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CHANGES PLANNED FOR SMALL COMPANIES (LECTURE A485 – 30.04 MINUTES)

On 29 August 2014, the Department for Business Innovation and Skills (BIS) announced details of proposals relating to how it intends to transpose the EU Accounting Directive into companies' legislation and is seeking views on the proposed implementation of the new Directive. The UK has until 20 July 2015 in which to transpose the Accounting Directive into legislation, although the current proposals indicate that they are to take effect for financial years beginning on or after 1 January 2016 (the proposals do not allow earlier adoption). The BIS consultation closed for comment on 24 October 2014.

Overview of the proposals

The Directive is essentially set to replace the 4th and 7th Accounting Directive and it establishes minimum legal requirements in the EU as well as providing 100 Member State with options. These options will allow approximately 11,000 additional companies to access the 'lighter touch' financial reporting framework which is available under the proposed small companies' regime.

The main objectives of the Accounting Directive are to:

- Simplify accounting requirements so as to reduce the administrative burden on companies with particular emphasis focused on smaller companies.
- Increase the clarity and comparability of financial statements of companies. The idea with this is to reduce the cost of capital and increase the level of cross-border trade and merger and acquisition activity.
- Protect essential user needs by retaining necessary accounting information for users.

In order to achieve the above objectives, the Directive:

- Introduces a 'building block' approach to the statutory financial statements whereby disclosure levels are increased depending on the size of the undertaking.
- Reduces the number of options available to the preparers in respect of recognition, measurement and presentation.
- Creates a largely harmonised small companies regime and, for the first time, limits the amount of information which Member States are permitted to require small undertakings to place in their annual financial statements.

The government is currently undertaking a programme of reducing unnecessary burdens on businesses, particularly for smaller businesses and the consultation document recognises that the changes in EU law provide an opportunity for government to further reduce the administrative burdens which they claim are associated with the preparation and publication of statutory accounts, especially for smaller companies. However, at the same time the government does not want to reduce the quality of information that financial statements provide to interested stakeholders, such as creditors, shareholders and regulators. To preserve the quality of financial information, BIS proposes to retain most of the Member State options.

Size categories

Perhaps the most notable of changes contained within the consultation document relates to the size criteria of companies. It is to be noted at the outset that the proposals **only increase the size criteria for accounting purposes only** – the audit exemption limits will

remain the same for the time being and will be subjected to a separate consultation in the future.

The Accounting Directive sets out mandatory thresholds for micro, small, medium and large companies which are all relative to:

- The average number of employees
- Balance sheet total (or gross (fixed + current) assets)
- Net turnover at the balance sheet date

A micro or medium company comes under the relevant size if it does not exceed the limits of at least two of the three criteria. Large undertakings (or groups) are those which, on their balance sheet date, exceed at least two of the three criteria for medium-sized undertakings (or groups). The current regime is set out as follows:

	Small company	**Medium-sized company**
Turnover	£6.5 million	£25.9 million
Balance sheet total	£3.26 million	£12.9 million
Average number of employees (on a monthly basis)	50	250

For groups the current regime is set out as follows:

	Small group	**Medium-sized group**
Turnover	£6.5 million net £7.8 million gross	£25.9 million net £31.1 million gross
Balance sheet total	£3.26 million net £3.9 million gross	£12.9 million net £15.5 million gross
Average number of employees (on a monthly basis)	50	250

The proposals set out a table of the revised proposals as follows:

	Balance sheet **£**	**Net turnover** **£**	**Average number of employees**
For individual company accounts			
Micro-entity company	≤316,000	≤632,000	≤10
Medium-sized company	≤18,000,000	≤36,000,000	≤250

Large company	≥18,000,000	≥36,000,000	≥250
For group/consolidated accounts			
Medium-sized group	≤18,000,000 net ≤21,600,000 gross	≤36,000,000 net ≤43,200,000 gross	≤250
Large group	≥18,000,000 net ≥21,600,000 gross	≥36,000,000 net ≥43,200,000 gross	≥250

The Directive also sets out a mandatory minimum threshold for small companies. A company will qualify as a small company if it does not exceed the limits of at least two of the three criteria. There is an added concession within the Directive for small companies which allows Member States to increase the balance sheet total and net turnover values by up to 50% so as to allow more companies to access the less burdensome small companies regime if they so wish.

The proposals issued by BIS acknowledge that if they were to adopt the minimum thresholds which define a small company, this would only offer a small increase of around 7% over the current thresholds and hence just 1,000 medium-sized companies would then fall into the small companies' regime. To allow more medium-sized companies the opportunity of becoming small BIS proposes to adopt the maximum small company thresholds so as to allow an additional 11,000 companies access to the small companies regime. The table below shows the minimum and maximum thresholds permitted (note the UK is planning to adopt the *maximum threshold values permitted*.

	Balance sheet **£**	**Net turnover** **£**	**Average number of employees**
For individual company accounts			
Small company Using *minimum* mandatory threshold values	≤3,500,000	≤7,000,000	≤50
Small company Using *maximum* threshold values permitted	≤5,100,000	≤10,200,000	≤50
For group/consolidated accounts			
Small group Using *minimum* mandatory threshold values	≤3,500,000 net ≤4,200,000 gross	≤7,000,000 net ≤8,400,000 gross	≤50
Small group Using *maximum* threshold values	≤5,100,000 net ≤6,100,000 gross	≤10,200,000 net ≤12,200,000 gross	≤50

permitted			

When calculating thresholds, the Accounting Directive provides Member States with the opportunity of considering additional factors in determining the 'reference point' for calculating the size of a company:

- First, the Directive permits that Member States may require other sources of income to be included for companies for which 'net turnover' is not relevant. The Directive acknowledges that many companies generate significant income from sources other than the principal activity of the business (such as investment income). By ignoring income from other sources a company which might otherwise be regarded as medium-sized (or even large) might be able to access the small companies' regime and take advantage of the reduced disclosure requirements.
- Second, the Directive permits that Member States may require parent undertakings to calculate their thresholds on a consolidated, rather than individual, basis and/or require 'affiliated undertakings' to calculate their thresholds on a consolidated or aggregated basis.

BIS have confirmed that the government have no plans to change the way in which UK law currently operates.

It is also to be noted that public interest entities (PIEs) are automatically excluded from access to the small company regime. BIS acknowledges that whilst it is still in the public interest to exclude PIEs who trade securities on a regulated market, they are asking whether it is appropriate (or necessary) to continue to exclude all other public companies.

Proposed new small companies' regime

In drafting the proposals, the Commission has applied a 'think small first' approach. In applying this concept, BIS believes that it has created a small companies regime which enables companies to prepare profit and loss accounts, balance sheets and related notes which are more proportionate to their size and which will satisfy the information needs of the users of the financial statements.

A point worthy of note in the proposals is that the small companies' regime which is being consulted upon is a harmonised regime. While financial statements will still be prepared under Generally Accepted Accounting Practice, several of the changes brought about by the Directive do not, in fact, affect the UK as we currently operate a small companies' regime. Notwithstanding the similar principles, the other changes either require (or allow) the government to further reduce the administrative burden placed on small companies when preparing financial statements.

Notes to the financial statements

The Directive restricts Member States' ability to require statutory disclosures from small companies within national reporting regimes. However, small companies will still be required to consider if their financial statements meet the requirements of the Companies Act 2006 and hence give a true and fair view of the financial affairs. To that end, a company will still be obliged to provide additional disclosure notes within their financial statements so as to achieve a true and fair view where it is considered that the mandatory notes are insufficient for this purpose.

The Accounting Directive allows that Member States may only require companies which fall to be classed as small to provide 13 disclosure notes as follows:

- Accounting policies adopted
- Fixed assets revaluation table
- Fair valuation note
- Financial commitments, guarantees or contingencies not included in the balance sheet
- The amount of advances and credits granted to members of the administrative, managerial and supervisory bodies (with supporting information)
- Exceptional items
- Amounts due or payable after more than five years and entire debts covered by valuable security
- Average number of employees during the financial year
- Fixed asset note (in addition to the mandatory revaluation table)
- Name and registered office of the undertaking drawing up the consolidated financial statements of the smallest body of undertakings of which the undertaking forms part
- Nature and business purpose of arrangements not included in the balance sheet
- Nature and effect of post balance sheet events
- (Limited) related party transactions

The Accounting Directive allows Member States flexibility in terms of five of the above mandatory notes and Member States need not require the following in small company financial statements:

- Fixed asset note (in addition to the mandatory revaluation table)
- Name and registered office of the undertaking drawing up the consolidated financial statements of the smallest body of undertakings of which the undertaking forms part
- Nature and business purpose of arrangements not included in the balance sheet
- Nature and effect of post balance sheet events
- (Limited) related party transactions

BIS has considered whether, or not, to take up the option of not requiring the above disclosures in financial statements. However, they have decided not to take up the option on the grounds that BIS considers all 13 disclosures to be important so as to aid a proper understanding of a company's financial statements. In addition, BIS also believes that the 13 disclosure requirements are consistent with the present UK accounting framework and also enables the financial statements to give a true and fair view.

BIS acknowledges that it does not consider the above disclosure requirements to be burdensome for small companies and confirms that in any event small companies would still need to provide this information in their annual financial statements so that they give a true and fair view.

Abbreviated financial statements

Companies which are classed as small in the UK have the ability to file abbreviated financial statements if they so wish. Many companies in the UK (in fact the vast majority) take up the option to file an abbreviated set of financial statements to Companies House.

Article 14 of the Accounting Directive makes a provision for a small company to file both an abbreviated balance sheet and an abbreviated profit and loss account. The UK has not taken this option previously and small companies (except those reporting under the micro-entities legislation) are required to prepare a directors' report, profit and loss account, full balance sheet and related notes which are circulated to the shareholders of the company.

The abbreviated financial statements are then derived from the full set of financial statements and contain an abbreviated balance sheet with limited disclosures.

The consultation document recognises that company directors must give their shareholders sufficient information in the form of full financial statements so that they can assess the financial position and financial performance of the business. Where there is an agency relationship between the shareholders as owners and the directors as managers of a small business, the need for greater levels of detail in the financial statements is justified. In owner-managed companies, the agency relationship is not present and hence the need for greater detail in the financial statements is reduced. For this reason, the government believes that companies (shareholders and directors in collaboration) should be given a choice concerning the level of detail which is to be included in the entity's financial statements having regard to the size and nature of the business concerned.

Therefore BIS proposes to take up the option in the Accounting Directive and allow eligible small companies to prepare and publish abbreviated accounts which will consist of an abbreviated balance sheet and an abbreviated profit and loss account, should they wish.

Dormant companies

The exemptions from preparing and filing accounts for dormant subsidiary companies (where the subsidiary has a parent company guarantee) currently excludes quoted companies from being able to take up this exemption. BIS are proposing to make amendments so that all companies with securities traded on a regulated market are excluded. This would include most quoted companies and some companies which are not quoted companies.

In addition, the dormant subsidiaries exemptions currently do not exclude companies which are classed as being part of an 'ineligible group' (as defined for the purpose of the small companies accounting regime). In light of the planned changes to the definition of an ineligible group for the purposes of small company accounts, BIS are also considering whether it would be appropriate to include such exclusion to the dormant subsidiaries exemptions.

Profit and loss account and balance sheet formats

The Accounting Directive reduces the number of permissible formats for the profit and loss account from four to two. In reality only Format 1 and Format 2 are commonly used, with Formats 3 and 4 being relatively uncommon in the UK.

As far as the balance sheet is concerned, the two permitted formats in the Companies Act will remain available to companies. However, there will be minor drafting changes needed to the balance sheet formats in order to implement the Accounting Directive, although BIS does not expect these drafting changes will be substantive or require any changes in approach by preparers of accounts.

Flexibility in layouts

The Accounting Directive makes provision for increased flexibility in relation to the customisation of layouts of both the balance sheet and profit and loss accounts (which also allows for sector-specific layouts to be adopted). BIS are looking into ways that this flexibility can be achieved in the UK and asked whether such flexibility should be included as separately available profit and loss account and balance sheet formats or whether this should be a matter that accounting standards deals with. BIS are particularly looking at the flexibility of incorporating IFRS layouts, which would alleviate the inherent problem in applying the requirements for Companies Act accounts to financial statements prepared under the provisions in FRS 101 *Reduced Disclosure Framework*.

Accounting for participating interests in individual accounts

Article 9.7 of the Accounting Directive now allows entities an option to permit or require participating interests to be accounted for under the equity method of accounting within an investor's individual financial statements. At present, the UK's Companies Act and accounting standards do not permit the use of the equity method when preparing separate financial statements as they only allow cost-based and fair value measurement methods (although the use of the equity method is required when the consolidated financial statements are prepared). Under EU-endorsed IFRS, the equity method of accounting for participating interests in the separate financial statements of the investor is an accounting policy choice and is in addition to the requirement to equity account the participating interest in the consolidated financial statements.

BIS acknowledges that the option to enable the use of equity accounting in the preparation of separate financial statements would provide greater flexibility for the UK and are therefore proposing to allow this option and hence change the legislative requirements accordingly.

Goodwill and development costs

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* currently requires goodwill and intangible assets to be written off over a five-year period where management are unable to assign a reliable useful economic life to goodwill/other intangibles. The Accounting Directive has a slight change in approach where this is concerned and requires that Member States set a maximum period over which the write-off of goodwill can be applied. The Accounting Directive says that the period must not be shorter than five years and must not exceed 10 years and acknowledges that the option is only intended to be applied in very narrow and exceptional circumstances. In addition, the option only applies to goodwill and development costs only where the useful life cannot be reliably estimated. Hence it is not expected that this provision will be relied upon very often. Current accounting standards require management to amortise goodwill and intangible assets over their expected useful lives and hence such lives, in theory, should have been reliably estimated on initial recognition (or revised accordingly at a subsequent date).

FRS 102 currently allows a maximum of five years for all intangible assets, including goodwill, where the useful economic life cannot be reliably measured. The government intends to implement the upper limit of 10 years which is permitted by the Accounting Directive and hence the FRC have said that they will review this limitation if legislation permits the upper limit of 10 years.

Information on subsidiaries within the consolidated accounts

The Accounting Directive makes it mandatory that the notes to the consolidated financial statements must include information in relation to the parent's subsidiaries that have been included within the consolidation. Currently, the UK allows companies to provide information relating to subsidiary companies when submitting the annual return to Companies House. However, BIS have acknowledged that whilst providing information on the annual return is a useful flexibility used by companies, it essentially dilutes the information conveyed within the consolidated financial statements as well as inherent delays in making such information publicly available.

Because of this problem (and the fact that such problems were noted during the *Company and Commercial Law Red Tape Challenge*) the option to provide information relating to subsidiaries within the annual return will be removed on implementation of the Accounting Directive within the UK.

Audit exemption

For a time the audit exemption limits will be decoupled from the small companies' limits as BIS are not proposing to increase the audit exemption thresholds for small undertakings as part of the implementation of the Accounting Directive.

As a consequence, the small companies audit exemption contained within companies' legislation will need to be amended so that it does not refer back to the thresholds which apply to the small companies' regime for accounting purposes. Instead, the audit exemption framework will set out the current thresholds so that those thresholds will continue to apply for the purposes of audit exemption.

BIS are proposing to undertake a separate consultation on increasing audit exemption limits in due course.

However, the implementation of the Accounting Directive will mean some changes will be made to the exclusions from the small companies accounting regime.

All public companies are prohibited from taking up the small companies audit exemption. However, BIS is proposing to make this 'blanket' prohibition narrower and apply the prohibition to those companies who trade their securities on a regulated market.

In addition, there are several cases where small companies are excluded from audit exemption (for example when they are part of a group). Whilst BIS are not considering on changing this existing requirement, they have recognised that the current framework will need to be changed so that it does not refer back to the definition of a small group for accounting purposes. BIS propose to set out the current thresholds for a small group within the audit exemption framework without the increases which are proposed for the purposes of the small companies accounting regime.

The term 'ineligible group' is defined within the small companies accounting regime. BIS are considering whether the consequential amendments to that definition due to changes being made to the small companies' framework should also apply for the purposes of the small companies audit exemption. The definition would essentially be narrower so that the presence of a public company within the group would not necessary make that group ineligible.

Where groups are concerned, if a subsidiary company has a parent company guarantee then it can claim audit exemption but the current regime prohibits quoted companies from being able to take up the exemption. BIS are proposing to make changes to this exclusion so that all companies which trade their securities on a regulated market are excluded (including some companies which are not quoted companies).

Where dormant companies are concerned, the dormant companies audit exemption is currently available to companies which trade their securities on a regulated market as well as to companies which are part of an ineligible group. BIS proposes to make changes to the small companies audit exemption so as to bring dormant companies audit exemption in line with that for small companies.

Directors report for micro-entities

Finally, BIS are proposing to withdraw the requirement for entities which prepare financial statements under the micro-entities legislation to prepare a directors' report. However, if the micro-entity acquires any of its own shares, BIS are proposing to make it a requirement that such transactions appear as a footnote to the micro-entity's abbreviated balance sheet.

Financial reporting implications of the proposals

In light of the EU Accounting Directive, the Financial Reporting Council (FRC) issued a consultation document '*Accounting standards for small entities – Implementation of the EU Accounting Directive*' in September 2014.

The consultation document acknowledges that the most significant change which arises from the Accounting Directive relates to the small companies regime whereby current accounting standards may not specify disclosure requirements in addition to the limited number of disclosures which are set out in the Accounting Directive. The consultation document acknowledges that disclosures over and above those contained in the Accounting Directive must still be made in the financial statements of a small company in order to give a true and fair view.

It is apparent from the wording in the FRC's consultation document that the FRC are not in favour of the significant reduction in mandatory disclosures which the Accounting Directive brings and whilst the FRC have acknowledged that it was planning to consult on the recognition and measurement of items within small companies' financial statements and if it were not required to significantly reduce the disclosures made in small entity financial statements, it would not have proposed to do so. The reason that the FRC appear to view the proposals in an unfavourable light is due to the additional burden that will be placed on the directors of small companies to determine and provide those specific additional disclosures so that the entity's financial statements give a true and fair view. In reality many small entities will rely on their accountancy firms to assist them in determining and including additional disclosures to comply with the true and fair requirements within the Companies Act 2006.

The FRC's consultation document was open for comment until 30 November 2014.

Proposed financial reporting regime by the FRC

The number of 'tiers' where financial reporting is concerned has seen an increase due to the introduction of the micro-entities legislation. Currently the micro-entities legislation is incorporated within the FRSSE (effective April 2008) and (effective January 2015), which is not ideal. In light of this, the FRC are proposing to segregate the accounting and disclosure requirements for micro-entities into a separate standard, being the *Financial Reporting Standard for Micro-Entities* (FRSME). Some accountants may already be familiar with the abbreviation 'FRSME' as it related to the old exposure drafts of new UK GAAP when the standard was originally called *The Financial Reporting Standard for Mid-Sized Entities*.

In light of the legislative changes, the FRC propose the following framework:

(a) Micro-entities will be able to apply the *Financial Reporting Standard for Micro-Entities*.

(b) Small entities will apply FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, but a new section will be inserted setting out the presentation and disclosure requirements applicable to small entities, which will be based on the new legal provisions. Otherwise the scope of FRS 102 will remain the same.

(c) Entities that are required by the IAS Regulation or other legislation or regulation to prepare their financial statements in accordance with EU-adopted IFRS will continue to do so.

(d) A qualifying entity will continue to have the option to prepare its financial statements in accordance with FRS 102 *Reduced Disclosure Framework*.

(e) An entity will continue to have the option to apply a more comprehensive accounting standard. For example, a micro-entity will be able to choose between the FRSME, the small companies regime within FRS 102, FRS 102 in full or EU-adopted IFRS.

The FRC has an overriding objective where financial statements are concerned:

'To enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.'

The consultation document issued by the FRC states that only when financial statements give a true and fair view will the above objective be achieved and this requirements is still a key underlying principle within the Accounting Directive. The Accounting Directive mandates a minimum number of disclosures; however notwithstanding this 'minimalist approach', companies must still make disclosures over and above the mandatory minimum in order that the financial statements give a true and fair view. There are, however, limits imposed on the FRC insofar as the accounting requirements for small and micro-entities because the Accounting Directive:

(a) prohibits the remeasurement and the use of fair value by eligible entities choosing to apply the micro-entities regime; and

(b) restricts the disclosures that can be required by micro-entities and small entities.

The FRSSE

The FRC propose to withdraw the FRSSE in its entirety and replace it with:

(a) the FRSME for entities choosing to apply the micro-entities regime; and

(b) a small companies regime within FRS 102.

The FRSME is discussed in the next section of the notes, but the FRC are proposing to insert a new Section 1A *Small Entities* within FRS 102 which will set out the framework and presentation and disclosure requirements for small entities. FRS 102 for small companies will be based on the new Accounting Directive and hence small companies:

(a) will not be required to provide a cash flow statement, a statement of total comprehensive income or a statement of changes in equity; and

(b) will not have to prepare consolidated financial statements.

The FRC considers that bringing small companies under the scope of FRS 102 is more appropriate than having a separate standard for small companies (such as a FRSSE equivalent). This is because the recognition and measurement requirements of FRS 102 are suitable for small entities and there are disadvantages of having another separate framework for small companies in addition to the micro-entities regime. In addition, FRS 102 is a vastly reduced standard in terms of volume (spanning 360 pages as opposed to 3,000+ pages of current UK GAAP) and hence the FRC are of the opinion that the standard is accessible to small companies not applying the micro-entities legislation.

A standalone micro-entities regime is considered justifiable on the grounds that it legally prohibits remeasurement and the use of fair value accounting which in turn create recognition and measurement differences and hence it is appropriate to have the FRSME as a self-contained regime.

When a small company makes the transition from the FRSSE to FRS 102 for small companies there will be changes in financial reporting practices and such changes will include:

(a) recognising derivatives, such as interest rate swaps and foreign currency forward contracts, and measuring them at fair value;

(b) financial instruments at non-market rates of interest may be measured differently from in the past;

(c) some more complex financial instruments may be measured at fair value; and

(d) transactions in foreign currencies may no longer be recognised at contract rate, although hedge accounting may be applied which could result in a similar outcome.

The extent of changes in accounting practice by small companies will depend on the transactions each entity undertakes. Some entities might experience very few accounting practice changes, whereas some entities may experience a number of changes.

Other changes which will take place in accounting when a small company moves from the FRSSE to FRS 102 will include the following:

(a) changes in the fair value of investment property being recognised in profit or loss rather than through the statement of total recognised gains and losses;

(b) recognition of deferred tax on revaluations and in business combinations;

(c) recognition of holiday pay accruals; and

(d) recognition of equity-settled share-based payment transactions when the goods or services are received.

The FRSME

The FRSME is proposed to only apply to micro-entities. The qualifying conditions are met by a company in a year in which it does not exceed two or more of the following criteria:

Turnover	£632,000
Balance sheet total	£316,000
Number of employees	10

The micro-entities regime has key features which are discussed below.

(a) It cannot be applied by public benefit entities or financial institutions.

(b) It does not apply to financial statements (consolidated or individual) of parent companies that choose to prepare consolidated accounts (or the individual financial statements of subsidiaries which are included in the consolidated accounts).

(c) Only a balance sheet (Format 1 or Format 2) and a Format 1 profit and loss account is needed (no other statements eg the cash flow statement are required).

(d) The use of the Alternative Accounting Rules or Fair Value Rules in company law are prohibited hence it is not permissible to revalue or measure assets or liabilities at fair value.

(e) The only disclosures relate to guarantees and other financial commitments and advances, credits or guarantees to/on behalf of directors.

(f) Deeming provisions in the legislation mean that accounts prepared under the micro-entities legislation are presumed to give a true and fair view.

Further planned simplifications to be incorporated within the FRSME by the FRC are as follows:

(a) Presentation and disclosure requirements as set out in legislation (summarised above).

(b) Recognition and measurement requirements based on FRS 102, except for:

(i) simplifications of the requirements for financial instruments, which will be solely based on historical cost or amortised cost;

(ii) no requirement to account for deferred taxation;

(iii) no requirement to account for equity-settled share-based payments prior to the issue of the shares;

(iv) a simplification to accounting for post-employment benefits, that will permit defined benefit plans to be accounted for as defined contribution plans (including recognition of a liability for contributions payable arising from an agreement to fund a deficit in relation to past service because the micro-entity will no longer be recognising the net asset or liability arising from the defined benefit plan);

(v) no option to capitalise borrowing costs; and

(vi) deletion of sections that are unlikely to be applicable to micro-entities, such as Section 19 *Business Combinations and Goodwill* (with a cross-reference to FRS 102 if a micro-entity has undertaken a trade and assets acquisition), Section 31 *Hyperinflation* and most of Section 34 *Specialised Activities* (the sub-section *Agriculture* will be retained).

If a micro-entity has, say, a derivative financial instrument (which is likely to be rare but cannot be ignored completely), such as an interest rate swap or forward foreign currency contract, the FRC is unable to require the micro-entity to either recognise the derivative at fair value (because the legislation prohibits fair value measurement) or the disclosure of the existence and nature of such instruments (as this is also prohibited by the legislation). The FRC have proposed that the FRSME will clarify that when a derivative financial instrument becomes onerous the resulting obligation will be recognised, instead, at its present value.

Example – investment property held by a micro-entity on adoption of the FRSME

A company qualifies as a micro-entity and has decided to use the micro-entities regime in preparing its financial statements. It previously prepared its financial statements under the FRSSE (effective April 2008) and it has an investment property on its balance sheet which it carries at fair value. At 31 December 2013 the investment property had a carrying value of £100,000 (as per the valuation report) and there was an associated revaluation reserve account amounting to £25,000. The directors have decided to use the previous valuation as 'deemed cost' for the investment property for the year-end 31 December 2014.

The application of the Alternative Accounting Rules is prohibited in the micro-entities legislation and hence no revalued amounts can be included in the balance sheet under the legislation. In order to correctly apply the legislation, the investment property will have to be restated at cost less depreciation less any impairment from the date of acquisition up to 31 December 2014. This could potentially have a significant impact on the entity's balance sheet.

Other amendments to FRS 102

The overarching requirements of FRS 102 are not proposed to be amended as the FRC have acknowledged that this will be carried out as part of its first three-yearly review. However, there are a small number of amendments which are likely to be necessary so as to maintain consistency between FRS 102 and UK and Irish companies' legislation.

The areas of FRS 102 likely to change due to the company law changes are:

(a) updating any specific references to legal requirements that will now be out of date, for example in relation to the formats of the profit and loss account and balance sheet, and in relation to the requirements to prepare consolidated financial statements;

(b) removal of references to ordinary and extraordinary items for most entities (paragraphs 5.10 and 5.10A of FRS 102);

(c) amending the maximum useful economic life of goodwill and intangible assets, in situations where an entity is not able to estimate the useful economic life, to 10 years (paragraph 18.20 and paragraph 19.23(a) of FRS 102), if this is introduced into company law (see BIS consultation document);

(d) amending paragraph 27.28 of FRS 102 to prohibit a reversal of an impairment loss for goodwill; and

(e) any other areas, subsequently identified or arising as a result of consultation, where changes to company law would result in a change being necessary to FRS 102.

Amendments to FRS 101

Under FRS 101 *Reduced Disclosure Framework*, companies are still required to prepare 'Companies Act accounts' as opposed to 'IAS accounts'. As a consequence, any changes in company law as a result of the new Accounting Directive are likely to have an impact on those companies which apply FRS 101.

At present there are only two amendments which will need to be made to FRS 101 and relate to:

(a) extraordinary items, for which the FRC would propose to delete paragraph AG1(j) of FRS 101; and

(b) prohibiting a reversal of an impairment loss for goodwill, for which the FRC would propose to delete paragraph AG1(s) of FRS 101.

The consultation document issued by BIS does, however, provide an opportunity to consider whether alternative formats for both the balance sheet and profit and loss account should be permitted in legislation. If this flexibility is brought into law, the FRC will consider whether entities applying FRS 101 will be able to apply the presentation requirements in IAS 1 *Presentation of Financial Statements* and still comply with company law.

If this works, the FRC would make amendments to the Application Guidance in FRS 101 by deleting paragraphs AG1(h) and AG1(i) of FRS 101. However, as the flexibility in the Accounting Directive depends upon information being presented which is equivalent to that provided if the formats set out in the new Accounting Directive were applied, the FRC would have to consider whether additional disclosures are necessary so as to achieve this equivalence.

Next steps

In relation to BIS, the UK is required to transpose the Accounting Directive into UK legislation no later than 20 July 2015. BIS proposes to take up the option permitting that the changes may first apply to financial years commencing on or after 1 January 2016.

The FRC's comment period closed on 30 November 2014. Once feedback is considered, the FRC will develop the proposals and issue exposure drafts on which comments will be invited. The FRC then expects to issue new accounting standards in the summer of 2015 which will become effective for accounting periods commencing on or after 1 January 2016.

FRS 102: SECTION 11– LOANS AT < MARKET RATE (LECTURE A486 – 11.54 MINUTES)

It is not uncommon for entities to enter into debt instruments (either a financial asset or financial liability) which bear zero or a below market rate of interest and FRS 102 does set out subtle measurement requirements for financial instruments which contain such arrangements and the standard at paragraph 11.13 recognises that these will constitute a financing transaction. Paragraph 11.13 specifically outlines when a financing transaction takes place and it says that such a transaction:

'... may take place in connection with the sale of goods or services, for example, if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate.' [1]

Example – inter-company loan

Parent Co is the parent of a group of wholly-owned subsidiaries. The principal activity of one of the subsidiary companies (Sub A) is that of research and development. Sub A has to incur a high level of costs at the start of project before entering into the development phase and a significant period of time can elapse before the project starts to generate income for the company due to the costs that have to be incurred at the outset.

During the year to 31 December 2015, Parent Co agreed to make a loan to Sub A to fund its working capital requirements for a year until one of its projects started to generate income. Parent Co has provided this loan interest-free.

The interest-free loan would be classified as a financing transaction under the provisions in paragraph 11.13 of FRS 102 and hence it should be measured initially at the present value of the future payments discounted at a market rate of interest for a similar debt instrument.

Accounting requirements for loans at less than market rate

Financial assets and liabilities which are subject to a financing transaction and which are debt instruments that meet the condition of paragraph 11.8(b) of FRS 102 are initially measured at the present value of the future payments discounted at a market rate of interest for a similar debt instrument. After initial recognition such instruments are measured at *amortised cost*.

Amortised cost method

Paragraph 11.15 of FRS 102 says that the amortised cost of a financial asset or financial liability at each reporting date is the **net** of the following amounts:

(a) the amount at which the financial asset or financial liability is measured at initial recognition;

(b) minus any repayments of the principal;

(c) plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount;

(d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

A point worth noting is that if the financial asset/financial liability does not have a stated interest rate (and hence does not constitute a financing transaction) and the instrument is classified as payable or receivable within one year, the instrument is initially measured at an

[1] FRS 102 paragraph 11.13

undiscounted amount in accordance with paragraph 11.14(a) of FRS 102 and hence (c) above will not apply to such instruments.

Effective interest method

The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability (or a group of financial assets and financial liabilities) and then allocating the interest expense or income over the life of the financial instrument. The effective interest method uses the 'effective interest rate' which is the rate that exactly discounts estimated future cash flows (payments and receipts) through the expected life of the financial instrument or, when appropriate, a shorter period, to the carrying value of the instrument. The effective rate of interest is determined on the basis of the carrying value of the financial instrument at initial recognition. Points worth noting where the effective interest method is concerned are as follows:

(a) the amortised cost of a financial asset/financial liability is the present value of the future cash receipts/payments discounted at the effective interest rate; and

(b) the interest expense/income in a period equals the carrying amount of the financial liability/asset at the beginning of a period multiplied by the effective interest rate for the period.

To calculate the effective interest rate it is necessary to estimate cash flows associated with all the terms of the instrument (such as prepayment, call and similar options) as well as known credit losses which have been incurred. However, when calculating the effective interest rate you should ignore any possible future credit losses which have not yet been incurred. Related fees, finance charges paid or received (eg 'points'), transaction costs and other premiums or discounts are amortised over the expected life of the financial instrument. However, a shorter period of amortisation will be used if the shorter period is the period to which such fees, finance charges paid/received, transactions costs and other premiums or discounts relate. Paragraph 11.18 of FRS 102 says that this will be the case when the variable to which the fees, finance charges paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such scenarios, the appropriate amortisation period is the period to the next such reporting date.

Example – standard loan at 8%

On 1 January 2017 a bank provides an entity with a four-year loan of £5,000 on normal market terms, including charging interest at a fixed rate of 8% per year. Interest is payable at the end of each year. The figure of 8% is the market rate for similar four-year fixed-interest loans with interest paid annually in arrears. There are no transaction costs.

Cash flows are as follows:

Year	Cash flow (£)
0	5000.00
1	(400.00)
2	(400.00)
3	(400.00)
4	(5,400.00)

The effective interest rate is 8% per annum (determined using the IRR function in Excel).

The following was the original amortised cost calculation as at 1 January 20X1.

Year	Carrying amount at beginning of year	Interest payable at 8%	Cash outflow	Carrying amount at the end of the year
	£	£	£	£
20x1	5000.00	400.00	(400.00)	5000.00
20x2	5000.00	400.00	(400.00)	5000.00
20x3	5000.00	400.00	(400.00)	5000.00
20x4	5000.00	400.00	(5,400,00)	0.00

Example – inter-company loan at 0%

On 1 January 2017 Subsidiary A provides Subsidiary B with an interest free loan of £5,000. The loan is to be repaid in four years' time. Section 11 FRS 102 requires the loan to be presented using a market rate of interest for the loan. The market rate of interest for this type of loan has been determined as 8%.

The opening value of the loan has to be discounted using the market rate of interest of 8%.

The discounted value of the £5,000 loan is £5,000*1/ $(1.08)^3$ and this gives an opening value of £3,675 (rounded to the nearest £1).

The accounting treatment of the loan in Subsidiary B's books is as follows:

	DR	CR	
Bank account	£5,000		
Inter-company loan creditor		£3,675	
Profit and loss account		£1,325 →	Benefit of int-free loan

Being receipt of loan from Subsidiary A

The subsequent accounting treatment for the loan in Subsidiary B's books will be as follows:

Year	Carrying amount at start of year	Interest payable at 8%	Carrying amount at end of year
31.12.17	£3,675	£294	£3,969
31.12.18	£3,969	£318	£4,287
31.12.19	£4,287	£343	£4,630
31.12.20	£4,630	£370	£5,000
		£1,325	

The interest charge is allocated to the profit and loss account for each year as follows:

	DR	CR
Profit and loss account	£	£
Year 1		
Benefit of interest-free loan		1,325
Interest charge for year 1	294	

The net effect in year 1 is that the profit and loss account shows a net income of £1,031. This is then 'charged' in the profit and loss account over years 2 to 4:

	DR	CR
	£	£
P&L account year 2	318	
P&L account year 3	343	
P&L account year 4	370	
	1,031	

The accounting treatment in Subsidiary A would be the reverse of the treatment in Subsidiary B. On granting the loan the double-entry would be:

	DR	CR
Cash paid to Subsidiary B		£5,000
Inter-company loan debtor	£3,675	
Profit and loss account	£1,325 →	cost of int-free loan

Being loan to Subsidiary B

The profit and loss account for Subsidiary A would then show income equal to the interest paid that would be added to the debtor so that the £5,000 payment made in four years' time would clear the balance.

FRC GUIDANCE ON GOING CONCERN (LECTURE A487 – 17.17 MINUTES)

Going concern has moved up the ranks in the profession over recent years, due in large part to the recent economic crisis. Indeed even the most profitable companies can see themselves in financial difficulty due to cash flow constraints or in the worst cases the reporting of profits which are not cash-backed so as to mislead users into thinking the entity's financial position and performance is better than it actually is.

One of the most fundamental (and material) issues in companies, both large and small, is the concept of going concern. Going concern can never be said to be immaterial and it is the duty of all companies to ensure that the going concern basis of preparing financial statements is applicable in the individual circumstances. While the concept of going concern is a fundamental concept, it is still one that often causes a certain element of confusion among practitioners – particularly when it comes to the disclosure requirements. In the past companies have been severely criticised for inadequate disclosures (as have audit firms who have audited such companies) and as a consequence, professional regulators have issued various amounts of guidance regarding the issue of going concern.

Under current UK GAAP (FRS 18 *Accounting Policies*, the FRSSE (effective April 2008 and January 2015) and EU-adopted IFRS), it is the responsibility of the directors of companies to satisfy themselves that the use of the going concern basis of accounting is reasonable so as to conclude that the financial statements give a true and fair view. Where there are 'material uncertainties' relating to the entity's going concern status, then there should be additional disclosures made in the accounts.

Under the going concern concept, it is assumed that a company will continue in operation for the foreseeable future and that there is neither the intention, nor the need, to either liquidate it or to cease trading.

Guidance on going concern assessments and disclosures

In October 2009, the Financial Reporting Council (FRC) issued a document titled *'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009'*. Whilst this document was issued some five years ago, it still has particular relevance today.

The guidance itself brings together the requirements of the Companies Act 2006, accounting standards and the Listing Rules on going concern and liquidity risk for small, medium and large companies as well as providing guidance on their application.

The document itself is fairly brief, spanning just 26 pages, and deals with three principles in dealing with going concern:

1. Assessing going concern
2. The review period
3. Disclosures

The Appendices then offer examples of going concern disclosures in certain situations as well as key questions for boards.

The guidance applies to accounting periods ending on or after 31 December 2009 and superseded the guidance which was issued in 1994 for directors of listed companies. The 2009 version of the guidance extends to all sizes of companies for both annual and half-yearly financial statements.

Assessing going concern

The first principle in the guidance deals with the assessment of going concern. Principle 1 says:

Directors should make and document a rigorous assessment of whether the company is a going concern when preparing annual and half-yearly financial statements. The process carried out by directors should be proportionate in nature and depth depending upon the size, level of financial risk and complexity of the company and its operations.

There is no 'one-size-fits-all' where the assessment of going concern is concerned and directors of all companies are required to make a going concern assessment. The directors of a company cannot use the going concern basis of accounting if they intend to cease trading, or go into liquidation or they have no realistic alternative but to do so. In such cases this will mean change of basis in preparing the financial statements which will have an impact in the carrying amounts of assets and liabilities recognised in the financial statements.

Example – going concern basis not appropriate

Company A has lost a large contract in the year to 30 November 2014. In addition, the company's bankers have also expressed their unwillingness to continue to support the company and have 'called in' both the bank loan and overdraft. The loan and overdraft in combination are significant and the directors have been unsuccessful in negotiating refinancing with other banks and finance houses. The directors have concluded that they have no realistic alternative but to place the company into liquidation and cease trading.

Clearly in this scenario the going concern basis of preparing the financial statements as at 30 November 2014 will not be appropriate and in such cases the 'break-up' basis of accounting is used. Under this basis fixed assets will be reclassified to current at their expected realisable value. Long-term liabilities will be reclassified to current and additional disclosures will be made within the financial statements to explain that the company is not regarded as a going concern and to explain the basis on which the financial statements have been prepared.

The guidance issued by the FRC acknowledge that small companies must still have regard to the going concern status of the entity. However, the extent of the directors' review process will depend on both the nature and size of the company as well as the complexity of the business. In reality, assessing going concern in a smaller enterprise is likely to be much simpler than that for medium-sized and large companies as small companies tend only to have one business activity and a limited number of creditors and providers of finance. Notwithstanding this simplicity, the directors' must still document and address, to the extent necessary, their plans to manage the company's borrowing requirements, cash flow timings and the company's exposure to contingent liabilities.

Example – going concern assessment in a subsidiary

Company B is a subsidiary company and has a year-end of 30 November each year. The directors of Company B are not planning on making any going concern assessments in the belief that this is the responsibility of the parent company.

The directors of Company B are incorrect in their belief that the going concern assessment of a subsidiary is the responsibility of the parent company. The guidance confirms that directors of subsidiary companies need to make their going concern assessment taking into account:

- the need for support[2] from the parent company or fellow subsidiaries;
- the ability and willingness of the parent company or fellow subsidiaries to provide such support; and
- the risks to the company's going concern status arising from support that it has undertaken to provide to other members of the group.

In assessing the going concern status of the subsidiary, the subsidiary's directors should also consider the degree of autonomy the subsidiary company has and how the subsidiary fits into the group's activities and future plans. The directors should also consider the particular business risks which might arise that could threaten the appropriateness of the going concern basis when preparing the individual subsidiary financial statements.

The amount of evidence which the directors of a subsidiary company collates and retains to support their assessment of going concern is a matter of judgement – again there is no 'one-size-fits-all' where this is concerned. The directors' judgement will also usually involve their experience of dealing with the parent company over a period of time as well as taking into current facts, events and circumstances pertinent to the subsidiary.

Procedures relevant to all companies

The guidance offers procedures which all companies should generally adopt when assessing going concern, including:

Budgets and forecasts

The guidance recognises that budgets and forecasts prepared by an entity are long-established techniques in business management. Assumptions used in the preparation of such budgets and forecasts can be subjected to sensitivity analysis or 'stress-tested' which tends to offer a more likely outcome.

The guidance suggests that directors should prepare a budget, trading estimate, cash flow forecast or other equivalent analysis covering such a period as the consider appropriate.

Borrowing facilities

Directors should carefully consider the terms of borrowing arrangements (especially where covenants have been incorporated by the financiers). This is primarily to ensure that the terms and conditions are not breached which might result in the lender 'calling in' the loan which would then potentially bring into question the entity's ability to continue as a going concern.

It is the responsibility of the directors to be satisfied that there are adequate financing arrangements in place for the entity. Where there are any potential deficits, arrears or breaches which may arise then directors should enter into discussions with the lender sooner rather than later to avoid potential problems crystallising.

Procedures relevant to medium and large businesses

The guidance suggests that directors of medium and large businesses assess going concern beyond the use of forecasts and budgets and look to their long-term plans as an indication of how the directors expect the company to fare in the future. The guidance also suggests regard be given to the following for medium and large businesses:

[2] 'Support' for this purpose means both financial and non-financial support

Products, services and markets

Directors should gather information to support major aspects of the economic environment in which their business operates. They should pay particular attention to the size of the market, its strength, the entity's share of the market and assess whether there are any economic, political or other factors which might result in a change to the market.

For products or services, directors should consider their suitability to the market in which they operate as well as their quality and expected life.

Cash flow timings

In assessing the financial plans for the business, the directors need to be satisfied that cash inflows are adequately matched to cash outflows and that there are no long periods where projected cash flows are negative which may result in cash flow difficulties. Projected outflows should include liabilities such as loan repayments, corporation tax liabilities, other tax liabilities as well as other commitments (eg hire purchase payments).

Contingent liabilities

The company's exposure to contingent liabilities should be assessed by the directors and must also include the company's potential exposure to cash outflows involving legal proceedings, guarantees, margin or other credit support provision under derivative contracts, environmental costs and product liability.

Financial/operational risk management

The directors should consider those risks which are most significant to the business in terms of financial and operational risk. Foreign currency exchange risks are an example cited in the guidance. In addition, counterparty risk arising from concentration on key suppliers or customers who might also be facing financial difficulty should be considered.

Sensitivity analysis and stress testing

The critical assumptions used in forecasts and budgets should be subjected to sensitivity analysis/stress testing. Sensitivity analysis involves assessing the extent to which the headroom against facilities varies with changes in assumptions (such as changes in interest or exchange rates). Stress testing enables the directors to assess the effect of a combination of pessimistic, but plausible, estimates or assumptions.

Auditor's responsibilities over the going concern assessment

It is not the responsibility of the auditor to conclude whether the entity is a going concern – this responsibility rests with the directors. The auditor's responsibility is to evaluate the directors' assessment of the company's ability to continue as a going concern.

Where the auditor determines that a material uncertainty exists which may cast significant doubt over the entity's ability to continue as a going concern, then the auditor will modify the report (but not the opinion) by the inclusion of an 'emphasis of matter' paragraph in the audit report (directly underneath the opinion paragraph). This is, of course, subject to the disclosures in the financial statements concerning the material uncertainty being adequate.

Half-yearly financial statements

Companies admitted to trading on AIM or on the PLUS-quoted markets must prepare interim financial reports and include half-yearly financial statements. In recognition of this requirement the guidance acknowledges the need for directors to assess the use of the going concern basis of preparing financial statements at the half-yearly date. The guidance recognises the following issues which might give rise to the need to re-examine the going concern assumptions and going concern and liquidity risk disclosures:

- a significant adverse variation in operating cash flows between prior budgets and forecasts and the outturn in the first half of the year;
- a significant reduction in revenues or margins forecast for the second half of the year;
- a failure to obtain renewal or extension of bank facilities that had been anticipated; and
- a failure to sell capital assets for their expected amounts or within previously forecast timeframes.

When going concern becomes an issue since the last annual financial statements, the directors should carry out the same procedures they would have carried out for the annual financial statements to ensure all relevant issues have been considered.

If no new issues have been identified that brings into question the last assessment made, the directors will need to undertake procedures to roll forward the previous budgets and forecasts by the length of the half-yearly period.

If the auditor has been engaged to review the half-yearly financial statements, ISRE (UK and Ireland) 2410 *Review of interim financial information performed by the independent auditor of the entity* will require the auditor, among other things, to inquire as to whether the directors have changed their assessment of the entity's ability to continue as a going concern. In addition, if the auditor becomes aware of events or conditions which cast significant doubt on the ability of the company to continue as a going concern, the auditor must inquire of the directors as to their plans for future actions, consider the feasibility of those plans and whether the directors believe those plans will improve the situation.

The review period

The second principle in the guidance deals with the review period for going concern. Principle 2 says:

Directors should consider all available information about the future when concluding whether the company is a going concern at the date they approve the financial statements. Their review should usually cover a period of at least twelve months from the date of approval of financial and half-yearly financial statements.

The important aspect concerning principle 2 is the period of review. This should be for at least 12 months from the date of approval of the financial or half-yearly financial statements – not 12 months from the balance sheet date which is where some companies have gone wrong with this guidance.

In undertaking their review, directors should consider all available information about the future including information which they have obtained from budgets and forecasts. The FRSSE, UK GAAP and EU-adopted IFRS all provide for a minimum period that should be reviewed by the directors when assessing going concern (although the extent of the review period is a matter of judgement and in some situations it might be appropriate to obtain information for longer periods).

Auditor's report

If the review period of the director's assessment of going concern is less than 12 months from the date of approval of the financial statements and this fact has not been disclosed within the financial statements, the auditor is required to make reference to the review period being less than 12 months from the date of approval of the financial statements in their report.

Half-yearly financial statements

As with the review period above, the directors of companies preparing half-yearly financial statements must also consider all available information concerning the future at the date of approval of the half-yearly financial statements including information obtained from budgets and forecasts.

Companies reporting under EU-endorsed IFRS are required to apply the provisions in IAS 34 *Interim Financial Reporting* in their half-yearly financial statements. IAS 1 *Presentation of Financial Statements* at paragraph 26 says that in assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period. This paragraph also applies to half-yearly financial statements.

However, where companies preparing half-yearly financial statements use UK GAAP and are subject to the disclosure and transparency rules (DTR), they are required to refer to the FRC's *Half-Yearly Financial Reports* statement to which the DTR refers.

Disclosures

After the directors have undertaken an assessment of going concern using the appropriate review period and have assessed the going concern basis having regard to all the available information at their disposal, the directors are then required to make appropriate disclosures within the financial statements relating to the entity's going concern ability.

Principle 3 in the guidance says:

Directors should make balanced, proportionate and clear disclosures about going concern for the financial statements to give a true and fair view. Directors should disclose if the period that they have reviewed is less than twelve months from the date of approval of annual and half-yearly financial statements and explain their justification for limiting their review period.

Once the going concern review is done, there are three conclusions which can be drawn:

1. the going concern basis of accounting is appropriate because there are no material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern; or
2. the use of the going concern basis is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern; or
3. the going concern basis is not appropriate.

The disclosure requirements are set out in the FRSSE, UK GAAP, EU-endorsed IFRS, Companies Act 2006 and, for certain listed companies, the Listing Rules.

UK GAAP and the FRSSE

Both the FRSSE and UK GAAP require an entity to make disclosures in the financial statements where the directors have identified a material uncertainty which may cast significant doubt about the entity's ability to continue trading as a going concern. Directors should ensure that the disclosures set out the facts and circumstances in a manner which is proportionate to the nature (and size) of the company. Auditors will consider the adequacy of the disclosures made and if the auditors consider such disclosures to be inadequate this will have an impact on their audit report.

Strategic report

The 2009 guidance refers to the 'business review' which was required by Companies Act 2006 and which has now been superseded by the strategic report. Previously the business review was incorporated within the directors' report, but the strategic report is a standalone report within the financial statements of medium and large companies which must be signed by a director or the company secretary.

The strategic report must refer to the principal risks and uncertainties faced by the company which should include:

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

(b) information about persons with whom the company has contractual or other arrangements that are essential to the business of the company.

The main purpose of the strategic report is to assist shareholders assess how the directors have managed the success of the company during the reporting period and therefore it is not unreasonable to expect that the strategic report should contain an account of how the directors intend to respond to risks and uncertainties faced by the business. The guidance makes reference to certain issues which might require disclosure within the strategic report and include:

(a) uncertainties about current financing arrangements (whether committed or uncommitted);

(b) potential changes in financing arrangements such as critical covenants and any need to increase borrowing levels;

(c) counterparty risks arising from current credit arrangements (including the availability of insurance where relevant) with either customers or suppliers;

(d) a dependency on key suppliers and/or customers; and

(e) uncertainties posed by the potential impact of the economic outlook on business activities.

Disclosures relating to material uncertainties about going concern

Where the directors have concluded that there are material uncertainties about the company's ability to continue as a going concern, the FRSSE, FRS 18 *Accounting Policies* and IAS 1 *Presentation of Financial Statements* all require disclosure about the existence and nature of these uncertainties.

The FRSSE and FRS 18 at paragraph 61(b) requires the directors to make explicit disclosure where their review period has not been extended to 12 months from the date of approval of the financial statements together with a justification for the decision.

Where a company uses EU-endorsed IFRS as their financial reporting framework, a failure to consider a period of at least 12 months from the balance sheet date would be contrary to the requirements within accounting standards for companies applying IFRS and hence this would also require the directors to justify their departure from such a requirement.

The guidance also provides for other disclosures which might need to be considered by directors which might have a bearing on going concern including:

- Disclosures relating to financial instruments (including liquidity risk) where it is material.
- Disclosures relating to undrawn borrowing facilities and any restrictions attached to the use of those facilities (eg covenants) where relevant.

- Disclosure of defaults and covenant breaches.
- Disclosure of sources of estimation uncertainty about the carrying amount of assets and liabilities.

Statement on going concern by certain listed companies

Listing Rule 9.8.6R (3) (13 December 2013) of the FCA Handbook requires that the following must be included in the annual financial reports of listed companies which are incorporated within the UK:

'A statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary, that has been prepared in accordance with 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009, published by the Financial Reporting Council'.

Listing Rule 9.8.10R (1 April 2013) makes it a specific requirement that the auditor reviews the statement made by the directors that the business is a going concern *before* the annual report is published.

Where a listed company prepares a preliminary statement of annual results, the statement on going concern must be agreed with the auditor *before* it is published. In addition, the Listing Rules also require specific disclosure in the preliminary announcement of the nature of any likely modification contained in the auditor's report which is to be included with the annual report.

Illustrative disclosures for going concern for small companies

The FRC's guidance on going concern offers two examples which might assist directors when it comes to making disclosures in their financial statements. These are reproduced as follows (please note the guidance refers to the 'Business Review' and this has been substituted in the text below with the 'Strategic Report' following the introduction of Sections 414A to 414D of the Companies Act 2006 for financial years ending on or after 30 September 2013):

Example 1 – a small company that has adopted the FRSSE and anticipates reduced sales next year

There has been a significant reduction in requests for estimates for new decorating work and the directors expect sales to reduce significantly next year. However, costs are expected to reduce accordingly and the company should be able to operate within its overdraft. The directors are not aware of any reason why the overdraft facility might be withdrawn. As a result they have adopted the going concern basis of accounting.

In the above example there are no material uncertainties regarding going concern. Generally in practice few companies make reference to going concern if they conclude the going concern basis is appropriate and there are no material uncertainties. Care should also be taken where going concern disclosures are concerned (especially where there are not any concerns) as this may cause some discomfort with bankers and financiers (especially due to the wording used in the above example). Companies would ordinarily place such disclosures in the directors' report as opposed in the notes to the accounts. Notwithstanding this view, the above example is contained within guidance issued by the FRC and hence firms should be aware of what is being said as opposed to merely ignoring it and so it follows that firms are advised to discuss with their clients the views of the directors on going concern disclosures in the company's circumstances.

Example 2 – a small company that has adopted the FRSSE and has experienced difficulties in securing future work

The company has orders for work for the next two months. However, despite significant efforts, it has so far proved impossible to obtain additional sales orders. If new orders are not forthcoming, the directors will need to close the factory and make the employees redundant.

The directors have concluded that a material uncertainty exists that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realise its asses and discharge its liabilities in the normal course of business. However, given the continuing efforts to secure new orders, the directors continue to adopt the going concern basis of accounting.

Illustrative disclosures for going concern for companies other than small companies (including subsidiaries of large private or listed groups)

The FRC have included illustrative disclosures for going concern for companies which are not small and include companies who are subsidiaries of large private or listed groups. The idea behind these disclosures is to bring together going concern and liquidity risk disclosures although the guidance does acknowledge that such disclosures must be specific to the individual circumstances of each company.

Example 1(a) – a company with a significant positive bank balance, uncomplicated circumstances and little or no exposure to economic difficulties that may impact the going concern assumption

The company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Strategic Report on pages X to Y. The financial position of the company, its cash flows, liquidity position and borrowing facilities are described in the Finance Director's Review on pages P to Q. In addition, notes A-D to the financial statements include the company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposure to credit risk and liquidity risk.

The company has considerable financial resources together with long-term contracts with a number of customers and suppliers across different geographic areas and industries. As a consequence, the directors believe that the company is well placed to manage its business risks successfully despite the current uncertain economic outlook.

The directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

Example 1(b) – a significant subsidiary where the subsidiary is financed by its parent and participates in group banking arrangements

The company's business activities, together with the factors likely to affect its future development and position, are set out in the Strategic Report on pages X to Y.

The company is expected to continue to generate positive cash flows on its own account for the foreseeable future. The company participates in the group's centralised treasury arrangements and so shares banking arrangements with its parent and fellow subsidiaries.

The directors, having assessed the responses of the directors of the company's parent ABC Limited to their enquiries, have no reason to believe that a material uncertainty exists that may cast significant doubt about the ability of the ABC Group to continue as a going concern or its ability to continue with the current banking arrangements.

On the basis of their assessment of the company's financial position and of the enquiries made of the directors of ABC Limited, the company's directors have a reasonable expectation that the company will be able to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

Example 2 – a company with uncomplicated circumstances, some exposure to economic difficulties and either a current material bank overdraft or loan and a need to renew this facility in the foreseeable future albeit not imminently

The company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Strategic Report on pages X to Y. The financial position of the company, its cash flows, liquidity position and borrowing facilities are described in the Finance Director's Review on pages P to Q. In addition, notes A-D to the financial statements include the company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposure to credit risk and liquidity risk.

As highlighted in note B to the financial statements, the company meets its day-to-day working capital requirements through an overdraft facility that is due for renewal on [date]. The current economic conditions create uncertainty particularly over (a) the level of demand for the company's products; (b) the exchange rate between sterling and CY and thus the consequence for the cost of the company's raw materials; and (c) the availability of bank finance in the foreseeable future.

The company's forecasts and projections, taking account of reasonably possible changes in trading performance, show that the company should be able to operate within the level of its current facility. The company will open renewal negotiation with the bank in due course and has, at this stage, not sought any written commitment that the facility will be renewed. However, the company has held discussions with its bankers about its future borrowing needs and no matters have been drawn to its attention to suggest that renewal may not be forthcoming on acceptable terms.

The directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

Example 3 – a company with complicated circumstances, considerable exposure to economic difficulties and either a current material bank overdraft or loan that requires renewal and perhaps an increase in the year ahead

The company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Strategic Report on pages X to Y. The financial position of the company, its cash flows, liquidity position and borrowing facilities are described in the Finance Director's Review on pages P to Q. In addition, notes A-D to the financial statements include the company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

As described in the directors' report on page X, the current economic environment is difficult and the company has reported an operating loss for the year. The directors' consider that the outlook present significant challenges in terms of sales volume and pricing as well as input costs. Whilst the directors have instituted measures to preserve cash and secure additional finance, these circumstances create material uncertainties over future trading results and cash flows.

As explained on page X, the directors are seeking to sell a property to provide additional working capital. The company is in negotiations with a potential purchaser but there can be no certainty that a sale will proceed. Based on negotiations conducted to date, the directors have a reasonable expectation that the sale will proceed successfully, but if not the company will need to secure additional finance facilities.

As explained in the Strategic Report on page Y, the company has commenced discussions with its bankers about an additional facility that may prove to be necessary should the sale of the property not proceed or should material adverse changes in sales volumes or margins occur. It is likely that these discussions will not be completed for some time. The directors are also pursuing alternative sources of funding in case an additional facility is not forthcoming but have not yet secured a commitment.

The directors have concluded that the combination of these circumstances represents a material uncertainty that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realise its assets and discharge its liabilities in the normal course of business. Nevertheless, after making enquiries and considering the uncertainties described above, the directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis of accounting in preparing the annual financial statements.

Key questions for boards

The FRC's guidance provides some key questions which directors should ask when undertaking an assessment of going concern. The questions also include, where relevant, examples of factors that should be considered when assessing going concern. These questions (which can be found in Appendix III to the guidance) relate specifically to:

1. Forecasts and budgets
2. Borrowing requirements
3. Timing of cash flows
4. Contingent liabilities
5. Products, services and markets
6. Financial and operational risk management

7. Financial adaptability
8. Group companies
9. Documentation

FRS 102: SECTION 23 *REVENUE* *(LECTURE A488 – 19.26 MINUTES)*

The issue concerning revenue recognition has been in the headlines a lot over recent years. Indeed only in the last few weeks has the latest scandal in the form of Tesco's revenue recognition accounting policies hit the headlines and, once again, for all the wrong reasons. Inappropriate revenue recognition policies clearly detract from the relevant and reliability of the financial statements and such acts are unethical from both a professional perspective as well as a legal perspective.

New UK GAAP at Section 23 *Revenue* deals with the issue concerning revenue recognition. The section is a very comprehensive section with an Appendix of 26 examples to aid correct application of the principles. It covers revenue arising from:

(a) the sale of goods (whether produced by the entity or for the purpose of sale or purchased for resale);

(b) the rendering of services;

(c) construction contracts in which the entity is the contractor; and

(d) the use by others of entity assets yielding interest, royalties or dividends.

There are certain income streams which a company might receive which are not covered by Section 23 which are outlined below:

Section 23 is NOT applicable to:	**Relevant application Section:**
Lease agreements	Section 20 *Leases*
Dividends/other income from investments accounted for under the equity method	Section 14 *Investments in Associates* and Section 15 *Investments in Joint Ventures*
Fair value changes of financial assets and financial liabilities or their disposal	Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*
Fair value changes in investment property	Section 16 *Investment Property*
Initial recognition and changes in the fair value of biological assets related to agricultural activity	Section 34 *Specialised Activities*
Initial recognition of agricultural produce	Section 34 *Specialised Activities*

In addition Section 23 is also not applicable to revenue which arises from transactions and events that are within the scope of FRS 103 *Insurance Contracts*.

Basic measurement principles

Paragraph 23.3 says that an entity shall measure revenue at the *fair value* of the consideration received or receivable. The term 'fair value' is defined in the Glossary to FRS 102 as:

*'The amount for which an **asset** could be exchanged, a **liability** settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in paragraphs 11.27 to 11.32 shall be used in determining fair value.'*

Example – a sale with a discount

A company manufactures and sells office furniture to retailers and most of its customer base has a credit account. Terms of credit range from 30 days for smaller customers with larger customers (and those smaller customers with a long-standing association with the company) having credit terms between 60 and 90 days. Newer customers pay cash on delivery until they become established. The company's year-end is 30 September.

On 30 September 2014, the company made a sale to one of its larger customers amounting to £10,000 (before discount and VAT). The company entered into an agreement with its customer which states that any sales up to £11,000 net will attract a discount of 1% and sales to the value of £11,001 to £15,000 will attract a 2% discount. Sales discounts above £15,000 are at the discretion of the company and are agreed with the customer prior to the sale being made contractual.

The sale on 30 September 2014 will attract a 1% discount, hence a discount of £100. Section 23 says that revenue is to be recognised at the fair value of the consideration receivable and must take into account the amount of any trade discounts, prompt settlement discounts and rebates allowed by the entity.

Therefore, the company will recognise revenue of £9,900 (£10,000 less £100). Assuming the sale falls within the scope of VAT at 20%, VAT will be £1,980 (£9,900 x 20%) and hence a trade debtor will be recognised of £11,880 (£9,900 + £1,980).

Principal and agent relationship

Section 23 deals with the principal versus agent relationship in paragraph 23.4 and states that the agent must only recognise revenue to the extent of its commission. Any amounts which are collected on behalf of the principal must not be recognised as revenue of the agent.

Example – agent/principal relationship

A solicitor specialises in debt recovery and has agreed to take on a case where the client is owed an amount of £20,000 from one of its contractors who has refused to pay claiming defective work was carried out (although this failed to be proved in court and hence the contractor was still obliged to pay the £20,000 for work carried out). The solicitor has agreed with the client to charge a 5% commission for any monies recovered.

The contractor eventually paid the solicitor following a threat to issue a winding up petition in the court.

Of the £20,000 (ignoring any VAT implications), 5% will be deducted by the solicitor for their agreed commission, hence £1,000 will be recognised as revenue. The remaining £19,000 will be recognised as a liability in the books of the solicitor until the funds are remitted to the contractor.

Deferred payment

Deferred payments (ie where the inflow of cash or cash equivalents is deferred) may constitute a financing transaction. A financing transaction will arise when, for example, the entity provides interest-free credit to its customer or agrees to a loan which attracts an interest rate below market rate. In such cases the fair value of the consideration is the present value of all future receipts determined using an imputed rate of interest. For the purposes of Section 23, the imputed rate of interest is the more clearly determinable of either:

(a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or

(b) the rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

In this scenario, the entity must recognise the difference between the present value of all future receipts and the nominal amount of the consideration as interest revenue (as per paragraphs 23.28 and 23.29 and Section 11 *Basic Financial Instruments*).

Example – interest income calculation

A company sold goods amounting to £4,000 to a customer with three years' interest-free credit. The rate of interest which discounts the nominal value of the instrument to the current cash sales price of the goods is 8%. The company's accounting reference date is 31 December 2014.

For the year-ended 31 December 2014, revenue will be £3,175 (£4,000 x $1/(1.08)^3$. Interest income will be recognised in the financial statements amounting to £254 (£3,175 x 8%).

For the year-ended 31 December 2015, interest income will be £274 ((£3,175 + £254) x 8%) and in the 2015 the remaining interest income will be £297.

The treatment of the interest above will allow the full £4,000 sale to be recognised as revenue in the company's profit and loss account over the three years.

Exchanges of goods or services

Revenue should only be recognised in financial statements in respect of exchanges of goods or services when the transaction possesses *commercial substance.* A transaction is said to have 'commercial substance' when it is expected that the future cash flow of a business will change as a result of the transaction.

For exchanges of goods or services, paragraph 23.6 prohibits revenue being recognised:

(a) when goods or services are exchanged for goods or services that are of a similar nature and value; or

(b) when goods or services are exchanged for dissimilar goods or services but the transaction lacks commercial substance.

Example – a transaction lacking commercial substance

A manufacturer of lorries has a three-year old vehicle in its stock. The company has agreed to swap this lorry for a similar sized lorry with one of its competitors. The value of the competitor's lorry has been valued at £300 less than the company's lorry.

In this scenario the transaction lacks commercial substance because the cash flows of both parties to the transaction are not likely to change as a result of the transaction.

When goods or services are exchanged for dissimilar goods or services in a transaction that does possess commercial substance, the entity measures the transaction:

(a) at the fair value of the goods or services received adjusted by the amount of any cash or cash equivalents transferred;

(b) if the amount under (a) cannot be measured reliably, then at the fair value of the goods or services given up adjusted by the amount of any cash or cash equivalents transferred; or

(c) if the fair value of neither the goods or services received nor the goods or services given up can be measured reliably, then at the carrying amount of the goods or services given up adjusted by the amount of any cash or cash equivalents transferred.

Sale of goods

There are five criteria which must be fulfilled before an entity can recognise revenue in relation to the sale of goods (note **all** conditions must be fulfilled). These conditions are as follows:

(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;

(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

(c) the amount of revenue can be measured reliably;

(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

The key judgement call on the part of the entity will be in understanding when it has transferred all the significant risks and rewards of ownership of the goods. In many cases this might be clear; but in some cases it is often unclear and the transfer of risks and rewards might be at a later date than when legal title passes. To that end, paragraph 23.23 offers four examples of when the selling entity **retains** the significant risks and rewards over the goods and hence must **not** recognise revenue. These examples are:

(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranties;

(b) when the receipt of the revenue from a particular sale is contingent on the buyer selling the goods;

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract that has not yet been completed; and

(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract, or at the buyer's sole discretion without any reason, and the entity is uncertain about the probability of return.

Example – recognition of revenue and ongoing obligations

Company A Ltd enters into a contract to sell 10 items of machinery to Company B Inc which is located in Italy. The term of the contract are that Company A will ship the machines to Company B, install the machines and ensure that the machines are in full working order prior to Company B signing to say they are satisfied with the machines. Company A's year-end is 31 October 2014.

Due to an ongoing project, Company A's installation team have said that they cannot install the machines until 1 December 2014, to which Company B has agreed. The finance director of Company A proposes to recognise the revenue in the 31 October 2014 financial statements as he believes the installation will go ahead and is keen to report increased profitability in 2014.

The finance director cannot recognise the sale in the 31 October 2014 financial statements because the company still has an ongoing obligation after despatch of the machines to install them and ensure they are operating to full capacity. Revenue can only be recognised when Company B signs the contract to say they are satisfied the machinery is working to full capacity because it is at this point that all the risks and rewards pass from Company A to Company B. The sale, therefore, should be recognised in the 2015 financial year.

Condition (a) refers to 'significant risks and rewards' being transferred from seller to buyer in order to recognise revenue. Where the entity only retains an *insignificant* risk of ownership, the transaction falls to be classed as a sale and revenue can be recognised. This could be the case where, for example, the seller retains legal title to the goods in order that they can be taken back in the event on non-payment, a sale can still be recognised on the grounds that the selling company have retained an insignificant risk of ownership.

Rendering of services

This area of Section 23 lends itself to much more subjectivity in terms of revenue recognition than with the sale of goods. This is because in order to qualify for recognition of revenue, there often needs to be an estimate calculated of the amount of revenue to be recognised and this is done having reference to the 'stage of completion' of the transaction (which is often referred to as the 'percentage of completion method' and is dealt with in the 'construction contracts' section in the next section of these notes). In addition, the outcome of the transaction has to be reliably estimated and for the purposes of Section 23 and the rendering of services, the outcome of a transaction can be estimated reliably when **all** of the following conditions are satisfied:

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the entity;

(c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

Paragraph 23.15 of FRS 102 refers to a 'specific act' and a 'significant act'. The principle in this paragraph is that when a specific act is much more significant than any other act, the entity must postpone revenue recognition until the significant act is executed.

Example – services spanning more than one accounting period

A company operates in the document management industry and sells scanning equipment to companies who wish to become 'paperless'. In addition to the scanning equipment, the company also sells its own bespoke software and when the customer purchases the software it can choose to pay for a year's support services at the same time. The support service runs for a calendar year and the company has a year-end of 31 March.

Where customers purchase the support service they will be invoiced from 1 January to 31 December each year. However, the company's financial year ends on 31 March and hence nine months of the support services relate to the next financial year and so this portion of the services will be recognised as deferred income within creditors falling due within one year with the remaining three months being recognised as revenue.

Construction contracts

Construction contract accounting under Section 23 uses the 'stage of completion' method referred to in the 'rendering of services' section above.

When the outcome of a contract can be estimated reliably the entity recognises revenue and associated contract costs by reference to the stage of completion of the contract at the end of the reporting period. Paragraph 23.22 offers possible methods to determine the stage of completion of a transaction or contract which can include:

(a) the proportion that costs incurred for work performed to date bear to the estimated total costs. Costs incurred for work performed to date do not include costs relating to future activity, such as for materials or prepayments;

(b) surveys of work performed; and

(c) completion of a physical proportion of the contract work or the completion of a proportion of the service contract.

Example – progress payment received

During the course of a profitable construction contract, the company received a progress payment of £10,000 from the contractor. The finance director has credited this progress payment to revenue.

Any progress payments (or advances) which are received from customers (in this case the contractor) do not reflect the work performed and hence should **not** be taken directly to revenue. They should be credited to the 'contract account' in the nominal ledger and this amount will be taken into consideration when calculating the gross amount due from the contractor at the reporting date. The amount of revenue to be recognised at the reporting date should be calculated using the stage of completion method.

Where construction contracts are concerned, Section 23 is applied **separately** to each construction contracts. On occasion, however, it may be necessary to apply Section 23 to the separately identifiable components of a single contract (or to a group of contracts) so as to reflect the substance of a contract (or a group of contracts).

In the event that a contract covers a number of assets, the construction of each asset is treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation, and the contractor and customer are able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

Example – construction contracts covering a number of assets

Company A operates in the construction industry and is undertaking the construction of a retail park in the north of the UK. The contract is one contract but will comprise a number of individual retail outlets which include clothing retailers, a supermarket, a petrol station, a catalogue company and a 'do-it-yourself' outlet.

Each outlet has been subjected to separate proposals by the head office of each outlet which will be operating from the retail park. In addition, each outlet was subjected to a rigorous negotiation process and a number of offers were rejected by the contractor for each outlet until a satisfactory price was agreed and an undertaking from various construction companies that they would adhere to strict deadlines. As details have now been finalised each outlet has been assigned costs and revenues by the contractor.

In this example, one contract is covering the construction of a number of assets for which separate proposals have been received. Negotiations have been completed for the construction of each outlet and the costs and revenues relating to the construction of each outlet have now been assigned.

Despite one contract covering a number of assets, paragraph 23.19 of FRS 102 requires the construction of **each** asset to be treated as a **separate** construction contract.

The example above takes one contract and then segregates that contract into each individual component asset. Paragraph 23.20, on the other hand, says that a group of contracts (whether with a single customer or with several customers) shall be treated as a single contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

Example – rectification costs

A construction company agrees to build eight new houses on a plot of land. The terms of the contract state that any remedial costs (often referred to as 'rectification costs') are to be borne by the construction company and will not be able to be recovered from the contractor. During the course of the building process the construction company incurred rectification costs of £10,000.

In such situations, as the costs will not be recovered, the rectification costs are to be written off immediately in the profit and loss account.

Percentage of completion method

The methods that can be employed in determining the percentage of completion of a contract at the reporting date are contained in paragraphs 23.22 of FRS 102 and have been discussed above.

Accounting for construction contracts (and in many cases service contracts) will inherently involve a large degree of estimation on the part of the reporting entity. In terms of construction contracts the starting point is to determine the outcome of the contract. There are generally three outcomes where construction contracts are concerned:

1. the contract is to yield a profit; or
2. the contract is to yield a loss; or
3. the outcome is uncertain.

Profit-making contracts

When it is expected that the contract will make a profit, revenue and costs will be recognised by way of the percentage of completion method.

Example – profit-making contract

A construction company enters into a contract at a fixed price of £50 million. Costs have been analysed at the start of the contract as follows:

Materials to date plus additional costs	£14,000
Labour and other overheads	£15,000
Depreciation	£15,000
	£44,000

The estimated profit in the contract is expected to be £6 million (£50m fixed price less £44m costs).

At the year-end 31 October 2014, the costs actually incurred were as follows:

Purchase of materials	£9,000

Labour and other overheads	£7,000
Depreciation (£15,000 x 6/12)	£7,500
Costs incurred at 31 October 2014	£23,500

On 31 October 2014, the surveyor confirmed that the contract was 40% complete. At that date the customer made a progress payment of £15,000.

As the surveyor confirms that 40% of the contract is complete at 31 October 2014, 40% of the price can be recognised as revenue with 40% of the contract costs being recognised as cost of sales, ie:

		£
Turnover	(40% x £50m)	20,000
Cost of sales	(40% x £44m)	17,600
Gross profit		2,400 (ie 40% x £6m)

In the balance sheet, the gross amount due from the customer can be calculated as follows:

	£
Costs to date:	
Purchase of materials	9,000
Labour and other overheads	7,000
Plant depreciation	7,500
Total costs to date	23,500
Contract profit	2,400
	25,900
Less: progress payment received	(15,000)
Gross amount due from customer at 31.10.14	**10,900**

Loss-making contracts

When a contract is expected to make a loss, prudence should be exercised and the expected loss must be recognised immediately where cost recovery is not probable.

Example – a loss-making contract

The outcome of a project with a fixed price of £5 million has been assessed to make a loss of £900,000. At the year-end 31 October 2014 the surveyor confirms the project is 60% complete.

In this scenario revenue will be recognised equivalent to 60% of the contract price (ie £3m). The contract is expected to make a loss of £900,000 and hence cost of sales is essentially a balancing figure to generate the required loss so cost of sales will be £3.9 million, hence:

Turnover	£3,000,000
Cost of sales	£3,900,000
Gross loss	£900,000

Uncertain contracts

When the outcome of a contract is uncertain, no profit is recognised. The stage of completion method is still used to identify the amount of revenue that can be recognised on the contract, but cost of sales is again a balancing figure to generate a nil profit.

Example – an uncertain contract

The outcome of a project with a fixed price of £5 million is uncertain. At the year-end 31 October 2014 the surveyor confirms the project is 60% complete.

In this scenario revenue will be recognised equivalent to 60% of the contract price (ie £3m). It is uncertain whether the contract will make a profit or a loss so cost of sales will also be £3m, hence:

Turnover	£3,000,000
Cost of sales	£3,000,000
Gross profit	-

Interest, royalties and dividends

There are additional revenue streams which Section 23 deals with, namely revenue from income-yielding assets in the form of interest, royalties and dividends. Revenue in respect of such income streams can only be recognised when:

(a) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(b) the amount of the revenue can be measured reliably.

Interest revenue

Interest revenue must be recognised in the financial statements by way of the effective interest method. The effective interest method uses the effective interest rate and in calculating the effective interest rate, the entity must include any related fees, finance charges paid or received, transaction costs and other premiums or discounts.

Example – interest calculated using the effective interest method

A finance house agrees to lend £1,000 at a discount of £900 over three years to a company. The instrument has a coupon rate of 5% which is paid to the lender at the end of each year and the principal amount at maturity is £1,000. Using the internal rate of return function in Excel, the effective interest rate has been calculated at 8.95%. The loan profile in the lenders books can be analysed as follows:

Year	Opening amortised cost (A)	Interest and principal payments (B)	Interest income (A x 8.95%) (C)	Debt discount amortisation (C-B) (D)	Closing amortised cost (A+D)
1	900	50	81	31	931
2	931	50	83	33	964
3	964	1,050	86*	36	1,000

* = ignores the capital element

The effective interest method discounts the expected future cash inflows and outflows which are expected over the life of the underlying asset.

Royalties

Royalties are recognised on an accruals basis in accordance with the substance of the relevant agreement.

Dividends

Dividend income is to be recognised when the shareholder's right to receive payment is established. In some situations the right to receive the dividend may differ from the date on which the dividend is actually received so care must be taken in this regard.

Disclosure requirements

The disclosure requirements for revenue are contained in paragraphs 23.30 to 23.32 of Section 23. The disclosure requirements are split into two component parts:

- disclosures relating to revenue; and
- disclosures relating to revenue from construction contracts.

Disclosures relating to revenue

Reporting entities must disclose:

(a) the accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services; and

(b) the amount of each category of revenue recognised during the period, showing separately, at a minimum, revenue arising from:

  (i) the sale of goods;

(ii) the rendering of services;

(iii) interest;

(iv) royalties;

(v) dividends;

(vi) commissions;

(vii) grants; and

(viii) any other significant types of revenue.

Disclosures relating to revenue from construction contracts

In respect of construction contracts, reporting entities must disclose:

(a) the amount of contract revenue recognised as revenue in the period;

(b) the methods used to determine the contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

In addition, reporting entities should present:

(a) the gross amount due from customers for contract work, as an asset; and

(b) the gross amount due to customers for contract work, as a liability.

ISA 550 RELATED PARTIES (LECTURE A489 – 14.56 MINUTES)

Related parties are widely known to be a subjective area in both financial reporting and in auditing. Because of the subjective aspect of related parties, a specific UK and Ireland ISA is devoted to this area; namely that of ISA (UK and Ireland) 550 *Related Parties*.

The UK and Ireland ISA recognises that many transactions with related parties are entered into in the ordinary course of business and hence carry no higher risk of material misstatement than those with transactions with unrelated parties.

Notwithstanding this notion, it is recognised in auditing that the nature of related party relationships and associated transactions can, in certain situations, give rise to a higher risk of material misstatement and in this context the ISA+ recognises three situations.

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

ISA (UK and Ireland) 550 defines a related party as a part that is either:

(i) a related party as defined in the applicable financial reporting framework; or

(ii) where the applicable financial reporting framework establishes minimal or no related party requirements:

  (a) a person or other entity that has control or significant influence, directly or indirectly, through one or more intermediaries, over the reporting entity;

  (b) another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

  (c) another entity that is under common control with the reporting entity through having:

    (i) common controlling ownership;

    (ii) owners who are close family members; or

    (iii) common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

The auditor's responsibilities

In the UK, the applicable financial reporting framework (the FRSSE, UK GAAP or EU-endorsed IFRS) does establish related party requirements by virtue of Section 15 *Related party disclosures*, FRS 8 *Related party disclosures* and EU-endorsed IAS 24 *Related Party Disclosures*. ISA (UK and Ireland) 550 requires the auditor to obtain an understanding of related party relationships and transactions sufficient to be able recognise fraud risk factors (if any) which arise from related party relationships and transactions and to conclude, having regard to the audit evidence obtained, whether the financial statements (insofar as they are affected by related party transactions and relationships) give a true and fair view and are not misleading.

The auditor also has a responsibility to ensure that sufficient appropriate audit evidence has been obtained concerning related party relationships and to give reasonable assurance that transactions with such related parties have been properly accounted for and adequately disclosed in the financial statements to comply with the requirements of the FRSSE, FRS 8 and EU-endorsed IAS 24.

Understanding the entity

It is a specific requirement of the UK and Ireland ISAs that the auditor understands the entity and its environment and ISA (UK and Ireland) also requires the auditor to obtain an understanding of the entity's related party relationships and transactions with those related parties. Certainly at the planning stage of the audit, the audit team must have a discussion concerning the client, the areas where the financial statements may be susceptible to material misstatement, fraud issues etc. Where related parties are concerned, such discussions may also include:

- The nature and extent of the entity's relationships and transactions with related parties.
- Emphasising the need to maintain professional scepticism throughout the audit and hence recognising the potential for material misstatement due to related party transactions.

- Circumstances or conditions of the entity might indicate the existence of related party relationships which management have not identified and which the auditor has not been made aware of (eg complex organisational structure, special-purpose entities or inadequate IT systems).
- Records or documents might indicate the existence of related party transactions.
- The importance placed by management on the identification and appropriate accounting for related party transactions as well as disclosure of related party relationships and transactions. The risk of management override of controls in this area should also be discussed by the engagement team.

ISA (UK and Ireland) 550 also places a mandatory requirement for the audit team to discuss the susceptibility of the financial statements to material misstatement due to fraud with related parties. This discussion is **in addition to** the normal discussion concerning the susceptibility of the financial statements to fraud and/or error. Paragraph A10 of ISA (UK and Ireland) 550 outlines some factors that audit teams should consider when discussing the susceptibility of material misstatement due to fraud with related parties, for example:

- How special-purpose entities controlled by management might be used to facilitate earnings management.
- How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

During some file reviews, it has become apparent that some audit teams have not discussed the susceptibility of the financial statements to material misstatement due to related party transactions/relationships and this would be in contravention of ISA (UK and Ireland) 550 and hence firms should ensure that they cover this aspect during their audit team discussion.

Identifying related parties

ISA (UK and Ireland) 550 acknowledges that an entity's information system should have the ability to record, process and summarise related party relationships and transactions because this information is going to need disclosure within the entity's financial statements. In reality, whilst information systems nowadays will be able to generate the information required for statutory disclosure purposes, a comprehensive list of related parties (and changes from the previous period) is going to be needed, either from management or prepared by the auditor, so as to ensure that related party disclosures are complete and adequate.

It is often beneficial for the audit firm to have a comprehensive list of related parties on their file (usually on the permanent audit file) and update these on an annual basis so that transactions with such parties can be verified for completeness and disclosure accuracy. Identifying related parties ordinarily forms part of the auditor's risk assessment procedures at the planning phase of the audit and the auditor would normally be expected to gather information on:

- The entity's ownership and governance structure.
- The types of investments that the entity is making and plans to make.
- The way that the entity is structured and how it is financed.

Where a group audit is being carried out, ISA (UK and Ireland) 600 *Special considerations – audits of group financial statements (including the work of component auditors)* requires the group engagement team to provide each component auditor with a list of related parties together with a list of any other related parties whom the group engagement team is aware of.

Relevant related party information that may be shared among the engagement team includes:

- The identity of the entity's related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may require special audit consideration, in particular transactions in which management or those charged with governance are financially involved.

Controls over related party transactions and relationships

Auditors must obtain an understanding of the client's control environment so as to comply with the provisions in ISA (UK and Ireland) 315 *Identifying and assessing risks of material misstatement through understanding the entity and its environment*. The client should have established controls over related party transactions and relationships so as to reduce the risk of material misstatement arising in the financial statements and the auditor may consider these features. Such features might be:

- Internal ethical codes which are communicated to the entity's staff and enforced which stipulate the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- Assignment of responsibilities within the business for identifying, recording, summarising and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance about related party transactions outside the ordinary course of business (including whether those charged with governance have challenged the business rationale of such transactions).
- Clear guidelines for the approval of related party transactions for transactions which might give rise to a perceived conflict of interest (eg authorisation by a sub-committee).
- Periodic reviews by internal audit (where applicable).
- Proactive action taken by management to resolve related party disclosure issues.
- Existence of 'whistle-blowing' policies and procedures where appropriate.

Auditors need to pay particular attention to the controls over related party transactions and relationships where issues have been identified which might call into question the efficiency of a control(s), particularly when:

- Low importance is placed by management on identifying and disclosing related party relationships and transactions.
- Oversight by those charged with governance is lacking.
- Disregard for controls because related party disclosures might give rise to information being revealed which management considers to be sensitive (eg transactions with family members).
- Insufficient understanding by management about related party requirements commanded by GAAP.
- The absence of disclosure requirements under the applicable financial reporting framework.

The problem with the above is that if controls over related party transactions or relationships are non-existent or deficient, then the auditor may be unable to obtain sufficient appropriate audit evidence concerning related party transactions and relationships and hence this would have an impact on the audit report.

Fraud and related party transactions

It is widely known that the UK and Ireland ISAs command an attitude of professional scepticism to be applied by the auditor in the conduct of an audit. The term 'fraudulent financial reporting' is often committed by management overriding the internal control environment which may, on the face of it, appear to be operating effectively. This risk is accentuated when related party relationships exist because they provide management with greater opportunity to perpetrate fraud. The ISA+ cites examples of possible fraud including:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organising the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the financial position or financial performance of the entity.

Care should therefore be exercised by auditors to ensure audit procedures are specifically tailored to take account of the risk assessment that the financial statements might contain material misstatement due to fraud with related parties/transactions.

A fraud risk factor arises when there is domination of management by a single person (or a small group of persons) without compensating controls. Indicators of dominant influence exerted by a related party include:

- The related party has vetoed significant business decisions taken by management or those charged with governance.
- Significant transactions are referred to the related party for final approval.
- There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.
- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

This type of situation could be common in owner-managed businesses and additional procedures are suggested by ISA (UK and Ireland) 550, with a cross-reference to ISA (UK and Ireland) 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* and include the following substantive procedures:

- Inquiries of, and discussions with, management and those charged with governance.
- Inquiries of the related party.
- Inspection of significant contracts with the related party.
- Appropriate background research, such as through the Internet or specific external business information databases.
- Review of employee whistle-blowing reports where these are retained.

Inspection of records

Paragraph A22 to ISA (UK and Ireland) 550 refers to a comprehensive list of records or documents which the auditor might choose to inspect as part of their programme of audit procedures, for example:

- Third-party confirmations obtained by the auditor (in addition to bank and legal confirmations).
- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (for example, prospectuses).

Significant transactions outside the ordinary course of business

The UK and Ireland ISAs regard certain aspects regarding an entity's financial statements to be treated as a significant risk and significant transactions outside the ordinary course of business is one of those significant risks. Where an ISA+ treats an issue as a significant risk the auditor must design specific procedures to respond to that level of risk (for example making inquiries as to the business rationale of the transaction and the relevant terms and conditions). The auditor should also remain alert to fraud risk indicators as well as considering whether the transaction has been accounted for correctly and appropriately disclosed in the financial statements.

Paragraph A25 provides some examples of transactions outside the entity's normal course of business which may include:

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Transactions under contracts whose terms are changed before expiry.

In evaluating the business rationale of the transaction, the auditor might consider whether the transaction is overly complex, has unusual terms of trade, involves previously unidentified related parties or is processed in an unusual manner. Paragraph A27 recognises that a related party could be involved in a significant transaction outside the entity's normal course of business, not only by directly influencing the transaction through being a party to the transaction, but also by indirectly influencing it through an intermediary. In this scenario, the auditor must remain alert to the possibility of fraud risk factors.

Discovery of previously unidentified related parties/transactions

ISA (UK and Ireland) 550 requires additional procedures to be conducted when the auditor discovers a related party relationship or significant transaction with a related party that has not been disclosed by management. The additional procedures include the prompt communication of the discovery to the audit engagement as well as an inquiry with management as to why controls over related party transactions and relationships have failed to identify or disclose the related party or transaction. In addition, the auditor must also performance an analysis of the accounting records for transactions with the newly-identified related party.

When the auditor identifies a previously unidentified or undisclosed related party or significant related party transactions, the main issue for the auditor is to determine whether the non-identification of the related party or transaction is deliberate and whether there are other non-identified related parties or transactions.

Where management have deliberately concealed the identity of related parties or transactions with them, the auditor may deem it necessary to re-evaluate management's responses to the auditor's inquiries. This is because deliberate concealment may be viewed as a fraud risk factor and which the provisions in ISA (UK and Ireland) 240 become relevant.

Written representations

ISA (UK and Ireland) 550 requires that where the financial reporting framework establishes related party requirements, the auditor shall obtain a written representation from management and, where appropriate, those charged with governance that:

(a) they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and

(b) they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Written representations from those charged with governance

Paragraph A48 of ISA (UK and Ireland) 550 suggests three circumstances when the auditor may consider it appropriate to obtain written representations from those charged with governance which include:

(a) when they have approved specific related party transactions that (i) materially affect the financial statements, or (ii) involve management; and/or

(b) when they have made specific oral representations to the auditor on details of certain related party transactions; and/or

(c) when they have financial or other interests in the related parties or the related party transactions.

ISA 230 AUDIT DOCUMENTATION (LECTURE A490 – 18.34 MINUTES)

The importance of adequate audit documentation on an audit file cannot be over-emphasised and firms are frequently criticised by file reviewers and professional body regulators for failing to have adequate audit documentation on file. ISA (UK and Ireland) 230 *Audit documentation* deals with the auditor's responsibility to prepare audit documentation relating to an audit of financial statements. The ISA+ recognises that audit documentation which meets the requirement of ISA (UK and Ireland) 30 provides:

(a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) Evidence that the audit was planned and performed in accordance with the ISAs (UK and Ireland) and applicable legal and regulatory requirements.

Benefits of adequate audit documentation

Adequate audit documentation is mandatory under ISA (UK and Ireland) 230. However, it also serves a number of additional purposes, including:

- Assisting in the overall performance of the audit.
- Assisting those responsible for supervision and review to discharge their review responsibilities in accordance with ISA (UK and Ireland) 220 *Quality control for an audit of financial statements*.
- Enabling the audit team to be accountable for the work performed.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with ISQC (UK and Ireland) 1 or national requirements that are at least as demanding.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

In the modern day auditing profession, the use of 'paperless' auditing software is quite prevalent among firms. These are perfectly acceptable as a tool to use to conduct an audit, but the audit documentation must still comply with the requirements of ISA (UK and Ireland) 230. Many modern paperless systems have the ability to hyperlink working papers to other areas of the audit file and this facility should be used as much as possible as it is equivalent to the traditional cross-referencing of audit working papers to other working papers (for example cross-referencing the balance per the bank statement on the bank reconciliation statement to, say, the bank audit letter).

Audit documentation must also be prepared in such a way so as to enable an individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

- audit processes;
- ISAs and applicable legal and regulatory requirements;
- the business environment in which the entity operates; and
- auditing and financial reporting relevant to the entity's industry,

having no previous connection with the audit to understand:

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

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

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

Documenting audit procedures

Most audit methodologies will have their own formats in terms of how the working papers are generated. However, ISA (UK and Ireland) 230 requires the auditor to record:

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

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

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

When the review process is being undertaken, if the auditor identifies information which is inconsistent with the auditor's final conclusion in respect of a significant matter, the auditor must document how the auditor has addressed that inconsistency.

'Discussion' or 'inquiry' is a valid audit procedure under ISA (UK and Ireland) 500 *Audit evidence*. When the auditor discusses significant matters with management, those charged with governance and others, the auditor must document the discussion including the nature of the significant matters discussed and when, and with whom, the discussions took place. In this respect a template can often be used to aid correct documentation which can be laid out as follows:

Objective

What is to be achieved from having the discussion (eg to understand the company's accounting policy in respect of bad debt provisions).

Discussion/work done

Document what was discussed, with whom and what their role within the company is (eg discussion concerning bad debt provisions with John Smith, credit controller).

Evaluation

Significant observations/results of the discussion.

Conclusion

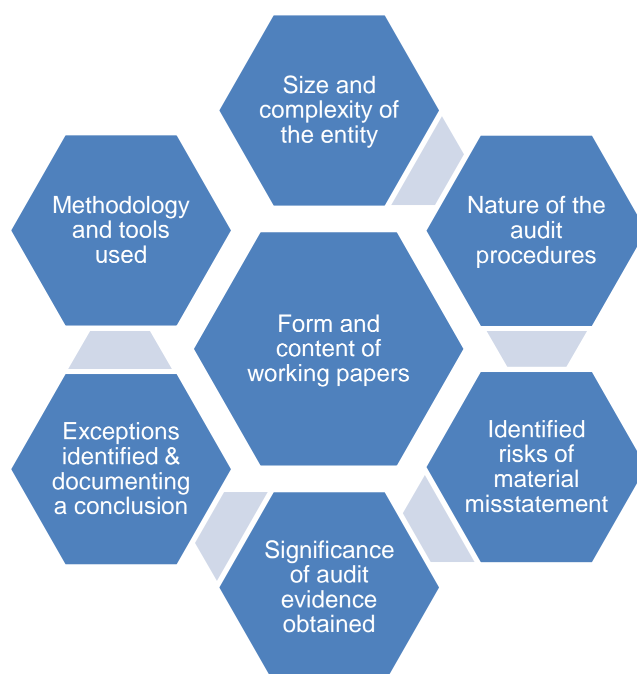
Key points and whether the objective has been achieved.

Form and content of audit working papers

The underlying theme in ISA (UK and Ireland) 230 is that audit working papers must be sufficiently complete and detailed so as to provide an overall understanding of the audit. In reality is impracticable to record absolutely everything that an auditor considers during the conduct of an audit and hence judgement must be applied as to the extent of working papers. There is no 'one-size-fits-all' approach to the form and content of audit working papers but, as mentioned earlier in this section, the key issue to be considered in establishing whether, or not, the auditor considers the working papers to be sufficient is to question whether an experienced auditor, with no previous connection to the audit, will understand the nature, timing and extent of audit procedures performed, the results and evidence obtained and the significant matters arising during the audit together with the conclusions thereon.

If the answer to that cosideration is 'no' then the audit documentation is not adequate for the purposes of the ISA.

Generally, the form and content of audit working papers are affected by several factors, including:



Examples of working papers

There is no 'hard and fast' rule where audit working papers are concerned and, as shown above the form and content of audit working papers will vary from one audit to another. However, typically the content of audit files will contain the following audit working papers (note the list below is **not** exhaustive):

- the auditor's understanding of the entity, including:
    - legal documentation, agreements and minutes;
    - extracts from the entity's internal control manual;
    - information concerning the industry, economic environment and central laws and regulations;
- evidence of the planning process;
- evidence of the auditor's reliance on internal audit (where applicable);
- analytical review procedures including ratio analysis and an analysis of transactions and balances;
- identified and assessed risks of material misstatement;
- the nature, timing, extent and results of audit procedures;
- evidence that the work was supervised and reviewed;
- who performed the audit procedures and when they were performed;
- details of audit procedures applied regarding components whose financial statements are audited by another audit firm;
- copies of communication with other auditors, experts and third parties;
- copies of management letters, minutes of meetings, notes of discussions and evidence of significant deficiencies in internal control;

- written representations received from the management and (where applicable) those charged with governance;
- conclusions reached by the auditor concerning significant issues relating to the audit and how exceptions and unusual matters were resolved or treated;
- departures from a relevant requirements in an ISA (UK and Ireland);
- copies of financial statements and auditor's reports; and
- notes of discussions with management and others concerning significant matters.

Matters arising after the audit report is signed

Once the audit file is assembled, the completion phase finished and the auditor's report is signed, no audit working papers must be removed or amended. However, in exceptional circumstances, the auditor may perform new, or additional, audit procedures. This could arise, for example, where the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. When any situation presents itself which results in the auditor having to perform new, or additional, procedures or which result in new conclusions after the date of the auditor's report, the auditor must document:

(a) the circumstances encountered;

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

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

Final assembly of the audit file

ISA (UK and Ireland) 230 recognises that preparing sufficient and appropriate audit evidence on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is signed. With this in mind, the ISA+ also recognises that documentation which is prepared *after* the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Paragraph A21 of ISA (UK and Ireland) 230 suggests that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. During the assembly of the final audit file, changes may be made to the audit documentation if they are administrative in nature which might include:

- deleting or discarding superseded documentation;
- sorting, collating and cross-referencing working papers;
- signing off on completion checklists relating to the file assembly process; and/or
- documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

Firms should ensure that they retain audit files for at least five years from the date of the auditor's report or, if later, the date of the group auditor's report.

QAD PRACTICE ASSURANCE REPORT 2013 (LECTURE A491 – 11.48 MNUTES)

Overview

The 2013 QAD Practice Assurance report concentrates upon the issues of client acceptance and disengagement. However, the report reminds us that all ICAEW practising certificate holders are required to follow the Practice Assurance standards:

Practice Assurance standard 1: laws, regulations and professional standards

A firm should comply with laws, regulations and standards that are relevant to the service provided, including the bye-laws, regulations and ethical guidance of ICAEW.

Practice Assurance standard 2: client acceptance and disengagement

A firm should agree to act for a client only if, in so doing, it does not contravene the professional, regulatory or ethical requirements of ICAEW.

Practice Assurance standard 3: competence

A firm should ensure that all principals, staff and subcontractors are competent to carry out their work.

Practice Assurance standard 4: quality control

A firm should ensure that work is conducted within an environment where quality is monitored.

What the QAD found

The QAD reported the following headline findings in 2013:

- 34% of firms had not given their new clients information relating to their professional indemnity insurer as required by the Provision of Services Regulations 2009.
- 13% of firms had not notified their clients in writing of their complaints procedure.
- 7% of firms did not have procedures to identify clients in accordance with the Money Laundering Regulations 2007.
- 5% of firms had not notified their clients in writing of the basis on which they charge their fees.

New client procedures

All firms should have new client procedures that ensure that the firm complies with its professional requirements as well as manage risk. The QAD recommend that all firms should review their current procedures, including staff training, and pay particular attention to the areas covered below.

Ethics

Ethics are not just for auditors. The ICAEW code of ethics applies to all work performed by professional accountants. Any threats to the accountant's independence and objectivity should be identified and if necessary, safeguards applied.

Examples of threats that the QAD come across are given as:

- the relative size of an individual fee

- a mutual or conflicting business interest between the firm and a client
- loans to or from clients
- receipt of goods, services or hospitality from a client and
- a beneficial interest in shares or other investments in clients.

Is everyone in your firm aware that these issues could threaten independence and that they should document the position and their response?

Resources

Firms should only take on new work and clients if they have access to the necessary skills and expertise. Ensuring that adequate CPD is undertaken is key here, and the firm needs to monitor and record staff CPD to ensure that this is happening.

Does your firm have a process for reviewing CPD undertaken by all staff, not just those working in reserved areas?

Professional enquiries

This procedure is sometimes, misleadingly, referred to as obtaining professional clearance. Firms should contact the previous accountant to find out if there is anything that could affect the firm's decision to accept the client engagement.

The QAD reminds members that:

- it is your duty to promptly respond to professional enquires made of you if you are the incumbent (note: that there are disciplinary cases where accounts do not respond!); and
- you need the client's authority before making enquiries.

Money laundering

Client due diligence for MLR purposes will always form an important part of the procedures for taking on new clients.

The QAD say that some firms struggle with these procedures and they give the following tips:

- Have clear, easy-to-follow procedures that are available to all staff for all service lines and which are consistent across the practice.
- Make them part of the overall take-on process so they are a core part of the risk assessment.
- Use the risk assessment to decide what checks to do, rather than carry out the same checks for all clients.
- Train all staff in how to use the procedures.
- Check staff are using them properly with a regular compliance review.

Engagement letters

It goes without saying that having up-to-date engagement letters can be a problem area for firms. The QAD report, interestingly, encourages the use of engagement letters but does not require them in areas of work other than audit, insolvency and investment business. However, if there is no letter there still needs to be a record of what has been agreed.

In practice, engagement letters should always be obtained and regularly updated. This should be an area that firms monitor in their own compliance reviews. Even some large firms are sometimes surprised that up-to-date engagement letters have 'gone missing' on many clients.

Disengagement

Firms are required to have procedures in place for disengagement. The objective is to clarify that the firm is no longer acting on the client's behalf and the respective responsibilities of the accountant and client. It is particularly important to communicate the date at which disengagement occurs so that the client is on notice that the firm is no longer responsible in any way for their affairs. This can all be done verbally but what has been agreed should be recorded by the accountants.

Does your firm have a disengagement procedure, disengagement checklist and model disengagement letter?

It is usually more straightforward to use a disengagement letter. An example letter can be found in: helpsheet PAS2/HS11 Disengagement letters.

AFFILIATE STATUS (LECTURE A492 – 2.38 MINUTES)

Disciplinary cases

Recently, there have been a number of ICAEW disciplinary cases receiving publicity similar to the one below, from March 2014:

> Firm X, has agreed to pay a regulatory penalty of £3,000, which was decided by the Audit Registration Committee. This was in view of the firm's admitted breach of Audit Regulations 2.03 (a) and 2.11 in that the firm failed to ensure that one of its directors had appropriate affiliate status between 2011 and 2013.

It is fairly clear that not everybody understands the need for obtaining affiliate status in certain situations. More importantly not everyone appreciates how seriously ICAEW take these breaches!

The need for Audit and DPB Affiliate status

All principals (and certain employees who hold Responsible Individual status) in firms that are registered with ICAEW for audit purposes or who do investment business holding a ICAEW DPB licence, must either:

- be a member of ICAEW, ICAS, ICAI or ACCA or
- affiliates of ICAEW.

There are similar rules applying to firms that do insolvency work.

General affiliates

All principals in ICAEW firms that use the designation 'Chartered Accountants' must have general affiliate status.

For more information and application forms go to http://www.icaew.com/en/members/practice-resources/practice-structure/affiliates/affiliates.

SUMMARY OF DEVELOPMENTS

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

Financial Reporting Council publishes Annual Report for 2013/14

16 July 2014

In its Annual Report for 2013/14 the Financial Reporting Council (FRC) outlines its achievements and challenges over the year. This is the first FRC Annual Report to be based on the new framework for the Strategic Report and includes its first financial statements prepared in accordance with the new UK Generally Accepted Accounting Principles (UK GAAP). Sir Winfried Bischoff, Chairman of the FRC, said:

'The FRC has focussed its authority and resources on the contribution that high quality corporate governance and reporting can make to the effective functioning of the capital markets and to economic stability and growth. Trust is only achieved through a shared belief that there is a strong public interest in sound governance, active stewardship and fair, balanced and understandable reporting.

'The FRC's effectiveness depends on its relationship with stakeholders, especially the investment community, directors, and those it regulates. While the FRC evolves, I am extremely grateful to those stakeholders who continue to provide input to its aims and extensive information about the impact of potential changes to regulation.'

Among its achievements the FRC has made good progress in making audit more integral to corporate governance and has seen a positive response to its efforts to promote audit re-tendering. The new EU Audit Regulation and Directive reflects a great deal of work by the FRC to ensure UK audit regulation can remain effective and proportionate.

Areas the FRC will continue to address in 2014 include:

- Implementation of aspects of EU Audit Regulation including reviewing auditor independence requirements.
- Completing a review of the quality of auditing of banks and building societies.
- Implementation of Lord Sharman's recommendations on going concern reporting.
- Promoting clarity and concision in corporate reports.
- Promoting improvements in the quality of reporting by smaller listed and AIM quoted companies.
- Influencing international prudential regulators in financial services, particularly as they grapple with tensions between reporting by banks and the risks of that to market stability.

FRC consults on Regulations and Guidance for Local Public Audit

21 July 2014

The Financial Reporting Council (FRC) has today issued a consultation on Statutory Regulations and Guidance for Local Public Audits, as part of establishing the new regulatory framework for local public audit in England and Wales.

The Audit and Accountability Act 2014 provides for the abolition of the Audit Commission and establishes a new framework for the regulation of auditors of local public bodies that reflects the current framework for the regulation of company auditors. The Government has asked that the FRC takes on specific responsibilities, including:

- inspecting the quality of the audits of the largest local public bodies and health bodies other than Foundation Trusts;
- overseeing the regulation of auditors of local public bodies by professional bodies the FRC recognises for this purpose; and
- setting specific statutory requirements on auditors.

The consultation document seeks views on statutory requirements:

- for transparency reports, which the 2014 Act requires that auditors of major local bodies public each year;
- for keeping the Register of Local Public Auditors;
- giving statutory guidance to a recognised supervisory body on the approval of individuals as Engagement Leads for local public audit.

Paul George, Executive Director, Conduct, said:

'This consultation seeks to strike an appropriate balance between recognising the particular challenges of local public audit and consistency with the arrangements for regulating company auditors. We would welcome views in particular from local public bodies.'

FRC issues amendments to FRS 101 and FRS 102

23 July 2014

The Financial Reporting Council (FRC) has today issued amendments to new UK GAAP to improve the accounting for certain financial transactions, which will also improve ease of use of the standards and reduce the cost of compliance. The amendments to FRS 102:

- relate to financial instruments:
  - updating the requirements on hedge accounting, making hedge accounting more readily available to entities where it is consistent with their risk management processes;
  - relaxing the conditions for regarding financial instruments as 'basic', with the effect that more financial instruments will be measured by reference to cost rather than fair value;
- make transition to FRS 102 less costly; and
- are effective from the same date as FRS 102, 1 January 2015.

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

'The FRC has amended FRS 102 prior to its effective date to improve its hedge accounting requirements, in line with international developments. The changes will better reflect entities' risk management strategies, and respond to entities' concerns that FRS 102 required too many financial instruments to be measured at fair value where a cost-based measurement would be appropriate. We have listened carefully to concerns about making changes close to the effective date of FRS 102, but we believe overall these amendments will both improve financial reporting by UK and Irish entities and reduce the costs of compliance. We have in particular provided flexible transitional arrangements, as requested by respondents.'

FRS 101 allows entities to apply IFRS with exemptions from some disclosures. The amendments to FRS 101 are the result of its first annual review to ensure those disclosure exemptions are updated on a timely basis as IFRS develops.

FRC issues Statement on Actuarial Standards

24 July 2014

The Financial Reporting Council (FRC) has issued a Statement on Actuarial Standards with the Institute and Faculty of Actuaries (IFoA) confirming their respective remits for setting standards following a review of responsibilities carried out in 2013. The FRC oversees the IFoA's regulation of the actuarial profession in the UK.

The statement confirms that the FRC's and IFoA's respective standard-setting responsibilities should continue as before but that there should be scope, by agreement, for more flexibility in the way in which those responsibilities are discharged.

The FRC will continue to set technical actuarial standards (TASs) for work carried out within the UK and the IFoA will continue to be responsible for setting ethical standards for all of its members, and for technical standards to be applied by its members carrying out work outside the UK.

In appropriate circumstances, the FRC can, with the IFoA's agreement, include ethical material in its TASs and the IFoA can, with the FRC's agreement, produce non-mandatory technical guidance. The FRC and IFoA have updated their Memorandum of Understanding (MoU) to reflect these arrangements.

Separately, the MoU has also been amended to give the FRC a reserve ability to issue ethical standards for actuaries when it considers that such action to be in the public interest and after it has consulted with the IFoA and given the IFoA reasonable opportunity to address the matter.

Following this statement and taking into account the work on identifying the risks relating to actuaries and/or actuarial work being undertaking by the Joint Forum on Actuarial Regulation (JFAR), the FRC intends to consult later this year on proposed changes to its actuarial standards framework which include:

- high-level principles which are recognised as applicable across all actuarial work; and
- more narrowly focussed specific standards where there is a need for additional requirements in the public interest beyond the high-level principles.

These changes will simplify and improve the structure of actuarial standards. Applying the high level principles to all actuarial work will help to ensure that users can be confident that actuarial work meets the minimum quality standards.

FRC comments on publication of IFRS 9

24 July 2014

Following the publication of IFRS 9 *Financial Instruments*, by the International Accounting Standards Board, the FRC's Executive Director of Codes and Standards, Melanie McLaren, welcomed the package of improvements:

'The FRC is pleased that an improved standard has now been issued and will be working to influence its swift endorsement in Europe.'

FRC publishes Lab report on Accounting Policies and Integration of Related Financial Information

25 July 2014

The Financial Reporting Council's (FRC) Financial Reporting Lab has published a report on '*Accounting policies and integration of related financial information*', which provides valuable insight for companies on what investors want from accounting policy disclosures and where they should appear in financial statements.

16 companies, 19 institutional investors and analyst organisations, and over 200 retail shareholders took part in the Lab project. This report is a further contribution to the FRC's programme of work to promote Clear & Concise reporting from which investors can, with justifiable confidence, draw conclusions about a company's performance, position and prospects. Sue Harding, Director of the Financial Reporting Lab, said:

'For significant accounting policies, investors want improved disclosure that avoids boilerplate text by being specific to the company and providing sufficient detail to understand how the company accounts for its transactions. They are also keen to gain a better understanding of the impact of judgement and estimation on the reporting of a company's results and financial position. Their suggestions support Clear & Concise reporting.'

The Lab report includes examples of current good practice as well as highlighting how disclosure could be modified to provide the most value to investors in the future.

A copy of the report can be downloaded from the FRC website:

https://frc.org.uk/Lab/published-project-reports.

Financial Reporting Lab issues insight report on 'Clear & Concise' reporting

12 August 2014

The Financial Reporting Council's (FRC) Financial Reporting Lab (Lab) has today published an insight report: *'Towards Clear & Concise Reporting'*. This examines progress made by companies towards producing relevant and succinct annual reports and accounts, and provides ideas on how companies can make further progress.

Based on a review of the most recent round of annual reports published by FTSE 350 companies, the Lab encourages companies to think about:

- the communication channels used and how to match information to users' needs;
- how to focus content on what is important to investors;
- removing immaterial disclosures;
- using cross-referencing and layout to improve clarity; and
- planning ahead.

The report also gives practical insight on the process of change and how BP and Prudential have managed this.

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

'The FRC's Clear & Concise reporting work seeks to promote reporting from which investors can, with justifiable confidence, draw conclusions about a company's performance, position and prospects. Now is an ideal time for companies to think about how to take steps to make their next annual reports clearer and more concise.

'The Lab insight report provides examples of how companies are actively working to improve their annual reports and accounts and identifies some questions companies may wish to address. By sharing observations on steps already being taken by some companies, we aim to provide a useful source of ideas to act as an impetus for further progress towards clear and concise reporting.'

A copy of the report can be downloaded from the FRC website:

https://frc.org.uk/Lab/published-project-reports.

FRC proposes amendments to FRS 102 relating to pension obligations

20 August 2014

The Financial Reporting Council (FRC) has today issued an exposure draft: FRED 55 *Draft Amendments to FRS 102 – Pension obligations*', in order to clarify issues relating to accounting for defined benefit pension plans in advance of the new UK and Irish GAAP becoming mandatory from 1 January 2015.

These proposed amendments would clarify that:

(a) UK and Irish GAAP does not include all the complexities of IFRS; no additional liabilities need to be recognised in respect of a 'schedule of contributions' that has been agreed in order to address a deficit in the plan; and

(b) consistent with current practice, the effect of restricting the recognition of a surplus in a defined benefit plan, where the surplus is not recoverable is recognised in other comprehensive income rather than profit or loss.

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

'The proposed amendments are intended to resolve uncertainty over the application of FRS 102 in a proportionate and practical manner before FRS 102 becomes mandatory.'

Comments are invited by 21 November 2014. The FRC expects to issue the final amendments to FRS 102 early in 2015. They will apply to accounting periods beginning on or after 1 January 2015.

FRC consults on accounting standards for small entities

1 September 2014

The Financial Reporting Council (FRC) has today issued a Consultation Document *Accounting standards for small entities – Implementation of the EU Accounting Directive*, to coincide with a Department of Business, Innovation and Skills (BIS) Consultation Document *UK implementation of the EU Accounting Directive*, which is also issued today.

Following changes in EU law, small companies need to include less information in their accounts and fewer mandatory disclosures. The FRC proposes to issue a new accounting standard for micro-entities, companies typically turning over less than £632,000 a year. The *Financial Reporting Standard for Micro-entities* (FRSME) will make accounts for these entities simpler.

The FRC will also introduce a new section into FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* for small entities, proposed as those turning over less than £10.2 million. The underlying accounting by small entities will in future be consistent with the standard for financial reporting used by other unlisted companies, subsidiaries of listed companies and public benefit entities such as charities; however the presentation and disclosure requirements for small entities may be more straightforward.

As a result the FRC's existing Financial Reporting Standard for Smaller Entities (FRSSE) will be withdrawn.

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

'We are seeking stakeholders' views on our proposals to revise accounting standards, particularly those for micro and small entities, following the new EU Accounting Directive. We believe the FRSME will provide significant simplifications for the very smallest companies choosing to apply the micro-entities regime. For other small entities there will be improvements in some areas of financial reporting, for example, more information about areas of financial risk, and greater consistency with the accounting by larger private entities which should offer benefit to users.'

The FRC has twice consulted on proposals to increase consistency in accounting by residential management companies. This Consultation Document includes further proposals to address this issue as residential management companies will generally be micro-entities or small entities.

In addition, limited amendments will be proposed to FRS 101 *Reduced Disclosure Framework* and FRS 102 to reflect changes in company law.

Comments are invited by 30 November 2014 and should be sent to Jenny Carter, Director of UK Accounting Standards, or submitted via ukfrs@frc.org.uk. After considering the feedback to the Consultation Document the FRC will develop these proposals further and expects to issue Exposure Drafts on the detailed proposals early in 2015.

Feedback statement on The Role of the Business Model in Financial Statements Research Paper

4 September 2014

In December 2013, EFRAG, the French ANC and the UK FRC published a Research Paper *The Role of the Business Model in Financial Statements*.

The Research Paper was preceded by a Bulletin, *The Role of the Business Model in Financial Reporting*, which was issued in June 2013 by EFRAG, the French ANC, the German ASCG, the UK FRC and the Italian OIC as part of a series of papers to promote discussion on topics related to the IFRS Conceptual Framework. The draft Research Paper served as an input for issuing the Bulletin.

The debate initiated by the Bulletin and Research Paper has revealed strong support for having the business model play a role in financial statements. The debate has also shown that the issue raises nevertheless some controversy.

The feedback statement on the Research Paper presents a summary of the comments received from the respondents.

FRC publishes conventions for electronic tagging of accounts

15 September 2014

The Financial Reporting council (FRC) has published three finalised XBRL tagging conventions ('taxonomies'). Taxonomies enable accounts to be filed electronically and for users of information in corporate reports to extract the data they want and analyse it more effectively.

The taxonomies will support XBRL reporting under the new UK GAAP standards, FRS 101, FRS 102 and EU-adopted IFRS. HMRC and Companies House are expected to adopt the taxonomies in due course. The Irish Revenue Commissioners are also expected to implement these once appropriate Irish requirements (extensions) are available.

The taxonomies have been developed by a project team at the FRC with guidance from a technical task force and a Governance Committee which includes staff from leading advisors, BIS, HMRC, Companies House and the Institute of Chartered Accountants in England and Wales, as well as the FRC. XBRL UK has also been involved.

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

'The release of these taxonomies is an important step in making corporate reports more transparent and accessible to investors. The e-enablement of reporting is an important element of standard setting and helps to foster investment in UK companies.'

FRC updates UK Corporate Governance Code

17 September 2014

The Financial Reporting Council (FRC) has issued today an updated version of the UK Corporate Governance Code (the Code). This significantly enhances the quality of information investors receive about the long-term health and strategy of listed companies, and raises the bar for risk management.

The FRC has confirmed proposals for boards to include a 'viability statement' in the strategic report to investors. This will provide an improved and broader assessment of long-term solvency and liquidity. It is expected that this statement will look forward significantly longer than 12 months. The Code has also been changed in relation to remuneration. Boards of listed companies will now need to ensure that executive remuneration is designed to promote the long-term success of the company and demonstrate how this is being achieved more clearly to shareholders.

Commenting on the UK Corporate Governance Code, FRC CEO Stephen Haddrill, said:

'The changes to the Code are designed to strengthen the focus of companies and investors on the longer term and the sustainability of value creation. The changes on going concern implement the reforms proposed by Lord Sharman whose work has stimulated a sea change in thinking about the assessment and reporting of risk and business prospects.

'The changes also reflect and have benefitted from extensive consultation. Recognising the different circumstances for business, companies are allowed to choose the period over which they look forward but we are clear this should be more than a year and reflect the nature of the business. Crucially the directors should explain their reasoning to investors. If included in the Strategic Report their statements will be subject to a safe harbour in accordance with companies' legislation.

'The changes on remuneration also focus companies on aligning reward with the sustained creation of value. The Code will continue to operate on the principle of "comply or explain", which has served investors and the UK corporate sector well for over 20 years.'

The revised Code will apply to accounting periods beginning on or after 1 October 2014.

The key changes to the Code include:

Going concern, risk management and internal control

- Companies should state 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 or 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;
- 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; and
- Companies can choose where to put the risk and viability disclosures. If placed in the Strategic Report, directors will be covered by the 'safe harbour' provisions in the Companies Act 2006.

Remuneration

- 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; and
- 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.

Shareholder engagement

- Companies should explain when publishing general meeting results how they intend to engage with shareholders when a significant percentage of them have voted against any resolution.

Other issues

The FRC has also highlighted the importance of the board's role in establishing the 'tone from the top' of the company in terms of its culture and values. The directors should lead by example in order to encourage good behaviours throughout the organisation.

In addition the FRC has emphasised that key to the effective functioning of any board is a dialogue which is both constructive and challenging. One of the ways in which such debate can be encouraged is through having sufficient diversity on the board, including gender and race. Nevertheless, diverse board composition in these respects is not on its own a guarantee. Diversity can be just as much about difference of approach and experience. The FRC is considering this as part of a review of board succession planning and will consider the need to consult on these issues for the next update to the Code in 2016.