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FRS 102: FINANCIAL INSTRUMENTS ISSUES (LECTURE A477 – 11.56 MINUTES)

Financial instruments have become a complex issue over the years – due in large part to the way in which business has evolved and the increasingly complicated nature that financial instruments can take.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with the issue of financial instruments in two sections: Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*. Together, they both deal with the recognition, derecognition, measurement and disclosure of an entity's financial instruments (both financial assets and financial liabilities). This course will look primarily at Section 12 which applies to more complex financial instruments and transactions. However, if a client only has *basic* financial instruments (for example, cash, trade debtors, trade creditors and bank loans) then Section 12 will more than likely not apply to them. However, many companies tend to have more complicated financial instruments (such as derivatives) which will need to be accounted for under the provisions in Section 12.

The scope section of Section 12 does acknowledge that even if a company only has *basic* financial instruments, it must consider the requirements in Section 12 to ensure that they are exempt from its scope.

The scope of section 12

The scope of Section 12 does NOT cover the following:

1. Financial instruments which are covered by Section 11.
2. Investments in subsidiaries (dealt with in Section 9 *Consolidated and Separate Financial Statements)*, investments in associates (dealt with in Section 14 *Investments in Associates*) and joint ventures (dealt with in Section 15 *Investments in Joint Ventures*).
3. Employers' rights and obligations under employee benefit plans (dealt with in Section 28 *Employee Benefits*).
4. Insurance contracts (including reinsurance contracts) that the entity issues and reinsurance contracts that the entity holds (dealt with in FRS 103 *Insurance Contracts*).
5. Financial instruments that meet the definition of an entity's own equity and the equity component of compound financial instruments issued by the reporting entity that contain both a liability and an equity component (dealt with in Section 22 *Liabilities and Equity*).
6. Leases, unless the lease could (as a result of non-typical contractual terms), result in a loss to the lessor or the lessee (otherwise they are dealt with in Section 20 *Leases*).
7. Contracts for contingent consideration in a business combination (dealt with in Section 19 *Business Combinations and Goodwill*). Although this exemption only applies to the acquirer.

8. Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree which will result in a business combination at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.
9. Financial instruments, contracts and obligations to which Section 26 *Share-based Payment* applies, except for contracts within the scope of paragraph 12.5.
10. Financial instruments issued by an entity with discretionary participation features (see FRS 103 *Insurance Contracts*).
11. Reimbursement assets accounted for in accordance with Section 21 *Provisions and Contingencies*.
12. Financial guarantee contracts (see Section 21).

Entities which have financial instruments in 4 or 10 above or hold the financial instruments in 4 above should apply FRS 103 to those insurance contracts.

The vast majority of contracts to purchase or sell a non-financial item such as a commodity, inventory or property, plant and equipment are excluded from the scope of Section 12 as they are not financial instruments. However, Section 12 does apply to all contracts to buy or sell non-financial items and hence would apply to contracts that (due to contractual terms) could result in a loss to the buyer or seller which is unrelated to changes in the price of the non-financial item, changes in foreign exchange rates, or a default by one of the counterparties.

In addition to the above, Section 12 applies to contracts to buy or sell non-financial items if the contract can be settled net in cash or another financial instrument, or by exchanging financial instruments as if the contracts were financial instruments, with the exception of contracts which were entered into, and continue to be held, for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Section 12 itself is a relatively short section (spanning to just over six pages long) – however the issues which are dealt with in this short section are complicated and in many places lacks guidance. As a result of this lack of guidance, it is important that preparers of financial statements read it in conjunction with Section 11 (as the two essentially go hand-in-hand) and the relevant parts of Companies Act 2006.

Section 11 and Section 12 are closely related and whilst Section 12 only deals with financial instruments which are NOT basic, Section 11 gives examples of financial instruments which it considers to be within the scope of Section 12 – i.e. complex financial instruments and include:

- Asset-backed securities, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables;
- Options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument;

- Financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in Section 12; and
- Commitments to make a loan to another entity and commitments to receive a loan, if the commitment can be settled net in cash.

In addition, paragraph 11.11 also requires the following to be accounted for in accordance with Section 12:

- An investment in another entity's equity instruments other than non-convertible preference shares and non-puttable ordinary and preference shares;
- An interest rate swap that returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow, because such swaps do not meet the condition in paragraph 11.9(a);
- Options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 11.9(a) is not met; and
- Investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates.

Accounting policy choice

For financial instruments which fall under the scope of Section 12 an entity can choose to apply one of the following accounting policies:

1. The provisions of both Section 11 and Section 12 in full; or
2. The recognition and measurement provisions of EU-endorsed IAS 39 Financial Instruments: Recognition and Measurement and the disclosure requirements of Section 11 and 12; or
3. The recognition and measurement provisions of IFRS 9 Financial Instruments and/or IAS 39 (as amended following the publication of IFRS 9) and the disclosure requirements of Sections 11 and 12.

When the entity chooses 2 or 3, it applies the scope of the relevant standard to its financial instruments. The choice of 1, 2 or 3 above is an entity's accounting policy choice and hence the provisions in Section 10 *Accounting Policies, Estimates and Errors* is relevant in this respect – notably paragraphs 10.8 to 10.14 which contain requirements for determining when a change in accounting policy is appropriate, how such a change should be dealt with in the financial statements and what information the entity should disclose in its financial statements relating to the change in accounting policy.

An important point to emphasise is that whatever choice the entity makes, that accounting policy choice must be applied to *all* of the entity's financial instruments. IAS 39 is, in itself, a hugely complicated standard (notwithstanding its eventual transition to IFRS 9 which is intended to be a simpler standard to work with) and in the rare circumstance that an entity is contemplating making the IAS 39 choice, it must undertake a thorough a comprehensive review of its financial instruments before committing to the choice – in other words, the IAS 39 option is not one that should be taken lightly!

Example – complexity of adopting IAS 39

An entity has a mixture of basic and complex financial instruments and is considering the best accounting policy choice for the measurement of its financial instruments. The finance director understands that one of the options is to apply the provisions in EU-endorsed IAS 39.

If the entity were to choose the IAS 39 option, then it would have to account for **all** its financial instruments (both basic and complex) using this option. Taking this example one step further, if the entity has (for example) some publicly traded fixed asset equity investments where the fair value can be measured reliably (by reference to the stock market), then changes in this fair value under IAS 39 would be recognised in other comprehensive income because the investment would fall to be classified as 'available for sale'. If the entity were to opt for the accounting policy choice in paragraph 12.2(a) of FRS 102 and apply the provisions in Section 11 and Section 12, then the fair value changes in the investment would be taken through profit or loss.

The example above illustrates the importance of an entity applying care in its accounting policy selection for financial instruments and to make sure the policy they select is appropriate and relevant to the entity's circumstances.

Recognition and measurement issues

Only when the entity becomes a party to the contractual provisions of a financial instrument can it recognise a financial asset or a financial liability.

When the entity becomes a party to a financial instrument contract, it is recognised as either a financial asset or a financial liability at its fair value. Fair value will be the transaction price which would also include transaction costs. The Glossary to FRS 102 defines 'transaction costs' as:

'Incremental costs that are directly attributable to the acquisition, issue or disposal of a ***financial asset*** *or* ***financial liability****, or the issue or reacquisition of an entity's* ***own equity instrument****. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial asset or financial liability, or had not issued or reacquired its own equity instrument.'*

Example – deferred transaction cost

Entity A becomes a party to a financial instrument (a financial asset) with Entity B. The terms of the contract allow for a maturity date in three years' time, which is considered to be beyond normal business terms for an instrument of this nature.

If payment for an asset is deferred beyond normal business terms, Entity A must measure the asset at the present value of future payments. These are discounted at a market rate of interest for a similar debt instrument.

Example – transaction cost excluded

A financial instrument qualifies as being measured at fair value as the instrument is publicly traded and subsequent changes in this fair value are taken through profit or loss.

Paragraph 12.7 of FRS 102 says that on initial recognition, a financial instrument should be measured at its fair value inclusive of transaction costs. However, where financial instruments are carried at fair value through profit or loss, transaction costs should be excluded and charged as an expense in profit or loss.

Subsequent measurement

After initial recognition, all financial instruments which fall under the scope of Section 12 are measured at fair value through profit or loss. There are, however, two exceptions to this rule:

- Equity instruments which are not publicly traded and where fair value cannot otherwise be reliably measured as well as contracts which are linked to such instruments which, if exercised, will result in delivery of such instruments. These types of instruments are to be measured at cost less impairment.

- Hedging instruments (for example forward foreign currency contracts and interest rate swaps) which are in a designated hedging relationship where hedge accounting is adopted.

Example – fair value no longer available

A financial instrument was publicly traded until half-way through the financial year. At the year-end, the entity was unable to obtain a reliable measure of fair value as no active market existed at the year-end.

In this example, where a reliable measure of fair value is no longer available, its fair value at the last date the instrument was reliably measurable is treated as the cost of the instrument. The entity should, therefore, measure the instrument at this cost less impairment until a reliable measure of fair value becomes available (if at all).

In the example above, the fair value of the financial instrument was not available at the year-end and so was measured at its last reliable fair value. This can also apply to an instrument (or a contract linked to such an instrument) which is not publicly traded.

Determining fair value

In the determination of fair value, an entity must apply the guidance on fair values contained in paragraphs 11.27 to 11.32 in accordance with Section 12.

Paragraph 11.27 to FRS 102 says:

'... In applying the fair value guidance to assets or liabilities accounted for in accordance with those sections, [as in paragraphs 11.27 to 11.32 of Section 11 and Sections 9, 13, 14, 15, 16, 17, 18, 27, 28 and 34] *the reference to ordinary shares or preference shares in these paragraphs should be read to include the types of assets and liabilities addressed in those sections.'*

Section 11 contains a fair value 'hierarchy' which is based on the fair value hierarchy in IFRS (which uses 'Levels' – i.e. Level 1, Level 2 and Level 3). The same sort of approach is adopted in FRS 102, but FRS 102 does not refer to them as 'Levels'.

An entity is required to use the following hierarchy to determine fair value:

- The best evidence of fair values is a quoted price for identical assets in an active market. In this case, the quoted price is usually the bid price.
- When quoted prices are not available, the price of a recent transaction for an identical asset can provide evidence of fair value, provided that there has not been a significant change in the economic circumstances or a significant lapse of time since the transaction took place. In certain circumstances, that price may need to be adjusted.
- When there is no active market and recent transactions of an identical asset on their own are not a good estimation of fair value, the entity must estimate the fair value by way of a valuation technique.

Valuation techniques in the absence of an active market

The third bullet above requires an entity to determine value by way of an estimation technique in the absence of an active market and where recent transactions of an identical asset on their own are not a good estimate of fair value. The objective of a valuation technique is to estimate what the transaction price would have been at the date of measurement in an arm's-length transaction between knowledgeable and willing persons.

The transaction price which the valuation technique will arrive at must be a reasonable estimate of the instrument's fair value at the measurement date and it follows, therefore, that the valuation process must reflect how the market could be expected to price the instrument. To achieve this objective, the valuation process must use, as far as is practicable, market inputs and rely less on entity-specific inputs.

In the broadest terms, the valuation process must consider all factors which market participants would consider in arriving at a price and be consistent with accepted methodologies for pricing financial instruments.

In reality, the valuation process is complex and the starting point for any valuation process is to consider the data that the entity itself has available which may help the process. This data can be adjusted if it indicates that other market participants might use different data. In this respect, the entity does not have to go into huge amounts depth to gather information regarding market participants' assumptions, but conversely the entity cannot ignore their assumptions when it is reasonably available.

Examples of valuation techniques include:

- Price/earnings models;
- Discounted cash flows; and
- Option pricing models.

In cases where there is a common valuation technique used by market participants to price the asset, and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, then the entity should adopt the use of that technique.

Credit risk

In arriving at a fair value using a valuation technique, the entity would usually incorporate their own credit risk and hence the value should include the impact of own credit risk to the extent that credit risk affects the price for which the liability could be exchanged in an arm's-length transaction.

Where derivatives are concerned, the entity will need to incorporate their own credit risk when the derivative instrument is in a liability position at the balance sheet date. In the vast majority of cases, the only way in which an entity would be able to settle a derivative liability at the balance sheet date would be through paying the counterparty a 'close-out amount' that does not incorporate changes in the entity's credit risk since the inception of the contract (i.e. the entity often has no practical ability to realise gains by settling liabilities at a lower amount due to deterioration in its own credit risk).

The impact of FRS 102 on financial instruments

FRS 102 classifies financial instruments into two portions – 'basic' and 'other'. The 'other' category will include instruments such as foreign exchange forward contracts and loans with complicated terms as well as derivative financial instruments. Under current UK GAAP many of these instruments are not recognised on the balance sheet but are merely disclosed. Under FRS 102, these will have to be brought onto the entity's balance sheet and measured at fair value with changes in fair value going through profit or loss and hence the balance sheet position and reported profits (or losses) of entities that are not applying FRS 26 *Financial Instruments: Recognition and Measurement* will change.

In respect of derivative financial instruments, assuming FRS 26 is not adopted, derivatives are accounted for on settlement but under FRS 102 they will be recognised earlier and so where entities have such instruments that will fall to be classed under Section 12, this could be a significant issue! In some cases, an entity might not be aware that they are carrying financial instruments in the form of interest-rate swaps, options, foreign exchange contracts or hedges which the banks may have included into their loan agreements. In a majority of cases this is likely not to apply to companies, but loan agreements should be carefully scrutinised to check if they involve any derivative or financial instruments because this will complicate matters further and also involve the use of Section 12.

Derivative financial instruments

The Glossary to FRS 102 defines a 'derivative' as:

'A financial instrument or other contract with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract;

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.'

Examples of financial instruments, together with the underlying variable are:

Type of contract	Underlying variable
Interest rate swap	Interest rates
Foreign exchange swap	Currency rates
Commodity swap	Commodity prices
Share swap	Share prices
Credit swap	Credit rating or credit price
Treasury bond option (call or put)	Interest rates
Currency option (call or put)	Currency rates
Commodity option (call or put)	Commodity prices
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Currency forward	Currency rates

Example – derivative financial instrument

Company A enters into a contract which requires it to pay Company B £20,000 if the share price of Company C rises by £5 per share or more during a six-month period. Conversely, Company A will receive £20,000 if the share price of Company C declines by £5 per share during that same six-month period. If price changes are within the ± £5 range, no payments will be made or received by either party.

This arrangement would qualify as a derivative instrument – the underlying variable being the share price of Company C.

Example – accounting for a derivative financial instrument (call option)

Company A purchases a call option on 2 January 2016 when the shares in Company B are trading at £100 per share. The contract gives Company A the option to purchase 1,000 shares in Company B at an option price of £100 per share and the option expires on 30 April 2016. The call option is purchased by Company A for a sum of £400.

On acquisition of the call option, Company A will record the transaction as:

DR call option £400

CR cash £400

This payment is generally known as the 'option premium' and is usually much less than the cost of purchasing the shares directly. The option premium consists of the 'intrinsic value' and the 'time value'. The 'intrinsic value' is the difference between the market price and the strike price at any point in time. It represents the amount realised by the holder of the call option if exercising the option immediately. When Company A purchases the option the intrinsic value is zero because the market price equals the strike price.

The 'time value' refers to the option's value over and above its intrinsic value. Time value reflects the possibility that the option has a fair value greater than zero. This is because there is some expectation that the price of B's shares will increase above the strike price during the term of the option and therefore the time value for the option is £400 as there is no intrinsic value.

On 31 March 2016, the price of B's shares increases to £120 per share. The intrinsic value of the call option is now £20,000. This is because Company A can exercise the call option and purchase 1,000 shares from Company B for £100 per share and it can then subsequently sell those shares in the market for £120 per share. This results in a gain for Company A of £20,000 (£120,000 - £100,000) on the option contract. The increase in the intrinsic value is as follows:

DR call option £20,000

CR profit and loss £20,000

A market appraisal indicates that the time value of the option as at 31 March 2016 is £100. Company A records this change in value of the option as follows:

DR profit and loss £300

CR call option £300 (£400 less £100)

The settlement of the call option contract is recorded as follows:

DR cash £20,000

DR loss on settlement of call option £100

CR call option £20,100

Example – forward foreign currency contract

A company based in the UK is planning on purchasing a machine from a supplier based in Spain at a cost of €500. Delivery is planned for 31 March 2016 with subsequent payment by 31 May 2016. On 30 November 2015, the company entered into a forward contract for purchase of €500 on 31 May 2016 at a rate of €1.5 to £1. The company is preparing financial statements for the year-ended 31 December 2015.

On the basis that the company does not opt for hedge accounting, the derivative asset/liability will be accounted for at fair value through profit or loss (assumed figures are used below for spot rates of exchange and fair values of the forward contract).

The bank has provided fair values for the derivative contract as follows:

At 31 December 2015 £3

At 31 May 2016 £37

Date	Narrative	DR	CR
30.11.15	Derivative	0	
	Cash		0
	Historical cost of derivative (assumed nil)		
31.12.15	Derivative	3	
	Profit and Loss account		3
	Increase in fair value of derivative		
31.03.16	Property, plant and equipment	350	
	Trade creditors		350
	Cost price of new machine at spot rate of 1.43 (€500/1.43)		
31.05.16	Trade creditors	350	
	Profit and loss account	20	
	Cash		370
	Payment to supplier at spot rate of 1.35 (€500/1.35)		
31.05.16	Derivative	34	

		DR	CR
	Profit and loss account		34
	*Increase in fair value of derivative between 01.01.16 and 31.05.16**		
		DR	**CR**
31.05.16	Cash	37	
	Derivative		37
	*Net settlement under forward contract***		

* = Fair value to date of derivative = £37 (£3 + £34)
** = Difference between €500 at spot rate of 1.35 and contract rate of 1.5

Example – directors' personal guarantees

The directors of Company A have entered into personal guarantees with the company's bank for the company's liabilities which require the directors to pay the bank an amount of £50,000 each if the company is to cease trading whilst its loan are in subsistence.

The question arises as to whether these personal guarantees for the company's borrowings given by the directors would be viewed as a financial instrument valued at fair value?

The personal guarantee would not be a financial instrument from the company's perspective because the guarantee is between the directors and the bank, but the personal guarantees would clearly be a disclosable transaction under the provisions in Section 33 *Related Party Disclosures*.

Derecognition of financial instruments

Derecognition of financial instruments is dealt with in Section 11 and is split between the derecognition of a financial asset and the derecognition of a financial liability.

Derecognition of a financial asset

An entity can only derecognise a financial asset when:

- The contractual rights to the cash flows from the financial asset expire or are settled; or
- The entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset; or
- The entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. In this case, the entity shall:
    - Derecognise the asset; and
    - Recognise separately any rights and obligations retained or created in the transfer.

One of the most common types of financial assets that could be impacted by the above is debt factoring.

Example – derecognition of debtors

A company sells its trade debtors to an invoice factoring company at less than their fair value in order to free up cash flow. The company continues to manage the debtors (i.e. receive monies from them and process those monies and send out monthly customer statements) for which it receives a market rate fee from the factoring company for this service. When the company receives monies from its customers, it is required to immediately remit them to the factoring company; however, it has no obligation to the factoring company for any bad debts (or slow-payers).

In this case, bullet point two above will apply because the company has transferred substantially all of the risks and rewards of the debtors on to the factoring company. The company will derecognise the trade debtors from its balance sheet but does not recognise any liability in respect of the proceeds from the invoice factoring company. Instead, the company will recognise a loss (as it has sold them to the factoring company at less than par value) which is calculated as the difference between the proceeds received from the bank and the carrying amount of the debtors.

If, however, at the balance sheet date the company has collected funds from its customers which it has not remitted to the invoice factoring company, a liability will be recognised representing the value of unremitted monies due to the factoring company at the balance sheet date.

The example above highlights the derecognition of a financial asset when substantially all of the risks and rewards have been passed on to a third party. However, if the company in the example above had an obligation to buy back any debtors that were slow-payers, the company would retain the risk of slow-payment (or even a bad debt) which is a significant risk where debtors are concerned. In this scenario, the company would NOT derecognise the trade debtors, but would treat the proceeds received from the invoice factoring company as a loan which is secured by the debtors and continue to recognise trade debtors as an asset until such time that they pay (or the debt is written off).

Derecognition of a financial liability

An entity must only derecognise a financial liability when the obligation within the liability has been discharged, cancelled or expired. A typical example would be a bank loan which is paid off in full before redemption.

Example – change of terms and conditions

A company has renegotiated its borrowings with the bank in order to reduce its interest charges. The original terms and conditions of the loans have been revised significantly.

When the terms and conditions with an existing borrower are changed substantially, both the bank (or financier) and the company must account for the transaction as an extinguishment of the original loan and the recognition of a new financial asset/liability. Any difference between the carrying amount of the original loan and the consideration paid is recognised in profit or loss.

EVENTS AFTER THE END OF THE PERIOD (LECTURE A478 – 14.32 MINUTES)

Events after the reporting period (or 'post balance sheet events' as many accountants are familiar with) are carried over into FRS 102 in Section 32 *Events after the end of the Reporting Period*. Such events can have a significant impact on a company's financial statements because of the need to reflect certain transactions which take place after the year-end but occur after the year-end in the financial statements and for other material issues which did not exist at the year-end to make additional disclosures within the notes.

Section 33 refers to two types of event under its scope:

- Adjusting events; and
- Non-adjusting events

Adjusting events

An adjusting event is one which is reflected within the financial statements and is an event where the conditions existed at the year-/period-end but which crystallises after the year-/period-end. The key to identifying whether the event is adjusting is to ensure that it is clear that the conditions giving rise to the event existed at the balance sheet date. Some examples of adjusting events are:

- The settlement of a court case after the balance sheet date which confirms that an asset had a liability at the balance sheet date.
- Receipt of information after the balance sheet date which confirms that an asset has suffered impairment.
- The classic scenario of the bankruptcy of a customer after the balance sheet date which confirms the trade debtor is irrecoverable (i.e. impaired).
- Sale of stock after the balance sheet date which may give evidence relating to their estimated selling price less costs to complete and sell.
- The cost of assets purchased after the balance sheet date, or proceeds received from the sale of assets sold prior to the balance sheet date.
- Determination of profit-sharing bonus payments made after the balance sheet date.
- Discovery of fraud/error.

If the conditions relating to the above existed at the balance sheet date, they would be reflected within the financial statements.

Example – bonus payments

Company A has always paid bonuses to its two directors based on 5% of profit before tax. The draft management accounts as at 31 March 2016 include a gross bonus, plus employer's NIC amounting to £11,500 each following the resolution to pay a bonus based on the draft figures on 20 March 2016. This bonus is not paid until such time that the financial statements are approved because of various adjustments that are often incorporated into the finalised financial statements. The financial statements are approved four months after the year-end and because of a large stock write-down, the profits have reduced to such an extent that the gross bonus, plus the employer's NIC should only be £4,500 each.

This is an example of an adjusting event because the decision to pay the bonuses was made prior to the year-end and therefore bonuses will need to be reduced.

Non-adjusting events

By their definition, non-adjusting events are not adjusted for in the financial statements. This is because their conditions did not exist at the balance sheet date. Instead, additional disclosures may be required in the financial statements. Some practitioners have fallen foul to non-compliance with standards regarding post-balance sheet events in the belief that if an event occurs after the year-end, then that is all there is to it and to deal with the issue in the subsequent accounting period. Section 32 (and its previous FRS 21 *Events after the Balance Sheet Date*) requires disclosure of a non-adjusting event if non-disclosure would influence the decisions that users make on the basis of the financial statements.

Section 32 offers some (non-exhaustive) examples of non-adjusting events at paragraph 32.7 and 32.11 as follows:

- A decline in the market value of investments between the end of the reporting period and the date when the financial statements are authorised for issue. The decline in market value does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments. Similarly, the entity does not update the amounts disclosed for the investments as at the end of the reporting period, although it may need to give additional disclosure in accordance with paragraph 32.10.
- An amount that becomes receivable as a result of a favourable judgement or settlement of a court case after the reporting date but before the financial statements are authorised for issue. This would be a contingent asset at the reporting date and disclosure may be required by paragraph 21.16. However, agreement on the amount of damages for a judgement that was reached before the reporting date, but was not previously recognised because the amount could not be measured reliably, may constitute an adjusting event.
- A major business combination or disposal of a major subsidiary.
- Announcement of a plan to discontinue an operation.

- Major purchases of assets, disposals or plans to dispose of assets, or expropriation of major assets by government;
- The destruction of a major production plant by a fire;
- Announcement, or commencement of the implementation, of a major restructuring;
- Issues or repurchases of an entity's debt or equity instruments;
- Abnormally large changes in asset prices or foreign exchange rates;
- Changes in tax rates or tax laws enacted or announced that have a significant effect on current and deferred tax assets and liabilities;
- Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and
- Commencement of major litigation arising solely out of events that occurred after the end of the reporting period.

Example – discontinuing a division

Company A Ltd is a supermarket which operates four different classes of business division: groceries, mobile telephone providers, internet service providers and domestic appliances. Each division is considered material to the financial statements of the company. The financial year-end is 31 August 2016 and the financial statements have not yet been approved. On 30 September 2016, the company directors decided that because of extremely difficult trading conditions, and a heavy loss, it would discontinue the domestic appliances division. This announcement was made on 1 October 2016.

This is a non-adjusting event because the decision to discontinue the division took place after the balance sheet date. However, because the division is considered to be material to the financial statements, it would need to make disclosure concerning the closure of the appliances division.

Example – share issue after year-end

Company B Limited has a year-end of 31 July 2016. On 4 August 2016, it issues a further 1,000 shares in an attempt to raise finance as the company has recently been experiencing cash flow difficulties and the bank have requested shareholders make further investment to demonstrate their commitment to the company before the bank will agree to further lending.

Section 32.11 recognises issues or repurchases of an entity's debt or equity instruments as a non-adjusting event and therefore this transaction should be disclosed as such within the financial statements.

Going concern

The issue of going concern is a material one in all companies – large and small. When preparing financial statements, the company usually does so on the going concern basis. However, a company will not be able to use the going concern basis of preparing the financial statements if management determines *after* the reporting date that it either intends to cease trading or liquidate the business, or has no realistic alternative but to cease trade or liquidate.

In situations when the directors feel that the financial statements should not be prepared on the going concern basis, the effect is so pervasive that there has to be a change in the basis of preparation (i.e. a basis other than the going concern basis). This alternative basis should not merely be an adjustment to the amounts recognised in the financial statements, but should be a complete change to the basis of accounting. The 'break up' basis is not explicitly mentioned in Section 32, but would be regarded as an appropriate basis when the going concern presumption is not used.

In addition to the change of basis of preparing the financial statements, management must ensure that it discloses the uncertainties about the entity being able to continue as a going concern together with the basis on which the financial statements have been prepared, the fact that they have not been prepared on the going concern basis and the reason why the entity is not regarded as a going concern.

Example – going concern basis not appropriate

Company A Ltd is preparing financial statements to 31 December 2015. On 4 February 2016, following negotiations, the bank have 'called in' the overdraft of £500,000 immediately to the company's ongoing trading difficulties. This has had a catastrophic effect on the company as they have failed to secure borrowing facilities with other financiers and the directors have decided that they have no realistic alternative but to cease trading with immediate effect and liquidate the company.

The going concern basis is not appropriate in this company's circumstances, and therefore the directors may make disclosures as follows **(please note the following disclosures are illustrative disclosures only and may not be appropriate in every situation)**.

In the directors' report:

Statement of directors' responsibilities

The last bullet point regarding the responsibility of the directors to prepare the financial statements on a going concern basis should be amended to make it clear that, despite their responsibilities still remaining the same, the going concern basis is no longer appropriate. Such a disclosure may be as follows:

As explained in Note X to the financial statements, the directors do not consider the going concern basis to be appropriate and these financial statements have therefore not been prepared on that basis.

Basis of preparation of the financial statements

The basis of preparation paragraph should explain the reasons why the going concern basis is no longer appropriate in the circumstances and the effect of this approach. Such a disclosure could be as follows:

The company has failed to reach agreement with its bankers concerning the renewal of the company's borrowing facilities. The company has ceased trading with immediate effect and therefore the financial statements have been prepared under the 'break-up' basis. Fixed assets have been restated to recoverable amount on the grounds that the company is no longer trading and are available for sale in their current condition and current assets have been stated at recoverable amounts. Creditors falling due after more than one year have been reclassified as current liabilities.

Event after the reporting period

This would be relevant in this scenario because the event causing the going concern presumption to be departed from occurred after the year-end. A disclosure example is as follows:

As disclosed in the accounting policies note at Note X, the company ceased to trade on 4 February 2016 on the grounds that the directors have been unable to source additional finance to enable the business to continue as a going concern. The going concern basis is not appropriate and the directors have therefore not prepared the financial statements on that basis.

Dividends

Dividends which are proposed after the balance sheet date cannot be recognised in the financial statements at the balance sheet date. This requirement also applies where the financial statements have not yet been authorised for issue. This is because at the balance sheet date, no obligation existed. However, the dividends proposed would be disclosed within the financial statements and could be shown as a separate component of retained earnings at the end of the reporting period.

Date of authorisation of the financial statements

Under Section 32, the entity must disclose the date on which the financial statements were authorised for issue and who gave that authorisation. This disclosure is usually generated automatically by the accounts production software system and may look something as follows:

The financial statements were approved by the Board of Directors on [insert date of approval] and were signed by:

....	....
J Smith – Director	*B Jones – Director*

If the business owners have the power to amend the financial statements after they have been issued, there must be disclosure also within the financial statements to that effect.

Disclosure requirements – non-adjusting events

As non-adjusting events require disclosure within the financial statements, an entity must disclose the following for each category of non-adjusting event(s) after the end of the reporting period:

(a) The nature of the event; and

(b) An estimate of its financial effect or a statement that such an estimate cannot be made.

RELATED PARTIES (LECTUTRE A479 – 13.51 MINUTES)

Related parties are dealt with in FRS 102 at Section 33 *Related Party Disclosures*. This particular section is concerned with the disclosures considered necessary in order to draw attention to the possibility that an entity's financial position and profit or loss have been affected by the existence of related parties and transactions between those related parties.

Definition of a related party

The definition of a related party is quite wide as it aims to be a 'catch all' for transactions with parties that are related. A related party is a person or entity that is related to the entity that is preparing its financial statements (the reporting entity).

(a) A person or a close member of that person's family is related to a reporting entity if that person:

- (i) has control or joint control over the reporting entity;
- (ii) has significant influence over the reporting entity; or
- (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions apply:

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

An important concept in Section 33 is that an entity must consider the *substance* of the relationship and not merely the legal form. This means that the entity considers the commercial reality that two or more parties are related.

Paragraph 33.4 to FRS 102 identifies situations when a related party relationship does NOT exist and hence the following are not considered to be related parties:

(a) Two entities simply because they have a director in common or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

(b) Two venturers simply because they share joint control over a joint venture.

(c) Any of the following simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process):

   (i) providers of finance;

   (ii) trade unions;

   (iii) public utilities; and

   (iv) government departments and agencies.

(d) A customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, merely by virtue of the resulting economic dependence.

There is a further disclosure exemption for certain transactions where a state has involvement with the reporting entity. The term 'state' refers to a national, regional or local government.

Example – intra-group trading

A parent wholly-owns two subsidiary companies (Sub A and Sub B). During the year to 31 October 2016, the parent purchases goods from both Sub A and Sub B. In addition, Sub A also receives services from the parent, for which a management charge is levied by the parent to Sub A. The financial controller is unsure whether such transactions need disclosure within the financial statements to 31 October 2016 under FRS 102.

Paragraph 33.1A says that disclosure of such intra-group trading need not be made provided that the subsidiary which is a party to the transaction is wholly-owned by a member of the group. Had the subsidiary not been wholly-owned, then disclosure of the relevant transactions would have been made within the financial statements.

Example – identification of a related party

Company A Limited is owned and controlled by Dave who is the sole director. Company A has the following transactions with the following parties:

1. Alicia who is Dave's domestic partner.
2. Alex – who is Alicia's brother. Alex lives with Dave and Alicia.
3. Jean – who is Alicia's daughter from a previous relationship. Jean lives in Buenos Aires and has never met Dave.
4. B Limited – a company owned and controlled by Dave.
5. C Limited – a company in which Dave is one of five directors but not a shareholder.
6. D Limited – a company owned and controlled by Alicia.

Which of the above are related parties of A Limited?

- Alicia is a member of Dave's close family and would be a related party.
- Alex is not a related party except in the circumstances where Alex is a dependant of Alicia or Dave.
- Jean is a close member of Dave's family and whilst she lives in Buenos Aires, she would be considered to be a related party under Section 33.
- B Limited is a related party of A Limited as both companies are owned by Dave.
- C Limited is a related party of A Limited because Dave controls A Limited and is a member of the key management personnel of C Limited.
- D Limited is a related party of A Limited because it is controlled by a close member of Dave's family.

Examples of related party transactions

Section 33 offers a variety of transactions which would be disclosable as a transaction with a related party if they are entered into between a company and a related party:

- Purchases or sales of gods (finished or unfinished);
- Purchases or sales of property and other assets;
- Rendering or receiving of services;
- Leases;
- Transfers of research and development;
- Transfers under licence agreements;
- Transfers under finance arrangements (including loans and equity contributions in cash or in kind);
- Provisions of guarantees or collateral;
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party; and
- Participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities.

Example – dividends paid to director-shareholders

Company A Ltd is reporting under FRS 102 for the first year. During the year to 31 December 2015, it has paid dividends to directors in their capacity of shareholders. It is aware that under previous GAAP it had to declare dividends paid to director-shareholders in the full financial statements to satisfy the related party requirements, but has not disclosed dividends in the first FRS 102 financial statements in the belief that the FRS does not specifically refer to dividends.

Dividends paid to directors and related parties with significant influence continue to be disclosable despite the fact that they are not explicitly referred to in FRS 102.

Disclosure requirements under Section 33

As expected, Section 33 contains a significant level of disclosure requirements for related party transactions. A notable difference between Section 33 and its outgoing predecessor, FRS 8 is that paragraph 33.9 does not specifically require the name of the transacting related party to be disclosed.

Disclosure of parent-subsidiary relationships

Even if no transactions have taken place between a parent and its subsidiaries, the entity must disclose the name of its parent and, if different, the ultimate controlling party. Where neither the entity's parent nor the ultimate controlling party produces financial statements which are made available for public use, the name of the next most senior parent that does so (if any) should be disclosed.

Disclosure of key management personnel compensation

The definition of 'key management personnel' is now included in the Glossary to FRS 102. Where individuals fall under the scope of key management personnel, the entity must disclose compensation paid to them in totality.

Related party transactions

Where related party transactions have been entered into during the reporting period (regardless of whether a price has been charged or not), the nature of the related party relationship should be disclosed, together with information about:

- the transactions;
- outstanding balances; and
- commitments

necessary for an understanding of the potential effect of the relationship on the financial statements.

At a minimum, the disclosures must include:

(a) The amount of the transactions.

(b) The amount of outstanding balances and:

  (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and

  (ii) details of any guarantees given or received.

(c) Provisions for uncollectible receivables related to the amount of outstanding balances.

(d) The expense recognised during the period in respect of bad or doubtful debts due from related parties.

Paragraph 33.9 recognises that transactions could include:

- Purchases;
- Sales;
- Transfers of goods and/or services;
- Leases; and
- Guarantees and settlements

by the entity on behalf of the related party or vice versa.

Transactions with related parties disclosed above must be shown separately for each of the following categories:

(a) Entities with control, joint control or significant influence over the entity;

(b) Entities over which the entity has control, joint control or significant influence;

(c) Key management personnel of the entity or its parent (in the aggregate); and

(d) Other related parties.

In respect of related party transactions, a reporting entity should not state that the transactions were entered into on terms equivalent to those which prevail in arm's-length transactions unless such terms can be substantiated. In addition, an entity may also disclose items of a similar nature in the aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

THE NEW LLP SORP (LECTURE A480 – 7.11 MINUTES)

Background

The CCAB published the draft LLP SORP in October 2013, requesting responses by 10 January 2014 and on 15 July 2014, the finalised SORP was published.

The SORP has been updated in response to the introduction of new UK GAAP, FRS 101 *Reduced Disclosure Framework* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and the effective date of the SORP matches that of FRS 102, namely periods commencing on or after 1 January 2015.

Summary of proposed changes

References to withdrawn Standards and Abstracts has been changed to refer to new UK GAAP. The SORP has also been amended to use terminology that is consistent with FRS 102.

There are more substantive changes which are set out below under appropriate headings, categorising the changes by what has driven the need for them.

Changes resulting from new UK GAAP

FRS 102 has necessitated the following changes:

- Merger accounting is not permitted by FRS 102, except in group reconstructions. Previously UK GAAP permitted it more widely. The SORP has been redrafted to recognise this.

- The requirements in Section 11 *Basic Financial Instruments* and 12 *Other Financial Instruments Issues* of FRS 102, relating to financial liabilities are different from previous UK GAAP. The guidance on contractual or constructive obligations and annuities has been aligned with this. Also, the requirements of FRS 103 *Insurance Contracts* has also been incorporated. (see below for a more detailed analysis of this complex change)

- FRS 102 permits a single statement of comprehensive income and this has been incorporated into the SORP. See example extract on the next page.

Extract from draft LLP SORP

Single statement of comprehensive income:

EXHIBIT F - LLP Statement of Comprehensive Income (single statement (Profit and loss account Format 2)

LLP WITH SOME AUTOMATIC DIVISION OF PROFIT	**20X5 £'000**	**20X4 £'000**
Turnover	55,500	49,500
Other operating income	2,500	2,000
	58,000	51,500
Other external charges	(8,500)	(7,500)
Staff costs	(21,500)	(18,500)
Depreciation	(2,000)	(2,000)
Other operating expenses	(11,000)	(9,000)
Operating profit	15,000	14,500
Profit on sale of fixed assets	1,000	-
Interest receivable and similar income	1,000	1,000
Interest payable and similar charges	(500)	(750)
Profit for the financial year before members' remuneration and profit shares	16,500	14,750
Profit for the financial year before members' remuneration and profit shares	16,500	14,750
Members' remuneration charged as an expense	(3,000)	(2,500)
Profit for the financial year available for discretionary division among members	13,500	12,250
Revaluation of freehold property	2,500	1,000
Actuarial loss on defined benefit pension scheme	(3,000)	(1,500)
Total comprehensive income	**13,000**	**11,750**

Clarification of previous SORP existing requirements

The following clarifications have been made in the SORP:

- A reconciliation of members' interests is to be shown as a primary statement in place of the statement of changes in equity then comparatives must be shown for all figures presented.
- Improving the recommended format for the reconciliation of members' interests to meet Companies Act requirements.
- Providing more guidance on cash flow statement presentation.
- Refining the examples in Appendix 2 to focus on more commonly encountered scenarios and to eliminate some duplication.

Debt v equity

The debt v equity debate is a key issue for many LLPs. FRS 102 at Section 22 *Liabilities and Equity* does not fundamentally change the accounting when compared with that under FRS 25 *Financial Instruments: Presentation*, but some of the wording has been changed to reflect new UK GAAP and the flowchart has been removed. This is because what was once controversial is now the accepted 'norm'.

SORP and the FRSSE

There will be some issues arising from the fact the FRSSE 2015 will be available for small LLPs. Note that the future of the FRSSE is in question and that it is likely that this problem will, to some extent, go away if and when an *FRS 102 'Light'* approach is followed by the FRC. However, there is still some way to go where this issue is concerned.

In the meantime small LLPs may follow the FRSSE. The SORP rarely specifically mentions the FRSSE and the argument goes that if the FRSSE does not mention an accounting treatment, FRS 102 will tend to be used as a guide to best practice anyway. Where relevant, an LLP can take advantage of the disclosure exemptions in the FRSSE.

Contractual and constructive obligations and annuities

Paragraph 76 of the SORP states:

'*LLPs should analyse their contractual or constructive obligations (including any relating to early retirement options) to make payments to members in their capacity of members at and after the point of their ceasing to be members of the LLP, between:*

- *those that meet the definition of an insurance contract and, therefore, fall within the scope of FRS 103* Insurance Contracts*;*
- *those that give rise to financial liabilities falling within the scope of section 11* Basic Financial Instruments *of FRS 102;*
- *those that give rise to financial liabilities falling within the scope of section 12* Other Financial Instruments Issues*; and*
- *those that give rise to non-financial liabilities of uncertain timing and amount falling within the scope of section 21* Provisions and Contingencies *of FRS 102.'*

To say that this is a complex area somewhat understates the position! LLPs who pay 'pensions' to retired members should examine the SORP carefully to decide the appropriate accounting treatment, presentation and disclosure. Indeed the SORP gives lots of guidance in this area, even if it can be a little difficult to follow in places.

However, here are simple tips to avoid some obvious pitfalls:

- FRS 103 will apply where annuities carry a significant insurance risk, that is to say the LLP's liability varies with the longevity of the retiring member.

- Where a member's entitlement builds up during their period of service FRS 102 Section 21 will apply as benefits are conditional on future service.
- Where entitlement to benefits arise on certain agreed milestones such completing a period of service, Section 21 will apply. As the LLP will rarely have control over whether the member reaches the milestone the provision will tend to be accrued over the period of service rather than at the milestone.
- Where there is an absolute, unconditional financial liability, this will be treated as a financial instrument under Section 11 or 12 of FRS 102.

Disclosure of remuneration for Key Management Personnel (KMP)

This could be a controversial area. The SORP now reflects the FRS 102 requirement to disclose in aggregate KMP remuneration. Paragraph 130A of the SORP says that Section 33.7 of FRS 102 requires the disclosure of the total of compensation paid to key management personnel which may comprise elements of employee remuneration and profit attributable to members.

In smaller LLPs all members are virtually certain to be involved in management and this could lead to some heated debates about who is KMP in a larger LLPs.

The transition problem

LLPs adopting FRS 102 will have to follow the transitional provisions in the Standard. This means that opening balances will be adjusted at the transition date for changes in FRS 102 which will often lead to changes in opening equity.

There is a commercial issue which arises from this. Who bares the cost or enjoys the benefit of these adjustments? For example, if a firm has received a lease incentive, the recognition period for these will change under FRS 102.

A prior year adjustment could deal with the accounting issue, but what about the portion of the lease incentive already allocated and paid to members? There is unlikely to be a mechanism in place that deals with because partnership agreements rarely say what to do if there is a fundamental change to the UK accounting framework.

If you have already paid out most of a lease incentive and partners have retired and gone off with their profit share, what should be done? Those partners who have left will not want to give any profit back and most firms would not want to ask them to. So where does that leave the current partners?

FINAL CHARITY SORPS 2015 (LECTURE A481 – 13.48 MINUTES)

The Charities Commission and Office of the Scottish Charity Regulator announced on 22 May 2014 that they had approved the new Charities SORPs, although it took until the middle of July before they were finally published.

The most radical change that has been made, compared to the draft SORP, is that there will be two Charities SORPs

Why two SORPs?

There are undoubtedly some advantages to splitting out the requirements for small and not-small charities, but it is not this alone that has prompted the production of two SORPs.

The central issue is that that the future of small entity UK GAAP is in a state of flux, whilst the future of medium-sized and large entity UK GAAP is agreed and proceeding apace. Whilst SORP (FRS 102) has a future, SORP (FRSSE) does not and will almost certainly be a stop-gap accounting solution whilst the Financial Reporting Council (FRC) and the Department for Business, Innovation and Skills (BIS) reshape the future of small entity UK GAAP.

New EU accounting directives will force changes to UK law and accounting standards, as they are applied to small companies, and the FRC’s view that the FRSSE must be convergent with FRS 102 appears to be hardening.

In short, two SORPs will avoid disrupting charities which adopt FRS 102 when the FRSSE revolution happens. The most likely date for new small entity UK GAAP and a consequent amendment to the SORP (FRSSE) is for accounting periods commencing 1 January 2016, but this has not been finalised.

Overview - Charities SORP (FRS 102)

Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland (FRS 102) (effective 1 January 2015)

This SORP, as its name implies, is for charities applying FRS 102. Therefore, most small charities will not apply this SORP, but will use the Charities SORP (FRSSE) instead. If a charity is eligible, due to its size and status to use SORP (FRSSE), the trustees are at liberty to apply SORP (FRS 102), if they choose. They might make this choice if the charity is part of a larger FRS 102 adopting group, the charity is growing and will soon not be eligible for FRSSE or the trustees might simply think that FRS 102 is more appropriate for the particular charity.

Overview - Charities SORP (FRSSE)

Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard for Smaller Entities (the FRSSE) (effective 1 January 2015).

The bottom line is that if a charity adopts SORP (FRSSE), it has to be prepared for the fact that it might have to change accounting policies and the format of its accounts twice in two years!

It also seems likely that, following a period of consultation, FRC will publish a FRSSE replacement that will be much more like FRS 102. Is there an argument for small charities to ignore SORP (FRSSE) and adopt SORP (FRS 102) instead to avoid two consecutive accounting changes? Probably not, but a few might consider it.

Because FRSSE 2015 is largely old UK GAAP, SORP (FRSSE) is inevitably old UK GAAP. This means that it has significant differences when compared to SORP (FRS 102). Also, moving from SORP (2005) to SORP (FRSSE) will be more straightforward than adopting SORP (FRS 102).

SORP (FRSSE) compared to SORP (FRS 102)

The following is not intended to be an exhaustive list of the differences between the charity SORPs, but it should help trustees and their advisers make the choice, where available, between the two SORPs.

Area	**SORP (FRSSE)**	**SORP (FRS 102)**
Trustees report	• Identical requirements	• Identical requirements
SoFA	• Retains columnar presentation • Gains and losses on investment assets presented ***'below the line'*** • Includes 'exceptional' and 'extraordinary' items	• Retains columnar presentation • Gains and losses on investment assets presented '***above the line'*** • Additional presentation of ***'other gains and losses'*** • Includes 'material items'
Balance sheet	• Common format • Uses old UK GAAP terminology • Useful life of goodwill assumed to be five years unless it can be reliably	• Common format • Uses new UK GAAP terminology • Useful life of goodwill assumed to be five years unless it can be reliably

	estimated. Maximum useful life of goodwill presumed to be 20 years • Properties occupied by group undertakings are fixed assets • Offers an alternative approach to the FV of investments	estimated • Properties occupied by group undertakings are investment properties • Requires FV through P&L for investments • Requires more disclosure to do with intangible fixed assets, investments, stock and liabilities
Statement of cash flows	• Optional • Old UK GAAP format	• Mandatory (no small company exemptions) • New UK GAAP format – i.e. FRS 102
Accounting policies	• Uses old UK GAAP terminology • Permits use of 'legacy' accounting policies where appropriate (i.e. where FRSSE is silent, FRS 102 is not applied if there is already an existing accounting policy)	• Uses new UK GAAP terminology • Old accounting policies have to be revised in accordance with the principles of FRS 102
Donated goods and services	• Identical approach except for donated fixed assets	• Identical approach except for donated fixed assets
Disclosure of staff remuneration		• Additional disclosures • Notably total key management personnel remuneration disclosures
Financial assets and liabilities		• Additional disclosures • Different accounting for basic and other financial instruments

More information

For more information on the Charities SORPs:

www.charitysorp.org

The following are available:

- Charities SORP (FRSSE)
- Charities SORP (FRS 102)
- Help sheet 1: Mapping SORP 2005 into the Charities SORP (FRS 102)
- Help sheet 2: What are the major changes between SORP 2005 and the Charities SORP (FRS 102)?
- Help sheet 3: Differences between the SORP for the Financial Reporting Standard for Smaller Entities - FRSSE SORP and the SORP for the Financial Reporting Standard applicable in the UK and Republic of Ireland - FRS 102 SORP

AUDIT: THEMATIC REVIEW – FRAUD RISK AND LAWS AND REGULATIONS (LECTURE A 482 – 23.46 MINUTES/ LECTURE A483 – 12.12 MINUTES)

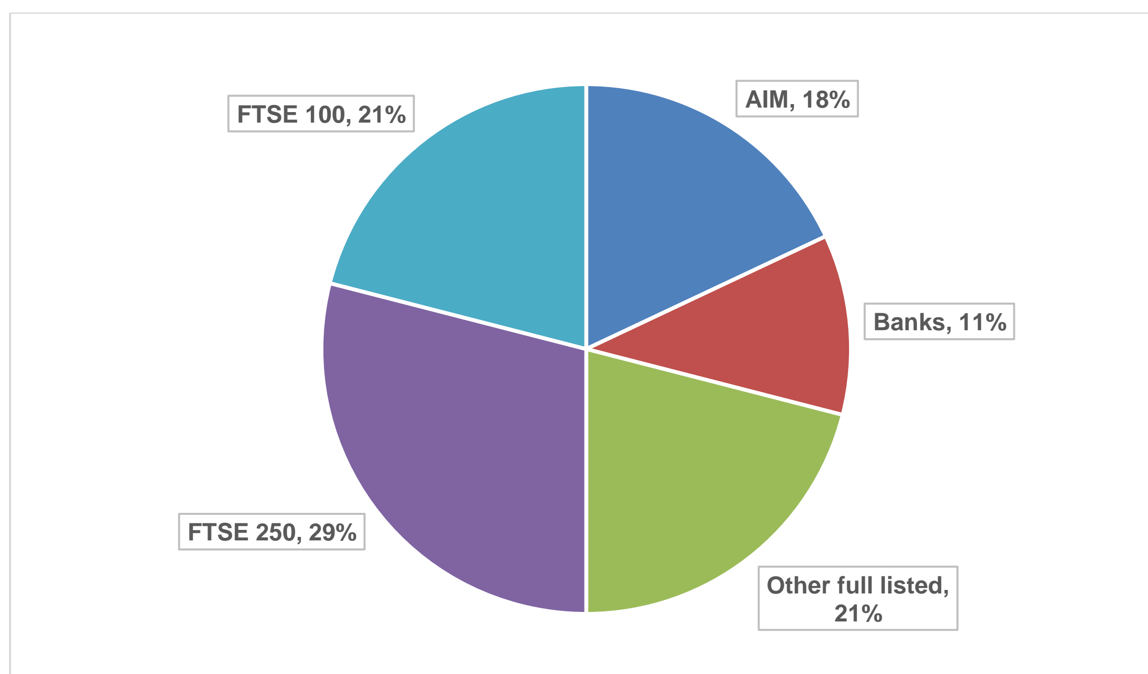
In January 2014, the Financial Reporting Council (FRC) issued a thematic review *Fraud risks and laws and regulations*. This was the second thematic review published by the FRC – the first being a thematic review on materiality, which was considered in the last Accounting and Audit Update.

A thematic review looks at a firm's policies and procedures in respect of a specific area of auditing and their application in practice. The reviews themselves are fairly narrow in their scope and the FRC have started to conduct them in recognition of the fact that their general findings have shown areas for improvement. The thematic reviews go into further detail in a specific area so as to make comparisons between firms with a view to identifying both good and weak practices.

The FRC visited six of the largest audit firms, being:

- BDO LLP
- Deloitte LLP
- E & Y LLP
- Grant Thornton UK LLP
- KPMG LLP
- KPMG Audit LLP

In their review, the FRC examined 26 entities in the retail, construction, support services, banking and mining industries and related to audits of financial statements for financial year-ends between December 2011 and September 2012. The review itself focused on the audit team's assessment of fraud risks and risks of non-compliance with laws and regulations and the planned audit procedures to address these risks. A summary of the entities covered by the audits reviewed as shown below:



The thematic review identified good practice observations as follows:

Fraud

- Requiring specific audit procedures to be performed for listed entities which also include the review of analysts' reports to identify fraud risk factors.
- The use of forensic specialists in fraud risk discussions and in running computer assisted audit techniques (CAATs) for the testing of journals.
- Employing the use of CAATs on all audits to test journal entries, with exceptions expected to be rare.
- Management override of internal control is considered to be a significant risk and good practice is where firm requires completion of a final conclusions document summarising the results of all audit procedures performed and reaching an overall conclusion.
- The requirement for all audit teams to review the results of audit work over accounting estimates in one place to assess if there are any indications of management bias.

Laws and regulations

- The use of a proforma document identifying the applicable laws and regulations; how they might affect the financial statements; and assessing the design and implementation of relevant controls.
- The provision of appropriate training and guidance to audit teams in respect of how they should respond to the UK Bribery Act in conducting audits.

The methodologies of all firms visited required the audit team to perform risk assessment and audit procedures outlined in the UK and Ireland International Standards on Auditing for fraud and laws and regulations. In conducting the thematic review, the FRC did not identify any significant deficiencies which would have given rise to an inappropriate audit opinion being expressed. However, there are a number of areas where the FRC have identified that firms should improve the quality and effectiveness of the audit procedures performed.

Areas for improvement

The thematic review identifies a number of key messages for audit firms for suggested improvements as follows:

Fraud risk

Partner-led discussions in respect of fraud risk in the audit team discussion. In addition, the discussion should focus on identifying fraud risk factors as well as the risk of material misstatement in the financial statements due to fraud. Larger, more complicated audits might benefit from the inclusion of forensic specialists to improve the identification of potential fraud risks.

The UK and Ireland ISAs require a discussion among key engagement team members, led by the engagement partner to discuss the susceptibility of the entity's financial statements to material misstatement (ISA (UK and Ireland) 315.10). This discussion places particular emphasis on how, and where, the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion occurs setting aside beliefs that the management and those charged with governance are honest and have integrity (ISA (UK and Ireland) 240.15).

The thematic review confirms that it was only clear in 12 out of the 26 audits reviewed that the discussion was led by the engagement partner. Concerns were raised by the FRC on the remaining audits, in particular that:

- In three audits there was no record of who attended this meeting.
- In two audits the engagement partner had met senior audit team members separately who then led the discussions with the rest of the audit team when the engagement was not present. In both cases there was no record of the matters discussed at the meeting with the engagement partner.
- In nine audits the engagement partner was noted as attending the meeting, but there was no record of either who led or who contributed to the fraud risk discussion.

The discussion required by ISA (UK and Ireland) 240 is so that the audit team can consider the risk of misappropriation of assets and the risk of fraudulent financial reporting. The thematic review identified that in four audits there was a lack of evidence of discussion of the potential risks of fraudulent financial reporting. In six audits there was a lack of evidence of discussion of the potential risks of asset misappropriation and hence the thematic review recommends that to comply with the UK and Ireland ISAs, audit teams must ensure that their discussions cover both of these risks.

The thematic review acknowledges that in most audits, the records of discussions were at a high level, although the records were more akin to a briefing for the audit team of the identified fraud risks as opposed to a discussion amongst the team of the potential fraud risks. Of particular concern was a lack of evidence of a discussion of the existence of fraud risk factors, or the audit team's approach to the testing of journals as well as how the team addressed the risk of the fraud risks identified despite the fact that the methodologies employed by the firm required this to be done.

Discussion with management and internal audit

The thematic review also suggests that auditors should improve their assessment of fraud risk factors and fraud risks by having more meaningful discussions with management (including internal audit and those outside the finance function). In addition, the FRC recommends that such discussions focus more on fraud risks rather than any frauds which have already been identified. The thematic review identifies that where discussions were held with management, the discussions did not always include internal audit as well as not adequately covering the consideration of the risks of material misstatement due to fraud.

The auditor is required to make inquiries of management and internal audit regarding their assessment of the risk that the financial statements may be materially misstated due to fraud, management's processes to mitigate the risks, management's communications to employees and those charged with governance and whether they have any knowledge of any actual or suspected frauds (ISA (UK and Ireland) 240.17-19).

In ten audits, the FRC noted that discussions with management were also held with individuals from outside of the finance team (e.g. operational management, head of legal, head of risk or the company secretary). The thematic review acknowledges that discussions with those outside of the finance team may be more useful because they may identify the risk of management override of internal controls, thus the review also acknowledges that the FRC would expect to see more fraud risk discussions with non-financial management.

Where audit teams had discussions with management, there was no evidence that the discussions covered the two types of risks of material misstatement due to fraud. In 16 audits reviewed by the FRC, there was no evidence that the discussions included the risk of misappropriation of assets (although immaterial actual misappropriation frauds were discussed). In 18 audits reviewed, there was no evidence that the risk of fraudulent financial reporting had been discussed. In many cases an agenda was included on the audit file but fraud risks were not included as an agenda item.

The FRC also identified a number of audits where the team discussion focussed on immaterial frauds reported by management. The thematic review recommends that audit teams ensure that this does not detract them from discussing the risk of material misstatement due to fraud which has not been detected by, or concealed by, management.

In six of the 26 audits reviewed, the audit teams did have a discussion with internal audit about their assessment of fraud risks. A further 11 audits did have an internal audit function, but the FRC noted that there was either no evidence that a discussion had been held, or that it had included a discussion of fraud risks (in additional to actual frauds). In addition, six entities reviewed had an outsourced internal audit function, but for five of these entities no discussion of fraud risks had been held with internal audit.

The thematic review recommends that where the audit client has an internal audit function, the team should meet with them to discuss the risks of material misstatement due to fraud.

Assessing the level of risk and planning the response

The UK and Ireland ISAs say that management is in a unique position to perpetrate a fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk will vary from entity to entity, the risk is nevertheless present in all entities (ISA (UK and Ireland) 240.3).

ISA (UK and Ireland) 240 at paragraph 32 sets out some specific audit procedures that the auditor must follow.

In addition, paragraph 33 requires the auditor to determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those in paragraph 32.

The thematic review acknowledges that whilst management override of internal controls had been identified as a significant risk, the level of risk specific to the audited entity was not assessed and in many cases the responses did not extend beyond the minimum audit procedures outlined in the ISA and hence were not responsive to the level of risk identified for the entity. In recognition of this weakness, the report recommends that audit committees request information from their auditor regarding their assessment of the level of risk of management override of internal controls and the audit procedures which the team have performed in response to this risk.

The thematic review concluded that on all the audits reviewed, there was no assessment of the level of risk of management override present. Two audit firms do not specifically identify that management override of internal control is a significant risk on their files on the grounds that they consider the audit procedures required by ISA (UK and Ireland) 240 to address the risk and are included in the various work programmes. Some audit firms presume that as the ISAs (UK and Ireland) view management override of controls to be a significant risk, the minimum procedures within them will address this risk. This is clearly an inappropriate assumption because ISA (UK and Ireland) 240 requires the auditor to consider whether other audit procedures should be performed.

The thematic review recommends that audit teams should assess the level of risk of management override of controls which is present and ensure that the planned audit procedures are responsive to the particular risks identified.

Testing of journals

Paragraph 32 to ISA (UK and Ireland) 240 places a specific requirement for the auditor to test journals and other adjustments made in the preparation of the financial statements. The thematic review identifies that in some cases it was not always clear that the testing of these journals was responsive to the fraud risks identified and that the use of CAATs to test journals entries was limited. Of the 26 audits reviewed, seven audits used manual identification, nine used CAATs and four used specialists (three IT and one forensic) to run CAATs. The FRC said that in their opinion because of the nature of the audits inspected (larger and more complex), they would have expected the use of CAATs to have been more extensive.

Where manual identification was used, the audit team tended to focus on journals that were for large or round sum amounts posted outside normal working hours. This limited criteria may not be the most appropriate fraud risk characteristic to use in order to select journals for testing.

In audits where the use of CAATs was employed, a wider criteria was used including analysing journals by user, journals targeted at specific balances (especially revenue) and searching for key words.

Whilst the thematic review acknowledges that this criteria is more targeted to the fraud risks identified for the entity, it also acknowledges that there could have been better linkage from the fraud risk factors and fraud risks to the fraud characteristics selected to identify journals for testing.

Sample sizes for journal testing

The thematic review says that sample sizes for journals testing varied significantly and in general the rationale for sample sizes was not clear as well as it being unclear as to how the sample selection criteria linked to the fraud risks identified. Where CAATs identify very large sample sizes, the audit team should consider whether the criteria used are appropriate for the circumstances of the entity and consider the possibility of refining them to identify a smaller population for testing.

In 11 audits, the FRC noted evidence that journals selected for testing agreed to supporting documentation and/or discussed with management. However, the purpose and appropriateness of the journal was not always considered by the audit team and discussions with management were noted, but no testing of journals had taken place and the thematic review criticises firms in this respect because discussion with management, without obtaining any corroboratory evidence, is not a sufficient audit response to address the risk of fraud.

No testing of journals performed

The FRC noted four instances where journals had not been tested by the audit firm. Out of these four audits, three files suggested the substantive audit procedures performed in relation to financial statement line items provided sufficient evidence that no further work was needed. In this respect the FRC notes that:

- Substantive analytical review procedures are unlikely to identify journals that have been posted by management to manipulate the amounts reported in order to meet expectations.
- Substantive audit testing is only required for material financial statement line items. Journals may be posted to accounts with immaterial or nil balances and these should also be considered for testing.

The FRC advises that it is not appropriate to rely on these audit procedures as an alternative to testing journal entries to address the risk of management override of internal controls.

Final analytical review

Analytical procedures are mandatory under ISA (UK and Ireland) 520 *Analytical Procedures*. Where analytical procedures are concerned, auditors must ensure that final analytical review are not merely limited to comparing line items in the current year income statement (profit and loss account) and statement of financial position (balance sheet) to prior year figures. The auditor should use more ratio analysis and inclusion of the cash flow statement in the analytical review which will improve the quality of the audit work in this area.

The idea of analytical review procedures at the end of an audit is so that the auditor can form an overall conclusion as to whether the financial statements are consistent with their understanding of the entity or indicate a previously unrecognised risk of material misstatement due to fraud.

Concluding on fraud audit procedures

An overall conclusion must be drawn relating to the risks of material misstatement in the financial statements due to fraud. This conclusion should be drawn when the auditor has considered all of the relevant audit evidence obtained during the detailed audit work. ISA (UK and Ireland) 700 *The Independent Auditor's Report on Financial Statements* at paragraph 8 requires the auditor to evaluate whether sufficient appropriate audit evidence has been obtained so as to conclude if the financial statements as a whole are free from material misstatement, whether due to fraud or error. Procedures recommended in the UK and Ireland ISA to respond to the risk of fraud include:

- Testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements;
- Performing procedures to respond to the risk of fraud in revenue recognition;
- Evaluating whether the selection and application of accounting policies by the entity may be indicative of fraudulent financial reporting;
- Reviewing accounting estimates for biases;
- Considering the business rationale for significant transactions (including with related parties);
- Evaluating unadjusted misstatements for indicators of fraud; and
- Performing final analytical procedures at, or near, the end of the audit.

The thematic review suggests better evidence of the link between the fraud risk assessment, the audit evidence obtained and the conclusions reached where a firm uses a concluding document for each significant risk, including revenue recognition and management override of controls and then a further document to demonstrate how professional scepticism has been applied.

Another firm in the review requires the audit team to consider the overall results of the audit procedures performed in relation to all accounting estimates and this is said to facilitate a more informed assessment of whether there are any indicators of management bias.

The final recommendation where fraud is concerned is that audit teams may benefit from frequent and up to date training in this area so as to improve the quality of audit work. In particular, the report suggests that when tendering their audit, the audit committee should consider enquiring about the nature and frequently of the fraud training provided by firms to audit staff.

The thematic review suggests that the levels of fraud training among firms varied significantly and in some cases the material used in the training was not very recent because new types of fraud are becoming apparent regularly and so frequent and up to date training is likely to be beneficial.

As aggressive earnings management is a fraud risk indicator, any judgements of this nature should be reached by the audit engagement partner.

Laws and regulations – the auditor's objective

ISA (UK and Ireland) 250A *Consideration of Laws and Regulations in an Audit of Financial Statements* outlines the auditor's objectives which are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Identification of laws and regulations relevant to the business

A key principle in ISA (UK and Ireland) 250A is that the auditor is required to obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry in which it operates and how the entity is complying with that framework. The thematic review suggests that audit teams are not identifying and evaluating all relevant laws and regulations specific to the entity as well as the potential impact of non-compliance on the financial statements.

The review recommends that audit committees should discuss with their auditors the relevant laws and regulations affecting the business that have, or may have, a material impact on the financial statements.

Where the entity had identified laws and regulations pertinent to them, the audit teams had not identified them, in particular:

- Laws and regulations identified on the audit file were not consistent with those referred to in the Annual Report – particularly laws and regulations noted within the principal risks and uncertainties facing the business were not identified by the audit team (e.g. Bribery Act 2010).
- Where legal cases had been discussed with legal counsel and these discussions highlighted non-compliance with certain laws and regulations, there was no check by the audit team that these had been identified as relevant laws and regulations affecting the business and that the planned audit procedure was appropriate.

An effective summary table is used by one firm which:

- Identified the applicable laws or regulations;
- Summarised the entity's policies and procedures;
- Described the potential impact on the financial statements; and
- Set out the planned audit procedures.

Several audits failed to analyse which laws and regulations were considered to have a direct material effect on the amounts and disclosures in the financial statements (a direct effect) and those which may have a material effect on the financial statement (an indirect effect). A different audit response is required depending on this assessment.

Discussions with management

Under ISA (UK and Ireland) 250A, the auditor is required to make inquiries of management as to whether the entity is in compliance with laws and regulations which may have a material impact on the financial statements.

Audit committees have a role to play in this regard because they should seek to understand how compliance with relevant laws and regulations has been addressed by the auditors during their audit.

The thematic review found little evidence that discussions held with management included the identification of laws and regulations which may have a material impact on the financial statements. Of more concern in some audits was no evidence of any discussion with management concerning compliance with law and regulations, despite the ISA (UK and Ireland) placing a specific requirement for such a discussion to be held.

The FRC have advised that audit teams should hold discussions with management in order to identify the relevant laws and regulations as well as the entity's processes for monitoring compliance with them. Where appropriate, inquiries should be made of the head of legal and/or other management with responsibility for compliance matters.

Evaluation of controls over compliance with laws and regulations

The thematic review found that in most of the audits reviewed, there was little in the way of evidence that the design and implementation of the entity's controls had been evaluated. The FRC advises audit committees to ensure that they have reviewed the key controls in place to mitigate the risk of material misstatement due to non-compliance with laws and regulations as well as ensuring that they have discussed these with the auditor.

Under the provisions in ISA (UK and Ireland) 315 *Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and its Environment*, the auditor is required to obtain an understanding of the internal controls relevant to the audit. Most controls are likely to relate to financial reporting but not all controls that relate to financial reporting are relevant to the audit. This is where the auditor's professional judgement must come into play.

When obtaining an understanding of the controls which are relevant to the audit, the auditor must evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. Such procedures would normally include tests of control.

The thematic review acknowledges that there was some evidence through discussions with management that audit teams had obtained an understanding of the actions taken and controls put in place by the entity relating to compliance with laws and regulations. However, there was a lack of assessment of the design and implementation of controls regarding the entity's policies which relate to compliance with laws and regulations, ethical behaviour and whistleblowing hotlines (in terms of the whistleblowing issue, only four audits had reviewed this log).

The thematic review advises that as controls that mitigate the risk of material misstatement due to non-compliance with laws and regulations are relevant to the audit, further audit procedures to assess the design and implementation of these controls should be performed.

Audit procedures performed in relation to laws and regulations having an indirect impact on the financial statements

The thematic review identified that in performing other procedures, there was limited evidence (in most of the audits) that the audit team were alert to identifying potential breaches of laws and regulations which may have a material impact on the financial statements. Such procedures might include:

- Reading board minutes;
- Inquiries of management; and
- Substantive procedures.

The thematic review acknowledges that board minutes were read, but it was not always clear whether matters relating to relevant laws and regulations had been identified or how their impact on the audit procedures that needed to be performed had been assessed. In addition, the review noted that minutes of inquiries with management and legal counsel did highlight potential breaches of laws or regulations not identified at planning by the audit team and it was not always clear how these potential breaches had been assessed and what audit procedures were then planned in response to them.

Bribery Act 2010

The FRC reminds audit committees to ensure that the entity has appropriate processes and controls in place in response to the UK Bribery Act 2010 and make inquiries of their auditors as to the steps that they have taken to address this risk. This is because the thematic review identified that most audits failed to consider the UK Bribery Act 2010 as a relevant law that may have a direct or indirect impact on the financial statements.

In terms of the Bribery Act 2010, which was introduced in July 2011, the audit team should be considering whether there is a risk of the financial statements being materially misstated as a result of the entity making questionable payments which might be deemed as bribes.

The Annual Reports of 15 entities identified compliance with the Bribery Act 2010 as a key risk facing their business and then went on to describe the processes and controls they had put in place to mitigate this risk.

Only eight of the audits reviewed identified the Bribery Act as a relevant law by the audit engagement team and one audit team identified the Bribery Act as a relevant law, despite no reference to the Act being made in the entity's Annual Report. In the remaining ten audits, the Bribery Act was neither mentioned in the Annual Report nor identified by the audit team as a relevant law which required consideration. The same applied to three of the seven mining entities reviewed and in all three cases, the main business operations were in countries which feature highly on Transparency International's perceived corruption index. Therefore, for these entities the Bribery Act should have been identified as a relevant law that may have a direct impact on the financial statements.

Laws and regulations training

In light of the thematic review, the FRC recommends that audit firms should ensure that they provide sufficient and up to date guidance to audit teams relating to relevant laws and regulations (e.g. the Bribery Act 2010).

Training levels varied across firms and other than training relating to laws and regulations in certain specialist fields (e.g. banking and finance), other areas of training were limited. The FRC advises that as regulators are now more willing to investigate and fine companies for breaches of their laws and regulations across a wide number of industries, more frequent and up to date training is required to enable audit teams to identify potential risks arising.

ISA 560 *SUBSEQUENT EVENTS* *(LECTURE A484 – 16.04 MINUTES)*

The provisions in ISA (UK and Ireland) 560 *Subsequent Events* outline the requirements for the auditor to ensure the auditor obtains sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements and to respond appropriately to facts that the auditor becomes aware of after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Subsequent events are split into two components:

- Those events that provide evidence of conditions that existed at the date of the financial statements; and
- Those events that provide evidence of conditions that arose after the date of the financial statements.

Events occurring between the date of the financial statements and date of the auditor's report

ISA (UK and Ireland) 560 is applied usually towards the end of the audit as part of the audit completion process. This particular standard is a companion standard to that of FRS 21 *Events after the Balance Sheet Date*, Section 32 *Events after the End of the Reporting Period* and EU-endorsed IAS 10 *Events after the Reporting Period*. The objective of ISA (UK and Ireland) 560 is to ensure that the auditor obtains sufficient and appropriate audit evidence that adjusting events have been properly reflected in the financial statements and non-adjusting events have been adequately disclosed. Such audit procedures include the following:

- Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- Reading any subsequent interim financial statements (if any).

Example – adjusting or non-adjusting events

The audit of Company A Ltd for the year-ended 31 December 2015 is nearing completion and the financial statements are due to be approved in the Annual General Meeting on 4 April 2016. The following matters have been included on the 'Points for Partner's Attention' schedule:

1. A material fraud was discovered by the financial controller on 15 January 2016. The purchase ledger clerk had been diverting funds into a fictitious supplier bank account set up by the employee which had been occurring for the past eight months. The employees was immediately dismissed and legal proceedings have been instigated against the employee.
2. On 20 December 2015, a customer instigated legal proceedings against Company A in relation to a breach of contract. On 30 December 2015, the company's legal counsel advised that it was unlikely the company would be found liable; therefore no provision has been made in the financial statements (although disclosure as a contingent liability has been made). On 20 February 2015, the court found the company liable for breach of contract on a technicality and is now required to pay damages which amount to a material sum.
3. On 30 March 2016, a customer ceased trading due to financial difficulties and the balance of £800 on the sales ledger at the year-end was still owed on this date. As the amount was considered immaterial by the financial controller, no adjustment has been made. The auditor has also confirmed this sum is immaterial.

Fraud

The fraud committed by the purchase ledger clerk has been ongoing during, and beyond, the financial year under audit. Fraud, error and other irregularities that occur prior to the year-end date, but which are only discovered after the year-end should be adjusted for and hence the fraud should be accounted for in the year-end financial statements.

Audit procedures may include:

- Recalculation of the amounts involved.
- Discussions with management as to how the fraud has occurred.
- What controls (if any) contain weaknesses to enable them to be manipulated by employees to commit fraud.
- Performing substantive procedures on year-end (and other) journals.
- Creditors circularisation of balances.
- Reviewing purchase invoices for evidence of any 'doctored' invoices or 'copy' invoices and enquiring as to their authenticity.
- A review of human resources files for evidence of disciplinary proceedings against the employee (this will confirm compliance with laws and regulations relating to employment legislation as the employee has been dismissed).
- Obtaining a written representation relating to the fraud.

- Test checking after-date cash receipts for evidence of any reimbursements by the employee (e.g. withheld wages).
- Discussions with the entity's legal counsel as to any potential further reimbursement by the employee.

Legal proceedings

A contingent liability has been disclosed in the year-end financial statements. However, as the legal proceedings were instigated some ten days before the year-end, this is evidence that the conditions existed at the balance sheet date. The result of a court case after the reporting date needs to be adjusted for in the financial statements when the conditions existed at the balance sheet date hence this is an adjusting event and a provision, rather than a contingent liability disclosure, should be made to comply with the requirements in Section 21 *Provisions and Contingencies*, FRS 12 *Provisions, Contingent Liabilities and Contingent Assets* and EU-endorsed IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Audit procedures may include:

- Reviewing the court order/correspondence from the lawyers relating to the legal proceedings to confirm the company has been found liable to pay compensation.
- Test checking after-date cash payments to confirm payment to the customer.
- Ensuring a provision has been recognised in accordance with Section 21/FRS 12/IAS 37.
- Obtaining a written representation from management to confirm the treatment of the provision.

Bad debt

A customer ceasing to trade so soon after the year-end date indicates the debt to be impaired and so should be provided against to bring trade debtors down to recoverable amount.

Audit procedures may include:

- Discussion with management as to the reason why they are not going to make provision against the bad debt.
- Putting the error on the summary of unadjusted misstatements and ensuring that this amount remains immaterial at the completion stage (both individually and when aggregated with other misstatements). If the error does still remain immaterial a qualified opinion in respect of the non-adjusting for the bad debt need not be made.

The examples above illustrate the interaction between accounting standards and the UK and Ireland auditing standard on post balance sheet events. The objective of ISA (UK and Ireland) 560 is to ensure that the auditor has obtained sufficient appropriate audit evidence to ensure that the entity has complied, in all material respects, with the accounting standard and properly reflected or adequately disclosed adjusting or non-adjusting events respectively.

Facts become known to the auditor after the date of the audit report but before the financial statements are issued

ISA (UK and Ireland) 560 recognises that the auditor has no responsibility to perform audit procedures regarding the financial statements after the date of the auditor's report. However, there may be situations that present themselves which might occur after the date the auditor signs the report, but before the date on which the financial statements are issued, which if they had been known to the auditor beforehand, would have caused the auditor to amend the audit report. There are three procedures which the auditor must adopt in this instance:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment.

(c) If the financial statements DO requirement amendment, inquire with management as to how they intend to address the matter in the financial statements.

If management amends the financial statements the auditor shall:

(a) Carry out appropriate audit procedures which they deem necessary in the circumstances on the amendment.

(b) Extend the audit procedures already performed to the date of the new auditor's report; and

(c) Provide a new auditor's report on the amended financial statements. This new report must not be dated earlier than the date of approval of the amended financial statements.

In the event that legislation or regulation does not prohibit those charged with governance from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the entity's financial statements are not prohibited from restricting their approval to that amendment, the auditor can restrict the audit procedures in (b) above to that amendment. When this happens, the auditor must:

(a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or

(b) Provide a new or amended audit report that includes a statement in an Emphasis of Matter paragraph or Other Matter paragraph that explains that the audit procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

When law or regulation does not stipulate that the financial statements should be amended, the auditor need not provide an amended or new auditor's report.

However, where the auditor believes that the financial statements *should* be amended and the management does not amend them, the auditor should take the following actions:

(a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by ISA (UK and Ireland) 705 *Modifications to the Opinion in the Independent Auditor's Report*; or

(b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action to seek to prevent third parties from placing reliance on the auditor's report.

Facts become known after the financial statements have been issued

The auditor has no obligation to perform audit procedures on the financial statements after they have been issued. However, in situations when facts become known to the auditor after the financial statements have been issued which, had they been known to the auditor before the issuance of the financial statements, would have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance;

(b) Determine whether the financial statements need amendment; and, if so

(c) Inquire how management intends to address the matter in the financial statements.

When management amends the financial statements, the auditor shall then:

(a) Carry out audit procedures necessary in the circumstances on the amendment.

(b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements (together with the auditor's report) is informed of the situation.

(c) Unless the circumstances in paragraph 12 to ISA (UK and Ireland) 560 apply:

    (i) Extend the audit procedures already performed to the date of the new auditor's report, and date the new auditor's report no earlier than the date of approval of the amended financial statements; and

    (ii) Provide a new auditor's report on the amended financial statements.

(d) When the circumstances in paragraph 12 to ISA (UK and Ireland) 560 apply, amend the auditor's report, or provide a new auditor's report as required by paragraph 12.

In addition, the auditor must also include in the new or amended auditor's report an Emphasis of Matter paragraph (or Other Matter(s)) paragraph referring to a note to the financial statements which discusses the reason for the amendment in more detail and to the earlier report provided by the auditor.

If management do *not* take the steps considered necessary to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements when the auditor believes they should be amended, the auditor must notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If management and those charged with governance still do not take the necessary steps, the auditor shall take appropriate action to prevent reliance on the auditor's report.

ISA (UK AND IRELAND) 240 *THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS*

ISA (UK and Ireland) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* outlines the auditor's responsibilities when it comes to fraud and outlines certain procedures that an auditor should apply as a minimum when obtaining their audit evidence as to whether the financial statements contain material misstatement whether due to fraud or error.

The distinction between whether a misstatement is due to 'fraud' or 'error' is important and will all depend on whether the underlying action is intentional or unintentional. In almost all cases fraud is perpetrated for personal financial gain and fraud tends to be committed by management by the overriding of internal controls, whilst employees will commit fraud by the manipulation of weaknesses in internal controls.

ISA (UK and Ireland) 240 is concerned with two types of fraud: fraudulent financial reporting and misappropriation of assets. It is not up to the auditor to make legal determinations of whether a fraud has actually occurred – this responsibility is down to the legal system to make such determinations.

Responsibilities of management, those charged with governance and the auditor

It is not the auditor's responsibility to prevent and detect fraud – this is the primary responsibility of management and those charged with governance. To prevent and detect fraud, management and those charged with governance should create a culture of honesty and ethical behaviour within the organisation which is reinforced by an active oversight by those charged with governance. Oversight of this culture is achieved by those charged with governance considering the potential for override of internal controls or inappropriate influence over the financial reporting process (e.g. earnings management).

The auditor's responsibilities according to ISA (UK and Ireland) 240 is to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. The terminology 'reasonable assurance' is critical in this respect.

An audit cannot give absolute assurance that the financial statements are free from material misstatement, whether caused by fraud or error, due to the inherent limitations of an audit (use of judgement, sampling, audit evidence being persuasive rather than conclusive etc.) and so the UK and Ireland ISA recognises that even though an audit may be properly planned and executed, there is an unavoidable risk that a material misstatement may remain undetected. Indeed, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting a material misstatement due to error. Fraud, by its very nature, is designed to be concealed and nowadays uses sophisticated schemes in order to prevent it being discovered.

Management override of internal controls is a particularly significant risk (as noted in the UK and Ireland ISA) because management is in a position to directly or indirectly manipulate the accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

During the audit, the auditor has a responsibility to maintain professional scepticism throughout. The auditor must consider the potential for management override of internal controls and recognise the fact that audit procedures which are effective for detecting error, may not be effective for detecting fraud.

Professional bodies have become increasingly concerned about the lack of professional scepticism being applied by auditors and professional scepticism was the subject of the Quarter 2 Accounting and Audit Update as well as the subject of an article in *Audit and Beyond* written by Adrian Gibbons from SWAT.

Audit team discussion

At the planning phase of the audit, the audit team (including the engagement partner) should discuss the susceptibility of the financial statements to material misstatement due to fraud. An important point to emphasise where ISA (UK and Ireland) 240 is concerned is that all beliefs concerning the integrity and honesty of management and those charged with governance must be set aside because the team must exercise professional scepticism throughout the course of the audit.

When discussing the susceptibility of the financial statements to material misstatement due to fraud, the audit team should consider how a fraud may occur. For example, if controls have been deemed weak then this is going to give rise to more scope for fraud. If management are aggressive or domineering, this is more likely to give rise to more scope for management override of internal control. It is not enough to merely conclude in the audit team meeting that as fraud has not occurred in prior year audits, then this year will be no different, because in this respect the audit team will be relying on past experiences of the client for which the ISA (UK and Ireland) actively discourages.

In addition to the requirements for the audit team to discuss how the financial statements can be materially misstated due to fraud, the team should discuss how the financial statements can be materially misstated due to fraud with related parties. ISA (UK and Ireland) 550 *Related Parties* contains a specific requirement for the audit team to hold this discussion and the requirement is frequently overlooked by audit teams.

Risk assessment procedures

There are certain procedures the auditor must perform to comply with the requirements in ISA (UK and Ireland) 240 in order to identify the risk of material misstatement due to fraud which are discussed as follows.

Inquiries of management and others

The auditor should enquire of management concerning:

(a) Management's assessment of risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.

The auditor should also make inquiries of others within the entity (as they deem appropriate) to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

When the entity has an internal audit function, the auditor must make enquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud as well as obtaining its views about the risks of fraud.

Those charged with governance

Unless all of those charged with governance (TCWG) are involved in the management of the entity, the auditor must obtain an understanding of how TCWG oversee management's processes for identifying and responding to the risks of fraud in the entity and the controls that management have put in place to reduce these risks accordingly.

The auditor must also make inquiries of TCWG to establish if they themselves have any knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made to corroborate the assertions made by management concerning fraud.

Unusual or unexpected relationships identified/other information

As part of analytical procedures, the auditor will undertake a preliminary analytical review to identify any unusual or unexpected relationships – particularly those related to revenue accounts. When the auditor identifies any unusual or unexpected relationships, the auditor must evaluate whether these indicate risks of material misstatement due to fraud.

Other information obtained by the auditor may also be considered as to whether it indicates a risk of material misstatement due to fraud.

Evaluation of fraud risk factors

The auditor must evaluate whether the information obtained from other risk assessment procedures (and related activities performed) indicates that one or more fraud risk factors are present. Notwithstanding the fact that fraud risk factors may not necessarily indicate the existence of fraud, the UK and Ireland ISA does acknowledge that they have often been present in circumstances where frauds have occurred and therefore may indicate the financial statements are materially misstated due to fraud.

Responses to assessed risks of material misstatement due to fraud

ISA (UK and Ireland) 330 *The Auditor's Responses to Assessed Risks* requires the auditor to determine overall responses to address risks that the financial statements contain material misstatement due to fraud at the financial statement level.

To address this risk, the auditor must:

(a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatemen/t due to fraud for the engagement;

(b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's efforts to manage earnings; and

(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

The issue concerning management override of internal controls can pose particular problems for auditors because they are in a unique position to perpetrate fraud by overriding controls which may, on the face of it, appear to be operating effectively. In recognition of this, ISA (UK and Ireland) 240 automatically places this risk as a significant risk. In light of this significant risk, ISA (UK and Ireland) 240 outlines specific audit procedures which the auditor is required to undertake and such procedures must be designed and performed to:

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

    (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

    (ii) Select journal entries and other adjustments made at the end of a reporting period; and

    (iii) Consider the need to test journal entries and other adjustments through the period.

(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

   (i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

   (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

ISA (UK and Ireland) 240 also requires the auditor to determine whether, in order to respond to the identified risks of management override of internal controls, the auditor needs to perform other audit procedures in addition to those above (for example where there are specific additional risks of management override not covered as part of the procedures performed to address the above requirements).

The ICAEW's Quality Assurance Department (QAD) have said that as part of their reviews of audit files, they will be looking specifically to make sure that member firms have undertaken the above requirements contained in paragraph 32 of ISA (UK and Ireland) 240.

Revenue recognition

Revenue recognition is an area which is frequently cited by regulators as concerning. ISA (UK and Ireland) 240 automatically assumes that fraud in relation to revenue recognition is a high risk area and whilst auditors are identifying revenue recognition as an area of significant risk, the work performed in this area is often deemed in adequate in response to the high risk attached to revenue recognition.

What is absolutely critical is that when the auditor concludes that the risk of fraud in relation to revenue recognition is NOT applicable, the auditor must adequately document the reasons why it is not applicable (bearing in mind the default automatic high-risk classification in the UK and Ireland ISA). It is quite common for auditors to consider fraud in relation to revenue recognition to be 'low risk' because the auditors have not encountered fraud in the past where revenue recognition is concerned. The problem with this approach is that it relies on past experience of the audit client and contains little in the way of professional scepticism.

Auditors need to take extreme care when concluding that fraud in relation to revenue recognition is not applicable as in the vast majority of cases it will be applicable to the entity.

Evaluation of the audit evidence

Under the provisions in ISA (UK and Ireland) 520 *Analytical Procedures*, the auditor must apply analytical procedures near the end of the audit in order to form an overall conclusion as to whether the financial statements are consistent with their understanding of the entity. This requirement is incorporated within ISA (UK and Ireland) 240 but requires the auditor to perform analytical procedures near the end of the audit to see if there is any indication of a previously unrecognised risk of material misstatement due to fraud.

When the auditor identifies a misstatement, they must evaluate whether such a misstatement is indicative of fraud. When there is such an indication, the auditor must evaluate the implications of the misstatement in relation to other aspects of the audit – especially the reliability of any management representations and recognise that an instance of fraud is unlikely to be an isolated occurrence.

If the auditor identifies a misstatement which they believe is indicative of fraud and management (particularly senior management) are involved the auditor must then re-evaluate the assessment of the risks of material misstatement due to fraud and the resulting impact on the nature, timing and extent of audit procedures in order to respond to the assessed levels of risk. In addition, the auditor must also consider whether circumstances or conditions indicate that there is collusion among management, employees or other third parties.

When the auditor concludes that the financial statements contain material misstatement due to fraud (or cannot form a conclusion), then they should consider the impact this has on the audit report.

Auditor unable to continue with the engagement

In exceptional circumstances, the auditor may question whether, or not, they can continue with the audit engagement. When these circumstances present themselves, there are specific requirements in ISA (UK and Ireland) 240 which says that the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

    (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Obtaining written representations

There is a specific requirement in ISA (UK and Ireland) 240 for the auditor to obtain a written representation from management and, where appropriate, those charged with governance, that:

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:

(i) Management;

(ii) Employees who have significant roles in internal control; or

(iii) Others where the fraud could have a material effect on the financial statements; and

(d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

Discovery of fraud/fraud indicators – communication

The auditor must communicate, on a timely basis, to the appropriate level of management, if they have discovered a fraud or if indicators of fraud exist. Also, unless all of those charged with governance are involved in managing the entity, if the auditor has identified suspected fraud which involves:

- Management;
- Employees who have significant roles in internal control; or
- Others where the fraud results in a material misstatement in the financial statements,

then the auditor must communicate these issues to those charged with governance on a timely basis. Where the auditor suspects management is involved with fraud, the auditor communicates such suspicions to those charged with governance and discusses with them the nature, timing and extent of audit procedures necessary to finish the audit.

In addition to those responsibilities, the auditor must also consider whether there is a need to report any occurrences of fraud, or suspicions of fraud, to third parties outside of the entity bearing in mind the auditor's duty of client confidentiality may be overridden by a legal requirement to make such disclosure (e.g. to comply with Anti-Money Laundering Regulations).

Audit documentation

Included within the audit file must be documentation relating to:

- The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the financial statements to material misstatement due to fraud; and
- The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

With regards to the assessed risks of material misstatement, the auditor must ensure documentation is on file relating to:

- The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- The results of the audit procedures, including those designed to address the risk of management override of controls.

Where communications have been made to management, those charged with governance, regulators and others concerning fraud, a record of those communications must be maintained in the audit file.

SUMMARY OF DEVELOPMENTS

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

FRC publishes compendium of Audit and Assurance Standards and Guidance 2014

1 April 2014

The FRC has published its compendium of 'Audit and Assurance Standards and Guidance 2014'.

The compendium includes the FRC's audit and assurance standards in issue at 1 February 2014, including:

- International Standards on Auditing (ISAs) (UK and Ireland);
- International Standard on Quality Control (ISQC) (UK and Ireland) 1;
- International Standard on Review Engagements (ISRE) (UK and Ireland) 2410;
- Standard for Investment Reporting (SIRs);
- Ethical Standards for Auditors; and
- Ethical Standard for Reporting Accountants.

It also includes selected Practice Notes and Bulletins likely to be of broad current interest.

The compendium includes the revised International Standards on Auditing (ISAs) (UK and Ireland) that were issued in 2013:

- 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment;*
- 610 *Using the Work of Internal Auditors; and*
- 700 *The Independent Auditor's Report on Financial Statements.*

The compendium also includes the revised Practice Note 23, *Special Considerations in Auditing Financial Instruments*, which was issued in July 2013.

The revised ISAs (UK and Ireland) 315 and 610 are effective for audits of financial statements for periods ending on or after 15 June 2014. The conforming changes to other ISAs (UK and Ireland) and ISQC (UK and Ireland) 1, which are set out in the Annexure to the revised ISA (UK and Ireland) 610, have been incorporated in those individual standards in this compendium. The definition of 'audit team' in the Glossary of Terms has also been updated to reflect the prohibition on obtaining direct assistance from internal auditors.

The revised ISA (UK and Ireland) 700 is effective for periods commencing on or after 1 October 2012. The Statement issued by the FRC in November 2013 that clarifies the application of paragraph 19A to auditor's reports for group and parent company is also included.

UK and Swiss regulators agree to cooperate on cross-border supervision of audit firms

3 April 2014

On 18 March 2014, the Financial Reporting Council (FRC) and the Federal Audit Oversight Authority (FAOA) of Switzerland signed a Memorandum of Understanding which facilitates mutual cooperation in the area of public oversight, registration, inspections and investigations of auditors of companies that are subject to the regulatory jurisdictions of both parties.

The FAOA and the FRC seek to improve the quality, accuracy and reliability of the audit of public companies through audit regulation and auditor oversight so as to protect investors, help strengthen public trust in the audit process and increase investor confidence in their respective capital markets. Given the global nature of capital markets, it is in the common interest of both parties to cooperate in the oversight of auditors to avoid the undue burden of overlapping supervision.

Paul George, Executive Director of Conduct, said:

'The FRC and the FAOA have developed an excellent working relationship and this agreement will enable more specific cooperation, for example, in respect of the inspection of audit firms organised on a regional basis and the inspection of audits with significant Anglo-Swiss activities.'

Stephen Haddrill responds to Commission Recommendations on the quality of corporate governance reporting

9 April 2014

Responding to European Commission's publication of the Recommendation on the quality of corporate governance reporting ('comply or explain' principle), Stephen Haddrill, FRC CEO said:

'The FRC welcomes the release of the Commission's Recommendation on the quality of corporate governance reporting ('comply or explain'). The FRC supports the Commission's assertion that an effective corporate governance framework plays a key role in contributing to growth, stability and long-term investment, and recognising the concept of 'comply or explain' as a truly European mechanism.

'The FRC advocates the concept of comply or explain as a key feature of European corporate governance structures and one which the FRC champions through the UK Corporate Governance Code. A European corporate governance framework will assist companies in how they report and help investors better to understand the companies in which they invest.

'The FRC endorses the Commission's focus on explanations. There will at times be legitimate reasons for departures from the requirements of corporate governance codes, but such departures must be considered and well explained. In this context, the FRC considers that outlining the elements required for explanations may be helpful in encouraging better reporting. The focus on the company's specific characteristics and situation and ensuring clear, accurate and comprehensive explanations will ensure that investors receive the information they require.

‘The FRC shares the Commission’s views on the importance of good quality corporate reporting and believes this recommendation will help to enshrine good corporate governance throughout Europe.’

FRC’s Audit and Assurance Bulletin highlights the auditor’s responsibilities with respect to the Strategic Report and the Directors’ Remuneration Report

10 April 2014

The Financial Reporting Council’s (FRC) latest *Audit and Assurance Bulletin* highlights recent changes to auditors’ responsibilities which will have a significant impact in 2014. These include the introduction of the Strategic Report and changes to the content of the Directors’ Remuneration Report, including the requirement to report a single total remuneration figure for each director.

The Bulletin notes that auditors have the same statutory reporting responsibility for the new Strategic Repot as they have for the existing Directors’ Report. The Bulletin also sets out their responsibilities in relation to the directors’ remuneration report.

The FRC’s Bulletins provide auditors with guidance on new or emerging issues, they are persuasive rather than prescriptive, but are indicative of good practice.

The FRC plans to update ISA (UK and Ireland) 720 to take account of these new auditor responsibilities. The updates will be developed once the International Auditing and Assurance Standards Board (IAASB) has finalised the revision of its equivalent standard. It will be consulting on this shortly.

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

‘Recent developments in UK company law, the UK Listing Rules and the audit standards affect both the auditor’s duties and the wording of auditor’s reports on the financial statements of companies. The auditor is required to audit some but not all of the Directors’ Remuneration Report. It is particularly important, therefore, that the auditor should clearly describe within its report which elements of the Report that it has audited.’

The effects of the various developments, described in the bulletin, on the auditor’s report of a company preparing accounts under the FRSSE and of a premium listed group are illustrated in two Appendices.

FRC consults on revised operating procedures for reviewing corporate reporting

14 April 2014

The Financial Reporting Council (FRC) published a consultation paper proposing amendments to its Conduct Committee’s Operating Procedures for the review of company reports and accounts. In its Corporate Reporting Review (CRR) work, the Conduct Committee seeks to ensure that the provision of such financial information by public and large private companies complies with relevant reporting requirements.

Where a Conduct Committee enquiry gives rise to a significant correction or improvement in a company's report and accounts, the informal practice has been that the Conduct Committee may ask the company to refer to the exchange of correspondence in the report in which the change is made.

The revised operating procedures formally introduce the concept of the 'Committee Reference' and indicate the tests applied to ensure that the explanation published by the company is fair and balanced. The Conduct Committee expects to be given the opportunity to comment on any such disclosure a company intends to provide in its report and accounts in which it refers to its engagement with the Committee.

Although it is in the public domain, the Committee Reference is generally only known to those users who read the set of accounts in which it appears. A proposed amendment to the operating procedures will allow the Conduct Committee to include the names of those companies who have published Committee References in its annual CRR report.

Other amendments include:

- An explanation that the Conduct Committee's letter to a company may include references to aspects of reporting other than compliance with mandatory reporting requirements; for example, cutting clutter;
- Recording that, where practicable, the Conduct Committee's opening letter to the company Chairman is copied to the Finance Director and Audit Committee Chairman; and
- Providing more information about how the Conduct Committee manages complaints.

Stephen Haddrill comments on today's vote in the European Parliament on the disclosure of non-financial information

15 April 2014

Stephen Haddrill, Chief Executive Officer, Financial Reporting Council, said:

'The approval by the European Parliament of the new non-financial disclosure requirements for EU companies is a positive move for investors and complements the FRC's work on UK Guidance on the Strategic Report, consistent with our mission to promote high quality reporting to foster investment.

'The FRC worked closely with European Unions, institutions and the UK government to ensure that the risk of proliferation of 'boilerplate' was removed. This will ensure that investors receive only relevant and proportionate information. There have been numerous debates on what information is essential; by limiting the scope to large public interest entities with over 500 employees and only including material information this will help to ensure that these increased transparency requirements will encourage better corporate conduct and better informed investment decisions. By allowing flexibility around the location of these disclosures, it will enable companies to disclose information in a manner that communicates most effectively.'

FRC issues its Plan and Budget for 2014/2015

22 April 2014

The Financial Reporting Council (FRC) has today published its Plan, Budget and Levies for 2014/15. The Plan confirms the FRC's mission, highlights progress on its three-year strategy for 2013-16 and sets outs its priorities and projects for the current year.

The FRC is grateful to those who responded to its consultation on the Plan. Taking account of the comments received it intends in 2014/15 to focus on the following projects:

- Promoting better quality in the audits of banks and building societies.
- Encouraging greater clarity and concision in corporate reporting, including cutting unnecessary clutter.
- Encouraging better quality reporting by smaller listed companies to enhance investor confidence and their potential for growth.
- Promoting more extensive engagement between fund managers and owners with company boards.
- Ensuring effective implementation of major changes to audit tendering, audit committee reporting and the audit report.
- Extending audit inspections to deliver on the recommendations of the Competition Commission.
- Review the framework of actuarial standards, including in the light of new mapping of actuarial risk.

In addition the FRC will continue to work closely with EU institutions to promote justifiable confidence in the UK's regulatory framework and influence the thinking of the IASB and the IAASB. In particular it will focus on encouraging the IASB to put more weight on prudence and relevance in the development of accounting standards.

FRC CEO, Stephen Haddrill, said:

'Across all its activities the FRC seeks to act in the public interest. The Plan sets out an agenda aligned with the need to maintain confidence in the UK's governance and reporting and so underpin competitiveness in world markets and contribute to growth,.

'Parliament has given companies the privilege of limited liability. In return the public has a right to expect high standards of accounting and reporting, supported by effective independent audit. Our Plan sets out a work programme that we hope will enhance confidence in this system and that will help bring forward investment to underpin growth and prosperity.'

<u>Budget</u>

The FRC faces considerable pressures on its budget. In particular, to deliver on the Competition Commission proposals the number of audit inspections will increase 25 per cent in 2014/15, and the FRC needs to prepare for further significant increases over the following two years.

The costs for this activity and the FRC's disciplinary work, which will increase substantially as more cases are brought to tribunal, are funded by the professional bodies. The FRC will also invest in new projects to support its core reporting and governance activities and it faces unavoidable increases in its accommodation costs. The FRC plans to increase its levies on large account preparers by 4.8%, typically equivalent to £1,220 per annum on average; on smaller companies by 2.2%, equivalent to £160 per annum; and on the professional bodies by 2.2% on top of specific charges for disciplinary and audit monitoring work. Actuarial levies are unchanged.

Consultation on the UK Corporate Governance Code published

24 April 2014

The Financial Reporting Council (FRC) today is consulting on its two-yearly review of changes to the UK Corporate Governance Code following earlier consultations on directors' remuneration (October 2013) and risk management, internal control and the going concern basis of accounting (November 2013).

The UK Corporate Governance Code sets out good practice for UK listed companies on issues such as board composition and effectiveness, risk management, directors' remuneration and relations with shareholders. The Code operates on a 'comply or explain' basis. It was established in 1992 and is usually reviewed by the FRC every two years with a full consultation on all proposed changes.

The proposed changes to the UK Corporate Governance Code are that:

- Greater emphasis be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind, and that the lead responsibility for doing so rests with the remuneration committee;
- Companies should put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and should consider appropriate vesting and holding periods for deferred remuneration;
- Companies should explain when publishing AGM results how they intend to engage with shareholders when a significant percentage of them have voted against any resolution;
- Companies should state in their financial statements whether they consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to their ability to continue to do so;
- Companies should robustly assess their principal risks and explain how they are being managed and mitigated;
- Companies should state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks, and specify the period covered by this statement and why they consider it appropriate. It is expected that the period assessed will be significantly longer than 12 months; and
- Companies should monitor their risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report.

Commenting on the consultation, Stephen Haddrill explained:

'The role of the board is to ensure the sustained success of their company and exercise responsible stewardship on behalf of their shareholders. To do this effectively they need to understand and manage the risks to the future health of the company. The remuneration of executives on the Board must also incentivise them to put the company's well-being before their own. These proposals, which reflect the views of investors and others on earlier consultations, are intended to encourage boards to focus on the longer-term, and increase their accountability to shareholders.'

Subject to the outcome of the consultation, which closed on Friday 27 June 2014, the proposed changes will apply to financial years beginning on or after 1 October 2014.

FRC's work to enhance justifiable confidence in audit

28 April 2014

The Financial Reporting Council (FRC) today sets out it work to give justifiable confidence in the quality of audit. This expands on the outline of projects and activity announced in the FRC's current three-year strategic programme.

Audit is a key pillar of public confidence in the UK's corporate governance and reporting. Since the financial crisis the FRC has introduced a number of measures designed to enhance audit quality and increase the value of auditor reporting to investors to underpin UK corporate activity. These measures include retendering, enhanced and extended auditor reporting, and directly informing audit committees of the results of the FRC's audit quality inspections.

In the near to medium term, the FRC will focus on the expansion of its audit inspection work in line with recommendations from the Competition Commission, the implementation of the new EU Directive on statutory audit and enhancing the quality of bank audits, including through its thematic review of audits in this sector. It will also develop best practice guidance for audit committees on assessing audit quality; assess whether the ethical standards for audit remain fit for purpose; and review audit firm governance including whether the declining proportion of audit in the total business of the major audit firms poses unacceptable risk to audit quality and capacity.

Over the longer term, the FRC will assess whether any change to the scope of audit is necessary to meet investor expectations.

The above programme has been developed, in part, in response to a survey commissioned by the FRC, which benchmarked the views of key audit stakeholders under in 2013.

Stephen Haddrill, FRC Chief Executive, said:

'Audit is fundamental to good governance and reporting. The quality of audit in the UK is generally good but not always so and not always perceived as such. The many measures that have been and will shortly be introduced are designed to enhance audit quality and strengthen investor confidence.'

Benchmarking stakeholder confidence in audit

The stakeholder survey carried out last year and published today provides a new benchmark of confidence in audit and will be repeated in future to test the effectiveness of the FRC's programme in meeting legitimate expectations. The survey shows:

- Confidence in the value of audit is correlated with the extent of day-to-day experience of audit – audits and companies are generally confident in the value of audit.
- However, the largest proportion of stakeholders, and in particular many investors, call for more change including more transparency in auditor reporting and a more open and competitive appointment process to help improve their confidence in the independence of auditors and the transparency of their audit conclusions.
- Some of the concerns about independence and objectivity arise from the current concentration of the market in the hands of a few firms.

FRC simplifies accounting for micro-entities

29 April 2014

The Financial Reporting Council (FRC) today publishes an amended version of the *Financial Reporting Standard for Smaller Entities* (FRSSE) for use by micro-entities which want to take advantage of new regulations allowing them to prepare simplified financial statements.

Micro-entities are the UK's smallest companies. They are now able to use the FRSSE when choosing to apply the new micro-entities regime and prepare simplified financial statements with fewer disclosure notes than previously required by the FRSSE. The micro-entities regime was introduced into UK company law in November 2013 following new EU legislation.

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

'The FRC has amended the FRSSE to bring it in line with the new regulations. In consequence, micro-entities that currently prepare their financial statements in accordance with the FRSSE will continue to be able to use the same standards whilst also benefitting from the Government's simplification of the law. The micro-entities regime will be available to over one and a half million small businesses.'

The amendments to the FRSSE are effective from the same date as the new legislation, financial years ending on or after 30 September 3013 for companies filing their accounts on or after 1 December 2013.

FRC Lab explores Corporate Reporting in a Digital World

30 April 2014

The Financial Reporting Council (FRC) announces a project to investigate how companies are, and might in the future, use digital media in their corporate reporting to improve investors' access to information.

The project will be undertaken by the Financial Reporting Lab (the Lab). The Lab will initially review how companies currently use a wide range of digital media, including websites, videos, apps, social media platforms and blogs in their external communications to investors, and how investors use what is produced.

This project is the first part in a series of three projects on Corporate Reporting in a Digital World. Over the next 18 months the Lab plans to investigate:

- Digital Present: The current state of corporate reporting through digital media,
- Digital Challenges: Barriers to the use of digital media in reporting and,
- Digital Future: How companies might make the most of technological opportunities.

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

'This project doesn't signal the end of reporting by companies on paper, but rather is designed to look forward to the opportunity digital methods may offer. Many companies have already begun to innovate in the area of digital reporting, and the Lab can uniquely add to the debate by helping companies and investors explore what is best in current practice as well as looking towards a vision of what reporting might look like in the future to better meet their needs.'

The Lab is inviting listed companies, investors and analysts to express their interest by taking part in the project.

FRC consults on conventions for electronic tagging of accounts

8 May 2014

Following transfer of responsibility to the Financial Reporting Council (FRC), the XBRL accounts tagging conventions ('taxonomies') have been updated and the FRC announces a public consultation on three of the taxonomies to enhance the quality of financial reporting in the UK and Ireland.

Taxonomies are used when tagging accounts for electronic filing and for other analytical purposes. Electronic tagging helps users of financial information in corporate reports to extract the information they want and analyse it more efficiently.

These are the first taxonomies resulting from the project which was announced in September 2013 to improve the quality of electronic tagging of accounts and reflect UK reporting using EU-adopted IFRS as well as the new financial reporting standards (FRS 101 and FRS 102) for the UK and Ireland. They can be viewed at https://uk-taxonomies-tdp.corefiling.com/yeti or download from the FRC website https://xbrl.frc.org.uk/.

The consultations will close on 8 July 2014 after which the taxonomies will be finalised. HMRC and Companies House are expected to adopt the taxonomies in due course for filings of accounts under the relevant standards. The Irish Revenue Commissioners also expect to adopt these taxonomies once the appropriate Irish extensions are available.

FRC comments on publication of IMA Stewardship Code Survey

19 May 2014

Commenting on today's publication of the IMA's fourth report on adherence to the FRC's Stewardship Code, Executive Director Codes and Standards, Melanie McLaren, said:

'The FRC is pleased to see that asset manager mandates are referring more to stewardship and that investors are engaging on a broad range of issues. This is essential if we are to see the success of effective stewardship over the long term. The IMA's work in this area is very helpful and FRC will be closely monitoring the AGM season to gather further information.'

The full report can be found at http://www.investmentuk.org/research/stewardship-survey/.

FRC publishes Audit Quality Inspections Annual Report 2013/14

28 May 2014

Good standards in audit quality maintained but greater consistency required

The Financial Reporting Council (FRC) today publishes its 10th annual report on its inspections of audit quality in the UK, individual reports on each of the four largest firms and, for the first time, a separate report on its overseas inspections.

The quality of auditing in the UK is generally good, 60 per cent of audits were good or required only limited improvements, maintaining the significant improvements observed last year. The proportion of audits with the highest grade in the FRC's inspections continues to increase and this is a high bar to pass. 86 per cent of the audits inspected of FTSE 100 companies were good or required only limited improvements.

However quality is not consistent across all audit firms and types of company. 15 per cent of all audits inspected required significant improvements including one FTSE 100 company. The FRC found breaches of the rules on auditor independence and continuing problems in the audit of letterbox companies. Most significantly the quality of bank and building society audits continues to fall below average, in particular because of insufficient testing and challenge of the provision banks have been making against possible losses on their loans. In consequence a thematic inspection of auditing across the sector is underway, based on the review of 13 bank audits. If necessary firms will be required to undertake more work when significant shortcomings are found. The FRC's conclusions will be published in November 2014.

Paul George, Executive Director, Conduct, said:

'Audit makes a vital contribution to investor confidence in financial statements and in the UK is generally good, particularly among the FTSE 100. Where improvements in audit quality are needed action plans are developed with the firms and followed up with them.

'However we have not seen enough progress in the quality of bank and building society audits which continues to be generally below that of other types of entities. We are particularly concerned about the lack of sufficient challenge when testing key assumptions underpinning loan loss provisions.

'Looking ahead, our inspection activities will be significantly affected by a number of recent development including the recommendations made by the Competition Commission, the changes arising from the revised EU Statutory Audit Directive, and the abolition of the Audit Commission. These changes will significantly expand the scope of our inspections and the number of audits we report on each year. Following the Competition Commission's recommendations we will also consult later in the year on guidance for audit committees on how they might report to shareholders on the findings of an Audit Quality Review.'

FRC comments on publication of the EU Audit Directive and Regulation

28 May 2014

The new Audit Directive and Regulation were published in the Official Journal of the European Union on 27 May 2014. As a result they are now part of EU law with a coming into force date of 16 June 2014.

Commenting on this, Melanie McLaren, Executive Director, Codes and Standards, said:

'The FRC welcomes today's publication of the audit regulation and directive in the official journal of the EU. The time for discussion and debate on the proposals has been completed, and we now need to move to effective implementation.

'The FRC is pleased that the concept of audit tendering, which the UK introduced in 2012 to enhance the quality of audits and stimulate trust by the investor community, alongside audit rotation on a longer timescale. This mechanism accompanied with stricter rules on non-audit services, enhanced auditor reporting and increased Member State pan EU cooperation in the Committee of European Audit Oversight Bodies (CEAOB) is designed to strengthen the workings of the single market and benefit investors in Europe as well as in the UK.

'The FRC stands ready to work closely with BIS as it implements the necessary legal changes.'

FRC publishes 'True and Fair' statement

4 June 2014

The Financial Reporting Council (FRC) today publishes a statement reconfirming that the presentation of a true and fair view remains a fundamental requirement of financial reporting.

In October 2013, the Department for Business, Innovation and Skills (BIS) and the FRC confirmed that the current legal framework requires companies to present a true and fair view. Consistent with this, the FRC today publishes an updated statement on the application of the true and fair requirement under International Financial Reporting Standards (IFRS) and UK GAAP. A previous statement was issued in 2011.

The new statement reflects developments in UK GAAP, the now finalised European audit legislation, the legal advice obtained and published by the FRC in October 2013, and feedback from stakeholders seeking clarity as to the primary requirement to present a true and fair view.

In the vast majority of cases a true and fair view will be achieved by compliance with accounting standards and by additional disclosure to fully explain an issue. However, where compliance with an accounting standard would result in accounts being so misleading that they would conflict with the objectives of financial statements, the standard should be overridden. The FRC will continue to discharge its responsibilities in relation to the monitoring and enforcement of reporting on that basis.

The FRC seeks improvements in international financial reporting standards and the IASB's Conceptual Framework.

In particular the FRC has sought changes to the Conceptual Framework that ensures it recognises fully the objective of providing information that specifically helps investors assess the stewardship of the company's assets; and the importance of exercising prudence, meaning the exercise of caution, in reporting.

Accordingly, the FRC welcomes the IASB's recent decisions, expected to be implemented in 2015, to reintroduce explicit reference to prudence and to increase the prominence given to stewardship in the revised Conceptual Framework.

Stephen Haddrill, Chief Executive of the FRC, said:

'The requirement to present a true and fair view in financial statements is enshrined in EU and UK law. This statement confirms the fundamental importance of this concept to UK GAAP and IFRS.'

UK and Japanese regulators agree to cooperate on cross-border supervision of audit firms

6 June 2014

On 23 May 2014, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) and the Financial Services Agency (JFSA) of Japan exchanged letters on cooperation with the Financial Reporting Council (IFRC), to facilitate the exchange of information related to the oversight of auditors and mutual cooperation in the area of public oversight, registration, inspections and investigations of auditors of companies that are subject to the regulatory jurisdictions of both parties.

The CPAAOB, JFSA and the FRC seek to improve the quality, accuracy and reliability of the audit of public companies through audit regulation and auditor oversight in order to protect investors, help strengthen public trust in the audit process and increase investor confidence in their respective capital markets. Given the global nature of capital markets, it is in the common interest of both parties to cooperate in the oversight of auditors to avoid the undue burden of overlapping supervision.

Paul George, Executive Director of Conduct, said:

'The FRC, the CPAAOB and JFSA have an excellent working relationship and this agreement enables more specific cooperation, for example, the sharing of information about inspections of audits of companies listed on one another's capital markets.'

FRC's work to encourage clear and concise reporting: FRC publishes Guidance on the Strategic Report

9 June 2014

The Financial Reporting Council (FRC) today announces a programme of work to promote clear and concise reporting from which investors can, with justifiable confidence, draw conclusions about a company's performance, position and prospects.

The clear and concise programme comprises a series of initiatives to be delivered during 2014 and beyond. As a first step the FRC has today published Guidance on the Strategic Report; the new reporting requirement designed to give investors an insight into the way the business is run and its strategic direction.

Further initiatives include:

- Publishing a review of progress towards clear and concise reporting in the 2014 reporting cycle, including, examples of practical application.
- Publishing Financial Reporting Lab case studies setting out investor feedback on how well companies have addressed clarity and conciseness.
- Reporting by the Corporate Reporting Review team on reports where it commonly observes 'clutter', contrary to the objectives of clear and concise reporting.

Stephen Haddrill, FRC Chief Executive, said:

‘In 2012 the FRC introduced the requirement that corporate reports of listed companies should be “fair, balanced and understandable”. Since then the FRC has also introduced a number of measures including changes to auditor and audit committee reports. There have also been legislative changes, notably the introduction of the strategic report.

‘However, investors still express concern that the key messages about the business are buried too much verbiage of little value or are obscured by boilerplate. The programme we launch today is designed to tackle this persistent problem and promote clear and concise reporting. We will be seeking the views of stakeholders through roundtable discussions.’

The Guidance on the Strategic Report gives an overview of the various components of an annual report and considers where information should best be placed. It aims to help companies think innovatively about communication. The Guidance also encourages companies to focus on ensuring disclosures are material, as a key step towards concise reporting.

Commenting on the publication of the Guidance, Melanie McLaren, Executive Director Codes and Standards, said:

‘The new legal requirements for the strategic report have already made a positive impact, with a number of companies focussing on clarity of communication rather than a compliance-driven checklist approach to reporting. We hope to encourage that trend.

‘We have worked closely with the Department of Business, Innovation and Skills which has clarified a number of legal points related to the regulations. These clarifications are published alongside this Guidance.

‘We have also kept an eye on developments such as the EU Directive on Non-Financial Reporting and the work of the International Integrated Reporting Council. Reports that follow the Guidance should result in reporting that is consistent with the International (IR) Framework.’

FRC issues Key Facts and Trends in the Accountancy Profession

10 June 2014

The FRC has today issued its annual ‘Key Facts and Trends in the Accountancy Profession’ report which provides key data on the accountancy profession, its member bodies and practising firms.

The information illustrates the size and shape of the accountancy profession and shows how it has evolved over recent years. It brings together information about the major audit firms and seven accountancy bodies including both those who offer audit qualifications and those who register and supervise audit firms.

Paul George, Executive Director, Conduct, said:

‘The accountancy profession is an important component of the UK economy and accountancy expertise is relied upon by all sectors of society and all types of business. It is, therefore, important to monitor the health of the profession.

'It is clear from the report that the profession remains attractive with the number of students and new members indicating there is a good flow of bright, young accountants coming into the profession who will be able to support our economy in the years to come.'

Key messages:

- Total membership of the accountancy bodies continues to grow steadily with compound growth rates for 2009-13 of 2.7% in the UK to 327,000 and 3.5% worldwide to 465,000.
- Student number increased in 2013 by 1.6% in the UK to 167,000 and 4.5% worldwide to 529,000. The compound annual growth rate of worldwide students was 3.4% from 2009-2013.
- UK student numbers have remained broadly static over the same period.
- Total fee income for all the firms surveyed increased in 2012-13. The increase for the Big Four firms was 3.9% compared with 2.6% for the larger firms outside the Big Four.
- Audit fee income for Big Four firms increased by 2.8% in 2012-13 as compared to a decrease of 1.7% for the larger registered firms outside the Big Four.

FRC comments on launch of the IIRC's Corporate Reporting Dialogue

17 June 2014

Commenting on the launch today of the International Integrated Reporting Council's Corporate Reporting Dialogue, Executive Director, Codes and Standards, Melanie McLaren, said:

'The FRC as the integrated standard setter for Europe's largest capital market welcomes efforts to develop an integrated approach to governance and reporting on an international stage and stands ready to participate in the dialogue.'

The full IIRC press notice can be found at:

http://www.theiirc.og/2014/06/17/corporate-reporting-dialogue-launched-responding-to-calls-for-alignment-in-corporate-reporting/.

FRC reminds audit firms of approaching deadline for terminating or amending contracts for tax services provided on a contingent fee basis

25 June 2014

In December 2010, changes to Ethical Standards for Auditors became effective that prohibited firms from undertaking any tax services on a contingent fee basis for companies that they audit where the outcome is dependent on the proposed application of tax law which is uncertain or has not been established.

Recognising that firms were likely to have a number of uncompleted engagements of the nature described above, the revised Ethical Standards contained a transitional provision permitting firms to continue with such engagements until the earlier of the completion of the engagement or 31 December 2011. In November 2011, following consultation, the transitional period was extended to 31 December 2014.

When announcing the extension of the transitional period, it was made clear that the transitional provision would not be revisited again at a later date as the new deadline was believed to provide sufficient time for audit firms to undertake an orderly process of termination or amending prohibited contracts which will not have been completed by this date.

The FRC reminds auditors that the deadline of 31 December 2014 is not being reviewed and that, where applicable, they will need to have undertaken the necessary steps to terminate or amend such contracts, or to take other appropriate action so as to remain compliant with the Ethical Standards for Auditors, by 31 December 2014

EFRAG and the National Standards Setters ANC, ASCG, FRC and OIC invite companies to participate in an additional public consultation on lessee accounting

30 June 2014

On 16 May 2013, the IASB issued the revised Exposure Draft Leases (the ED). After the comment period ended in September 2013, the IASB and the FASB (the Boards) started the re-deliberation process. In March 2014, the two Boards tentatively decided to support two different approaches for lessees. The IASB proposed a single model based on Type-A lease accounting. The FASB proposed a model that, based on IAS 17 criteria, distinguishes leases that are in effect purchases and other leases; these are accounted for using a straight line cost recognition pattern.

EFRAG and the National Standard Setters are performing this additional public consultation to acquire constituents' views on the two alternative approaches for lessees. EFRAG and the National Standards Setters are also interested in examples of contracts or transactions that would qualify as leases under the proposals, but in constituents' view are in-substance services.

What is the objective of this additional public consultation?

The objective of this additional public consultation is twofold. Firstly, it is meant to help to identify transactions that would qualify as leases under the proposals but constituents view as in-substance service transactions that should not be recognised by a lessee. Secondly, we seek constituents' views and their preference of the two alternative approaches by the Boards.

When and how will this field-test be conducted?

This additional public consultation will start on 30 June 2014.

The participants are requested to answer the developed consultation questions on the scope of the proposals and alternative approaches. Participants should submit their replies not later than on Friday 22 August 2014.

Additionally, follow-up interviews may be conducted by EFRAG and the National Standard Setters. The information provided to EFRAG and the National Standards Setters will remain confidential. Information used in any reports will be presented in such a way that no individual company or person can be identified. However, the list of participants in this additional public consultation will be made public unless participants explicitly request anonymity. The output of this additional public consultation will be shared between EFRAG and the National Standards.

Would you like to participate?

EFRAG and the National Standard Setters encourage all entities that believe they are significantly impacted by the lease proposals to participate in this additional public consultation.

If you would like to participate, please contact your designated point of contact as described hereafter. Participants are encouraged to contact their respect National Standard Setter (as per the table below) where possible. Otherwise participants should contact EFRAG.

Country	Contact	Contact name	Phone number	E-mail address
All other countries	EGRAG	Robert Stojek	+32 (0)2 210.44.00	Robert.stojek@efrag.org
France	ANC	Isabelle Grauer-Gaynor	+33 (1) 5344 2904	Isabelle.GRAUER-GAYNOR@anc.gouv.fr
Germany	DRSC	Peter Zimniok	+49-(0) 30-206412-19	Zimniok@drsc.de
Italy	OIC	Marco Mattei	+39 0669 766821	mmattei@fondazioneoic.it
UK	FRC	Annette Davis	+44 (0)207 492 2322	a.davis@frc.org.uk

STOP PRESS! (LECTURE A476 – 16.08 MINUTES)

UK GAAP for small and micro companies

What was new UK GAAP going to look like?

Originally it was proposed that the standards would apply as follows:

IFRS:	Quoted companies
FRS 101:	Parents and subsidiaries in IFRS adopting groups
FRS 102:	Medium sized and large companies
FRSSE:	Small companies

FRC eNewsletters October 2013 – January 2014/ February 2014 – June 2014

These announced that later in 2014 there would be a consultation to discuss:

- the withdrawal of FRSSE
- small entities being brought within the scope of FRS 102
- the introduction of a new Financial Reporting Standard for Micro-entities that may include appropriate recognition and measurement simplifications

August 2014 consultation

Two consultations were published at the end of the summer:

1. Department for Business Innovation & Skills (BIS): UK Implementation of the EU Accounting Directive
2. Financial Reporting Council: Accounting standards for small entities – Implementation of the EU Accounting Directive

BIS consultation

BIS are proposing to increase small company accounting thresholds so that the limits become:

Total assets	£5.1m
Turnover	£10.2m
Employees	50

BIS are proposing that the increased accounting thresholds will apply for periods commencing from 1 January 2016 but why wait so long. Should we bring them in earlier to take advantage of the small company accounting exemptions?

They are also talking about:

- Extending the small company exemptions to PLCs
- Why the useful life for goodwill in FRS 102 is assumed to be 5 years?
- Removing the directors' report for micro companies

FRC consultation

As expected the consultation proposes that small entities will adopt FRS 102 which will include a section on disclosure exemptions for small companies.

The new FRSME will be built around the existing legislative framework for micro entities so to qualify companies must meet two out of three criteria for two consecutive accounting periods:

- Turnover ≤ £632,000
- Gross assets ≤ £316,000
- Employees ≤ 10

Such companies will produce Abridged P&L and Balance Sheet but no notes. S413 disclosure on directors' loans, advances, credits and guarantees as well as disclosure of any outstanding obligations is needed. S444 accounts are filed with the Registrar at Companies House so just a Balance Sheet.

It is proposed that the FRSME will be brought in for periods commencing 1 January 2016.