description of the extent to which the charity can be liable to the plan for other entities' obligations; and an explanation of how any liability arising from an agreement to fund the plan has been determined.

Branches

Regarding branches, the SORP excludes from its scope charities that are independently run by their own board of trustees. If they fall within the appropriate definition these are dealt with as subsidiaries in the group accounts not as branches with the entity's own accounts.

Fund accounting

The SORP clarifies the point that fund transfers should always net to zero. Previously single sided fund transfers have been used for acquisitions and transfers of trusts to other charities. This approach is no longer acceptable

Legacies

The SORP also makes it clearer that probate is the event that enables the recognition of a legacy but that an accrual is only made once there is the necessary probability of the legacy's receipt and the amount of the gift can be reliably measured.

Mixed use of investment properties

SORP 2005 required the main use of the property to be considered when distinguishing between fixed assets and investment properties. The new SORP requires the uses to be analysed in the balance sheet between the part of the property used for operational purposes and the part that represents an investment.

This is not required when the valuation of the investment portion cannot be measured without undue cost or effort. Care should be taken not apply this apparent exemption too broadly.

Investment properties

Note, that the SORP retains the exclusion that a property occupied by a group company is not an investment property. This SSAP 19 feature does not exist in FRS 102.

Also, note that charities have to fair value investment properties at each period end and do not have the option of overriding this requirement on the ground of undue cost or effort. This argument is restricted to mixed use properties (see above).

Key management personnel

The total amount of employee benefit received by the charity's key management personnel for their services to the charity will be disclosed in bandings as previously.

Additionally, the draft SORP appears to encourage additional disclosure such as by individual. A number of commentators have suggested that this should have been a requirement of the SORP, but it is not. It is unclear whether this would be for senior management named in the reference details or all those key personnel who would be identified as related parties.

Other changes

The helpsheet also identifies other areas where there are changes in the SORP. Charities, where this issues are present, should look at the SORP in more detail:

- Where the useful economic life for goodwill and intangibles cannot be reliably estimated, amortisation will be calculated over no more than five years rather than a 20-year maximum life in line with FRS 102.
- Income is first recognised when its receipt is to 'probable' (this point has been clarified).
- There is a more extensive requirement for discounting for the time value of money with respect to both income and expenditure where settlement is delayed by more than 12 months and the effect is material.
- Internally generated databases cannot normally be capitalised.
- A new category of 'mixed motive' investments is introduced.
- The use of merger accounting for charity mergers and reconstructions is explained.
- Joint venture entities are normally accounted for on an equity rather than gross equity basis.

Transition to FRS 102

Do not forget the transitional provisions in FRS 102. The onerous nature of transition should not be overestimated.

A charity with a year-end of 31 December 2015, would have a transition date of 1 January 2014. The transition date is the first day of the earliest period of comparatives presented in the financial statements. Asset, liabilities and funds will need to be restated as of that date subject to the application of exceptions or the adoption of exemptions.

Fortunately, for small charities applying the FRSSE there are no similar transitional provisions.

Future of the Charities SORP

The Charity Commission and OSCR say that:

'*The SORP consultation has closed with 179 responses received. The responses together with the feedback from the 26 consultation events held across the UK and Republic of Ireland are to be considered by the SORP Committee in early 2014. Those responses which were not confidential, together with the analysis and the SORP Committee minutes indicating the action taken are to be posted on this micro-site at the end of February 2014.*'

It is hoped that the SORP will be put forward for FRC approval in May 2014 and finalised in time for mandatory adoption for periods commencing 1 January 2015.

## AUDIT: ETHICAL STANDARDS (Lecture A461 – 23.28 minutes)

Disciplinary pages of the various professional bodies are often littered with proceedings taken against practitioners because they have failed to comply with professional ethics (for example, levels of fees or honesty and integrity).

In the UK and Ireland, there are five Ethical Standards (ESs) which auditors must adhere which are:

- ES1 *Integrity, Objectivity and Independence*
- ES2 *Financial, Business, Employment and Personal Relationships*
- ES3 *Long Association with the Audit Engagement*
- ES4 *Fees, Remuneration and Evaluation Policies, Litigation, Gifts and Hospitality*
- ES5 *Non-Audit Services Provided to Audit Clients*

This section of the course will not go into every minute detail of the ESs, but will cover some of the most significant areas. It is important that auditors have an awareness of the ESs to ensure compliance and reduce the risk of running into difficulties with professional regulators for non-compliance with the ESs. Often audit firms become so engrossed in ensuring compliance with the UK and Ireland International Standards on Auditing (ISAs) that they are not aware of any (potential) breaches in the ESs that may arise (or have already arisen) until such time they are subjected to a monitoring review by a professional regulator.

### *ES1 Integrity, Objectivity and Independence*

To a large extent, this ES tells us what many auditors already know; auditors have to act with integrity which the ES itself recognises as not just including honesty, but other qualities. The ES refers to characteristics such as:

- Fairness;
- Candour;
- Courage;
- Intellectual honesty; and
- Confidentiality.

Auditors have been severely criticised over recent years for the ways in which they have allegedly approached and undertaken their audit work. They have been accused of being anything but objective and independent. Unfortunately the audit profession always appears to be in the 'firing line' when scandals hit the media and the same recommendations always appear to be repeated *'auditors must be more independent' 'auditors must show more scepticism'* as well as *'the audit model needs to evolve'.* Auditors must, however, be (and be seen to be) independent and objective in their approach to an audit. ES1 considers objectivity to be a state of mind which excludes bias, prejudice and compromise. It goes on that being objective will enable the auditor to give a fair and impartial consideration to all matters which are relevant. It also recognises that, essentially, objectivity goes 'hand in hand' with integrity.

Objectivity is a personal behavioural characteristic which is concerned with the auditor’s state of mind. Independence, according to ES1, is freedom from situations and relationships which would otherwise make others think that objectivity is (or could be) impaired.

The overarching principle in ES1 is that integrity, objectivity and independence must be maintained at all times during the course of an audit. Where threats to any of these characteristics presents themselves, they must either be reduced to an acceptable level or the audit firm must consider resignation from the audit (or declining the audit as the case may be). The ES recognises the following threats to an auditor’s objectivity and independence:

Self-interest threat

This can occur when the auditor has a financial interest in the audit client or where the auditor has other interests in the client which may cause the auditor to be reluctant to take actions that would be adverse to the interests of the audit firm or any individual in a position to influence the conduct or outcome of the audit.

Self-review threat

Self-review threats occur when the audit firm also performs non-audit services, such as the preparation of the financial statements or management accounts and then also acts in the capacity as auditor.

Management threat

A management threat occurs when the audit firm performs non-audit services and management make judgements and take decisions based on those non-audit services. The ES itself cites the design, selection and implementation of an accounting IT system.

Advocacy threat

This can arise when the audit firm acts as a legal advocate for the audit client because here the audit firm will have to adopt a position which is very similar to that of a management role.

Familiarity threat

Familiarity threats are very common – they arise when the auditor develops a close relationship with the audit client, usually because of long association. Such a threat is also referred to as a ‘trust threat’.

Intimidation threat

This can arise when the client is aggressive or the auditor feels intimidated by the client.

The above threats are not exhaustive by any means, and other threats may well present themselves which will also need to be considered by the audit firm in the context of ES1.

## *ES2 Financial, Business, Employment and Personal Relationships*

Auditors cannot have any financial interest in their audit client. To do so would give rise to a self-interest threat as described above and ES2 acknowledges that there are no safeguards which can be implemented by a firm to reduce this risk to an acceptable level. However, situations can arise when the family of the audit partner may have a financial interest in the audit client. ES2 makes allowances for these situations, but only in situations when an immediate family member of an audit partner is not in a position to influence the conduct and outcome of the audit. Generally speaking, where such financial interests are material and the audit partner has close contact with the audit engagement team, the ethics partner would consider the need to put safeguards in place and this may involve substituting the audit partner.

<u>Business relationships</u>

Business relationships can occur when the audit firm and the client have a common commercial interest and the ES itself recognises that this can create a self-interest, advocacy or intimidation threat. It gives various descriptions in ES2 at paragraph 28 as to what may constitute a business relationship and is quite specific on what the audit firm should do in these circumstances. Basically, the audit firm must not enter into a business relationship with an audit client, its management or its affiliates. The ES does, however, give two exceptions to this rule and does allow the audit firm to enter into a business relationship where they:

- Involve the purchase of goods and services from the audit firm or the audited entity in the ordinary course of business and on an arm’s length basis and which are not material to either party; and
- Are clearly inconsequential to either party.

<u>Employment relationships</u>

Employment relationships occur when an audit firm employs someone from the audit client, or admits (say) the financial director to the audit firm’s partnership. The ES also recognises instances when the audit firm might enter into an agreement with the audit client to supply staff (secondments). Such agreements are not permitted unless the agreement is for a short period of time and would not involve the staff (or the partners) providing services to the client which would not be permitted under ES5 *Non-Audit Services Provided to Audited Clients*. In addition, the audit firm must also ensure that the client agrees that the staff member(s) concerned will not hold a management position, make management decisions or exercise discretionary authority to commit the audit client to a certain position or accounting treatment.

The ES is also quite strict on what happens when a staff loan assignment has been undertaken which is permissible under ES2. Where an audit partner or member of staff of the audit firm returns after completion of the loan assignment, they must not be involved in any area of the audit which may involve a function or activity which the employee or audit partner performed or supervised during their engagement.

In situations where a former audit partner takes up employment with the audit client, the firm must ensure that it takes all relevant action to ensure that no significant connections remain between the firm and the individual who has joined the client. Also, where an audit partner who has been the partner in charge of the audit client leaves to take up employment with that same audit client in a key management position or appointed as a director of the audit client, the audit firm must resign and not be re-appointed until a two-year period has elapsed. The two-year clock starts running when the former partner ceased to be able to influence the conduct and outcome of the audit, or when the former partner ceases to be employed by the audit client, whichever is the sooner.

Personal relationships

Personal relationships can hinder objectivity and independence when a family member has a financial, business or employment relationship with the audited entity. ES2 acknowledges that this can result in a self-interest, familiarity or intimidation threat arising.

The audit firm must have procedures in place whereby partners and audit staff must report any family, close family and other personal relationships which involve the audit client and which may give rise to a threat to the auditor's objectivity or perceived loss of independence. The audit engagement partner will then assess these threats and apply appropriate safeguards which will normally involve removing the relevant individuals from the audit assignments.

## *ES3 Long Association with the Audit Client*

This is a fairly common incidence and one which has been frequently criticised by the various professional bodies. Essentially the audit firm must have procedures and policies in place which monitor the length of time that the audit engagement partners and other key staff (including key partners) are involved in the audit. Where such individuals have had a long association with the audit client, the firm must assess the threats to the auditor's objectivity and independence and apply safeguards to reduce any threats to an acceptable level. This can usually involve partner rotation. In cases where the audit firm is small and partner rotation may not be available, and there are no other safeguards which can be applied, the audit firm must resign.

## *ES4 Fees, Remuneration and Evaluation Policies, Litigation, Gifts and Hospitality*

Fees

In terms of fees, the audit partner must ensure that audit fees are not influenced or determined by any non-audit services which the firm may provide to the client. The audit fee must be appropriate and not manipulated in order to secure other work. Fees must also never be undertaken on a contingent basis; fees must always be calculated in accordance with the time spent on the audit and the level of skills and experience of the staff required to perform the audit work effectively. Some audit firms are getting into trouble with regulators for audit fees which have been reduced to such an extent that they are not representative of the time needed to complete the audit in accordance with the UK and Ireland ISAs and hence audit firms may 'cut corners' in an attempt to complete the audit within a budget that is unrealistic because of a desire to continue with non-audit services (or secure additional non-audit work) (which is a breach of paragraph 7 to ES4).

Another thing to watch out for is the level of fees from an audit client. Fees for both audit and non-audit work from unquoted companies (and subsidiary companies) which regularly exceed 15% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm where the audit engagement partner's profit share is calculated, will mean that the audit firm must either resign or not stand for re-appointment (whichever is appropriate). The 15% figure is reduced to 10% for those companies which are listed.

In terms of fees, where it is expected that fees for both audit and non-audit work from an unquoted company and its subsidiaries will regularly exceed 10% of the annual fee income of the firm, but will not regularly exceed 15%, the audit engagement partner must disclose this fact to the ethics partner as well as to those charged with governance. The audit firm must then arrange for an external, independent quality control review prior to the auditor's report being signed (in other words a 'hot' review).

In terms of listed entities, where it is expected that fees for both audit and non-audit work will regularly exceed 5% of the annual fee income of the firm (or part of the firm from which the partner's profit share is calculated), but will not regularly exceed 10% then the audit engagement partner must disclose that expectation to the ethics partner and to those charged with governance of the audit client and consider the need of appropriate safeguards to eliminate or reduce the threat to the auditor's objectivity and independence to an acceptable level.

Safeguards in respect of fees can usually include reducing the non-audit work to be undertaken (not the audit fee, however, as this would mean fees from non-audit work have influenced the audit fee in contravention of ES4 paragraph 7), or applying independent file reviews.

Remuneration and evaluation policies

Remuneration and evaluation policies are where the audit firm sell non-audit services to an audit client and where the audit team is judged on the amount of non-audit services it sells to clients. Paragraph 44 to ES4 requires an audit firm to establish policies and procedures which ensure that the objectives of the team do not include selling non-audit services to the audit client. In addition, any appraisals of the audit team for the purposes of promotion or deciding on the levels of pay must not include success in selling non-audit services to the client. The remuneration level of a member of the audit team cannot be based on their success in selling non-audit services to the client.

Litigation

Unfortunately sometimes clients may not pay the auditor for the work performed and the auditor may decide to instigate legal proceedings to recover the monies due to the audit firm. This can give rise to a self-interest threat, advocacy and intimidation threat and where litigation is significant and in progress, or where the audit engagement partner considers such legal action to be probable, the audit firm must either not continue with, or accept, the audit engagement.

Gifts and hospitality

On the flip side of suing clients, the relationship between the audit firm and the client may well be very good and everyone gets on very well. Sometimes the audit client may want to offer gifts or other hospitality to the audit team. The rules are clear – those in a position to influence the conduct and outcome of an audit (including immediate family members of such people) cannot accept hospitality from the audit client, unless it is reasonable in terms of its frequency, nature and cost. So a two-week cruise around the Mediterranean would not be considered ‘reasonable’, although the offer of lunch would not ordinarily be considered to threaten objectivity and independence.

## *ES5 Non-Audit Services Provided to Audited Entities*

The debate about the provision of non-audit services to audit clients has raged on for years. It is a fact of life that many auditors (particularly smaller firms of auditors) do provide additional services beyond the scope of audit work to their audit clients. For example, payroll and tax advisory services. Essentially in such situations, the audit engagement partner must ensure that there are sufficient safeguards in place to eliminate any threats to objectivity and independence and ensure that these threats are reduced to an acceptable level. A typical safeguard could be to have the audit file independently reviewed before the auditor report is signed (a ‘hot’ review). If the audit firm has the staff resources available, it might be more appropriate in the circumstances to have a separate team undertaking the non-audit work and a separate team performing the audit work.

In situations where the audit engagement partner concludes that there are no appropriate safeguards available to eliminate or reduce the threat to independence and objectivity to an acceptable level, the firm must either refuse the non-audit work or not accept, or withdraw, from the engagement.

Where the firm does accept both the audit and non-audit work, the audit engagement partner must ensure that they document the reasons for undertaking the non-audit work to and the safeguards that they have put in place to ensure independence and objectivity are not impaired as a result of the non-audit work undertaken.

ES5 provides a number of general principles which are specific to non-audit services that should be applied. These are covered in paragraphs 54 to 168 and include requirements for both listed and unlisted entities.

## THE AUDIT OF GOING CONCERN (LectureA462 – 9.55 minutes)

One of the 'issues' that has been picked up by the ICAEW's QAD and reported in their 2012 *Audit Monitoring* report was the work done by audit firms on a reporting entity's going concern. Other file reviewers have also criticised audit firms for undertaking insufficient work relating to the going concern assessment undertaken by management. This criticism largely surrounds insufficient audit evidence on file to corroborate the assertion by management that the entity has the ability to continue as a going concern.

ISA (UK and Ireland) 570 *Going Concern* outlines its objectives for the auditor at paragraph 9 which says:

*'The objectives of the auditor are:*

*(a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;*

*(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and*

*(c) To determine the implications for the auditor's report.'*

Professional bodies are still placing the audit of going concern as an important area of the audit given the current economic uncertainties because an entity's exposure to collapse is higher in times of economic strain than in economic boom (the housing market is a prime example). If the directors of a company consider it appropriate to cease trading, or liquidate the company, clearly the company will not be a going concern and the financial statements should not be prepared using the going concern presumption. Instead, 'break-up' values should be used and this concept is emphasised in paragraph 14 to FRS 21 *Events after the Balance Sheet Date* which states:

*'An entity shall not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading or that it has no realistic alternative but to do so.'*

Break-up values cannot generally be used for an entity where the going concern basis is deemed appropriate because such values ordinarily do not give relevant information to users who are seeking to assess the entity's financial performance.

### *Responsibilities relating to an entity's going concern*

ISA (UK and Ireland) 570 stipulates that the management of an entity is responsible for assessing the entity's ability to continue as a going concern. This will involve making judgements concerning the future outcomes of events or conditions which, at the time of assessing the entity's ability to continue as a going concern, are uncertain.

The auditor's responsibility is to consider the appropriateness of management's assessment that the going concern basis is applicable in the circumstances. In particular, the auditor must consider whether there are material uncertainties which may cast doubt on an entity's ability to continue trading as a going concern for the foreseeable future. In many cases the auditor will consider the going concern presumption appropriate to an entity's particular circumstances and no reference to going concern uncertainty will be made in the financial statements, or in the audit report. This does not, however, give a guarantee that the entity is a going concern. This is accentuated in paragraph 7 to ISA (UK and Ireland) 570 which cross-refers to ISA (UK and Ireland) 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing (UK and Ireland)*. This particular paragraph refers to the potential inherent limitations on the auditor's ability to detect material misstatements which are considered to be greater for future events or conditions which may cause an entity to cease to continue as a going concern. Paragraph 7 in ISA (UK and Ireland) 570 acknowledges that auditors cannot predict future events or conditions and therefore the absence of any reference to the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Notwithstanding paragraph 7 in ISA (UK and Ireland) 570, this does not preclude the auditor from obtaining sufficient appropriate audit evidence concerning management's assessment that the entity does have the ability to continue as a going concern for the foreseeable future, or otherwise.

## *Period of assessment*

Care needs to be taken by auditors to ensure the correct period of assessment is undertaken because there is difference between the mainstream ISA 570 as issued by the International Auditing and Assurance Standards Board and the UK and Ireland version of ISA 570. ISA (UK and Ireland) 570 requires management to assess an entity's ability to continue as a going concern for a period of at least 12 months' from the date of approval of the financial statements (note 12 months from the <u>date of approval</u>). The mainstream ISA 570 requires management to undertake an assessment of going concern for a period of 12 months from the date of the financial statements and this is often where the confusion lies.

If management's assessment of going concern is less than 12 months from the date of approval of the financial statements, the auditor must request that management extends its assessment period to at least 12 months from that date. Where the assessment of going concern is less than one year from the date of approval of the financial statements, and those charged with governance have not disclosed that fact, the auditor must do so within the auditor's report as well as considering the implications for their audit report. The auditor must also bear in mind that if the non-disclosure of the fact in the financial statements is a departure from the requirements of the applicable financial reporting framework, the auditor must express a qualified opinion 'except for'.

## *Reporting*

The auditor must consider, in light of the audit evidence obtained, whether a material uncertainty exists which relates to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. Paragraph 17 to ISA (UK and Ireland) 570 says that a material uncertainty exists when the magnitude of its potential impact and likelihood of its occurrence is such that, in the auditor's judgement, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

(a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(b) In the case of a compliance framework, the financial statements not to be misleading.

<u>Going concern assumption appropriate but a material uncertainty exists</u>

The concept of going concern is always a material issue, whether there are any uncertainties or not. If, in light of the audit evidence obtained, the auditor concludes that the use of the going concern assumption is appropriate, but a material uncertainty exists, the auditor must determine whether the financial statements:

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's (or those charged with governance) plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

<u>Audit opinion</u>

On the basis that adequate disclosure is made by management or those charged with governance about material uncertainties relating to going concern, the auditor shall express an unqualified opinion but modify the auditor's report to include an emphasis of matter paragraph which cross-references to the note in the financial statements which discloses the uncertainties relating to going concern. The emphasis of matter paragraph should also confirm that the audit report is not qualified in respect of this matter.

If adequate disclosure is not made in the financial statements, the auditor must express a qualified opinion or adverse opinion as appropriate. The auditor must also state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

In situations where the auditor concludes that the going concern basis is inappropriate, but the financial statements have been prepared on that basis, the auditor must express an adverse opinion.

## AUDITING FINANCIAL INSTRUMENTS (Lecture A463 – 13.24 minutes)

### *Background*

In the UK, under SSAPs and FRSs, auditing financial instruments has been an issue of relatively narrative interest for the audit profession. Only entities in the financial sector or those with complex financial arrangements were likely to be recognising financial instruments on their balance sheets.

Section 11 *Basic Financial Instruments* and particularly Section 12 *Other Financial Instruments Issues* of FRS 102 require many more financial instruments to be recognised at fair value on the balance sheet through profit and loss. This will be a big change for entities holding derivatives like interest rate swaps or foreign exchange (forex) contracts which will be recognised for the first time under UK GAAP.

Auditing these financial instruments will become much more of an issue for the profession from 2015, when FRS 102 first applies. The FRC guidance in this area can be found in Practice Note 23 *Special Considerations in Auditing Financial Instruments*.

These notes are produced to help auditors of smaller, simpler entities rather than large banks or traders. This is intended to be a practical guide to the audit of financial instruments rather than a summary of every detail in PN 23.

### *The issues in summary*

Auditing financial instruments is like any other audit area. The auditor needs to:

- ***Understand the entity*** – understand the financial instruments and how they should be valued. Also, the auditor needs to understand the recognition, measurement and disclosure requirements in the accounting standards.
- ***Assess Risk*** – determine the estimation uncertainty and in particular consider the nature of possible fraud risks.
- ***Obtain sufficient appropriate audit evidence*** – this will often involve evidence from third parties such as banks, brokers, experts and any other relevant counterparty.

What is special about financial instruments is that they can be complex and hard to understand. There is a very real possibility that management might not properly understand them!

In turn this contributes to higher audit risk. Add to this the susceptibility of financial instruments to fraud and this is potentially one of the highest risk audit areas.

Granted there are situations when risk is low but auditors will still need to carefully document their work. This might be a particular problem on transition to FRS 102 when auditors and management alike are going up a learning curve on new UK GAAP. Following last years' audit plan will not be an option! Permanent audit information will need updating.

## *Competence of the audit team and the ability to be sceptical*

Many UK auditors will have a significant learning curve ahead of them in dealing with financial instruments. This includes:

- The practical application of the requirement of FRS 102 to recognise many non-basic financial instruments at fair value through profit and loss.
- Getting to grips with the workings of financial instruments like swaps and forex contracts and understanding the way they work in practice and how to value them.
- How to obtain sufficient appropriate audit evidence

Additionally, auditors might need to help management on the first two points and this needs to be considered as the provision of a non-audit service, for the purposes of compliance with the APB Ethical Standards.

Financial instruments present significant risks for auditors and management may have to make assumptions in their valuation. The combination of higher risk and significant judgement being applied by management mean that auditors will have to remember to carefully apply professional scepticism when looking at audit evidence.

## *Understanding financial instruments*

Auditors need to obtain an understanding of:

- What financial instruments the entity might have and how and why they are used. The intention behind entering into these arrangement often influences the accounting treatment. Also, understanding the entity's intentions assists with the risk assessment and designing tests.
- The detailed workings of the financial instruments in question.
- Any relevant internal controls.
- The relevant accounting requirements in the standards and the entity's accounting policies and the way it makes the necessary accounting estimates.
- The valuation techniques to be applied to the different categories of financial instruments and the practicalities of how management intend to value them e.g. will they simply ask the counterparty for a valuation? Auditors, should be prepared to request third party confirmations if need be.

It should go without saying that this needs to be adequately documented, probably as part of the permanent audit information. The majority of this documentation could be added to the section of the file that deals with accounting estimates, in so far as valuation is often the biggest issue.

## *Risk assessment and the fraud risk*

Auditors need to adequately document the process of assessing the risk of fraud or error in relation to financial instruments. The key issues for auditors to think about at the risk assessment phase are fraud and estimation uncertainty.

Fraud risk

Due to their complexity, the manipulation of the financial statements through the misstatement of financial instruments is often a risk. Auditors should, as always, consider what risk factors are present, such as:

- Are management or other relevant staff receiving profit related pay?
- Are management under pressure to report good results to shareholders or the bank?
- Is the entity regulated and required to meet solvency requirements?

**Example – responding to risks**

A company has a fixed for floating interest rate swap and is preparing accounts for the year ended 31 December 2015. The swap will need to be recognised on the balance sheet for the first time and management have requested valuations from the bank

The company has significant bank borrowings and is experiencing cash flow problems. How should the auditor assess and respond to these risks?

*There is higher audit risk in this area. It is possible that management might resist the recognition of a liability on the balance and the auditors would be right in assuming that this swap is likely to be a liability rather than an asset.*

*Management might be motivated to falsify the valuation from the bank so the auditors should consider obtain the valuation directly from the bank. As a significant risk the auditors might consider using their own model to value the swap by way of comparison.*

Estimation uncertainty

ISA (UK and Ireland) 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* deals with the auditor's responsibilities relating to auditing accounting estimates, including accounting estimates related to financial instruments measured at fair value. This ISA is crucial in understanding the auditors' responsibilities in relation to financial instruments.

Auditors are required in paragraph 9 of the ISA to determine estimation uncertainty for each accounting estimate which would include determining the fair value of financial instruments. The ISA defines estimation uncertainty as:

'*The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.'*

Estimation uncertainty will vary according to the nature of the financial instrument and the method of valuation. IFRS and FRS 102 establishes a fair value hierarchy to develop increased consistency and comparability in fair value measurements and related disclosures. IFRS and FRS 102 contain similar hierarchies although only IFRS numbers the three levels:

Level 1 inputs—Quoted prices (unadjusted) in active markets for identical financial assets or financial liabilities that the entity can access at the measurement date.

Level 2 inputs—Inputs other than quoted prices included within level 1 that are observable for the financial asset or financial liability, either directly or indirectly. If the financial asset or financial liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the financial asset or financial liability.

Level 3 inputs—Unobservable inputs for the financial asset or financial liability. Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the financial asset or financial liability at the measurement date.

In general, estimation uncertainty increases as a financial instrument moves from level 1 to level 2, or level 2 to level 3. Also, within level 2 there may be a wide range of measurement uncertainty depending on the observability of inputs, the complexity of the financial instrument, its valuation, and other factors.

Once the auditor has evaluated the degree of estimation uncertainty associated with an accounting estimate, the auditor must then determine whether any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

Estimation uncertainty and the prior period review

The auditor is required to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period.

The review will provide information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's estimation processes in the current period. It will also provide the auditor with information about estimation uncertainty and possible management bias.

Reviewing financial instruments that mature post year end could provide useful information about the entities valuation techniques.

## *Internal control*

The internal controls relating to financial instruments will always be an issue for auditors. Even where internal controls are not being relied upon the auditor has to obtain an understanding of the design and implementation of internal controls.

Design and implementation

Even in smaller entities with few financial instruments and informal internal controls this is still a real issue. In practice this is often very straightforward but auditors sometimes forget to take into account the control environment when planning their work. The following example illustrates this.

**Example – informal internal controls**

A small manufacturer funds its capital needs through a bank term loan. The company is an owner-managed family run business with informal internal controls. None of the directors have any strong financial knowledge. There are few formal internal controls.

What impact does the informality of the control environment and risk assessment procedures have on the audit?

*The auditor should be aware that management might enter into arrangements that they do not fully understand the implications of. For instance they could feel obliged to enter into a fixed or floating interest swap with the bank where the terms are heavily stacked in the bank's favour – there are many well documented cases of this happening. The directors might also not think to volunteer this information to the auditor, not out of fraudulent intent but because they do not understand its implications.*

<u>Reliance on internal controls</u>

Where there is a high volume of financial instruments then it is likely that there will be good internal controls and the auditors will often choose to rely on them.

Where there are non-routine financial instruments the auditor would usually revert to a fully substantive approach.

### *Audit evidence*

PN 23 has a number of interesting things to say about audit obtaining sufficient appropriate audit evidence, which are set out below.

<u>Analytical review</u>

Analytical review will be a useful tool to better understand the financial instruments that the entity has and assess risk (i.e. preliminary analytical review). However, it is unlikely to be a good substantive procedure in this area. Tests of detail are much more appropriate or, of course, reliance on internal control.

<u>Sampling</u>

PN23 suggests that the financial instrument portfolio will comprise instruments with varying complexity and risk. In such cases, judgmental sampling may be useful.

For instance a particular entity has for many years purchased forward US$ and euros, but has only just started selling forward South African rand and other softer currencies. The auditor would use their judgment to test the contracts in the new currencies.

External confirmations

Auditors will often seek external confirmation of bank accounts, trades, and custodian statements. This can be done by direct confirmation with the counterparty (including the use of bank confirmations), where a reply is sent to the auditor directly. External confirmations, however, often do not provide adequate audit evidence with respect to the valuation assertion though they may assist in identifying any side agreements and the precise terms of the financial instrument.

Testing year-end journals

ISA (UK and Ireland) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires auditors to test year-end journals. Auditors should be particularly vigilant for year-end journals relating to financial instruments, which could be fraudulent.

Completeness relating to derivatives

Auditors should not just audit the financial instruments that have been recognised on the balance sheet. A feature of derivatives is that they often have no initial cost so they will nearly always have to be identified by management to be brought into the financial statements. Auditors will have to make enquires and review appropriate correspondence records to identify any unrecorded financial instruments.

This will be a particular problem upon first time adoption of FRS 102.

### *Management representations*

The valuation of financial instruments often requires the exercise of judgement by management. These judgements will involve making assumptions such as their intention to hold a particular financial instrument to maturity and auditors will have to satisfy themselves that management will and can do this.

These significant verbal representations should be included in the letter of representation. Of course written representations on their own do not constitute audit evidence and they need to be corroborated.

### *Communications with those charged with governance*

ISA (UK and Ireland) 260 *Communication with Those Charged with Governance* requires that auditors communicate to management their views about the qualitative aspects of the entity's accounting practices and financial reporting. Given the subjectivity of valuing certain financial instruments this could be a central issue for reporting to these charged with governance.

### *Hedge accounting*

Given the wave of newly recognised financial instruments that FRS 102 will bring, certain UK businesses might start applying the hedge accounting rules. The application of these will of course require auditing.

## INTERNAL CONTROLS – A PLANNING PROCEDURE (Lecture A464 – 13.34 minutes)

It has been more than three years since the introduction of the 'Clarified' UK and Ireland International Standards on Auditing and the review, design and implementation of internal controls is still one of the weakest and confused areas in the audit files that we review. The common issue among firms is that planning procedures in relation to internal controls as explained by ISA (UK and Ireland) 315 *Identifying and Assessing Risks of Material Misstatement through Understanding the Entity and its Environment* are often confused with the test of controls which are explained by ISA (UK and Ireland) 330 *The Auditor's Responses to Assessed Risks*.

### *ISA (UK and Ireland) 315*

This standard deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the client entity and its environment, including the internal controls.

All the procedures laid down under this ISA must be performed at the planning stage because all the risks are identified and assessed at the planning stage of the audit. One of the procedures is to obtain an understanding of the internal controls which are operating over the client's accounting systems, which are relevant to the audit. In obtaining this understanding, the auditor shall evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel (as per paragraphs 12 and 13 to ISA (UK and Ireland) 315).

Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, a material misstatement. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control (for which consideration must then be given to the requirements in ISA (UK and Ireland) 265 *Communicating Deficiencies in Internal Control to those Charged with Governance and Management*).

The risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiry of the entity's personnel;
- Observing the application of specific controls;
- Inspection of documents and reports; and
- Tracing transactions through the information system relevant to financial reporting.

This is a mandatory procedure which must be performed at the planning stage on all audits, regardless of placing any reliance on these controls for testing purposes. Moreover, these procedures must be performed each year regardless of whether the controls remain the same as last year.

## *ISA (UK and Ireland) 330*

This ISA deals with the auditor's responsibility to design and implement responses to the assessed risks of material misstatement, identified and assessed by the auditor in accordance with ISA (UK and Ireland) 315.

As stated above, all the requirements laid down in this UK and Ireland ISA are in response to the risks identified and assessed at the planning stage; therefore all the procedures are performed during the core audit work (i.e. gather sufficient appropriate audit evidence). In relation to internal controls, the auditors must perform tests of control to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

- The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of control, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control

## *Frequently asked questions*

Some common queries raised by firms to our technical team members include the following:

**Q. We are not relying on controls, therefore we have not performed the review of design and implementation of controls at the planning stage. Is this correct?**

A. As explained above, the review of the design and implementation of controls is a mandatory procedure which much be performed on all audit assignments, regardless of placing any reliance on those controls. If this procedure has not been performed, it increases the inherent risk of the assignment by default which results in increased levels of testing during the audit work.

**Q. There are no controls that exist within the accounting system of a client which are relevant to the audit, therefore can I assume that I need not undertake a review of the design and implementation of controls?**

A. It is virtually impossible for there not to be any controls within a client's accounting system. There are always some controls that exist, even if the company is run and managed by a single person. Issuing sales invoices, matching sales receipts against invoices, bank reconciliations and reviewing supplier statements before payment is made are some of the more common internal controls that are present in virtually all businesses. These controls must be documented by the auditor so they can perform the review of the design and implementation of those controls.

**Q. We performed a review of the design and implementation of controls last year and as such we have not performed one this year. Moreover, there are no changes within the client's systems and controls therefore we did not feel it necessary to perform a review in the current year. Is this acceptable?**

A. As the review of the design and implementation of controls is a planning procedure which is required to identify and assess the risks of material misstatement in the financial statements, the review must be performed every year. The fact that a review was performed last year is not relevant because risks must be identified every year and this is one of the risk assessment procedures. This procedure should also be considered in the same way as other planning procedures which are mandatory under the UK and Ireland ISAs, regardless of the fact that there may not have been any changes made.

# SUMMARY OF DEVELOPMENTS

The following are extracts from Press Releases issued by the FRC over the last three months.

## *FRC calls for action for improving disclosures*

*29 October 2013*

As the reporting season approaches, Roger Marshall, Director of the Financial Reporting Council sets out a series of calls to action for preparers and auditors to consider improving the quality of disclosures in annual reports. These calls to action are based on feedback received on the FRC's thought leadership paper '*Thinking about disclosures in a broader context.'*

The FRC recommends that:

1. Disclosures should focus on communication of relevant information to investors.
2. Core information that is relevant for investors is separated from supplementary information that only meets the needs of a wider stakeholder group.
3. Placement of information outside the annual report may be more appropriate for supplementary information, where the law permits this.
4. Immaterial information should be excluded.
5. Boilerplate language should be avoided with a focus on entity specific disclosures.
6. Related information is linked to tell the story of a company.

The FRC have also read the speech by the IASB's Chairman, Hans Hoogervorst *'Breaking the Boilerplate*' and the FRC have acknowledged that the IASB echoes the FRC's thinking on disclosures. The IASB intend to:

- Update IAS 1 *Financial Statement Presentation* to refer to the exclusion of immaterial information;
- Provide guidance on the application of materiality; and
- Focus on disclosure objectives and use less prescriptive language.

The FRC have recommended that the IASB also:

- Develops a disclosure framework that considers disclosures in the financial report as a whole.
- Defines the boundaries of financial reporting.
- Develops placement criteria.
- Reduces and defines the 'magnitude' terms used in IFRSs, such as significant, key and critical.

## *FRC raises the bar for risk management*

*6 November 2013*

The FRC has published for consultation changes to the UK Corporate Governance Code, guidance for boards of listed companies and standards for auditors covering risk management and reporting. Supplementary guidance for directors of all banks is also being issued.

The proposals build on the FRC's work on '*Boards and Risk*' and aim to raise the bar for risk management by boards and communication to the providers of risk capital about the risks faced by companies in which they invest and how they are managed or mitigated.

In response to concerns expressed on earlier proposals issued in January 2013, these new proposals set out afresh how the FRC will implement the recommendations of Lord Sharman's 2012 Inquiry *'Going Concern and Liquidity Risks: Lessons for companies and auditors'*. The Inquiry looked at the corporate governance and reporting lessons to be learnt from the failure of ostensibly healthy businesses in the financial crisis.

The FRC has made a key change in these proposals by bringing together its previous guidance on risk management and internal control with the assessment of the going concern basis of accounting; so encouraging the integrated assessment and reporting recommended by Lord Sharman.

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

*'Risk management is one of the most important responsibilities of the board. Understanding the principal risks facing the company is essential for the development of strategic objectives, and the ability to seize new opportunities. For investors, as providers of risk capital, knowing how the board is managing and mitigating risks is an important indicator when judging whether the company will be able to deliver the value that investors seek. The new guidance, and the proposed changes to the Code, highlight the issues that boards need to consider when assessing and managing risk, crucially including risks to solvency and liquidity. We have placed considerable emphasis on the need for robust assessment by boards and on the important role of auditors in ensuring reliable communication to investors.'*

The guidance includes:

- Broader risk considerations and role of the auditor
- Solvency and liquidity risks and going concern
- Banking considerations
- Feedback statement and other companies

## *FRC publishes new Auditor Regulatory Sanctions Procedure and Guidance*

*11 November 2013*

The FRC has published the Auditor Regulatory Sanctions Procedure and Guidance, previously consulted on earlier this year, which comes into effect for all audit firms who are registered with the ICAEW and subject to independent monitoring by the FRC's Audit Quality Review.

The new Auditor Regulatory Sanctions Procedures follow amendments to the Companies Act 2006 which require that Recognised Supervisory Bodies (RSB) enable the body performing independent monitoring function to determine sanctions. These sanctions can be brought against statutory auditors where they have not complied with the rules relevant to statutory audit. The new procedure is another important reinforcement to the independence of the FRC, as envisaged by the package of FRC reforms introduced in 2012. The procedure allows the FRC, through its Monitoring Committee or an Independent Sanctions Tribunal, to determine sanctions or suggested undertakings itself following an inspection, where appropriate, rather than referring the matter to the RSB to decide whether to take action.

FRC CEO, Stephen Haddrill, said:

*'The quality of audit in the UK is strong. However sometimes our inspections reveal shortcomings that we expect the firms to address. The new procedures enable the FRC to require such work to be done and if appropriate a penalty to be applied without reference to the professional bodies. This reinforces our independence and enhances the impact of our audit monitoring activity. Sanctioning poor quality work provides further encouragement for firms to conduct high quality audits and ultimately enhances trust in the audit profession. The new Guidance sets out a clear approach for Committees and Tribunals that ensures transparency and consistency in administering sanctions.'*

## *FRC proposes amendments to hedge accounting*

*15 November 2013*

On 15 November 2013, the FRC issued hedge accounting proposals for consultation in UK and Irish GAAP. Businesses enter into hedging arrangements in order to mitigate financial risks and hedge accounting allows them to reflect the economic substance of their hedging relationships in the financial statements, by reducing volatility in reported profit or loss.

The FRC issued the new GAAP in March 2013, highlighting that it would review hedge accounting in the light of international developments.

The existing requirements, although relatively simple, are very prescriptive and may unduly restrict the application of hedge accounting. Under the new proposal hedge accounting will be available for a wider range of hedging relationships.

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

*'In developing our hedge accounting proposals, we have followed the same principles as in developing the new UK and Irish GAAP; basing them on international approaches but pragmatically tailored to the nature and circumstances of those businesses that may apply them.*

*The IASB's recently agreed principles for hedge accounting are the basis for these proposals, but we have taken a practical approach and made a number of simplifications. We were mindful that smaller, less complex businesses also enter into arrangements to hedge financial risks and hedge accounting should be accessible as possible to all types of businesses, large and small.'*

The amendments are proposed to be effective from the same date as the new UK GAAP, 1 January 2015.

## *FRC publishes consultation paper on amending AS TM1 for revised disclosure regulations*

*15 November 2013*

On 15 November 2013, the FRC published a fast-track consultation paper on proposed amendments to Actuarial Standard Technical Memorandum 1 (AS TM1) to reflect changes introduced by new disclosure regulations which affect Statutory Money Purchase Illustrations (SMPIs). The amendments to the disclosure regulations and AS TM1 will mean that, from 6 April 2014, pension providers can present more personalised illustrations to pension scheme members in their annual statements.

The FRC's consultation follows regulations published on 31 October 2013 which consolidate and amend some of the requirements for disclosure of information to pension scheme members introducing additional options. The amendments include changes to the information shown in SMPIs. Accordingly, the FRC proposes changes to its standard AS TM1 to enable providers to present illustrations which allow:

- For cash lump sums to be taken out prior to the calculation of the illustrated pension;
- Varying percentages of dependants' pension to be assumed; and
- Different levels of pension increases to be assumed.

## *FRC proposes to simplify accounting for smaller businesses*

*10 December 2013*

The FRC has issued consultation proposals to amend the Financial Reporting Standard for Smaller Entities (FRSSE) to reflect new legislation, introduced by BIS in November 2013, applicable to the UK's smallest companies, known as micro-entities.

Micro-entities are now able to prepare more simplified financial statements with fewer disclosure notes.

Roger Marshall, FRC Board Member and Chair of the Accounting Council, said:

*'The FRC is proposing these amendments to allow micro-entities taking advantage of the new legal provisions, which permit reduced disclosure, to continue to apply the accounting principles of the FRSSE. This will ease the burden considerably on the UK's 1.56 million smallest companies, many of which offer unique, specialist services and include the types of business the government sees as critical to the UK's future economic growth.'*

The FRC invites comments on these proposals, which are set out in FRED 52 *Draft Amendments to the Financial Reporting Standard for Smaller Entities (effective April 2008) – Micro-entities.* The comment period closes on 12 February 2014.

## *FRC seeks consistency in the reporting of exceptional items*

*13 December 2013*

The FRC has issued a reminder to Boards on the need to improve the reporting of additional and exceptional items by companies and ensure consistency in their presentation.

The Financial Reporting Review Panel (FRRP) of the FRC has identified a significant number of companies that report exceptional items on the face of the income statement and include subtotals to show the profit before such items (sometimes referred to as 'underlying profit'). The FRC today reminds boards of what they should consider when they present exceptional or similar items and encourages them to improve reporting in this area.

Many companies present additional line items in the income statement to provide clear and useful information on the trends in the components of their profit in the income statement, as required by IAS 1 *Presentation of Financial Statements*. The FRC, however, has identified a number where the disclosure falls short of the consistency and clarity required, with a consequential effect on the profit reported before such items.

Richard Fleck, chairman of the FRC's Conduct Committee and chair of the FRRP, said:

*'It is essential that investors should be able to understand and rely on the trends in the profitability of companies. This announcement draws attention to the importance of providing information in a way that enables users to assess the quality of a company's profitability. It is a timely reminder as directors consider their response to the Corporate Governance Code principles that the annual report and accounts as a whole should be fair, balanced and understandable.'*

The FRRP has considered the relevant principles in the law and IFRS, and has reflected on improvements agreed with companies regarding the provision of information that is relevant to an understanding of trends in components of profit. Based on those considerations, the FRRP believes that, in judging what to include in additional items and underlying profit, companies should have regard to the following:

- The approach taken in identifying additional items that qualify for separate presentation should be even handed between gains and losses, clearly disclosed and applied consistently from one year to the next. It should also be clearly distinguished from alternative performance measures used by the company that are not intended to be consistent with IFRS principles.
- Gains and losses should not be netted off in arriving at the amount disclosed unless otherwise permitted.
- Where the same category of material items recurs each year and in similar amounts (for example, restructuring costs), companies should consider whether such amounts should be included as part of underlying profit.
- Where significant items of expense are unlikely to be finalised for a number of years or may subsequently be reversed, the income statement effect of such changes should be similarly identified as additional items in subsequent periods and readers should be able to track movements in respect of these items between periods.
- The tax effect of additional items should be explained.
- Material cash amounts related to additional items should be presented clearly in the cash flow statement.
- Where underlying profit is used in determine executive remuneration or in the definition of loan covenants, companies should take care to disclose clearly the measures used.
- Management commentary on results should be clear on which measures of profit are being commented on and should discuss all significant items which make up the profit determined according to IFRS.

## *FRC issues report on auditor's materiality judgements*

*16 December 2013*

The FRC has published the report of its first Audit Quality Thematic Review into the auditor's consideration and application of materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

The report identifies a requirement for greater focus by auditors on the needs and expectations of users in setting and revising overall materiality levels and for audit committees to seek to better understand the related judgements made by auditors. It also makes a number of recommendations to audit committees and encourages them to discuss with their auditors the basis for the materiality levels set including, in particular, how these reflect the needs and expectations of users of the entity's financial statements.

Materiality is an area of particular interest to investors given its potential impact on the scope of an audit and the extent of the audit work performed. Audit committees play a highly important role in safeguarding the quality of audit and should actively engage with their auditors in relation to the determination and application of materiality.

The recent revision to ISA (UK and Ireland) 700 requires auditors to report how they applied the concept of materiality in performing the audit and how this affected the scope of their audit. This will enable investors and other users of financial statements to engage directly with audit committees in relation to this area.

Paul George, Executive Director, Conduct said:

*'Thematic reviews enable us to probe deeper into aspects of auditing not normally considered in detail during routine inspections. They allow us to make comparisons between firms with a view to identifying both good practice and areas of common weakness. This report should promote a better understanding of current practice at the largest firms and how materiality decisions affect the scope and extent of auditors' work. Our findings assist the development of good practice within firms and should help Audit Committees in discharging their responsibilities.'*

Key messages:

- Qualitative factors relating to the needs and expectations of users of an entity's financial statements should be the overriding consideration for auditors in determining the overall materiality level.
- Auditors should ensure that where materiality benchmarks are adjusted for 'one-off' items, these adjustments are appropriate in the circumstances. Firms should ensure that their guidance assists audit teams in making these judgements.
- Auditors should demonstrate the consideration of risk in setting performance materiality and avoid, as a default, simply setting this at the highest level allowed under the firm's guidance.
- Auditors should improve the quality and accuracy of their reporting of materiality levels to Audit Committees and ensure that all uncorrected misstatements above the reporting threshold agreed are collated and reported.
- Auditors should ensure that materiality is appropriately addressed when planning analytical procedures.
- Audit firms should review their internal guidance in the light of the areas requiring improvement identified in the report, including in particular how the need and expectations of users of financial statements are assessed and taken into account in determining materiality levels.

## *FRC proposes first annual update to the Reduced Disclosure Framework*

*17 December 2013*

The FRC issued for consultation proposals to update its UK GAAP standard on the *Reduced Disclosure Framework* (FRS 101).

FRS 101, which was published in November 2012, reduced the reporting burden for groups reporting under IFRS by allowing their subsidiaries to use the same accounting standards as in the group accounts but with fewer disclosures.

The announcement is in line with the FRC's commitment to update the standard at regular intervals to ensure that the reduced disclosure framework maintains consistency with IFRS and so is cost-effective for groups. The FRC intends to review FRS 101 on an annual basis.

The FRC proposes to simplify, in the reduced disclosure framework, the new disclosure requirements of IAS 36 *Impairment of Assets* and clarify how those applying FRS 101 can adopt the new international accounting practice for investment entities (set out in IFRS 10 *Investment Entities* and its consequential amendments to IAS 27 *Separate Financial Statements*), whilst still complying with legal requirements.

Roger Marshall, FRC Board member and Chair of the Accounting Council, said:

*'It has been a year since the publication of FRS 101 and a number of important developments have occurred in IFRS. The FRC is committed to provide succinct financial reporting standards that promote efficiency within groups and are cost effective to apply. Therefore, we have carried out this first update now so that FRS 101 continues to be a cost effective option for UK groups.'*

Comments on these proposals close on 21 March 2014.

## *Stephen Haddrill comments on EU audit reform agreement*

*19 December 2013*

Following agreement in Brussels on the EU audit directive, FRC CEO Stephen Haddrill said:

*'After four years of discussion and negotiation the EU is a hairsbreadth away from finalising major changes to the regulation of the larger audit firm.*

*The final outcome deals with the longstanding problem of companies holding on to their auditors for fifty years on average, calling into question auditor independence. The Commission originally proposed that the audit had to change hands every six years. This was quickly shown to be unworkable.*

*In response, the FRC developed and implemented its own plan introducing retendering of the audit every 10 years for FTSE 350 companies. We felt a company had to be able to show to its investors that it had the best available auditor for its business. How could it do so if it did not test the market? But equally how could it do so if it excluded the incumbent, especially when the choice is low? The UK's Competition Commission has been persuaded by the merits of our approach.*

*The EU has now put this plan at the heart of its directive. In future, companies will be able to retender at 10 years and then must change the auditor at 20. This is a good compromise, made possible by the UK developing a plan, showing it was practical and thereby giving confidence to MEP's and policymakers. Other parts of the directive similarly borrow from experience in other Member States, including France and Germany. Europe is at its best when it takes the best of the experience of its Member States rather than when it adopts centrally designed dictats.*

*Commissioner Barnier is to be congratulated on his achievement, most of all for adopting in the final stages the best practice of Member States.'*