TABLE OF CONTENTS

FRS 102: THE IMPACT FOR TAX PURPOSES (LECTURES A465/ 466 – 27.19/ 23.24 MINUTES)

Background

HMRC has published a paper on the tax implications of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* which was published in January 2014. This paper sets out their views with additional commentary and examples on the practical implications.

It is easy to focus purely on the corporation tax issues faced by medium-sized and large companies. However, income tax paid by larger unincorporated entities will also be an issue. Looking forward, it is possible and perhaps likely that all entities including small entities will be applying FRS 102-based recognition and measurement requirements in the short to medium term.

Obviously, FRS 102 becomes new UK GAAP for many entities and, for tax purposes, profits of a trade are calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes (section 46 Corporation Taxes Act 2009).

Generally accepted accountancy practice for corporation tax purposes is defined in section 1127 Corporation Taxes Act 2010 as:

- UK Generally accepted accountancy practice – generally accepted accountancy practice in relation to accounts of UK companies (other than IAS accounts) that are intended to give a true and fair view; or

- In relation to a company that prepares IAS accounts means generally accepted accountancy practice in relation to IAS accounts.

Reporting financial performance

There have been some significant changes to the form and content of financial statements under FRS 102. Some of the primary financial statements have changed in format and content, others have changed principally in name. The table below maps the old UK GAAP statements to FRS 102.

Old UK GAAP	**FRS 102**
Profit and loss account	Income statement
Balance sheet	Statement of financial position
Statement of total recognised gains and losses (STRGL)	Statement of comprehensive income (sometimes referred to as statement of other comprehensive income (OCI))
Cash flow statement	Statement of cash flows
Reconciliation of movement in	Statement of changes in equity

shareholders' funds	

FRS 102 gives the option of a single income statement encompassing both the income statement and OCI.

Also, note that FRS 102 permits the use of different headings where appropriate, so the terms balance sheet and profit and loss account could continue in use.

The only practical impact on the tax position resulting from these changes is that tax statutes have to be updated to use the relevant new terminology.

Consolidated financial statements

The consolidated financial statements have no influence on the entity's tax position. Therefore, the changes in FRS 102 have no impact.

Accounting policies, estimates and errors

The accounting treatments resulting from changes of accounting policies or changes in accounting estimates have not changed significantly under FRS 102. The requirements still account for changes to accounting policies retrospectively but changes to accounting estimates prospectively.

This means that a change to an accounting estimate only effects the current period for tax purposes.

Example – change in estimated useful life of goodwill

A company reduces the estimated useful life of goodwill from 20 years to five years and four years of its life have already expired at the time of the change. This is a change of an accounting estimate and not a change of accounting policy, so there is no prior year adjustment. The carrying amount for goodwill at the beginning of the accounting period is simply amortised over the next five years rather than the next 16.

The same would apply in circumstances where the estimated useful life were extended.

Changes in accounting policy give rise to prior year adjustments as do adjustments for errors found in the prior period.

FRS 102 requires any *material* error in the prior period to be accounted for in this way. Previously, only errors that are *fundamental* to the financial statements required correction by prior period adjustment. A fundamental error was described, in FRS 3, *Reporting Financial Performance*, as one that destroyed the true and fair view. This change is likely to require more prior period adjustments for errors than was previously the case, because the threshold for materiality is generally thought to be lower than what is considered fundamental.

Tax implications of prior period adjustments

The tax treatment of a prior period adjustment differs depending upon the reason for the adjustment.

Chapter 14 Part 3 CTA 2009 states that where there is a change from one valid basis on which the profits of a trade are calculated to another valid basis (for example a change of accounting policy), an adjustment must be calculated to ensure that business receipts will be taxed once and once only and deductions will be given once and once only. This means that the adjustment will be accounted for just once - probably in the current period.

However, when the basis that was used was not valid, in circumstances like a prior year error, then the adjustment should be made in the relevant period for tax purposes.

Example – change of accounting standard

As a result of a change in accounting standards, a company changes its accounting policy to recognise revenue earlier on sales contracts. This has resulted in a prior period adjustment, increasing opening reserves by £200,000. This uplift in revenue is not recognised in the income statement this year or in the prior period. Therefore, it should be subject to a charge to tax in the current year and be added into the computation.

Financial instruments – including foreign exchange

This area is complex for accounting and tax purposes. The complexity is not helped because of the options given in FRS 102, namely that entities can choose to apply FRS 102, IAS 32, *Financial Instruments: Presentation* and IAS 39, *Financial Instruments: Recognition and Measurement* or IFRS 9, *Financial Instruments*. Also an entity's current GAAP could be FRS 4, *Capital Instruments*, FRS 26, *Financial Instruments: Recognition and Measurement* or EU-endorsed IFRS.

These notes concentrate on entities not currently using the FRS 26 treatment for financial instruments and which intend to adopt FRS 102 with no reference to EU-endorsed IFRS.

There is a huge amount that could be said about this area but a summary of the most relevant changes is shown below:

- Basic financial instruments should be measured at amortised cost, using the effective interest rate method.
- Investments in shares should be revalued to fair value through the profit and loss account where the investment is publicly traded, or where the fair values of such shares can otherwise be measured reliably. Otherwise investments in shares should be at cost.
- Under FRS 102 derivatives are required to be shown on the balance sheet. This includes foreign exchange contracts and interest rate swaps.

- Where foreign exchange contracts exist, related transactions cannot be accounted for at the contract rate, which is the existing preferred option of many SSAP 20, *Foreign Currency Translation* adopters.
- Foreign exchange transactions will typically be translated at the spot rate prevailing. There is an option to use average rates but accounts preparers should be wary of significant rate fluctuations.
- There has been a subtle change to the requirements relation to the recognition of financial liabilities. FRS 102 requires derecognition wherever the terms change significantly, which differs from the old UK GAAP approach which only derecognised liabilities once a further obligation had been extinguished.

Useful examples are shown below of the workings of these new FRS 102 requirements in practical situations.

Tax implications - overview

The basic principle is that tax law provides in general that the accounting treatment of these types of instruments is followed for tax purposes. The legislation also ensures that most items taken to reserves are brought into account. This means that transactions appearing through both the income statement and OCI need to be considered.

Tax implications – debt restructuring

Where the terms relating to debt alter significantly there tends to be very little effect on the tax position under old UK GAAP. Debts only tend to be written off once any outstanding conditions are removed. FRS 102 says that a significant change in the terms is by 10% or more.

Example – debt restructuring

A company is in financial difficulty and is unable to meet repayments on its £5,000,000 bank loan. The bank agrees to waive repayment of £2,000,000 of the principal, provided that the company repays the loan in three tranches over the next three years. Only then are the conditions met and the balance on the loan is legally written off by the bank.

Under old UK GAAP the £2,000,000 will be recognised as gain in the profit and loss account, only once the conditions set by the bank have been satisfied, that is to say after the last payment.

Under FRS 102 the terms of the loan are considered to be significantly changed so the previous debt is derecognised (£5,000,000) and replaced with a new financial liability (£3,000,000). The net effect on the income statement is writing off the £2,000,000 when the new terms are agreed.

Tax implications – derivatives and foreign exchange

Subject to limited exceptions, gains and losses recognised in the income statement on derivatives and foreign exchange transactions will form part of taxable income. The following example illustrates how this applies.

Example – sale in foreign currency

Company A is a UK company and sells goods to an Italian company for €1,000. The sale is on 1 May 2016, and settlement for the goods is on 31 July 2016. Company A's year end is on 30 June 2016.

Company A sells forward €1,000 at a contract rate of €1.20:£1.

The impact on the P&L would be as follows under SSAP 20, using the option to use the contract rate:

1 May 2016		£
Sale of goods	(€1,000 / €1.20)	833

By way of comparison the impact on the P&L would be as follows under FRS 102:

1 May 2016	£
Sale of goods at spot rate €1.25:£1	800
30 June 2016 – year-end adjustments	
Loss on forex debtor – year end rate €1.30:£1	(31)
Gain on forex contract – forward rate at year end €1.28:£1	52
31 July 2016	
Loss on forex debtor – spot rate €1.31:£1	(6)
Gain on forex contract – spot rate €1.31:£1	17

All of these adjustments form part of the taxable profit for the relevant periods.

Tax implications – hedge accounting

There are special accounting rules that permit hedge accounting which has the effect of reducing the volatility of derivatives valued at fair value passing through the income statement. These adjustments often do not apply for tax purposes but there are special tax rules that could be relevant in some situations.

Stock and work in progress

Comfortingly, FRS 102 requires that stock is generally valued at the lower of cost and net realisable value.

There are some exceptions in Section 34, *Specialised Activities* of FRS 102 which covers, amongst other things, agricultural produce and biological assets. For these assets there is an option to account at fair value through profit and loss.

Investment property

There are very significant changes in FRS 102 for investment properties, namely:

- Revaluation gains and losses are not taken to reserves as required by SSAP 19, *Accounting for Investment Properties*. Instead the investment property is revalued to fair value through the profit and loss account.
- Properties that are occupied by a group company have previously been excluded from the definition of investment properties by SSAP 19 and treated as fixed assets instead. This is no longer the case under FRS 102, and those properties should be treated as investment properties.
- There is an option not to fair value investment properties in FRS 102, on the grounds of 'undue cost or effort'. It is possible that this option could be over used in situations when it is not appropriate.

However, HMRC say in its paper on the tax implications of FRS 102 that the accounting treatment of investment properties does not determine, for tax purposes, whether the property is an investment property or whether a disposal of a property is a capital or a revenue disposal. For tax purposes, income arising on an investment property is brought into tax as it is recognised in the accounts (for example rental income would be brought into tax as recognised in the P&L). Movements in fair value of investment properties are not taxable. On disposal investment properties are subject to capital gains.

Note: FRS 102 requires deferred tax provisions to be made on revaluation gains, recognising the possible tax payable on the capital gain.

Property, plant and equipment

UK tax law disallows depreciation and revaluations. Therefore, what few changes that exist in FRS 102, when compared to FRS 15, *Tangible Fixed Assets* are expected to have a minimal effect.

Intangible assets including goodwill

FRS 102 broadens the definition of intangibles so new UK GAAP should have to deal with more intangibles than before. The other big change is in the way that the estimation of an intangible's useful life is addressed.

For tax purposes, sections 871-879 of Part 8 CTA 2009 provide a comprehensive set of rules for changes in accounting for intangibles and especially for cases where what is included entirely as goodwill under Current UK GAAP is disaggregated into different types of intangible property with different amortisation rates or impairment factors under FRS 102.

Useful economic life and amortisation

FRS 10, *Goodwill and Intangible Assets* sets out a presumption that the useful economic life of an intangible should not exceed 20 years. This presumption could be rebutted if the intangible was sufficiently durable and measureable. Also, FRS 10 does not discourage long useful lives just because there is uncertainty over the estimation of the useful life.

FRS 102 takes a very different approach. Whilst there is no limit to an intangible's useful life, the standard does not tolerate uncertainty in the same way that FRS 10 does. Unless the useful life can be estimated reliably, FRS 102 states that the life is limited to a maximum of five years.

It is likely that many entities will be forced to shorten the useful life of their intangibles because of this change.

Tax relief is provided on either the amortisation/impairment of goodwill and intangibles recognised in the accounts, subject to various exceptions.

Example – goodwill - reliable estimates of useful life

Company A purchases a business for £1,000,000. The fair value of the acquired assets and liabilities totals £400,000, excluding intangibles. Company A made the acquisition because they wanted to get access to the database of loyal customers that their target enjoyed. The database is thought to have a fair value of £600,000 and there is no goodwill. Based on evidence relating to the loyalty of the customers the estimated useful life of the customer database is thought to be ten years.

Example – goodwill – no reliable estimate

Company B purchases a business for £1,000,000. The fair value of the acquired assets and liabilities totals £400,000. No intangible assets have been identified on acquisition and goodwill is £600,000, being the difference between the fair value of the acquired assets and liabilities and the fair value of consideration.

Because the nature of this goodwill has not been identified it is difficult to reliably estimate its useful life because there are no reliable input values to use. Therefore, the estimated useful life is limited to five years.

Software costs

FRS 102 requires software used in the business to be treated as an intangible asset rather than as part of fixed assets. This means that tax relief is gained through amortisation in the financial statements rather than capital allowances.

Leases

The headline changes in FRS 102 relate to identifying operating/finance leases and lease incentives.

Operating/finance leases

The method used to identify finance leases and operating leases is different in FRS 102 when compared with SSAP 21, *Accounting for Leases and Hire Purchase Contracts*. Most notably the 90% rule no longer plays a part. In practice, however, the model based on the transfer of risks and rewards in FRS 102 is unlikely to lead to any significant change.

UK tax law is not entirely consistent with SSAP 21 (see Statement of Practice 3/91). This will continue under FRS 102.

Lease incentives

UITF 28, *Operating Lease Incentives* requires lease incentives to be recognised over the period until a full market rent is paid. FRS 102 differs, in requiring the incentive to be recognised over the period of the lease, as illustrated by the example below.

Example – rent free period

A company takes on a ten-year lease on a property. Annual rent is £5,000, with an 18-month rent-free period and a rent review in five years.

Year	**Rent**	**UITF 28**	**FRS 102**
	Cash	**P&L**	**P&L**
	£	**£**	**£**
1	Nil	3,500	4,250
2	2,500	3,500	4,250
3	5,000	3,500	4,250
4	5,000	3,500	4,250
5	5,000	3,500	4,250
6	5,000	5,000	4,250
7	5,000	5,000	4,250
8	5,000	5,000	4,250
9	5,000	5,000	4,250
10	5,000	5,000	4,250

In relation to lease incentives the tax treatment follows the accounting treatment, provided that the incentives are not of a capital nature.

Provisions

FRS 102 and FRS 12, *Provisions, Contingent Liabilities and Contingent Assets* are virtually identical in their treatment of provisions. This should not be a surprise because both are virtually identical to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

There should be no significant change for tax purposes.

Revenue recognition

The recognition of revenue for accounting and tax purposes has been highly controversial in the UK for the past ten years ever since the publication of Appendix G to FRS 5, *Reporting the Substance of Transactions*. The fact that the UK does not have a separate accounting standard that addresses the issue has not helped and revenue recognition remains a difficult area.

The requirements come from a number of places under old UK GAAP. Application note G of FRS 5 provides revenue recognition guidance in respect of the sale of goods and services as well as other specific revenue recognition scenarios. SSAP 9, *Stocks and Long-Term Contracts* provides guidance in respect of long-term contracts and UITF 40 addresses service contracts.

FRS 102 contains a section that addresses revenue recognition. Section 23 is not as specific in its requirements as certain components of old UK GAAP, but its principles are the same.

At this point it is worth mentioning that UITF 40, on revenue recognition on contracts for services, is being withdrawn. The detail in Section 23, *Revenue* of FRS 102 is not quite the same as UITF 40 and arguments could (and perhaps will be) made to recognise revenue on such contracts later than UITF 40.

HMRC have taken the view that '... *for many companies there will be no accounting or tax impact.*' Some taxpayers may choose to challenge this view. If there is significant 'abuse' of the principles-based approach in Section 23 then the Financial Reporting Council (FRC) have the power to issue FRC Abstracts to clarify the position.

Government grants

FRS 102 permits the accruals model or the performance model to be used when recognising the receipt of revenue grants. The accruals model is very similar to the model used in SSAP 4, *Accounting for Government Grants*. The performance model is different and is a new concept that is not recognised in SSAP 4.

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

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

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

Any differences that do occur under the performance model will tend to be limited to the timing of receipts.

For tax purposes grants which meet revenue expenditure are normally trading receipts, and this will continue where Section 24, *Government Grants* of FRS 102 applies.

Share-based payment

Accounting for share-based payments under FRS 20, *Share-based Payment* and Section 26, *Share-based* Payment of FRS 102 are virtually identical.

Tax deductions in respect of share-based payments are governed by specific legislation in Part 12 CTA 2009.

Employee benefits

Holiday pay accruals

Section 28, *Employee* Benefits of FRS 102 specifically requires that companies provide for any accrued rights for compensated absences - namely holiday pay or sick pay. This tends to be less of an issue when the holiday year is coterminous with the financial year end.

For tax purposes this accrual is treated in line with the treatment of unpaid remuneration in Part 20 Chapter 1 CTA 2009. S1288 of the Act states:

1288 Unpaid remuneration

(1) This section applies if—

(a) An amount is charged in respect of employees' remuneration in a company's accounts for a period;

(b) The amount would, apart from this section, be deductible in calculating income from any source for corporation tax purposes; and

(c) The remuneration is not paid before the end of the period of nine months immediately following the end of the period of account.

(2) If the remuneration is paid after the end of that period of nine months, the deduction for it is allowed for the period of account in which it is paid.

FRS 102: THE TAX CONSEQUENCES OF TRANSITION (LECTURES A467 – 6.53 MINUTES)

First-time adoption of FRS 102

Adoption of the new framework is mandatory for accounting periods commencing on or after 1 January 2015. Transition to FRS 102 is dealt with in Section 35, *Transition to this FRS* and this section applies to the first financial statements in which the entity makes an explicit and unreserved statement of compliance with FRS 102.

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

Transition date

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

Paragraph 7 of Section 35 requires the entity to prepare an opening statement of financial position (balance sheet) as at the date of transition which recognises and measure all assets and liabilities in accordance with the requirements of FRS 102. Similarly the entity must not recognise items as assets or liabilities if FRS 102 does not permit such recognition.

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

Example – revaluation of a property

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

For X Ltd, the change may be viewed as simply transferring the tax element from the revaluation reserve to deferred tax.

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

Example – forward foreign exchange contract

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

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

X Ltd has established (by discussion with the company's bank) that the FFX contract is an asset at 1 January 2013 with a fair value of £20,000.

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

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

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

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

The tax position

The tax position is set out in relation to trading profit in Chapter 14 Part 3 CTA 2009. It provides that where there is a change from one valid basis on which the profits of a trade are calculated to another valid basis (for example on a change of accounting policy), an adjustment must be calculated to ensure that business receipts will be taxed once and once only and deductions will be given once and once only.

So is first-time adoption of FRS 102 a change of accounting policy? The Act states in section 180(4):

> (4) A 'change of accounting policy' includes, in particular—
>
> (a) a change from using UK generally accepted accounting practice to using generally accepted accounting practice with respect to accounts prepared in accordance with international accounting standards; and
>
> (b) a change from using generally accepted accounting practice with respect to accounts prepared in accordance with international accounting standards to using UK generally accepted accounting practice.

Whilst not specifically stating the fact, first-time adoption of FRS 102, when transitioning from old UK GAAP, is certainly within scope.

Intangibles

It is possible that the carrying amount of intangibles will be adjusted in the opening balances on transition. The relevant legislation that addresses these issues can be found in CTA 2009 at Part 8, Chapter 15.

No taxable credit or allowable debit is permitted under Chapter 15 to the extent that it is already brought into account by section 723 (revaluations), section 725 (reversal of accounting loss) or section 732 (reversal of accounting gain).

Where there are changes to the opening balances relating to intangibles and no section 730 election has been made, section 872 treats an increase as a taxable credit, and a decrease as an allowable debit, arising at the start of the later accounting period.

Financial instruments

When IFRS was first adopted in the UK, by certain listed companies, the tax consequences of transition were addressed by Change of Accounting Practice (COAP) Regulations (SI 2004/3271). HMRC have said that these regulations should be applied on transition from old UK GAAP to FRS 101 and FRS 102.

Accounting for financial instruments under IFRS gave rise to significant transitional adjustments and because the extent of the impact was unknown at the time the regulations defer the tax effect. In most cases, the effect of the regulations is to spread the transitional adjustment over ten years, starting with the first period in which the new accounting policy applies.

There are exclusions to the regulations and in such cases they do apply:

- A loan relationship which comes to a natural end in the accounting period that the transition takes place because it is repaid or redeemed on the date which is the latest date on which, under its terms, it falls to be repaid or redeemed;
- An embedded derivative that is bifurcated out of a loan asset or liability described in the first bullet; or

- A derivative contract which hedges a loan asset or liability described in the first bullet.

MICRO-ENTITIES AND THE FRSSE (LECTURES A468 – 9.08 MINUTES)

On 29 April 2014, the Financial Reporting Council (FRC) issued amendments to the FRSSE (effective April 2008) and (effective January 2015). These amendments were issued in light of the micro-entities legislation which applies to financial statements for years ending on or after 30 September 2013 where accounts are filed at Companies House on or after 1 December 2013.

Under the micro-entities legislation, qualifying entities can take advantage of certain exemptions in the preparation of financial statements. Accounts that are prepared under the micro-entities legislation are presumed to give a true and fair view and the definition of a micro-entity is found in sections 384A and 384B of Companies Act 2006. A company qualifies as a micro-entity in a year in which it does not exceed two, or more, of the following criteria:

- Turnover £632,000
- Balance sheet total (gross assets) £316,000
- Employees 10

The above conditions must be met for two consecutive years and the exception to this rule is in relation to newly-incorporated entities.

The micro-entities legislation does not apply to the following:

- Certain financial institutions (for example investment undertakings and credit institutions);
- Companies that voluntarily prepare consolidated financial statements (and those companies included in the consolidated financial statements); and
- Limited liability partnerships.

Amendments to the FRSSE

The FRSSE (effective April 2008 and January 2015) has been amended with a new paragraph 1.2 which says that a micro-entity preparing its financial statements in accordance with section 393(1A) (individual company accounts which give a true and fair view) must disregard all the presentation and disclosure requirements contained in the FRSSEs including the formats for both the balance sheet and the profit and loss account. Paragraphs 2.40 and 2.42 to the FRSSEs will apply to micro-entities which relate to financial statement formats and the notes which will only apply to micro-entities.

There are also some new accounting policy rules which only relate to micro-entities:

- Micro-entities will not be able to adopt the revaluation model in respect of tangible fixed assets.
- Fixed asset investments will not be measured at market value.
- Investment properties will be carried under normal fixed asset rules (at cost less depreciation and impairment rather than at fair value).
- Current asset investments will no longer be measured at current cost.

Example – reporting under the revaluation model

A company that qualifies as a micro-entity has a building that is carried under the revaluation model in accordance with paragraph 6.23 of the FRSSE and has chosen to report under the micro-entities legislation.

As the company will not be able to adopt the revaluation model it must account for the building at cost less depreciation and impairment. This will be a change in accounting policy and therefore the amounts for the current and corresponding periods must be restated on the basis of the new accounting policy.

If, on the other hand, the company wishes to continue reporting under the revaluation model it could continue using the small companies' regime and report under 'full' FRSSE as the micro-entities legislation is not mandatory.

The Financial Reporting Council were unable to permit entities to use a previous revaluation for assets carried under the revaluation model (i.e. as a 'deemed cost') because the micro-entities regime only allows micro-entities to use historical cost accounting rules and these require fixed assets to be recognised at purchase price or production cost.

Financial statement presentation

Under the micro-entities legislation, the balance sheet can be prepared under Format 1 or Format 2. However, the profit and loss account can only be prepared under Format 2.

<u>Balance sheet – Format 1</u>

A. Called up share capital not paid

B. Fixed assets

C. Current assets

D. Prepayments and accrued income

E. Creditors: amounts falling due within one year

F. Net current assets (liabilities)

G. Total assets less current liabilities

H. Creditors: amounts falling due after more than one year

I. Provisions for liabilities

J. Accruals and deferred income

K. Capital and reserves

Balance sheet – Format 2

ASSETS

A. Called up share capital not paid

B. Fixed assets

C. Current assets

D. Prepayments and accrued income

LIABILITIES

A. Capital and reserves

B. Provisions for liabilities

C. Creditors*

D. Accruals and deferred income

*creditors due within and after more than one year should be shown separately.

The profit and loss account can only be prepared under Format 2 as follows:

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 loss

The notes will only comprise:

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

The requirements relating to directors' benefits such as advances, credits and guarantees relate to any person who was a director at any time during the financial year and apply to every advance, credit or guarantee subsisting at any time in the financial year to which the accounts relate, whenever it was entered into and whether or not the person concerned was a director of the company at the time it was entered into.

Effective date

The micro-entities regime in the FRSSEs is effective for accounting periods commencing on or after 30 September 2013 for those companies filing accounts with the Registrar of Companies on or after 1 December 2013. Early adoption is NOT permissible.

STRATEGIC REPORTS (LECTURES A469 – 7.02 MINUTES)

For financial years ending on or after 30 September 2013, the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 will apply. Companies should review the guidance which has been issued by the Financial Reporting Council (FRC) although the majority of the FRC's guidance relates to quoted companies, other public companies, large companies and medium-sized companies. Companies that qualify as small or that would also qualify as small except for being, or having been, a member of an ineligible group are exempted from the requirement to prepare a strategic report. Parent companies that prepare consolidated financial statements must also prepare a 'group strategic report' which relates to all the undertakings that have been included in the consolidation.

For financial years that end on or after 30 September 2013, the directors of a company which qualifies as large or medium-sized must prepare a strategic report in addition to the directors' report and this requirement has been introduced by new sections 414A to 414D to Companies Act 2006. At the same time, section 417 of Companies Act 2006 which required a directors' report to include a business review of the company has been repealed. The consequence for unquoted companies is that the strategic report will essentially mirror the requirements of the business review.

The main difference between the strategic report and the business review is that the strategic report must be presented separately in the financial statements from the directors' report. In addition, section 414D to Companies Act 2006 requires the strategic report to be separately approved by the board of directors and signed on behalf of the board by a director or the company secretary.

Content of the strategic report

The overarching objective of the strategic report is to inform shareholders and help them to assess how the directors have discharged their duty to promote the success of the company. To achieve this objective, the strategic report must:

- Contain a fair review of the company's business, that is a balanced and comprehensive analysis of the development and performance of the company's business in the period and of its position at the end of it;

- Contain a description of the principal risks and uncertainties facing the company;

- To the extent necessary for an understanding of the development, performance or position of the company's business include analysis using key financial performance indicators and, where appropriate, analysis using other key performance indicators, including information relating to environmental and employee matters. 'Key performance indicators' are factors by reference to which the development, performance or position of the company's business can be measured effectively. A company qualifying as medium-sized for a financial year does not need to include non-financial information;

- Where appropriate include references to, and additional explanations of, amounts included in the company's annual accounts;

- Contain matters otherwise required by regulations, like the Large and Medium-sized Companies and Group Accounting Regulations (SI 2008/410), to be disclosed in the directors' report that the directors consider to be of strategic importance to the company. However, when a company chooses to disclose in the strategic report information that is required to be included in the directors' report, it should state in the directors' report that it has done so and so should indicate which information has been disclosed elsewhere.

For quoted companies, the strategic report must contain additional information as follows:

- The main trends and factors likely to affect the future development, performance and position of the company's business and information about environmental matters (including the impact of the company's business on the environment), the company's employees, social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies. If the report does not contain the information on environmental matters, employees and social, community and human rights issues, it must state which of those kinds of information it does not contain;

- A description of the company's strategy and the company's business model;

- A breakdown showing at the end of the financial year the number of persons of each sex who were directors of the company, the number of persons of each sex who were senior managers of the company (other than those who were directors) and the number of each person of each sex who were employees of the company.

- A company is not required to disclose information in the strategic report about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

The amendments to Companies Act 2006 have resulted in some disclosures no longer being required in the directors' report, in particular:

- A description of the principal activities of the company during the year;

- Details of charitable donations;

- Policy and practice on payment of creditors; and

- The acquisition of own shares by private companies.

PROVISIONS AND CONTINGENCIES (LECTURES A470 – 20.19 MINUTES)

The accounting and disclosure issues in FRS 102 for provisions and contingencies is contained in Section 21, *Provisions and Contingencies*. Section 21 also deals with financial guarantee contracts, unless:

(a) An entity has chosen to apply IAS 39, *Financial Instruments: Recognition and Measurement* and/or IFRS 9, *Financial Instruments* to its financial instruments; or

(b) An entity has elected under FRS 103, *Insurance Contracts* to continue the application of insurance contract accounting.

Before the introduction of accounting standards governing the accounting requirements for provisions, companies were quite able to 'massage' the profits (or losses) and report figures which were desired as opposed to factual. The focus would be on the bottom line (the profit) and then companies would work upwards. This particular method of profit manipulation was coined 'big bath accounting' and was quite common prior to the introduction of SSAP 18, *Accounting for Contingencies* which was superseded by FRS 12, (IAS 37) *Provisions, Contingent Liabilities and Contingent Assets*. A typical scenario using big bath accounting entailed a company calculating 'actual' profits and then deciding these were too high (usually because if profit was too high in one year, shareholders would expect higher profits in the next). Management would then create a provision for expenditure which had not actually occurred, or been committed, at the balance sheet date and this would then have the effect of reducing profit and (on the face of it) increasing liabilities. In the subsequent financial year when profit was not quite as high as shareholders would like, some (or all) of the provision was reversed and it was for this very reason that FRS 12 (IAS 37) was issued; in other words preventing management from looking 'bottom up' in the profit and loss account and using the profit figure as a driver for figures above profit.

The requirements that are contained in FRS 12 have been carried over into Section 21 and so there is little in the way of change that companies will have to deal with where provisions and contingencies are concerned.

Section 21 does not, however, deal with financial instruments, including loan commitments, which fall under the scope of Section 11, *Basic Financial Instruments* or Section 12, *Other Financial Instruments Issues*. Nor does Section 21 deal with insurance (or reinsurance) contracts which are issued by an entity and reinsurance contracts that the entity holds, or financial instruments issued by an entity with a discretionary participation feature that falls under the scope of FRS 103.

Section 21 will also not apply to executory contracts unless they are onerous contracts. The term 'onerous contracts' is defined as:

'A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.'

The Glossary merely defines a provision as *'A **liability** of uncertain timing or amount'*. Care must be taken in ensuring that any amounts in respect of a provision meet the definition of such. To that end, Section 21 specifies three criteria which must be met before an amount qualifies for recognition of a provision as follows:

(a) The entity has an obligation at the **reporting date** as a result of a past event;

(b) It is **probable** (i.e. more likely than not) that the entity will be required to transfer economic benefits in settlement; and

(c) The amount of the obligation can be estimated reliably.

If the above criteria cannot be met, the entity must not recognise a provision but make disclosure of a contingency (where this is material).

This criteria was introduced to counter the act of big bath accounting. The key driver in the recognition of a provision is (a) above – in other words the entity must have an **obligation** at the reporting date. An obligation can be created in two ways:

1. A ‘constructive’ obligation; or

2. A ‘legal’ obligation.

Paragraphs 2.20(a) and (b) to Section 2 *Concepts and Pervasive Principles* says that a constructive obligation is an obligation that derives from an entity’s actions when:

- By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Example – bonus payment

A company has been in existence for over 20 years and has a long-established practice of paying bonuses to its management team using a pre-determined formula on year-end profits if they exceed a certain benchmark. This benchmark has not been increased for the last ten years and the directors have intimated that they have no intention of increasing the benchmark.

Monthly management accounts are prepared with reasonable accuracy and at the year-end 31 December 2015 these showed a relatively high level of profitability. The company accountant has made an accrual for a bonus, together with the associated employer’s national insurance contribution.

The company has created a constructive obligation by way of an established pattern of past practice by paying bonuses. It is this past practice that gives rise to a constructive obligation because it has created an expectation in the mindsets of management that they will receive a bonus. As the company has a constructive obligation, it would be permissible to recognise the bonus provision in the year-end 31 December 2015 financial statements.

The example above illustrates the situation whereby management have a valid expectation because of the entity's past practice. Care, however, must be taken to ensure that the obligation can be demonstrable as a constructive obligation. If the company's past practice was NOT to pay a bonus year on year, then it would be difficult to make such a provision unless there was adequate documentation prior to the year-end (for example a board resolution declaring the bonus).

Paragraph 21.11C deals with the issue relating to the restructuring of a company. This paragraph says that a restructuring gives rise to a constructive obligation (and therefore recognition of a provision) only when an entity:

(a) Has a detailed formal plan for the restructuring identifying at least:

- (i) The business or part of a business concerned;
- (ii) The principal locations affected;
- (iii) The location, function, and approximate number of employees who will be compensated for terminating their services;
- (iv) The expenditures that will be undertaken; and
- (v) When the plan will be implemented; and

(b) Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Examples of factors which may fall under the definition of restructuring include:

- A line of business being sold or terminated;
- Closure of business locations or the relocation of business activities;
- An entity's management structure being changed; or
- Other fundamental reorganisations which have a material impact on the effect and nature of the company's operations.

Legal obligation

A legal obligation is an obligation that can be enforced by law. Normally it is obvious when the company has a legal obligation (for example because of a court order). Provisions can also be made for normal day-to-day transactions, such as provisions for goods and/or services received by the balance sheet date but not yet invoiced.

Section 21.6 is strict on its approach to an entity's future actions (the future conduct of its business). This is because such actions do not meet the definition of a provision and the entity has not got an obligation at the balance sheet date for its future actions, regardless of how likely (or unlikely) they are to occur.

Example – recognition of future costs

A company has an item of machinery that requires a major component to be overhauled every five years. The directors wish to provide for 1/5 of the cost of the future overhaul in the current year's financial statements.

The directors will not be able to provide for the future overhaul costs as a liability. These costs are merely an 'intention' at the balance sheet date as opposed to an 'obligation'. The directors could well sell the item of machinery before the five years have elapsed.

Example – no obligating event at the balance sheet date

A company operates in the brick industry and has an overseas depot which operates in a jurisdiction which has recently introduced legislation that now mandates the use of air filters for all companies in the brick industry to be fitted to all buildings. The number of air filters to be fitted is determined by the size of each building. The company has calculated that it will need 250 air filters and as at 31 December 2015, the company had not fitted the air filters. The finance director has made a provision in the balance sheet for the cost of the air filters on the basis that it is a legal requirement and that the company will, inevitably, have to fit the air filters.

The provision should not be recognised because at the balance sheet date no obligating event (the fitting of the air filters) had taken place.

On 31 December the company had still not fitted the air filters. Again, there is still no obligating event (despite a year passing) as no obligating event has taken place (the fitting of the air filters). There could well be good reason to make a provision for fines and penalties which may be levied under legislation because in this respect an obligating event has arisen (the non-compliance with legislation).

Example – irrecoverable trade debtors and impaired brand

A company supplies sunbeds to beauty salons throughout the country. The company's year-end is 31 October 2016 and on this date the management undertook a review of the aged debtors list. Management determined that there were a number of very overdue debts which they considered to be impaired. In addition, the company has its own outlets and utilises its own developed brand. Recent adverse press reports in respect of the company's brand has resulted in a significant decline in demand for their brand and management have therefore estimated that the recoverable amount of the brand is below its carrying amount in the balance sheet. The question arises as to whether provisions for impairment of the financial and non-financial assets within the balance sheet fall under the scope of Section 21.

The impairment loss on the trade debtors is not actually a provision as far as Section 21 is concerned. The company would actually recognise a reduction in the trade debtors (a financial asset) by way of a provision for bad debts.

In respect of the impairment of the brand, the brand should be presented net of the impairment in the balance sheet in accordance with Section 27, *Impairment of Assets*. An impairment charge is not a probable outflow of economic resources, but instead it is a reduction in the cash flows expected from the brand. As a result, an impairment charge does not fall within the scope of Section 21.

Recognition and measurement of a provision

FRS 102 says that where a provision qualifies for recognition, it should be recognised in the financial statements at the best estimate of the amount which will be required to settle the obligation. In many cases this will be clear – especially where monetary amounts are known. Estimates, however, may be required for items such as interest charges or penalties.

When a provision involves a large population of items, paragraph 21.7(a) to FRS 102 requires the estimate to reflect the weighting of all possible outcomes by their associated probabilities. Where there is a continuous range of potential outcomes and each outcome is as likely as another outcome, the mid-point range is used.

Example – provision for defective goods

A company sells electrical products such as dishwashers, washing machines, TVs and audio equipment. It sells goods to the general public with a warranty which covers customers for the costs of repairs that occur during the first six months from the date of purchase. The company is preparing financial statements for the year-ended 31 December 2015 and it has calculated that if all the products sold contained minor defects, the costs of repair would be £1 million. If major defects occurred in all the products, the costs of repair would be £4 million.

Management have concluded that past experience, and future expectations, suggest that for the coming year 75% of the goods sold will contain no defects, 20% will contain minor defects and 5% will have major defects.

The provision for the year-ended 31 December 2015 can be calculated as follows:

	£	
75% x £nil	nil	
20% x £1 million	200,000	
5% x £4 million	200,000	
Total provision		400,000

Where provisions are concerned, consideration must be given to the time value of money. This is because the time value of money may become a material issue to the entity and paragraph 21.7 to FRS 102 requires the provision to be the expected value of the expenditure expected to be required in order for the obligation to be settled. Where the time value of money is material, the discount rate(s) used in discounting the obligation to present-day values must be the pre-tax rate(s) that reflect market assessments of the time value of money and risks which are specific to the liability. In practice, it is likely to be fairly uncommon for the effects of the time value of money to be material and in many cases no discounting will be required because the cash flows associated with the provision will not be sufficiently so far into the future for discounting to have a material impact.

There are some instances when a provision may be settled by a third party – for example an insurance company. Before an entity can recognise a provision as an asset, the entity must consider whether reimbursement is virtually certain. The term 'virtually certain' is inherently more stringent than 'probable' and therefore an asset should only be recognised if the third party has confirmed that it will settle the provision.

Example – settlement of a provision by a third party

A firm of accountants has been sued by one of its clients for the negligent preparation of a tax return. The firm has made a provision for a liability in its year-end financial statements which is equivalent to the levels of penalties and interest due to HMRC. The firm's professional indemnity insurers have confirmed that they will reimburse the firm for these costs. This confirmation has been received from the professional indemnity insurers in writing and the reimbursement will take place after the firm's year-end has passed.

In this respect, the firm will be able to recognise a provision in respect of the reimbursement asset because it is virtually certain that the obligation will be settled by the insurers. However, the firm must make sure that, in order to comply with paragraph 21.9 of FRS 102, that the amount of the reimbursement provided for within the financial statements does not exceed the amount of the provision. In addition, the firm will not be able to offset the asset against the provision - the two must be presented separately in the firm's statement of financial position (balance sheet). However, the expense within the firm's profit and loss account can be presented net of the amount recognised for the reimbursement.

At each reporting date, management must undertake a review of the provisions and make adjustments which reflect the current best estimate of the amount that would be required to settle the obligation at that reporting date. This is important because if a provision is long-standing, information may come to light during the year which would result in a change to the estimate being made. When adjustments are made to provisions, they must be recognised in profit or loss. The only exception to recognising adjustments in profit or loss are if the provision was recognised as part of the cost of an asset.

When the time value of money is a material issue and the entity recognises a provision at its present value of the amount required to settle the obligation, any unwinding of the discount must be reflected as a finance cost in profit or loss during the period in which it arises.

Onerous contracts

The Glossary to FRS 102 defines an onerous contract as:

'A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.'

Paragraph 21.11A says that where an entity has a contract that has become onerous, the present obligation under the contract is recognised and measured as a provision. A typical example of an onerous contract is when a company has an operating lease for a building which it cannot sub-let.

Example – onerous contract

Company A Ltd occupies two properties. One of the properties is owned by Company A and the other property is occupied under an operating lease and is owned by an unconnected third party. The provisions in the lease state that Company A will pay the landlord monthly rentals of £1,000 per annum from 1 April 2015 to 31 March 2019. However, due to a reduction in trade, Company A has been forced to downsize and has abandoned the property it occupied under an operating lease from 1 April 2016.

Company A has vacated a property it held under an operating lease but the contract is onerous as Company A is still committed to pay the landlord future rents until 31 March 2019. Therefore the present obligation under the contract is recognised and measured as a provision in Company A's financial statements.

Example – provision for future operating losses

Company B Ltd has an operating lease on a café situated in a vibrant town centre location. The landlord has notified Company B that the property's central heating system has to be replaced and due to Health and Safety legislation, the café must close for a few weeks commencing on 1 July 2016. Company B's year-end is 30 April 2016 and the accountant is proposing to make a provision for the rent that will still be payable to the landlord during the weeks that the café is closed.

Section 21 to FRS 102 prohibits the recognition of future operating losses (paragraph 21.6). A provision in respect of rent paid under the lease also cannot be made unless the contract is onerous. The contract would only become onerous if the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received under the contract. In this example, the operating lease cannot become onerous simply because the tenants expect to incur an operating loss for a small period of time. The facts in this example are that the rent payable over the full lease term is more than likely going to be recovered through future sales when the café is re-opened and so the contract is not onerous.

Example – termination of a contract

Company C Ltd has a contract with a supplier and this contract is onerous. The provisions in the contract stipulate that Company C will enter into the contract on 1 January 2016 and it will run for three years until 1 January 2019. Company C wishes to terminate the contract in 2017 because a competing supplier has offered more favourable terms; however, it will incur an early termination fee to terminate the contract by the existing supplier.

Company C wishes to make a provision in the 2016 financial statements for the costs of terminating the contract.

In this example, the contract has been determined as an onerous contract. It should, therefore, make provision for the net cost of terminating this contract. This is because the contract has automatically been deemed to be onerous. However, very often consideration will need to be given as to whether the business in which the products are used in is profitable. If it is profitable, the contract will not be onerous and the early termination fees should be charged when such fees are incurred (i.e. in 2017).

Contingencies

Paragraph 21.12 to FRS 102 says that a contingent liability is either a possible, but uncertain, obligation or a present obligation which is not recognised within the entity's financial statements because it fails to meet the recognition criteria for a provision. Contingent liabilities are not recognised in an entity's financial statements, although the exception to this rule relates to contingent liabilities that have been assumed by the acquirer of an acquiree in a business combination and for which the provisions in paragraphs 19.20 and 19.21 to FRS 102 will apply.

Contingent liabilities must be disclosed as such within the entity's financial statements, unless the possibility of an outflow of economic resources is considered to be remote.

Example – contingent liability

A company has made a provision for damages amounting to £10,000 in its financial statements for the year-ended 31 December 2015 in respect of a legal claim brought against the company by one of its customers. The legal advisers have advised the company that at the reporting date they are uncertain as to the potential outcome of the case.

The company should not recognise a provision for damages because it is not 'probable' that an outflow of resources will be required to settle the case. The legal advisers are unsure as to the outcome of the case. In such situations, disclosure of a contingent liability in the notes to the financial statements should be made.

A contingent asset is directly the opposite of a contingent liability and, again, is not reflected within the financial statements of an entity. Contingent assets should only ever be recognised if it is 'virtually certain' that an entity will realise the contingent asset (for example an insurance company agreeing to pay out a claim to the company).

Summary – provisions and contingencies

Contingent Liabilities		
There is a present obligation that probably requires a transfer of economic benefits to settle.	**There is a possible obligation or a present obligation that may, or may not, require a transfer of economic benefits to settle.**	**There is a possible obligation or a present obligation where the likelihood of a transfer of economic benefits is remote.**
A provision is required and disclosures are required relating to the provision.	No provision is recognised but disclosure as a contingent liability is required.	No provision is recognised and no disclosure is required.
Contingent Assets		
Inflow of economic benefits is virtually certain.	**Inflow of economic benefits is probable but not virtually certain.**	**Inflow is not probable.**
The asset is not contingent, thus provision should be made.	No asset is recognised but disclosures are made in the notes to the financial statements.	No asset is recognised and no disclosure is made.

Events after the reporting period

Where contingencies are concerned, management should undertake a review of events after the reporting period (often referred to as a 'post balance sheet events review') to determine whether a contingent liability exists. This is because a liability is only contingent if there is uncertainty surrounding the outcome at the time that the financial statements are approved. Because of the time period that elapses between the balance sheet date and the date on which the financial statements are approved, it may well be the case that once a post balance sheet events review is undertaken there may not be a contingent liability that requires disclosure.

Disclosures

Disclosure issues relating to provisions and contingencies are dealt with in paragraphs 21.14 to 21.17A. They are split according to their nature as follows:

- Provisions;
- Contingent liabilities;
- Contingent assets;
- Prejudicial disclosures; and
- Disclosure about financial guarantee contracts.

Provisions

For each class of provision, an entity shall disclose the following:

(a) A reconciliation showing:

(i) The carrying amount at the beginning and end of the period;

(ii) Additions during the period, including adjustments that result from changes in measuring the discounted amount;

(iii) Amounts charged against the provision during the period; and

(iv) Unused amounts reversed during the period.

(b) A brief description of the nature of the obligation and the expected amount and timing of any resulting payments;

(c) An indication of the uncertainties about the amount or timing of those outflows; and

(d) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

It is to be noted that comparative information is not required in respect of the above disclosures.

Contingent liabilities

Paragraph 21.15 to FRS 102 says that unless the possibility of any outflow of resources in settlement is remote, an entity shall disclose, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, when practicable:

(a) An estimate of its financial effect, measured in accordance with paragraphs 21.7 to 21.11;

(b) An indication of the uncertainties relating to the amount or timing of any outflow; and

(c) The possibility of any reimbursement.

If it is **impracticable** to make one, or more, of these disclosures, that fact must be stated.

Contingent assets

If an inflow of economic benefits is probable (i.e. more likely than not) but not virtually certain, an entity shall provide a description of the nature of the contingent asset at the end of the reporting period and, when practicable, an estimate of their financial effect, measured using the principles set out in paragraphs 21.7 to 21.11. If it is impracticable to make this disclosure, that fact must be stated.

Prejudicial disclosures

This section recognises that only in extremely rare cases might disclosure of some, or all, of the information required in paragraphs 21.14 to 21.16 of FRS 102 seriously prejudice the position of an entity in a dispute with third parties on the subject matter of a provision or contingency. When management conclude that the disclosures required in paragraphs 21.14 to 21.16 would seriously prejudice the entity, then paragraph 21.17 permits the entity not to make such disclosures but must disclose, instead, the general nature of the dispute, together with that fact and the reason why the information has not been disclosed.

Financial guarantee contracts

If the reporting entity has issued any financial guarantee contracts, then it must disclose the nature and business purpose of such contracts. Also, paragraph 21.17A requires an entity to provide the disclosures required by paragraphs 21.14 21.15.

ANTI-MONEY LAUNDERING UPDATE (LECTURES A471 – 14.56 MINUTES)

Ten year anniversary of AML regulations

It's been ten years since the Anti-Money Laundering (AML) Regulations came into force and yet they still remain one of the most common problem areas for practices across the country. There has been growing signs that all the AML supervisory bodies have been toughening their stances with more regulated firms facing disciplinary action for non-compliance with the Regulations.

Common areas of weakness

So where are firms falling down? Here are some of the most common areas of weakness we find on compliance reviews.

- Not assessing the risks for each client. Where firms do assess the risk, they then ignore it when it comes to the extent of customer due diligence.

- Not providing ongoing training to all staff. Training does not have to be face to face training, but you do need to provide ongoing training on how to recognise and deal with suspicious transactions.

- Not conducting ID checks and risk-assessments for current clients (in addition to new clients). The exemption for clients as at 1 March 2004 lapsed with the 2007 regulations, so you need customer due diligence for all clients. Not keeping your risk assessments, customer due diligence and KYC information up to date is reckless. You need a procedure in place to determine how often you check these and in what circumstances you need to update or redo them.

- Inadequate internal policies and procedures. You must have robust policies and procedures which are communicated to all staff applied to all clients. It is always surprising how many staff have no idea what they are, or even where they are stored on their firm's systems.

Recap of key aspects of the regulations

The key aspects of the Anti-Money Laundering Regulations are:

- You must have risk assessments in place:
    - A global risk assessment (what are we likely to come across?)
    - An initial risk assessment on all clients.
    - Ongoing risk assessment on all clients.
- Customer Due Diligence: You need to obtain the following:
    - Evidence of the existence of the entity (company, charity, trust etc).

- A full list of the principals, being the individuals who manage the entity (directors, trustees etc).
- On a risk basis, verify the identity of a sample of principals.
- A full list of any individuals who are beneficial owners, being: those who own or control (directly or indirectly) more than 25% of the entity (25% or more for trusts); anyone who otherwise exercises control over the management of the entity; and anyone on whose behalf the entity operates.
- On a risk basis, verify the identity of a sample of beneficial owners.

* You need to keep this customer due diligence up to date.
* You need to carry out ongoing monitoring of your clients' transactions. To this end you need 'Know Your Client' (KYC) information to help staff differentiate normal from suspicious transactions.
* You need to report knowledge or suspicion of money laundering. There are a number of criteria that apply before a suspicious activity report is required. A report is only required if all the following conditions apply:
    - You must know, or suspect, or have reasonable grounds for knowing or suspecting, that another person (the alleged offender) was engaged in money laundering. It is irrelevant whether this alleged offender is a client of yours or not.
    - The information or other matter on which your knowledge or suspicion was based, or which gave you reasonable grounds for such knowledge or suspicion, came to you in the course of a business in the regulated sector (i.e. at work). So there is no duty to report, for example, gossip overheard in the pub on Saturday night.
    - You can identify the alleged offender or the whereabouts of any of the laundered property, or you believe, or it is reasonable to expect you to believe, that the information or other matter will or may assist in identifying the alleged offender or the whereabouts of any of the laundered property. So a client telling you at work that someone broke into his business and stole some computers does not require a report.
    - The information was not received in privileged circumstances. This is a critical point. Many firms still don't understand the privilege exemption.
    - If the offence took place overseas then it was not exempt. To be exempt then it must have been legal in the country in which it occurred and if it had happened in the UK the maximum penalty must be less than 12 months in jail.

- Money laundering is dealing with criminal property, which is the benefit of criminal conduct.
  - But only where the alleged offender knows or suspects he is getting such a benefit.
- You must report knowledge or suspicion of money laundering or terrorist financing to your MLRO (covered later in the notes).
- You must not 'tip off' nor prejudice an investigation.
- The firm must:
  - Train relevant staff on the Proceeds of Crime Act, the Terrorism Acts and the Anti-Money Laundering Regulations.
  - Regularly train staff on recognising and dealing with suspicious transactions.
- You must keep records of customer due diligence and transaction files for at least five years from the end of a business relationship.
- The firm must maintain appropriate and robust policies and procedures, communicate them to all staff and ensure that they are fully complied with.

Changes in responsibilities

There have been some recent changes in AML responsibilities:

- On 7 October 2013 the Serious Organised Crime Agency ceased to exist and its responsibilities have been taken over by the newly formed National Crime Agency. The process for reporting suspicious activities remains the same, with over 99% of reports going through the SARs online system: https://www.ukciu.gov.uk/saronline.aspx.
- From 1 April 2014 the Office of Fair Trading has ceased to exist. Its AML responsibilities have been split between HMRC and the Financial Conduct Authority (FCA), with HMRC taking over responsibility for surveyors and estate agents. FCA takes over supervision of Consumer Credit Providers. The Joint Money Laundering Steering Group has published guidance for Consumer Credit Providers which can be downloaded at: http://www.jmlsg.org.uk/news/guidance-for-consumer-credit-providers.

Vince Cable plans beneficial owners register

Vince Cable announced plans recently to force companies to list their true owners on a public register. The aim is to combat tax evasion and money laundering.

The new rules will require disclosure of anyone with an interest in more than 25% of a company's shares or voting rights, or anyone who otherwise controls the way a company is run.

The concept of a register of beneficial owners is enshrined in the EU 4th Directive on money laundering. This will require entities to hold information on their own beneficial ownership. This information should be made available to both regulators and regulated entities. By opting for a public register Vince Cable is going much further. However, the chancellor pledged a public register last year as part of Britain's chairmanship of the G8.

At the time of writing, there is no timescale, as yet, for implementing this change.

AML implications of auto-enrolment for pensions

Many firms are beginning to think about auto-enrolment for pensions in terms of payroll and administration activities but you will also need to bear in mind the potential implications for money laundering reporting.

Even if you decide not to become involved in services related to auto-enrolment you will need to consider what you would do if a client was to breach its employer duties. As with any other reporting you would need to consider whether this breach was intentional or simply down to ignorance.

The new regime imposes offences regarding three specific employer duties:

- The duty to automatically enrol its eligible job-holders;
- The duty to re-enrol every three years; and
- The duty to 'opt-in' any non-eligible jobholder if they so request.

These three offences attract criminal penalties and if there are proceeds of this criminal activity, such as employer pension contributions saved, then consideration needs to be given to submitting a SARs report.

Where a client is ignorant of the requirements then they should be informed of the error and asked to correct it. As with any other such scenario if the client then chooses to do nothing then you would consider reporting, unless the information was initially gained in privileged circumstances with the client requesting your advice to correct the position.

For many clients the staging date may not be until 2015 or even 2016. There are others who, although small themselves, are part of a larger group. They may be brought in this year or are already up and running. This is however something that should be brought to the attention of your team so that they can recognise if there is a potential money laundering issue and report where necessary.

If you would like to read more on this matter ICAEW technical enquires team have published a couple of very interesting helpsheets entitled 'Auto-enrolment - Workplace Pension: Opportunities and Risks' and 'Auto-enrolment - Service planning for the workplace pension'. These can be found at: www.icaew.com/en/library/subject-gateways/pensions/auto-enrolment

Clients operating in countries with weak regimes

When considering the risk assessment for individual clients, you should consider any additional risks arising from the locations in which the client operates or in which key customers or suppliers of the client are based.

We have used a number of sources in arriving at the list below.

Financial Action Task Force list of countries with weak money laundering regimes

HM Treasury issued an advisory notice on 18 February 2014 setting out a list of such countries. The Treasury list is based on the Financial Action Task Force statement issued on 14 February 2014. The Treasury list is updated from time to time to take account of changes in the stances taken by the relevant countries.

Where a jurisdiction is considered to be high risk enhanced due diligence and monitoring is required.

The lists are split between those jurisdictions that are considered high risk and those that are potentially high risk.

At the time of writing these notes some countries (as indicated) have sanctions imposed on them.

You should take appropriate action in relation to those jurisdictions marked as ‘Potentially high risk’ to minimise the associated risks. This may include enhanced due diligence measures in high risk situations.

Transparency International 2013 Corruption Perception Index

See http://www.transparency.org/cpi2013/results

The 2013 Transparency International Corruption Perception Index ranks 178 countries on their perceived level of corruption. The scores range from a high of 100 representing no corruption to a low of zero representing totally corrupt. We have included countries scoring 50 or less in the table below.

Denmark and New Zealand all have the highest score at 91, followed by Finland and Sweden at 89 and then Norway and Singapore at 86. Bringing up the rear are Afghanistan, North Korea and Somalia who all score just 8, with Sudan at 11, South Sudan at 14 and Libya at 15.

The UK fell from 11th place in 2006 with a score of 86 to 12th place in 2008 (score 77) and to 20th place in 2010 (score 76). In 2011 it regained some ground, standing in joint 16th place (score 78), dropped back to joint 17th place in 2012 with a score of 74 but rose again to 14th place in 2013 with a score of 76.

Transparency International 2011 Bribe Payers Index

See http://bpi.transparency.org/bpi2011/

The 2011 Bribe Payers Index (BPI) ranks 28 of the world's largest economies according to the perceived likelihood of companies from these countries to pay bribes abroad. It is based on the views of business executives as captured by Transparency International's 2011 Bribe Payers Survey. These 28 countries represent more than 80% of the total world outflow of goods, services and investments.

Countries are scored on a scale of 0-10, where a maximum score of 10 corresponds with the view that companies from that country never bribe abroad and a 0 corresponds with the view that they always do. We have included countries scoring less than 7.8 in the table below. 7.8 was the average score for 2011.

Country	***2013 CPI Score (50 or less)***	**2011 BPI Score (<7.8)**	**FAFT February 2014**
Afghanistan	**8**		**Sanctions/potentially high risk**
Albania	31		Potentially high risk
Algeria	**36**		**High risk**
Angola	23		Potentially high risk
Antigua and Barbuda			
Argentina	34	7.3	Potentially high risk
Armenia	36		
Azerbaijan	28		
Bahrain	48		
Bangladesh	27		
Belarus	29		
Benin	36		
Bolivia	34		
Bosnia and Herzegovina	42		
Brazil	42	7.7	

Country	***2013 CPI Score (50 or less)***	**2011 BPI Score (<7.8)**	**FAFT February 2014**
Bulgaria	41		
Burkina Faso	38		
Burundi	21		
Cambodia	20		Potentially high risk
Cameroon	25		
Central African Republic	25		
Chad	19		
China	40	6.5	
Colombia	36		
Comoros	28		
Congo, Democratic Republic of	22		
Congo, Republic of	22		
Croatia	48		
Cuba	46		Potentially high risk
Czech Republic	48		
Djibouti	36		
Dominican Republic	29		
East Timor	30		
Ecuador	**35**		**High risk**
Egypt	32		
El Salvador	38		
Equatorial Guinea	19		

Country	*2013 CPI Score (50 or less)*	2011 BPI Score (<7.8)	FAFT February 2014
Eritrea	20		
Ethiopia	**33**		**High risk**
Gabon	34		
Gambia	28		
Georgia	49		
Ghana	46		
Greece	40		
Guatemala	29		
Guinea	24		
Guinea Bissau	19		
Guyana	27		
Haiti	19		
Honduras	26		
Hong Kong	75	7.6	
India	36	7.5	
Indonesia	**32**	**7.1**	**High risk**
Iran	**25**		**High risk/sanctions**
Iraq	16		Sanctions/potentially high risk
Italy	43	7.6	
Ivory Coast	27		
Jamaica	38		
Jordan	45		
Kazakhstan	26		
Kenya	27		Potentially high risk

Country	***2013 CPI Score (50 or less)***	**2011 BPI Score (<7.8)**	**FAFT February 2014**
Kosovo	33		
Kuwait	43		Potentially high risk
Kyrgyzstan	24		Potentially high risk
Lao People's Democratic Republic (Laos)	26		Potentially high risk
Lebanon	28		
Lesotho	49		
Liberia	38		
Libya	15		
Macedonia FYR	44		
Madagascar	28		
Malawi	37		
Malaysia	50	7.6	
Mali	28		
Mauritania	30		
Mexico	34	7.0	
Moldova	35		
Mongolia	38		Potentially high risk
Montenegro	44		
Morocco	37		
Mozambique	30		High risk
Myanmar	**21**		**High risk**
Namibia	48		Potentially high risk
Nepal	31		Potentially high risk

Country	***2013 CPI Score (50 or less)***	**2011 BPI Score (<7.8)**	**FAFT February 2014**
Nicaragua	28		Potentially high risk
Niger	34		
Nigeria	25		
North Korea	**8**		**High risk/sanctions**
Oman	47		
Pakistan	**28**		**High risk**
Panama	35		
Papua New Guinea	25		Potentially high risk
Paraguay	24		
Peru	38		
Philippines	36		
Romania	43		
Russia	28	6.1	
Sao Tome and Principe	42		
Saudi Arabia	46	7.4	
Senegal	41		
Serbia	42		
Sierra Leone	30		
Slovakia	47		
Somalia	8		
South Africa	42	7.6	
South Sudan	14		
Sri Lanka	37		

Country	***2013 CPI Score (50 or less)***	**2011 BPI Score (<7.8)**	**FAFT February 2014**
Sudan	11		Potentially high risk
Suriname	36		
Swaziland	39		
Syria	**17**		**High risk/sanctions**
Taiwan	61	7.5	
Tajikistan	22		Potentially high risk
Tanzania	33		Potentially high risk
Thailand	35		
Togo	29		
Trinidad and Tobago	38		
Tunisia	41		
Turkey	**50**	**7.5**	**High risk**
Turkmenistan	17		
Uganda	26		Potentially high risk
Ukraine	25		
United Arab Emirates	69	7.3	
Uzbekistan	17		
Venezuela	20		
Vietnam	31		
Yemen	**18**		**High risk**
Zambia	38		
Zimbabwe	**21**		**Sanctions/potentially high risk**

HM Treasury advice on complying with sanctions

HM Treasury has issued more detailed advice on complying with sanctions, adding a number of additional FAQs. The full 57 page PDF report can be downloaded from: https://www.gov.uk/government/publications/financial-sanctions-faqs.

Financial sanctions affect designated persons, being an individual or an entity. Those designated persons ('sanctions targets') are listed in the Consolidated List which you can download from the government website. However, as the Treasury has changed the URL twice in the last month we have set up our own URL which will redirect you to the correct page: www.swat.co.uk/sanctions.aspx.

Businesses should have policies and procedures to ensure that they comply with their obligations under sanctions. This will involve checking clients against the latest Consolidated List on a risk-sensitive basis. The guidance states that you do not have to check every client against the sanctions list, but if you find yourself acting for a designated person you could be in breach of the sanctions.

HM Treasury's FAQs address one of the common questions relating to the use of electronic verification. You have run your client through the sanctions check and found that someone with that name is on the list. Now what?!

The guidance differentiates between a target match and a name match. Your sanctions check on your client may give you a name match. This does not necessarily mean that your client is the target of the sanction. The guidance states that you need to decide, using the information you have about your client, whether he is a sanctions target or not.

In order to make this decision you need to conduct your own enquiries assessing your Know Your Client or Customer Due Diligence information, your customer profile and undertaking appropriate due diligence to assess this against the details available on the listed person.

If you conclude that this is a 'name match' rather than a 'target match' then record your conclusions and continue as if there were no match. If an electronic verification failed on this aspect alone then you can exclude that element of the report and rely on the remainder.

The same is not the case when you believe that you have a sanctions target match. You will need a licence from HM Treasury to allow an activity that would otherwise be prohibited. See the guidance notes for more details.

If the match is to a known PEP then you need senior management approval before you can accept the client. This is normally provided by the MLRO. You must designate the client as high risk and conduct enhanced customer due diligence and enhanced ongoing monitoring. Apart from that there are no other restrictions.

Equivalent Jurisdictions

The Regulations and guidance notes frequently refer to entities in the EU and EEA or those in other jurisdictions with equivalent anti-money laundering regulations. So as an example, simplified due diligence may be extended to financial services firms that are FCA registered (in the UK) or registered in the EU or equivalent jurisdiction by a regulator equivalent to the FCA.

Section 2.2 of Part 3 of the JMLSG guidance lists those countries where equivalence may be presumed. These are:

- EU/EEA member states, through the implementation of the money laundering directive; and
- Countries on a list of equivalent jurisdictions issued by the EU or by HM Treasury. This list is updated from time to time.

The EU/EEA member states are:

Austria	Estonia	Iceland (EEA)	Malta	Slovenia
Belgium	Finland	Ireland	Netherlands	Spain
Bulgaria	France	Italy	Norway (EEA)	Sweden
Croatia	Germany	Latvia	Poland	United Kingdom
Cyprus	Gibraltar	Liechtenstein (EEA)	Portugal	
Czech Republic	Greece	Lithuania	Romania	
Denmark	Hungary	Luxembourg	Slovakia	

In June 2012, the EU agreed that the following countries have equivalent anti-money laundering regulations. Russia was subsequently added to the June 2012 list.

Australia	Hong Kong	Mexico	South Africa	United States
Brazil	India	Russia	South Korea	
Canada	Japan	Singapore	Switzerland	

The list also includes the French overseas territories (Mayotte, New Caledonia, French Polynesia, Saint Pierre and Miquelon and Wallis and Futuna) and Aruba, Curacao, Sint Maarten, Bonaire, Sint Eustatius and Saba. Those countries and territories are not members of the EU/EEA but are part of the membership of France and the Kingdom of the Netherlands of the FATF. The UK Crown Dependencies (Jersey, Guernsey, Isle of Man) may also be considered as equivalent.

Whilst a country in the EU/EEA or on the approved list implies an acceptable level on regulation the level of compliance within countries may differ and you should continue to adopt a risk-based approach.

Extract from ICAEW AML System: Annual AML Compliance Review

For each client file selected answer the following questions.		
Client name:		
Confirm that the file contains each of the following:		
1. A risk assessment for the client	Yes / No	
2. Evidence of the existence of the business / entity (if applicable)	Yes / No / N/A	
3. Details of all individuals who control the business / entity (e.g. directors, trustees etc.)	Yes / No / N/A	
4. Details of all beneficial owners of the business / entity (if any)	Yes / No / N/A	
5. Adequate evidence of identification for: a. the key individuals who control the business / entity; or b. the individual if the client is an individual rather than a business / entity	Yes / No	
6. Adequate evidence of identification for the key beneficial owners of the business / entity	Yes / No / N/A	
7. Adequate know your client (KYC) information about the client	Yes / No	
Comments:		

AUDIT: EXERCISING PROFESSIONAL SCEPTICISM (LECTURES A472 – 16.17 MINUTES)

An auditor is required under the ISAs (UK and Ireland) to carry out their work with professional scepticism. Professional bodies and regulators frequently criticise audit firms for failing to evidence that they have exercised professional scepticism during the audit. Essentially, a high-quality audit features the exercising of professional judgement by the auditor and a mindset which includes professional scepticism being applied at both the planning stage and during the execution of the audit fieldwork.

Adopting an approach of professional scepticism will also involve a critical assessment of audit evidence and being alert for audit evidence which may contradict other audit evidence or may call into question the reliability of the information gathered from management and those charged with governance (TCWG).

While the ISAs (UK and Ireland) recognise the importance of professional scepticism being applied by the auditor, it is nevertheless a personal and professional trait to be adopted by the auditor. The auditor must recognise that professional scepticism is an integral part of their work and is closely interrelated to the fundamental concepts of independence and objectivity.

Training audit staff to be professionally sceptical is an important issue. Audit work needs to be undertaken to satisfy the relevant audit assertions and therefore creating an internal culture that recognises the importance of professional scepticism on all audits, regardless of past experiences with the audit client, is a pivotal activity that needs to be promoted within all firms so that it can be demonstrated that professional scepticism has been applied.

The global financial crisis in 2008-2009 highlighted a weak approach to professional scepticism in areas of the financial statements which are particularly subjective, such as fair values, related party transactions and going concern assessments. Professional bodies and regulators believe that it is in the public's interest to re-emphasise to both auditors and others which play an important role in an audit of financial statements of the need to adopt and maintain a degree of professional scepticism during the course of an audit.

Professional scepticism enables the auditor to exercise professional judgement – especially concerning decisions relating to:

- The nature, timing and extent of audit procedures to be performed;
- Whether sufficient appropriate audit evidence has been obtained and whether more needs to be done to achieve the objectives of the ISAs (UK and Ireland);
- The evaluation of management's judgements in applying the entity's applicable financial reporting framework; and

- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of estimates made by management in preparing the financial statements.

What is professional scepticism?

Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. The ISAs (UK and Ireland) explicitly require that the auditor plan and performs the audit with professional scepticism and keeping in mind that circumstances may be present which cause the financial statements to be materially misstated.

The problem that many auditors have with the concept of professional scepticism is that there is no single way of demonstrating that the auditor has exercised scepticism when conducting an audit in accordance with ISAs (UK and Ireland). Notwithstanding this problem, professional scepticism is a mindset and a sceptical mindset will enable the auditor to question aspects of the entity and the financial statements that are being audited rather than merely accepting information at face value. This questioning mindset will then enable the auditor to form conclusions on the information at hand. The concept of professional scepticism is very closely related to the concepts of independence and objectivity – two traits which are fundamental ethical principles. The auditor's independence enhances the auditor's ability to act with integrity, be objective and maintain an attitude of professional scepticism.

Professional scepticism can also be exercised by being alert to audit evidence which may contradict other audit evidence obtained. It can also be exercised by calling into question the reliability of documents or responses to inquiries and it also includes being alert to conditions that may indicate a potential fraud risk and thus developing audit procedures that adequately respond to the circumstances.

Applying professional scepticism when reviewing audit evidence is a critical aspect. Audit evidence has to be both sufficient and appropriate as well as covering the relevant audit assertions. An auditor can demonstrate professional scepticism by questioning and considering both the sufficiency and appropriateness of the audit evidence gathered in light of the circumstances. Where the auditor has doubt concerning the reliability of information or where evidence points to potential fraud risk, the ISAs (UK and Ireland) require the auditor to investigate further and determine what additional procedures are necessary to resolve the issue.

Firms often run into difficulty with regulators and professional bodies during audit file reviews because they believe that management and TCWG are honest and their integrity is intact. While this may be the case in the majority of audits, a belief that a client is honest and has integrity does not relieve the auditor of their responsibility under the ISAs (UK and Ireland) to maintain professional scepticism or be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

What audit firms can do to ensure professional scepticism is achieved

The firm's leadership and the examples that it sets will essentially drive the internal culture of the audit firm. Therefore audit engagement partners need to ensure that audit staff understand the importance of professional scepticism and the need to have a questioning mind. Audit firms should have policies and procedures in place that accord with the requirements of ISQC (UK and Ireland) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Engagements*. Such policies and procedures should contain specific emphasis on the importance of exercising professional scepticism throughout the course of an audit. In addition, the firm should consider documenting the importance of exercising professional scepticism when:

- Establishing policies and procedures which are designed to promote an internal culture recognising that quality is essential when performing engagements.

- Promoting a quality-oriented internal culture through clear, consistent and frequent actions and messages from all levels of the firm's management.

- Ensuring that the firm has sufficient personnel with the necessary competence, capabilities and commitment to ethical principles.

- Developing and implementing internal training and continuing professional development for all levels of the firm's personnel.

Demonstrating professional scepticism does not just apply at firm level – it should also be demonstrated at the engagement level also. The audit engagement partner is responsible for the overall quality of the audit to which they are assigned and this is why it is important that audit engagement partners communicate the importance of professional scepticism to staff who are deployed on the audit. Audit staff should not be hindered by clients in the execution of their duties and should not be in fear of reprisals and in issuing auditor's reports which are appropriate in circumstances.

Audit planning is an integral aspect of an audit and the audit team planning meeting is an ideal opportunity to re-affirm the importance of professional scepticism. An important part of the team meeting is for the team to discuss the susceptibility of the financial statements to material misstatement. This could be due to fraud and/or error and in the meeting it is the opportunity to discuss not only the susceptibility of the financial statements to material misstatement, but also HOW the financial statements could be materially misstated due to fraud or error. Many audit firms fall into the trap of relying on past experience concerning the honesty and integrity of clients and hence document that there are no issues relating to fraud/error on the grounds that no fraud/error was noted in prior year audits. This is clear evidence of failing to maintain professional scepticism. So how can this be overcome?

During the audit team meeting, the team should discuss how management COULD override internal controls to perhaps commit a fraud or how employees COULD manipulate weaknesses in internal controls for personal financial gain or how related party relationships may give rise to a fraud risk factor. These are some of the key points that should be discussed among the engagement team to demonstrate that professional scepticism is being applied. It may be the case that there is no fraud/error present but the idea of applying professional scepticism is for the auditor to remain alert to the possibility that there could be fraud/error (indeed fraud, by its very nature, is designed not to be detected).

As well as fraud issues, the team should also discuss how the financial COULD be materially misstated because of error. The word 'could' is capitalised to emphasise that it might not necessarily be the case that fraud has taken place once the audit has been completed or the financial statements may not contain any errors, but a sceptical mindset will approach the audit with an awareness that such misstatements due to fraud or error COULD have happened during the period under audit.

The audit engagement partner should also demonstrate the application of professional scepticism when taking responsibility for:

- The direction, supervision and performance of the audit;
- Reviews of work performed; and
- The engagement team undertaking appropriate consultation on difficult or contentious matters and considering the conclusions reached from such consultations.

Professional scepticism needs to be applied throughout the entire audit, even at the stage of accepting the engagement (for example when considering the integrity of the principal owners and management). In addition, professional scepticism should be applied:

- In identifying and assessing risks of material misstatement;
- Designing the nature, timing and extent of further audit procedures which are responsive to the assessed levels of risk;
- Evaluating audit evidence – such as recognising the need to increase the quantity of audit evidence or obtain evidence which is more relevant and reliable for areas which have a higher assessed risk;
- Designing and performing substantive analytical procedures;
- Addressing situations when management refuse to allow the auditor to send a confirmation request; and
- Forming an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

It is also particularly important to apply professional scepticism when addressing areas of the financial statements that are complex, significant or contain a high degree of judgement on the part of the client and challenge management's assumptions, for example:

- Accounting estimates, including fair value accounting estimates and related disclosure – particularly:
    - Evaluating the reasonableness of the significant assumptions used by management for accounting estimates that give rise to significant risks;
    - Determining whether changes in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances; and
    - Reviewing the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.
- Related party transactions and relationships and remaining alert during the audit for information which may indicate previously unidentified or undisclosed related party relationships or transactions.
- Significant transactions outside the ordinary course of business and evaluating whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into so as to engage in fraudulent financial reporting or to conceal misappropriation of assets or the reliability of external confirmation requests.
- Consideration of laws and regulations and remaining alert when performing the audit for instances of non-compliance with laws and regulations (or suspected non-compliance) which may have a material effect on the financial statements or that could have a fundamental effect on the operations of the client causing the business to cease trading or bring into question the entity's ability to continue as a going concern.
- Considering whether the going concern presumption is appropriate in the company's circumstances such as evaluating management's plans for future actions and whether the outcome of these plans is likely to improve the situation and whether such plans are feasible.
- If the auditor is auditing significantly unusual or highly complex transactions, they must apply professional scepticism because the nature of such transactions may give rise to material misstatement of the financial statements and hence will merit heightened attention by the auditor.

Evidencing professional scepticism

One of the main reasons that audit firms get criticised by professional bodies and regulators where professional scepticism is concerned is the lack of evidence proving that the auditor has applied professional scepticism when it comes to the file review. Where audit firms have documented certain points it is often clear that the auditor is relying on past experience where the client's honesty and integrity is concerned and merely saying that because fraud/error was not noted in previous audits then it can be assumed that the current year's audit will also not contain material misstatement due to fraud and/or error.

Care must also be taken by audit firms when they rebut the presumption that fraud in relation to revenue recognition is not applicable to the client. The presumption itself may be rebutted in cases where there may be a single type of simple revenue transaction (for example leasehold revenue from a single unit rental property). Management override of internal controls is also recognised as a significant risk in paragraph 31 to ISA (UK and Ireland) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and therefore the auditor must undertake the required procedures laid down in paragraph 31 to ISA (UK and Ireland) 240 and not simply overlook this requirement of the ISA (UK and Ireland) because of past beliefs concerning the client's integrity and honesty.

An auditor can evidence professional scepticism in conversations that they hold with TCWG. For example it might be the case that the audit client has applied a certain accounting practice which might be permitted under GAAP but which the auditor does not consider to be appropriate in the company's circumstances. Challenging such practices and making sure that the notes of any discussions are documented are key in demonstrating that professional scepticism has been applied.

Audit documentation is critical because it demonstrates that the requirements of the ISAs (UK and Ireland) and legislation have been applied. ISA (UK and Ireland) 230, *Audit Documentation* requires the auditor to prepare sufficient audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand, among other things, the significant decisions made regarding significant matters arising during the audit, the conclusions reached thereon, and significant judgements made in reaching those conclusions. Discussions of significant matters discussed with management and TCWG should also be documented including the nature of the significant matters discussed and when and with whom the discussions took place. By ensuring such matters are properly documented this will help the auditor demonstrate how significant judgements and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriate audit evidence has been obtained.

The following are examples of where appropriate audit documentation should be on file and where the maters and judgements are significant (note the list below is not exhaustive):

- The decisions reached during the audit team discussion concerning the susceptibility of the financial statements to material misstatement due to fraud.

- The decisions reached during the audit team discussion concerning the susceptibility of the financial statements to material misstatement due to fraud with related parties.

- Communication with management and TCWG, regulators and others in respect of fraud.

- Identified or suspected non-compliance with laws and regulations and the results of discussions with management and, where applicable, TCWG and other parties external to the entity.

- The basis for the auditor's conclusions concerning the reasonableness of accounting estimates and their disclosure which give rise to significant risks and any indicators of possible management bias.

- Identified information which is inconsistent with the auditor's conclusions concerning a significant matter and how that inconsistency was addressed.

- The basis for the auditor's conclusions concerning the reasonableness of areas of subjective judgements.

- The basis for the auditor's conclusion about the authenticity of a document when the procedures applied by the auditor caused them to believe that the document may not be authentic.

ANALYTICAL PROCEDURES (LECTURES A473 – 14.23 MINUTES)

Analytical procedures are one of the most useful tools at an auditor's disposal – provided they are used correctly and appropriately. ISA (UK and Ireland) 520, *Analytical Procedures* defines the term 'analytical procedures' as:

'… evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.'

ISA (UK and Ireland) 520 requires the auditor to apply substantive analytical procedures during the course of the audit as well as using analytical procedures near the end of the audit in order to assist the auditor in forming an overall conclusion on the financial statements.

In their 2013 *Audit Monitoring* review, QAD recently criticised some audit firms for not fully appreciating the difference between substantive analytical review and higher level analytical procedures undertaken at both the preliminary and completion stages of the audit.

Substantive analytical procedures

ISA (UK and Ireland) 520 at paragraph 5 outlines four approaches needed when applying substantive analytical procedures:

- Determining the suitability of substantive analytical procedures;
- Evaluating the reliability of data;
- Developing an expectation; and
- Determining the amount of any differences.

Determining the suitability of substantive analytical procedures

Here the auditor must assess the suitability of substantive analytical procedures in light of the assessed risks of material misstatement as well as other tests of detail (if any) for given assertions. Firms have been criticised for failing to determine the suitability of substantive analytical procedures and this is evidenced by the procedures applied failing to provide sufficient evidence to satisfy the audit assertion.

Designing substantive analytical procedures involves a lot of thought – there is no 'one-size-fits-all' solution to substantive analytical procedures. Care needs to be taken not to use substantive analytical procedures inappropriately (i.e. as a time-saving mechanism) because in so doing, the auditor runs the risk of failing to gather sufficient appropriate audit evidence to satisfy the key audit assertions. The auditor must appreciate that if substantive analytical procedures are not suitable in certain areas of the financial statements then further tests of detail will be necessary to ensure the audit evidence is sufficient and appropriate.

Evaluating the reliability of the data

In applying substantive analytical procedures, the auditor must ensure they test the reliability of the data from which the auditor's expectations of recorded amounts are developed. In evaluating the reliability of the data, the auditor should take into consideration the source of the information, comparability, nature and relevance of the information available. In addition, the auditor must also consider the reliability of the controls over the data and perform procedures over such reliability.

Developing an expectation

The requirement to develop an expectation also links in to evaluating the reliability of the data itself. There is little point in developing an expectation from data which is either unreliable or which the auditor is not satisfied over the adequacy of the controls relating to that data.

An important point to emphasise where the development of an expectation is concerned is to adequately document it. Essentially the point of developing an expectation at the outset is to then have a 'benchmark' as to what to expect. If there is no benchmark (i.e. the expected value) then there is nothing to compare actual values to, so if, for example, the financial statements show a depreciation charge for the year of £10,000 and we apply proof in total as a substantive analytical procedure which shows the depreciation charge to be £30,000 then we know that actual values deviate from expected values and therefore we should perform additional procedures to understand the difference.

Determining the amount of any differences

This step links into the development of an expectation above. Once the auditor has developed the expected value they compare that to the actual value and consider any differences. Where differences are noted, there are then three additional 'sub-steps' that should be undertaken:

- Investigation;
- Corroboration; and
- Forming the conclusion.

Investigation

The investigation stage is where the primary evidence is obtained. Auditors must undertake an investigation where fluctuations or inconsistencies are evident in light of other relevant information. It is important that this investigation is clearly documented.

The first stage of the investigation is usually inquiry with the client. Statements along the lines of 'cost of sales have increased because the company has bought more goods' is not sufficient or appropriate audit evidence and would be viewed as very low quality audit evidence by regulators and professional bodies.

Disaggregation of the data is likely to serve towards obtaining sufficient and appropriate audit evidence.

Example – disaggregation of data

A company has reported sales of £18 million for the year-ended 31 October 2013 (2012: £10 million). The increase in turnover of £8 million was not expected as the finance director told the audit partner that turnover had been relatively constant during the year in the pre-audit planning meeting.

Whilst inquiry is a valid audit procedure under ISA (UK and Ireland) 500, *Audit Evidence* having a discussion about the increase in turnover with the client is unlikely to give much evidence. Breaking down the turnover figure into months and by product line is more likely to assist in generating sufficient appropriate audit evidence to corroborate the increase or even identify mispostings within the financial statements.

Corroboration

ISA (UK and Ireland) 520 says that the auditor must obtain appropriate audit evidence to corroborate the client's responses. Simply taking the client's word for any fluctuations is not appropriate as a key part to analytical procedures is corroboration. So if the client says that the increase in turnover was due to a large, one-off order in the month of February then the auditor should obtain evidence to back-up that explanation and ensure that the procedures adopted and the evidence obtained is adequately documented.

Forming the conclusion

There may be occasions where substantive analytical procedures are applied that the auditor concludes more work is needed in certain areas. In some cases it might be that additional tests of detail are needed rather than redesigning the substantive analytical procedures. Generally, if the steps for substantive analytical procedures in ISA (UK and Ireland) 520 are followed properly, the auditor should be able to draw a conclusion and at the same time the analytical procedures can go to serve as sufficient and appropriate audit evidence for the current audit file.

Firms are often criticised for failing to use analytical procedures appropriately and hence it is evident that firms have used such procedures in an attempt to minimise further tests of detail when such tests of detail would have been more appropriate. Good analytical review can sometimes take the same amount of time as substantive testing and therefore audit firms are strongly advised to ensure care is taken to ensure that analytical procedures are applied appropriately and that the evidence gathered from such procedures satisfies both the audit assertions and the requirements of the ISAs (UK and Ireland).

Analytical procedures that assist in forming an overall conclusion

ISA (UK and Ireland) 520 makes it mandatory for the auditor to apply analytical procedures in forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. The *Application and other explanatory material* at paragraph A17-1 says that considerations may include:

(a) Whether the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of the audit;

(b) Whether the procedures reveal any new factors which may affect the presentation of, or disclosures in, the financial statements;

(c) Whether analytical procedures applied when completing the audit, such as comparing the information in the financial statements with other pertinent data, produce results which assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the entity's business;

(d) Whether the presentation adopted in the financial statements may have been unduly influenced by the desire of those charged with governance to present matters in a favourable or unfavourable light; and

(e) The potential impact on the financial statements of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if any.

CHANGES TO THE AUDITOR'S REPORT (LECTURES A474 – 9.54 MINUTES)

The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 has amended the Companies Act 2006 by requiring certain companies (medium-sized and large companies) to prepare a strategic report for each financial year of the company (see earlier in this course material). Small companies are exempted from the requirement to prepare a strategic report.

The auditor needs to state in their audit report whether the information given in the strategic report is consistent with the financial statements (which is the same statutory reporting responsibility as that which applies to the directors' report).

Where the directors of a company prepare a strategic report, the bullet point relating to the directors' report in the section headed 'Opinion on other matters prescribed by the Companies Act 2006' should now read (new text underlined):

- *The information given in the <u>Strategic Report and the</u> Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.*

For companies which have taken advantage of the small companies' exemption from the requirement to prepare a strategic report, the auditor's report is amended as follows (new text underlined):

'We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- *…*
- *The directors were not entitled to [prepare the financial statements in accordance with the small companies regime] [and] [take advantage of the small companies' exemption in preparing the directors' report] <u>[and] [take advantage of the small companies exemption from the requirement to prepare a strategic report]</u>'*

Listed companies

Changes to the Listing Rules took place by the Financial Conduct Authority (FCA) on 12 December 2013. The FCA deleted Listing Rules 9.8.11R and 9.8.12R which required premium listed companies to ensure that the auditors review certain directors' remuneration disclosures and for the auditor to provide details of any non-compliance in the audit report.

These changes apply to premium listed companies with a financial year ending on or after 30 September 2013 which had not published their annual financial report on or before 13 December 2013.

The implications for the audit report are shown below:

Audit report (extract)

Under the Listing Rules we are required to review:

- the directors statement **[**set out [on page …]**]**, in relation to going concern; <u>and</u>
- the part of the Corporate Governance Statement relating to the company's compliance with the nine provisions of the ~~[June 208 Combined Code]~~ [UK Corporate Governance Code ~~[25], [37], [42]~~] specified for our review<u>.</u>~~; and~~
- ~~certain elements of the report to the shareholders by the Board on directors' remuneration [26, 38, 43].~~

Changes applicable to all auditor's reports

Amendments made to ISA (UK and Ireland) 720A, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* have had a consequential effect on the description of the scope of an audit. The change is as follows with additional text underlined:

'In addition, we read all the financial and non-financial information in the [describe annual report] to identify material inconsistencies with the audited financial statements <u>and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit.</u>'

The above change is to be reflected in all of the example auditor's reports contained in Bulletin 201/2 (Revised March 2012).

Changes applicable to clients that apply the UK Corporate Governance Code

Further changes to ISA (UK and Ireland) 700 are only applicable to companies that apply the UK Corporate Governance Code. Changes were directed at:

- Enhancing auditor communications by requiring the auditor to communicate to the audit committee information that the auditor believes the audit committee will need to understand the significant professional judgments made in the audit; and
- Extending auditor reporting by requiring the auditor to report, by exception, if the board's statement that the annual report is fair, balanced and understandable is inconsistent with the knowledge acquired by the auditor in the course of performing the audit, or if the matters disclosed in the report from the audit committee do not appropriately address matters communicated by the auditor to the committee.

Audit report (extract) (new text underlined)

<u>Matters on which we are required to report by exception</u>

We have nothing to report in respect of the following:

<u>Under the ISAs (UK and Ireland), we are required to report to you if, in our opinion, information in the annual report is:</u>

- <u>materially inconsistent with the information in the audited financial statements; or</u>
- <u>apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or</u>
- <u>is otherwise misleading.</u>

<u>In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed.</u>

Further changes in June 2013 to ISA (UK and Ireland) 700 requires auditors of entities that apply the UK Corporate Governance Code to explain more about their work, including:

- A description of the assessed risks of material misstatement which the auditor has identified and has the greatest effect on:
  - The overall audit strategy;
  - The allocation of resources in the audit; and
  - Directing the efforts of the engagement team.
- An explanation of how the auditor has applied materiality in planning and executing the audit; and
- Providing an overview of the scope of the audit and how this addressed the risk and materiality considerations.

The audit report for such clients is amended as follows (new text underlined):

Audit report (extract)

<u>Our assessment of risks of material misstatement</u>

<u>[Insert a description of those specific assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.]</u>

Our application of materiality

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

An overview of the scope of our audit

[Insert an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement and was influenced by the auditor's application of materiality.]

[The disclosures about the above three matters are made in a manner that complements the description of significant issues relating to the financial statements required to be set out in the separate section of the annual report describing the work of the audit committee in discharging its responsibilities (see paragraphs [19B] and [A13D] of ISA (UK and Ireland) 700.

All of the above changes to ISA (UK and Ireland) 700 are effective for audits of financial statements for periods commencing on or after 1 October 2012.

AUDIT QUALITY THEMATIC REVIEW – MATERIALITY (LECTURES A475 – 11.17 MINUTES)

In December 2013, the Financial Reporting Council (FRC) issued a thematic review report on the auditor's consideration and application of materiality. A further thematic review was published in January 2014 relating to the identification of fraud risks and consideration of laws and regulations.

The FRC have said that thematic reviews will supplement their annual programme of audit inspections of individual firms. A thematic reviews involves the FRC reviewing a firm's policies and procedures in respect of a certain area of auditing and the application of these policies and procedures in practice. The reviews themselves are fairly narrow in their scope and enables the FRC to look at a specific area of auditing in more depth. This then allows the FRC to make comparisons between firms in order to identify good practice and areas of common weakness.

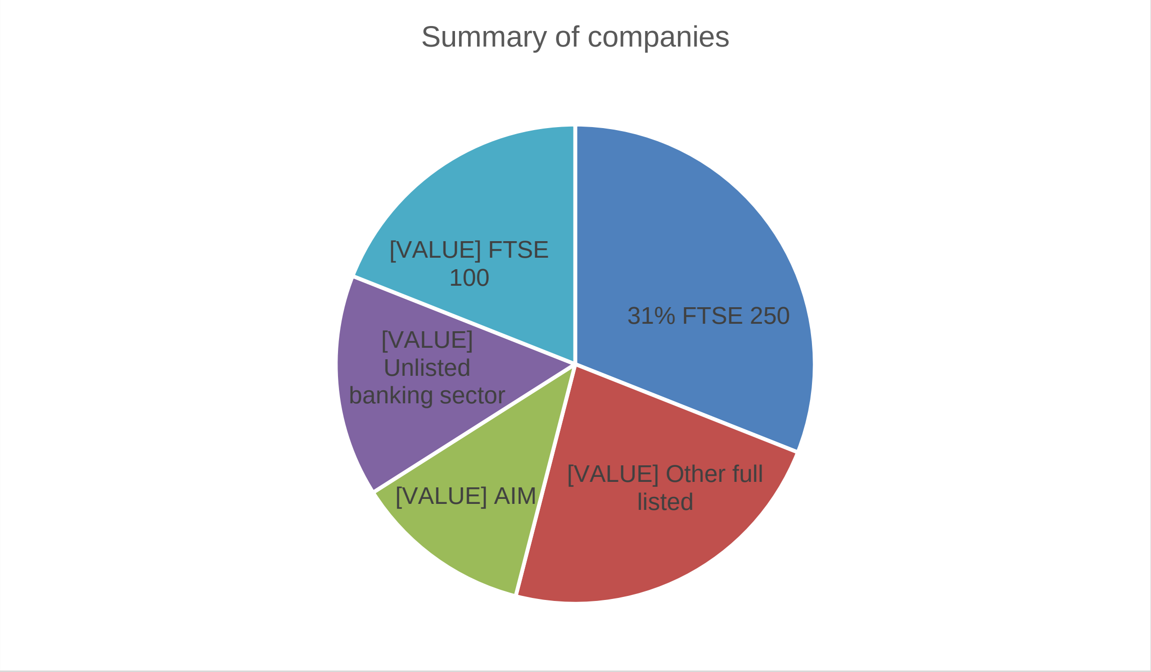
Materiality was chosen by the FRC on the basis that it is a particular area of interest to investors in light of its potential impact on the scope of an audit and the extent of the audit work performed. The report acknowledges that this is also reflected in the revised version of ISA (UK and Ireland) 700, *The Auditor's Report on Financial Statements* which now requires auditors to report on how they applied the concept of materiality in performing the audit and how this affected the scope of the audit.

The FRC visited six of the largest firms: BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and KPMG Audit Plc and PricewaterhouseCoopers LLP to undertake a review of their audit methodology and guidance in respect of materiality. In addition, the FRC undertook a review of certain aspects of audit procedures for 26 clients that operated in the following sectors:

- Retail
- Construction
- Real estate
- Industrial products
- Support services
- Banking
- Software
- Mining industries.

The reviews were carried out on audits of financial statements for financial years ending between March 2012 and March 2013. The FRC also selected at least one entity which was break-even or loss-making with a view to establishing how auditors applied their judgement in the determination of materiality.

The following chart gives a breakdown of the companies which were covered by the FRC's review:



The FRC have outlined what they determined to be 'good practice' where materiality considerations were concerned:

- Monitoring the materiality level set on all audits for a specified period and, where materiality was being set at a level outside the firm's suggested ranges, reviewing whether there was reasonable justification for this.
- Using an exceptions report to identify where no justification for the materiality benchmark or percentage used has been recorded.
- Providing specific guidance for industry sectors where the judgments involved may be more complex, for example pension funds, mutual funds, insurance companies, banks and building societies, mining companies and real estate/property companies.

Overview of the FRC's findings

Out of the six firms visited, five had made changes to their materiality guidance leading to either higher materiality levels being set or the impact of materiality assessments on the level of audit work performed being reduced.

The FRC also found that some firms had significantly higher permitted acceptable percentage ranges than other firms to determine both overall financial statement materiality and performance materiality (especially those firms which do not distinguish between public interest and non-public interest entities). As a result, some firms may undertake less work when compared to entities of similar size and risk profiles and the FRC have also acknowledged that such practices may also lead to a variability in materiality judgments within the firm.

At all six firms, it was found that there were templates to set financial statement and performance materiality as well as limits for items deemed as 'clearly trivial'. Templates were also present for revising materiality levels during the audit and for the evaluation of unadjusted errors. The problem acknowledged by the FRC where these templates were concerned was that they did not always appropriately explain and justify the auditor's judgments in completing them.

Another problem noted by the FRC was that in the majority of cases, materiality levels set were usually the maximum permitted under the firm's policies regardless of the risks that had been identified. The FRC has criticised this practice as such an approach is inconsistent with the appropriate exercise of individual judgment required by ISAs (UK and Ireland).

The FRC have also found that auditors did not consider revising materiality levels which had been based on forecast results when the actual results were significantly worse than forecast.

A final finding by the FRC was that despite there being many examples of accurate and high quality reporting to Audit Committees, four audits reviewed by them had recorded and collated errors which were at a higher level than the reporting threshold notified to the Audit Committee. In addition, in six audits reviewed by the FRC it was evidenced that the team did not report all errors above the reporting threshold and in one audit, no reporting of materiality levels or considerations had been reported to the Audit Committee.

Key messages from the FRC to audit firms

The FRC require firms to review their guidance to ensure that it appropriately addresses areas that require improvement, including:

- The promotion of judgment when determining materiality levels and performance materiality levels;
- Considering the need to distinguish between those entities which are public interest and non-public interest entities when it comes to setting materiality levels (the FRC have acknowledged that while some firms do this, others do not);
- Considering improving guidance issued to audit staff in how they consider component materiality on group audits;
- Having procedures to ensure audit staff undertake internal consultation relating to complex judgments or in situations where audit teams propose to use higher percentages of a chosen benchmark than is ordinarily used within the firm for establishing materiality; and
- Providing audit teams with additional industry-specific guidance or enhancing industry-specific guidance.

If audit teams use benchmarks which are adjusted for 'one-off' items, such adjustments must be appropriate in the circumstances and the FRC have advised firms to ensure that their guidance assists audit teams in making such judgments.

Auditors should not simply set materiality at the highest level permitted by the firm's guidance – instead they should consider the risk assessment in setting materiality levels.

The FRC have also advised audit firms to improve the quality and accuracy in their reporting of materiality levels to Audit Committees and also ensure that all uncorrected misstatements identified which are above the reporting threshold agreed are collated and reported accordingly.

Finally, the FRC have advised firms to ensure that materiality is appropriately addressed when planning analytical procedures.

Key messages from the FRC to Audit Committees

The FRC have acknowledged that Audit Committees play a vital role in ensuring the quality of financial reporting – especially discussing with the auditors the audit plan and the audit findings as these can contribute to audit quality which is something the FRC is keen to improve. The following is a summary of recommendations by the FRC which they believe may enhance the Audit Committee's oversight of the audit process in relation to materiality levels which will serve to contribute to an overall improvement in audit quality:

- Audit Committees (ACs) have an important role to play in ensuring materiality levels are appropriate. As a result, ACs should obtain an understanding of the materiality levels set and how these reflect the needs and expectations of the financial statement users.

- ACs need an understanding of how materiality levels will affect the level of work performed.

- ACs should obtain an understanding of the benchmarks used by auditors in the determination of materiality and why these are appropriate.

- When materiality levels are increased, ACs should seek to understand the reasons including whether the auditors believe the needs of users of the financial statements have changed as well as the impact of the increase on the auditors' work.

- ACs should understand how materiality levels affect the extent of audit work undertaken in significant areas.

- For group audits, ACs should understand how materiality is being determined at both group and component level.

- In situations when actual results are worse than forecasted, ACs should discuss with auditors whether materiality levels need to be revised as well as whether the nature and extent of the audit work performed remains appropriate.

- Where management have not corrected the financial statements for misstatements identified during the course of an audit, ACs should ensure they understand the reasons and instruct management to make the relevant adjustments when appropriate.

- If disclosure omissions have been discovered by the auditor and reported to the AC, the AC should seek to understand whether such omissions have arisen through error or because of a management judgment. In addition, ACs should also consider whether the omission is likely to provide material information to users of the financial statements.

- ACs are advised to seek confirmation from the auditors that any changes that are made to the materiality levels and reporting threshold initially advised to them have been reported to them.

SUMMARY OF DEVELOPMENTS

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

FRC urges IASB to bring back prudence, stewardship and reliability

13 January 2014

The Financial Reporting Council (FRC) believes the concept of prudence, stewardship and reliability should be reintroduced into the international accounting standards Conceptual Framework, as they are fundamental to financial reporting.

The FRC's comments are made in its response to the IASB's Discussion Paper on its Conceptual Framework which sets out the concepts that underlie the preparation and presentation of financial statements. It identifies principles for the IASB to use when it develops and revises International Financial Reporting Standards (IFRSs). The FRC believes the Paper is a detailed and thoughtful overview of many complex issues.

Commenting on the FRC's response, Melanie McLaren, FRC Executive Director, Codes and Standards, said:

'The IASB's Discussion Paper makes a number of valuable and thoughtful suggestions. In particular we welcome the emphasis placed on the importance of the profit and loss account as well as the balance sheet, and the recognition that financial reporting should not be based entirely on market values. As future standards will be developed from the Conceptual Framework, it is essential that the Conceptual Framework is of the highest quality possible. We hope that our suggestions will assist the IASB in achieving that.'

The FRC response also proposes that the IASB's Framework states that financial statements show the performance of an entity's business model. Of this, Melanie McLaren said:

'It is all too often said that directors cannot recognise their business from their financial statements. Accounting standards should allow an appreciation of the results of the business model.'

Roger Marshall, FRC Board member and Chairman of its Accounting Council, said:

'In 2010, the IASB made some changes that downplayed the ideas of prudence, stewardship/accountability and reliability. We are pleased that the IASB has said that it will reconsider this in light of work on the rest of the Conceptual Framework. In our response we explain why the importance of these ideas should be clearly acknowledged in the Conceptual Framework.'

The FRC's response also suggests that a more fundamental analysis of issues relating to measurement of assets and liabilities than that provided in the Discussion Paper is required, and that the objective of the statement of profit or loss needs to be specified.

FRC challenges the reporting of companies classifying pension liabilities as equity

15 January 2014

The Financial Reporting Council (FRC) warns Boards against entering into arrangements that turn pension obligations into equity instruments in their accounts. Several companies that used Scottish Limited Partnerships to achieve this outcome have taken steps to address the FRC's regulatory enquiries.

The Financial Reporting Review Panel (FRRP) of the FRC has, over recent years, considered several annual reports and accounts of companies which have put in place arrangements to provide additional collateral to their pension schemes in exchange for reduced annual contributions and a longer period to fund the pension scheme deficit.

The FRRP acknowledges the genuine commercial reasons for establishing such arrangements and has focused on companies that have reclassified pension liabilities as equity instruments.

Specifically, some of these arrangements, usually involving the establishment of a Scottish Limited Partnership which holds the collateral, have included additional features which appear to have been introduced in order to achieve an accounting outcome whereby the company's obligation to make future payments to its pension scheme is transformed into an equity instrument in the company's consolidated accounts. This has a favourable impact on the financial solvency, gearing and reported comprehensive income notwithstanding that the company has retained the obligation to fund the pension deficit.

Following enquiries by the FRRP, each of the companies has revised either the arrangements or the amounts recognised with the result that the concerns of the FRRP have been addressed for the future from the date of the change.

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

'The FRRP believes that it is important that companies and their advisers are aware that the FRRP will ordinarily open an enquiry into the financial reporting of any company in which material pension liabilities are reclassified from debt to equity.'

FRC seeks improvements in auditors' identification of and response to fraud risks, and consideration of laws and regulations

23 January 2014

The Financial Reporting Council (FRC) has published the report of its Audit Quality Thematic Review into auditors' identification of and response to fraud risks, and their consideration of compliance with laws and regulations by audited entities.

The themes for the review, which looked at relevant aspects of 26 audits by the six largest audit firms, were chosen because they are matters of public interest where there are high expectations and common misunderstandings of the auditor's role. The report highlights a number of areas where auditors should improve the quality and effectiveness of their audit procedures and provides an overview of areas of good practice identified at one or more audit firms. These improvements would better position auditors to detect possible material misstatements in the financial statements due to fraud and to non-compliance with laws and regulations. The extent to which improvements in these areas have been achieved will be assessed in the FRC's future inspections of individual firms.

Auditors are encouraged to increase their focus on identifying fraud risk factors when assessing the risks of the financial statements being materially misstated due to fraud. In particular, they should ensure their approach is tailored to the entity they are auditing. Auditors should also improve their identification and assessment of laws and regulations affecting the specific audited entity, as well as exercising greater professional scepticism in relation to possible breaches that could affect the financial statements.

To assist Audit Committees, the report also identifies a number of areas in which their oversight of the audit process relating to fraud risks and laws and regulations might be enhanced. Further, when tendering their audit, Audit Committees are encouraged to enquire about the nature and frequency of the training firms provide on these areas to audit staff.

Paul George, Executive Director, Conduct said:

'The consideration of fraud risks and compliance with relevant laws and regulations, and the performance of related audit procedures tends to be viewed as a compliance exercise rather than as an important and integral part of the audit. Improvements are needed to better focus attention on the potential impact on the financial statements and the need for appropriate professional scepticism to be exercised in these areas throughout the audit process.'

FRC issues guidance on the audit of housing associations

30 January 2014

The Financial Reporting Council (FRC) has issued guidance for auditors on the audit of housing associations in light of the landscape in which the social housing sector now operates.

Reductions in grant funding, welfare reform and the impact on availability of funding following the financial crisis have led many Associations to diversify their activities and funding models. Some associations augment their traditional housing activities with more commercial activities such as student accommodation or care homes. Some have moved away from long term bank financing to bond financing and an increased use of interest rate swaps.

This new guidance enables auditors to respond to these business risks and to identify risks of material misstatement of Housing Associations financial statements.

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

'Housing Associations provide some 3 million homes. Changes in recent years have given rise to potential business and audit risks that auditors need to be aware of when undertaking audits in this economically important sector of the UK economy.

'This new update is intended to assist auditors in understanding the nature of these risks in, among other things, the context of recent regulatory developments, pressures on public expenditure and changes in the ways in which some Housing Associations finance their activities.'

Guidance for auditors was previously issued in 2006 and withdrawn in 2012 pending this revision. The updated guidance is given in Practice Note 14: *The audit of housing associations in the United Kingdom*.

EFRAG and the National Standard Setters of the UK, France, Germany and Italy publish a Bulletin on complexity

10 February 2014

EFRAG and the National Standard Setters of the United Kingdom, France, Germany and Italy have published a Bulletin on complexity to promote discussion on this issue, and to help form European views that are influential in the debate on the IFRS Conceptual Framework.

Many recent reports have expressed concern that financial statements have become too complex, to the detriment of users' understanding. These reports acknowledge that some of this complexity arises because transactions are becoming increasingly complex. However, they also note other possible causes, including the degree of complexity in IFRSs.

Despite this common concern about complexity in financial statements and the criticism of IFRS as being too complex, neither the existing Conceptual Framework nor the IASB's discussion paper on the review of the Conceptual Framework include or propose much guidance on the issue.

The Bulletin reflects in detail on the causes of complexity in accounting and suggests that additional guidance in the Conceptual Framework could be of help to minimise complexity.

FRC proposes amendments to accounting for debt instruments

13 February 2014

The Financial Reporting Council (FRC) has issued proposals for consultation intended to reduce the need for businesses to measure debt instruments at fair value. The exposure draft, FRED 54 *Draft Amendments to FRS 102 – Basic financial instruments* proposes to amend the conditions that determine whether debt instruments can be measured at amortised cost or fair value under new UK and Irish GAAP (FRS 102).

Businesses of all sizes lend and borrow money. Depending on the terms and conditions of the debt instruments, new UK and Irish GAAP determines whether amortised cost or fair value is the appropriate method of measuring them.

Since the FRC issued new UK and Irish GAAP in March 2013 for mandatory implementation in 2015, businesses and their advisers have noted that the requirements setting out when a debt instrument can be measured at amortised cost may be overly restrictive. The FRC has therefore reconsidered the requirements to reduce the reporting burden and avoid unnecessary cost and effort for businesses.

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

'The issue addressed in this proposal was only highlighted after publication of new UK and Irish GAAP. It was important to act swiftly and we have drawn up a workable solution in a short space of time. We aim to finalise the new requirements by this summer in order to allow as much time as possible for implementation.'

The FRC invited comments on these proposals. The comment period was slightly shorter than three months and closed on 30 April 2014. The amendments are proposed to be effective from the same date as the new UK and Irish GAAP, 1 January 2015.

The FRC issued FRS 103, *Insurance Contracts* in March 2014 and taking into account the responses to the consultation on its hedging proposals (FRED 51), the FRC aims to finalise the new hedge accounting requirements before the summer.

In response to new EU legislation, the FRC will assess the impact of the newly agreed EU Accounting Directive, in particular for small companies and continues to consider the accounting requirements for micro-entities.

In respect of forthcoming changes to IFRS, the FRC does not intend to make amendments to new UK and Irish GAAP prior to 1 January 2015 concerning the impairment of financial assets.

New version of Statutory Money Purchase Illustration rules published

20 February 2014

Following consultation the Financial Reporting Council (FRC) has published a revised version of the standard that sets out how pension providers should treat statutory money purchase illustrations for members of pension schemes. The changes will enable providers to issue personalised statements that more closely reflect an individual pension holder's circumstances.

Since 6 April 2003 members of money purchase pension schemes have received annual statutory money purchase illustrations (SMPI) showing the amount of future pension in 'real terms' that might become payable to them under the scheme.

The revised Actuarial Standard Technical Memorandum 1 (AS TM1) sets out the methods and assumptions to be used in statutory money purchase illustrations and reflects changes introduced by new disclosure regulations allowing pension providers to present more personalised illustrations to scheme members in their annual statements from 6 April 2014.

The changes to AS TM1, enable providers to present illustrations which allow:

- 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.

Version 4.0 of AS TM1 is effective from 6 April 2014.

FRC issues new accounting standard for insurance contracts

20 March 2014

The FRC published new accounting and reporting requirements for entities with insurance contracts, set out in FRS 103, *Insurance Contracts*. The new requirements apply to companies that apply FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland* as the basis for their accounting and therefore FRS 103 adds to new UK and Irish GAAP.

Together, FRS 103, which was developed from relevant IFRS, and the accompanying non-mandatory Implementation Guidance (also issued on 20 March 2014), consolidate existing UK and Irish financial reporting requirements and guidance for insurance contracts. As a result, FRS 103 allows entities, generally, to continue with their current accounting practices for insurance contracts, but permits entities the same flexibility to make improvements (subject to legal and regulatory requirements) as entities in the UK and Republic of Ireland that apply IFRS. The suite of new UK and Irish accounting standards improves financial reporting for financial instruments, which will lead to some changes for insurers.

The FRC expects FRS 103 to provide an interim solution whilst the IASB completes its project to revise accounting for insurance contracts. The FRC, therefore, expects to review FRS 103 and consult on any proposed changes after the IASB has completed its project, although the exact timing of this review has yet to be determined.

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

'We are issuing FRS 103 to fill a gap in UK and Irish accounting standards for those entities applying FRS 102 that have insurance contracts. We recognise that there are forthcoming changes to the regulatory framework for insurers, as well as on-going work internationally on financial reporting for insurance contracts, and as a result we are allowing entities, generally, to continue with their existing accounting policies for the time being. We expect to revisit this topic in a few years' time, to consider whether changes to FRS 103 are desirable in response to regulatory or international accounting developments.'