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NEW SMALL COMPANY DRAFT REGULATIONS ISSUED (LECTURE A493 – 27.13 MINUTES)

On 29 August 2014, the Department for Business Innovation and Skills (BIS) issued a Consultation Document which outlined how it intends to implement the new EU Accounting Directive (the Directive) into companies' legislation. The consultation document outlined some fairly wide-reaching changes which will affect small companies in the UK, although BIS have suggested that the Directive does not set out to make significant changes to the fundamentals of EU financial reporting as most of the options contained in the current 4th and 7th Company Law Directives are to be retained.

Overview of the Directive

Directive 2013/34/EU of the European Parliament and of the Council was issued on 26 June 2013. It is going to replace the 4th and 7th Accounting Directive and it establishes minimum legal requirements for financial statements in the EU as well as providing 100 Member State options. These options will set out to allow more companies to have access to a less burdensome financial reporting regime which will be available under a new small company accounting regime. The Directive has three core objectives, which 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 so as to reduce the cost of capital and increase the level of cross-border trade and merger and acquisition activity; and
- protect essential user needs by retaining necessary accounting information for users.

Whilst the Directive has the objective of simplifying accounting requirements for entities within its scope, paragraph 9 says that:

'Annual financial statements should be prepared on a prudent basis and should give a true and fair view of an undertaking's assets and liabilities, financial position and profit or loss. It is possible that, in exceptional cases, a financial statement does not give such a true and fair view where provisions of this Directive are applied. In such cases, the undertaking should depart from such provisions in order to give a true and fair view... .'

In light of the above, and the fact that the Companies Act does require financial statements to give a true and fair view, it is likely that company directors will have to use professional judgement in ensuring that the overall content of the financial statements achieves a true and fair view.

The Directive achieves its core objectives by the application of a 'think small first' principle, which:

- introduces a 'building block' approach to the statutory accounts 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; and
- creates a largely harmonised small company 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.

BIS response to its consultation

In January 2015, BIS issued its *Response to the consultation on the UK Implementation of the EU Accounting Directive: Chapter 1-9 Financial statements and general requirements for audit*. During the consultation period (which ended on 24 October 2014), BIS received 33 responses in total and it confirmed that these responses were broadly supportive of the proposals.

The Statutory Instrument has already been drafted (although the rules are considered affirmative regulation because they are part of an EU Directive). Parliamentary procedure is to debate the Statutory Instrument, but the draft Regulations are expected to come into force on 6 April 2015 after Parliament has been dissolved on 30 March 2015. Companies will be mandatorily required to apply the new legislation for accounting periods commencing **on or after 1 January 2016**. However, a point worthy of note is that the legislation can be adopted earlier to enable a company to access a less burdensome financial reporting regime (therefore a company classed as medium-sized under the old regime, which would be classed as small under the new regime could early-adopt the new legislation and take advantage of the new small companies' regime sooner).

Impact of the Directive on small company financial statements

For most (if not all) accountancy practices, the implementation of the Directive into company law is going to have an impact. The new regime will not affect the recognition and measurement requirements of amounts in the financial statements themselves (although the micro-entities' regime does not allow any assets to be revalued or fair valued), but will affect the levels of disclosure that a small company will make.

Small company qualification criteria

The most notable change within the new regime is an increase in the thresholds which determine the size of a company. BIS has chosen to take advantage of the maximum thresholds which the Directive makes available to Member States so as to allow 11,000 medium-sized companies to be re-categorised and allow them to take advantage of the small companies' regime and hence make less disclosure than would otherwise be the case. In their response, BIS has also confirmed that they will also apply mandatory increases in the thresholds for medium-sized and large companies.

The new regime is summarised in the table below:

	Turnover	Balance Sheet Total	Average no. of Employees
Micro-entity	Not more than £632,000	Not more than £316,000	Not more than 10
Small company	Not more than £10.2 million	Not more than £5.1 million	Not more than 50
Small group	Not more than £10.2 million NET or Not more than £12.2 million GROSS	Not more than £5.1 million NET or Not more than £6.1 million GROSS	Not more than 50

	Turnover	Balance Sheet Total	Average no. of Employees
Medium-sized company	Not more than £36 million	Not more than £18 million	Not more than 250
Medium-sized group	Not more than £36 million NET or Not more than £43.2 million GROSS	Not more than £18 million NET or Not more than £21.6 million GROSS	Not more than 250
Large company	£36 million or more	£18 million or more	250 or more
Large group	£36 million NET or more or £43.2 million gross or more	£18 million NET or more or £21.6 million gross or more	250 or more

The qualifying conditions above are met by a company or group in a year in which it satisfies two, or more, of the turnover, balance sheet total and employee head count criteria. Section 382(4) of the Companies Act 2006 says that if a company has a short accounting period (for example, where the company is a new start-up), the turnover figure must be proportionately adjusted.

The term 'balance sheet total' is defined in paragraph 3 of Article 11 of the Directive which says:

'The balance sheet total referred to in paragraph 1 to 7 of this Article shall consist of the total value of the assets in A to E under 'Assets' in the layout set out in Annex III or of the assets in A to E in the layout set out in Annex IV.'

Therefore, when reference is made to 'balance sheet total' it is taken to mean fixed assets *plus* current assets.

A common mistake made when it comes to deciphering the average number of employees is to effectively take the number of employees at the year-end or at a specific point in time. This is not correct and section 382(6) of Companies Act 2006 says that the number of employees means the average number of employees employed by the company in the year, which is determined as follows:

- Find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not);
- Add together the monthly totals; and
- Divide by the number of months in the financial year.

Example – Average number of employees

Epsilon Ltd has a 31 December accounting reference date and has a relatively high turnover of staff due to the nature of its production. The HR officer has extracted the following information from the payroll files in respect of the company's employee numbers:

Month	Number of employees in that month's payroll
January	46
February	42
March	48
April	39
May	42
June	42
July	48
August	47
September	46
October	46
November	45
December	43

The average number of persons employed by the company during the accounting period is 45 (sum of monthly numbers of staff divided by 12 months).

Disclosure notes

With the exception of the micro-entities regime (which is going to be the subject of a separate standard with its own disclosure requirements for companies which qualify as such an entity and prepare financial statements under that regime), there will be a maximum of 13 mandatory disclosure notes contained in a small company's financial statements prepared under the new legislation.

As mentioned earlier in the notes, the duty to prepare financial statements which give a true and fair view is still a fundamental principle in the Companies Act and as such care must be taken where the application of the minimum disclosure notes is concerned. Where application of the mandatory disclosures does not result in the financial statements giving a true and fair view, the directors must include the necessary disclosures required so that they do give a true and fair view. In practice, this is likely to be problematic for smaller clients who may require assistance from their professional accountant to ensure that the financial statements give a true and fair view. Where the client is subject to audit, and assistance is given by the audit firm, care must be taken by audit firms in ensuring adequate safeguards are applied so as not to impede on independence and objectivity.

The following are the 13 mandatory disclosure notes:

- 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 (along with supporting information)
- Exceptional items

- Amounts due or repayable 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 Directive makes the following disclosures optional and essentially allows Member States to decide whether, or not, to require them:

- 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 concluded that the five optional disclosures above are to be made mandatory in the UK on the basis that it is not considered overly burdensome for companies' to make these disclosures as well as the fact that they are important for a proper understanding of the company's accounts.

(Limited) related party transactions

The legislation says that 'limited' related party transactions are to be disclosed. Under the new regime, particulars of related party transactions are to be given where such transactions are material and have not been concluded under normal conditions with:

- owners holding a participating interest in the company;
- companies in which the company itself has a participating interest; and
- the company's directors.

Where such transactions are material and have not been concluded under normal conditions, the following should be disclosed:

- the amount of such transactions;
- the nature of the related party relationship; and
- other information about the transactions necessary for an understanding of the financial position of the company.

The legislation does allow information concerning individual transactions to be combined (aggregated) according to their nature; the exception to this provision would be where separate information is necessary for an understanding of the effects of the related party transactions on the financial position of the company.

The exemption of disclosing transactions entered into between two, or more, members of a group where any subsidiary undertaking which is a party to the transaction is wholly-owned, is carried over into the new legislation and hence no disclosure of such transactions will be required.

Abridged accounts

Regulation 16 amends Part 1 (general rules and formats) of Schedule 1 (Companies Act individual accounts) to the Small Companies Accounts Regulations by allowing a small company to prepare 'abridged' accounts provided that this has been approved by **all** of the company's shareholders. In their response, the Government said:

'It is important that shareholders receive appropriate information on the performance of companies in which they invest. Therefore, small companies will only be permitted to prepare abbreviated accounts with the consent of all members of the company.'

The revised Companies Act reduces the number of formats for the profit and loss account from four to two (with format 1 and format 2 being the only permissible formats – format 3 and format 4 have been abolished in the revised Act – largely because they were rarely used in practice). There are still two formats for the balance sheet (being format 1 or format 2).

Profit and loss account – format 1

The revised format 1 profit and loss account is as follows:

1. Turnover
2. Cost of sales *(11)*
3. Gross profit or loss
4. Distribution costs *(11)*
5. Administrative expenses *(11)*
6. Other operating income
7. Income from shares in group undertakings
8. Income from participating interests
9. Income from other fixed asset investments *(12)*
10. Other interest receivable and similar income *(12)*
11. Amounts written off investments
12. Interest payable and similar expenses *(13)*
13. Tax on profit or loss
14. Profit or loss after taxation
15. Deleted
16. Deleted
17. Deleted
18. Deleted
19. Other taxes not shown under the above items
20. Profit or loss for the financial year

Profit and loss account – format 2

The revised format 2 profit and loss account is as follows:

1. Turnover
2. Change in stocks of finished goods and in work in progress
3. Own work capitalised
4. Other operating income
5. (a) Raw materials and consumables

   (b) Other external charges
6. Staff costs

   (a) wages and salaries

   (b) social security costs

   (c) other pension costs
7. (a) Depreciation and other amounts written off tangible and intangible fixed assets

   (b) Amounts written off current assets, to the extent that they exceed write-offs which are normal in the undertaking concerned
8. Other operating expenses
9. Income from shares in group undertakings
10. Income from participating interests
11. Income from other fixed asset investments *(12)*
12. Other interest receivable and similar income *(12)*
13. Amounts written off investments
14. Interest payable and similar expenses *(13)*
15. Tax on profit or loss
16. Profit or loss after taxation
17. Deleted
18. Deleted
19. Deleted
20. Deleted
21. Other taxes not shown under the above items
22. Profit or loss for the financial year

Notes on the profit and loss account formats

(11) Cost of sales: distribution costs: administrative expenses

Format 1: items 2, 4 and 5 must be stated after taking into account any necessary provisions for depreciation or diminution in value of assets.

(12) Income from other fixed asset investments: other interest receivable and similar income

Format 1: items 9 and 10 and Format 2: items 11 and 12 – income and interest derived from group undertakings must be shown separately from income and interest derived from other sources.

(13) Interest payable and similar expenses

Format 1: item 12 and Format 2: item 14 – the amount payable to group undertakings must be shown separately.

The revised balance sheet formats (for small companies which are not micro-entities and do not prepare accounts under the micro-entities legislation) (format 1 and format 2) are as follows (note format 1 balance sheet was not subjected to any changes in the revised legislation and hence is included here for completeness).

Balance sheet – format 1

A. Called up share capital not paid *(1)*

B. Fixed assets

- I. Intangible assets
  1. Goodwill *(2)*
  2. Other intangible assets *(3)*
- II. Tangible assets
  1. Land and buildings
  2. Plant and machinery etc.
- III. Investments
  1. Shares in group undertakings and participating interests
  2. Loans to group undertakings and undertakings in which the company has a participating interest
  3. Other investments other than loans
  4. Other investments *(4)*

C. Current assets

- I. Stocks
  1. Stocks
  2. Payments on account
- II. Debtors *(5)*
  1. Trade debtors
  2. Amounts owed by group undertakings and undertakings in which the company has a participating interest
  3. Other debtors *(1)*
- III. Investments
  1. Shares in group undertakings
  2. Other investments *(4)*
- IV. Cash at bank and in hand

D. Prepayments and accrued income *(6)*

E. Creditors: amounts falling due within one year

1. Bank loans and overdrafts
2. Trade creditors
3. Amounts owed to group undertakings and undertakings in which the company has a participating interest
4. Other creditors *(7)*

F. Net current assets (liabilities) *(8)*

G. Total assets less current liabilities

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

1. Bank loans and overdrafts
2. Trade creditors
3. Amounts owed to group undertakings and undertakings in which the company has a participating interest
4. Other creditors *(7)*

I. Provisions for liabilities

J. Accruals and deferred income *(7)*

K. Capital and reserves

I. Called up share capital *(9)*
II. Share premium account
III. Revaluation reserve
IV. Other reserves
V. Profit and loss account

Balance sheet – format 2

ASSETS

A. Called up share capital not paid *(1)*

B. Fixed assets

I. Intangible assets

1. Goodwill *(2)*
2. Other intangible assets *(3)*

II. Tangible assets

1. Land and buildings
2. Plant and machinery etc.

III. Investments

1. Shares in group undertakings and participating interests
2. Loans to group undertakings and undertakings in which the company has a participating interest
3. Other investments other than loans

4. Other investments *(4)*

C. Current assets

I. Stocks

1. Stocks

2. Payments on account

II. Debtors *(5)*

1. Trade debtors

2. Amounts owed by group undertakings and undertakings in which the company has a participating interest

3. Other debtors *(1)*

III. Investments

1. Shares in group undertakings

2. Other investments *(4)*

IV. Cash at bank and in hand

D. Prepayments and accrued income *(6)*

CAPITAL, RESERVES AND LIABILITIES

A. Capital and reserves

I. Called up share capital *(9)*

II. Share premium account

III. Revaluation reserve

IV. Other reserves

V. Profit and loss account

B. Provisions for liabilities

C. Creditors *(10)*

1. Bank loans and overdrafts

2. Trade creditors

3. Amounts owed to group undertakings and undertakings in which the company has a participating interest

4. Other creditors *(7)*

D. Accruals and deferred income *(7)*

Notes to the balance sheet formats

(1) Called up share capital not paid

Formats 1 and 2, items A and C.II.3:

This item may either be shown at item A or included under item C.II.3 in Format 1 or 2

(2) Goodwill

Formats 1 and 2, item B.I.1:

Amounts representing goodwill must only be included to the extent that the goodwill was acquired for valuable consideration.

(3) Other intangible assets

Formats 1 and 2, item B.I.2:

Amounts in respect of concessions, patents, licences, trademarks and similar rights and assets must only be included in a company's balance sheet under this item if either—

(a) the assets were acquired for valuable consideration and are not required to be shown under goodwill, or

(b) the assets in question were created by the company itself.

(4) Others: Other investments

Formats 1 and 2, items B.III.4 and C.III.2:

Where amounts in respect of own shares held are included under either of these items, the nominal value of such shares must be shown separately.

(5) Debtors

Formats 1 and 2, items C.II.1 to 3:

The amount falling due after more than one year must be shown separately for each item included under debtors and in the case of format 2, the aggregate amount falling due after more than one year must also be shown.

(6) Prepayments and accrued income

Formats 1 and 2, item D:

This item may alternatively be included under item C.II.3 in Format 1 or 2.

(7) Other creditors

Format 1, items E.4, H.4 and J and Format 2, items C.4 and D:

There must be shown separately:

(a) the amount of any convertible loans, and

(b) the amount for creditors in respect of taxation and social security.

Payments received on account of orders must be included in so far as they are not shown as deductions from stocks.

In Format 1, accruals and deferred income may be shown under item J or included under item E.4 or H.4, or both (as the case may require). In Format 2, accruals and deferred income may be shown under item D or within item C.4 under liabilities.

(8) Net current assets (liabilities)

Format 1, item F:

In determining the amount to be shown under this item any prepayments and accrued income must be taken into account wherever shown.

(9) Called up share capital

Format 1, item K.I and Format 2, Liabilities item A.I:

The amount of allotted share capital and the amount of called up share capital which has been paid up must be shown separately.

(10) Creditors

Format 2 Liabilities items C.1 to 4:

Amounts falling due within one year and after one year must be shown separately for each of these items and for the aggregate of all of these items.

Schedule 1 to the Regulations at 1(A) (1) says that when it is appropriate in the company's circumstances, the company's directors may, with reference to one of the formats in Section B, draw up an abridged balance sheet. An abridged balance sheet will only show those items in that format (either format 1 or format 2) preceded by letters and roman numerals. However, there are certain requirements to note:

- in the case of a format 1 balance sheet, note (5) of the notes to the formats must be complied with (see above);
- in the case of a format 2 balance sheet, notes (5) and (10) of the notes to the formats are complied with (see above); and
- all of the members of the company have given their consent to the company drawing up an abridged balance sheet.

As well as an abridged balance sheet, sub-section 1A(2) also allows an abridge profit and loss account to be drawn up where it is appropriate to the company's business. In preparing the abridged profit and loss account (under either format 1 or format 2 in Section B of the Regulations), the company can combine under one item called 'Gross profit or loss':

- items 1, 2, 3 and 6 in the case of format 1; and
- items 1 to 5 in the case of format 2

As with the abridged balance sheet, all members of the company must have consented to the company drawing up an abridged profit and loss account.

It is worth emphasising that the Regulations require the consent of ALL members when it comes to drawing up the abridged accounts. In addition, such consent can only be given in respect of the balance sheet or profit and loss account in respect of the preceding financial year and hence this consent is required to be given annually.

Companies that were a charity at any time during the accounting period cannot prepare an abridged profit and loss account or abridged balance sheet.

Where an abridged balance sheet or profit and loss account is prepared (per paragraph 1A of Schedule 1 SI 2008/409), the directors must deliver to the Registrar a statement that all the members have consented to the abridgement.

Abbreviated accounts for filing with Companies House (companies subject to small companies regime)

The concept of abbreviated accounts that have always been submitted to Companies has essentially been abolished. Regulation 21 repeals Schedule 4 SI 2008/409 which requires abbreviated accounts to be delivered to the Registrar of Companies (Companies House) to reflect the fact that small companies are no longer permitted to file accounts which are

different to those which they prepare and send to shareholders. For small companies, Regulation 8(3) makes changes to section 444 of Companies Act 2006 concerning the filing obligations of a small company. The major change is that a small company will no longer be able to file annual accounts at Companies House which are an abbreviated version of the accounts which it prepares and sends to shareholders. Instead, a small company will file the versions of the balance sheet and profit and loss account (where the profit and loss account is filed) which are prepared and sent to the shareholders.

The revised section 444(1) says:

The directors of a company subject to the small companies regime—

(a) must deliver to the registrar for each financial year a copy of a balance sheet drawn up as at the last day of that year, and

(b) may also deliver to the registrar—

(i) a copy of the company's profit and loss account for that year, and

(ii) a copy of the directors' report for that year.

The revised section 444(2) says:

'Where the directors deliver to the registrar a copy of the company's profit and loss account under subsection (1)(b)(i) The directors must also deliver to the registrar a copy of the auditor's report on the accounts (and any directors' report) that it delivers.

'This does not apply if the company is exempt from audit and the directors have taken advantage of that exemption.'

The final paragraph of the revised section 444(2) is important because many small companies are not subject to external audit and hence where audit exemption is taken by a company, any profit and loss account submitted to Companies House will therefore not be accompanied with an auditor's report.

A new section 444(2A) is inserted into the legislation saying:

*'Where the balance sheet or profit and loss account is abridged pursuant to paragraph 1A of Schedule 1 to the Small Companies and Groups (Accounts and Directors' Report) Regulations (S.I. 2008/409)(***b***), the directors must also deliver to the registrar a statement by the company that all the members of the company have consented to the abridgement.'*

In drafting the legislation, BIS has suggested that allowing small companies to prepare an abbreviated balance sheet and abbreviated profit and loss account only if approved by all of the company's shareholders will strike a balance between enabling simplification and protecting minority shareholder interests.

Companies not delivering a profit and loss account to Companies House

Where the directors of a company decide NOT to file a profit and loss account or a directors' report then the copy of the balance sheet which is filed at Companies House must contain (in a prominent position) a statement that the company's annual accounts and reports have been delivered in accordance with the provisions applicable to companies subject to the small companies regime. This requirement is contained in the revised section 444(5).

There are further points to note regarding small companies and their filing requirements under the new regime:

- Section 444(5A) states that where a company subject to the small companies' regime does not deliver a copy of the company's profit and loss account, the copy of the balance sheet filed must disclose that fact and unless the company is exempt from

audit and the directors have taken advantage of that exemption, the notes to the balance sheet must satisfy the requirements in subsection (5B).

- Subsection (5B) says that the notes to the balance sheet must:
    - state whether the auditor's report was qualified or unqualified;
    - where the report was qualified, disclose the basis of the qualification (reproducing any statement under section 498(2)(a) or (b), if applicable);
    - where the report was unqualified, include a reference to any matters to which the auditor drew attention by way of emphasis; and
    - state:
        - the name of the auditor and (where the auditor is a firm) the name of the person who signed the auditor's report as senior statutory auditor; or
        - if the conditions in section 506 (circumstances in which names are omitted) are met, that a resolution has been passed and notified to the Secretary of State in accordance with that section.
- Subsection (5C) states that subsection (5A) [the first bullet point above] does not apply if the company qualifies as a micro-entity and the company's accounts are prepared for a year in accordance with any of the micro-entity provisions.

Filing obligations of medium-sized companies

Section 445(1) requires a medium-sized company to deliver to the Registrar a copy of:

- the company's annual accounts;
- the strategic report; and
- the directors' report.

The auditor's report on those accounts (and on the strategic report and directors' report) should also be delivered to the Registrar (unless the company is exempt from audit and the directors have taken advantage of that exemption).

The concept of abbreviated accounts as we previously knew it is now abolished by the repealing of section 445(3) and 445(4).

Companies in the same group as a public company

The Act has been changed to allow companies which are in the same group as a public company, but which are not listed companies, to have access to the small or medium-sized companies' regime. The key point to emphasise where this concession is concerned is that the company concerned must not be a listed company. Section 384(2)(a) has been amended to remove the word 'public' and substitute this for the word 'traded' and hence this amendment has the effect that a company which is a member of a group of companies, one or more of which is admitted to trading on an EEA regulated market (e.g. the London Stock Exchange) does not qualify as small.

A further change to the legislation is reflected in section 399 (2A) related to group companies. This section allows a parent company not to prepare group accounts if the only reason why it does not qualify as small is because it is a public company. However, this exemption will not apply if it is a company admitted to trading on a regulated EEA market. In addition, a parent which is itself included in the group accounts of a larger group might also be able to claim exemption from preparing group accounts (again, provided that it is not a company admitted to trading on a regulated EEA market).

Use of alternative layouts for the profit and loss account and balance sheet

Part 4 of the Regulations makes changes to the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410). Regulation 27 makes various changes, the most notable being the ability for companies to adapt the prescribed balance sheet and profit and loss account formats which are set out in Schedule 1 and changes to the prescribed formats. Therefore, a company will now have flexibility in how they present financial information in the profit and loss account and balance sheet.

However, the wording of the legislation has been drafted in such a way to ensure that where companies do exercise this concession in adapting the formats of the profit and loss account and balance sheet, the information provided in those primary statements must be at least equivalent to the information which would otherwise have been required by the standard formats.

This concession will be of great benefit to users of FRS 101 *Reduced Disclosure Framework* because the primary objective of the concession is to reduce the burden of consolidation for those in a group which adopt EU-adapted IFRS. FRS 101 still requires Companies Act accounts to be prepared and therefore can (at present) cause difficulties for the preparer when it comes to consolidating the Companies Act accounts in with financial statements prepared under EU-endorsed IFRS because IAS 1 *Presentation of Financial Statements* does allow flexibility in the preparation of financial statements to IFRS principles.

Goodwill

Goodwill is proving to be somewhat of a contentious issue in the area of accounting and financial reporting! FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* is modelled on IFRSs (specifically *IFRS for SMEs*). *IFRS for SMEs* requires all goodwill to be amortised and where the entity is unable to estimate the useful economic life of goodwill, the default amortisation period is 10 years. Under mainstream IFRSs, IFRS 3 *Business Combinations* prohibits goodwill amortisation and instead it is tested annually for impairment. In the IFRS world, there is often heated debate surrounding the non-amortisation of goodwill with some critics arguing it is inappropriate to amortise goodwill on the grounds that a business might be amortising an asset which is increasing in value, with others arguing the opposite; however at present mainstream IFRS 3 does not allow amortisation to take place.

FRS 102 is also different in its approach to amortising goodwill. Whilst the standard itself is modelled on *IFRS for SMEs*, where management cannot come up with a reliable estimate of the economic life of goodwill, FRS 102 reduces this expected life further to five years. This has caused considerable confusion within the UK for some accountants and this confusion is understandable because currently goodwill could be being amortised over a 20-year life, or not at all because management view the goodwill's useful economic life to be indefinite (although this will have to change when FRS 102 is adopted because goodwill (and other intangible assets) cannot have indefinite useful lives).

The Regulations have been amended to not refer specifically to 'Goodwill' but to refer instead to 'intangible assets' which would include goodwill. Regulation 22(1) says that intangible assets must be written off over the useful economic life of the intangible asset. This follows the same principles in GAAP.

Regulation 22(2) then goes on to say that:

'Where in exceptional cases the useful life of intangible assets cannot be reliably estimated, such assets must be written off over a period chosen by the directors of the company.'

However, Regulation 22(3) does cap the amortisation period to 10 years and if management are unable to reliably estimate an intangible asset(s) useful economic life then Regulation

22(4) requires a disclosure note to be made in the financial statements stating the period over which the intangible asset is being amortised together with the reason for choosing that period. Therefore, directors should give careful thought to the period over which they are amortising intangible assets rather than just making an arbitrary guess.

Subsidiaries information in the consolidated financial statements

The UK currently permits companies to provide information on subsidiaries which have been included in the consolidated financial statements in the annual return submitted to Companies House. Critics of this method argue that providing such information in the annual return dilutes the meaningfulness of the consolidated financial statements.

Regulation 5(13) repeals section 410 of Companies Act 2006 with the effect that it will no longer be possible for a company to disclose relevant information concerning such companies in the annual return lodged with Companies House. Instead this information will have to be given in the notes to the financial statements.

Off-balance sheet arrangements, employee numbers and costs and directors' benefits

Regulations 5(14), (15) and (16) make amendments to sections 410A, 411 and 413 of Companies Act 2006 concerning information which (generally) companies must provide in their annual accounts concerning:

- off-balance sheet arrangements;
- employee numbers and costs; and
- directors' benefits.

Off-balance sheet arrangements

Section 410A(1) requires that where a company has been a party to arrangements which are not reflected in its balance sheet and at the balance sheet date the risks or benefits arising from those arrangements are material, then the following disclosures required by section 410A(2) need to be made in the financial statements (although section 410A(3) only requires this information to be given to the extent necessary for enabling the financial position of the company to be assessed):

1. the nature of the business purpose of the arrangements; and
2. the financial impact of the arrangements on the company.

A company that is classed as small only needs to give the disclosures in 1 above.

Employee numbers and costs

Section 411(1) requires the notes to the company's financial statements to disclose the average number of persons employed by the company in the financial year. This includes small companies (which only need to disclose the average number of persons employed in the year). This requirement has been introduced into the legislation due to the EU Accounting Directive making this one of the mandatory disclosures in small companies' financial statements.

For companies not classed as small, the notes to the company's financial statements must also disclose the average number of persons within each category of persons employed by the company (such as management and administrative personnel). However, the categories should be determined by management having regard to the manner in which the company's

activities are organised, so a manufacturing company could, for example, classify its staff categories as:

- Management
- Administrative
- Manufacturing
- Warehouse
- Other

Again care must be taken when it comes calculating the employee numbers because the Act requires the **average** number of employees and section 411(3) and (4) offers further guidance in calculating the average as follows:

411(3) The average number required by subsection (1) or (1A) is determined by dividing the relevant annual number by the number of months in the financial year.

411(4) The relevant annual number is determined by ascertaining for each month in the financial year—

(a) for the purposes of subsection (1), the number of persons employed under contracts of service by the company in that month (whether throughout the month or not);

(b) for the purposes of subsection (1A), the number of persons in the category in question of persons so employed; and adding together all the monthly numbers.

Companies which are not small must make disclosure (either in the notes or on the face of the profit and loss account), having reference to all persons employed by the company during the financial year, the total staff costs of the company. This is to be broken down into its various components as follows:

- wages and salaries paid or payable in respect of that year to those persons;
- social security costs incurred by the company on their behalf; and
- other pension costs so incurred.

Pension costs includes any costs incurred by the company in respect of:

- any pension scheme established for the purpose of providing pensions for persons currently or formerly employed by the company;
- any sums set aside for the future payment of pensions directly by the company to current or former employees; and
- any pensions paid directly to such persons without having first been set aside.

Directors' remuneration

No changes have been made to the Act in respect of directors' remuneration and the matters about which information may be required to be included in the notes to the financial statements may be in respect of:

- gains made by directors on the exercise of share options;
- benefits received or receivable by directors under long-term incentive schemes;
- payments for loss of office (as defined in section 215);
- benefits receivable, and contributions for the purpose of providing benefits, in respect of past services of a person as director or in any other capacity whilst director; or

- consideration paid to or receivable by third parties for making available the services of a person as director or in any other capacity while director.

Directors' advances, credits and guarantees

Additional information has been included in section 413(3) which requires the following details to be disclosed in respect of an advance or credit:

a. its amount;
b. an indication of the interest rate;
c. its main conditions;
d. any amounts repaid
e. any amounts written off*; and
f. any amounts waived*.

*these are the additional disclosures required to be made in the revised section 413(3).

As a consequence of the additional disclosures, section 413(5) has been amended to say:

There must also be stated in the notes to the accounts the totals—

(a) of amounts stated under subsection 3(a);

(b) of amounts stated under subsection 3(d);

(ba) of amounts stated under subsection 3(e);*

(bb) of amounts stated under subsection 3(f); and*

(c) of amounts stated under subsection (4)(b); and

(d) of amounts stated under subsection (4)(c).

*these are the additional disclosures required to be made in the revised section 413(5).

Directors' reports for micro-entities

As expected, Chapter 5 of Part 15 (accounts and reports: directors' report) has been amended so that a company which qualifies as a micro-entity and prepares its financial statements under the micro-entities legislation will not have to prepare a directors' report.

In addition, it was intimated by the Financial Reporting Council in their consultation to the impact that the Directive will have on accounting standards that there may be further simplifications to the micro-entities reporting framework once the standard for the micro-entities regime has been issued.

Use of the 'equity method' in individual company financial statements

The Directive allows Member States the option to permit (or require) participating interests to be accounted for using the equity method in an **investor's individual** financial statements. Article 2.2(2) says that 'participating interest':

'means rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the activities of the undertaking which holds those rights. The holding of part of the capital of another undertaking is presumed to constitute a participating interest where it exceeds a percentage threshold fixed by the Member States which is lower than or equal to 20%.'

Part 2 of the Regulations *Accounting principles and rules* includes a new section 29A(1) which now allows the use of the equity method for participating interests.

Essentially the proportion of profit or loss attributable to a participating interest which is recognised in the profit and loss account may be that proportion which corresponds to the amount of any dividends. However, where the profit attributable to a participating interest and recognised in the profit and loss account EXCEEDS the amount of any dividends, the difference is taken to a reserve account. The value of the excess does not qualify for distribution to shareholders.

For clarity, where the Regulations refer to 'dividends' in this respect, the meaning includes dividends which have already been paid as well as those which can be claimed.

This section of the Act had to be changed because the previous version of the Act did not allow the investor to use the equity method in their individual accounts (they could only use cost-based and fair value measurements).

Example – Illustration of the equity method

On 1 January 2015, Company A acquires a 35% interest in Company B which cost £475,000. On this date the book value of Company B's net assets was £900,000. During the year to 31 December 2015, B made a profit of £80,000 and paid a dividend of £120,000 (on 31 December 2015).

Under the equity method, Company A would account for its investment in B as follows:

	£	£
Acquisition of investment in B		
Share of B's net assets (35% x £900,000)	315,000	
Goodwill on investment of B (£475k - £315k)	160,000	
		475,000
Profit during the year		
A's share of B's profit (35% x £80k)		28,000
Dividend received by A during the year		
£120,000 x 35%		(42,000)
		461,000
Reconciled as:		
Share in book value of B's net assets:		
£315,000 + 35% (£80,000 - £120,000)	301,000	
Goodwill on investment of B	160,000	
Closing balance of A's investment in B	461,000	

Further points relating to the changes in the Act

Other issues relevant to the draft Regulations include:

- Definition of 'turnover' to possibly include other sources of income; and
- De-coupling of the link between the small company thresholds for accounting and audit purposes.

Definition of 'turnover' to possibly include other sources of income

In the original consultation, BIS was considering whether to amend the definition of 'turnover' so as to include other sources of income. However, the definition has not been amended so as to include other sources of income and section 474(1) says that 'turnover' is:

'In relation to a company, means the amounts derived from the provision of goods and services after deduction of—

(a) trade discounts,

(b) value added tax, and

(c) any other taxes on the amounts so derived.'

During the consultation period, there was a particular interest in the position of charitable companies which may receive a significant proportion of their income from other sources other than the sale of goods and the rendering of services. At present, BIS is still in discussion with the Charity Commission in respect of this issue.

De-coupling of the link between the small company thresholds for accounting and audit purposes

The government launched a discussion document in December 2014 *Auditor regulation: discussion document on the implications of the EU and wider reforms*. Section 4.6 of this discussion document outlines a consultation that the government is carrying out on the small companies audit exemption thresholds.

The response document issued by BIS in January 2015 confirms that the government will not take action to de-couple the link between the small company thresholds for accounting and audit purposes as part of the implication of the Directive. The discussion document issued by the government recognises that maintaining the current approach, whereby audit exemption thresholds automatically track those for the small companies regime is the government's preferred approach. This reflects:

- the longstanding process to align the thresholds;
- the view that even those companies between the current and increased thresholds would typically only have a small number of shareholders, who would normally be expected to take sufficient interest in the company to secure an audit when one was needed and to know, in any case, how the board had sought to prepare the accounts;
- the view that the value of audit, as a signal to lenders and investors that can reduce the cost of capital to the undertaking, is increased where that audit is voluntary rather than mandatory; and
- the comparatively small number of undertakings that the government thinks are affected – for the impact assessment on this change the government identified approximately 7,400 companies.

The final outcome of whether, or not, small company thresholds will remain the same as audit exemption thresholds will all depend on the outcome of the stakeholder views received. If the government decides, in light of the responses to that document, that specific audit exemption thresholds should be introduced into the Companies Act, this could be legislated in 2015.

The consultation on the audit exemption thresholds closed on 19 February 2015.

LOANS TO GROUP MEMBERS UNDER FRS 102 (LECTURE A 494 – 22.13 MINUTES)

In a group situation, it is not uncommon for one member of the group to make a loan to another member of the group; for example the parent of the group may make a loan to a subsidiary. There are various reasons why intra-group loans are made from simplicity (often it can be time-consuming for a company to raise finance through a third party) through to the company concerned being unable to obtain finance (for example because of an unwillingness by its bank/financiers to support the company further due to trading difficulties). Whatever the reason for obtaining the loan, FRS 102 at Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* requires a different method of accounting for such loans than under previous GAAP.

For short-term intra-group loans there is often not a problem (provided, of course, that repayment is not deferred beyond normal commercial terms). However, for long-term business loans measurement issues will arise if the rate of interest charged on the loan is not a market interest rate (which is often the case among intra-group loans).

Loans below market rate

It is often the case that a group member will make a loan to another group member (for example a loan from parent to subsidiary) which may be a long-term loan. The parent may decide to charge an interest rate lower than market rate, or even charge interest at 0%. In addition, there may also be cases where intra-group balances (such as trade debtors in the individual parent's balance sheet) may be due from the subsidiary but these are unlikely to be recovered in a short timescale or under normal commercial terms.

The problems are further accentuated in respect of intra-group loans when there are no formal loan terms attaching to the finance (which is often the case). Where there are formal loan terms in place, it is often difficult to retrospectively change these terms and so it is advisable to change the terms of any intra-group loans (or introduce loan terms) **before** the date of transition to FRS 102 so as to avoid any measurement issues. In addition, there are two potential ways around avoiding any measurement issues:

1. the lender charges the borrower a market rate of interest; or
2. the terms of the loan make provision for the loan to be repaid back to the lender at a very short notice period.

When deciphering on a market rate of interest, the simplest method might be to charge the rate of interest which the borrower would incur from a third party (i.e. from its bank). However, other factors to consider would be:

- cash flow pattern;
- the company's credit-rating (and credit risk);
- currency;
- maturity; and
- any collateral pledged.

If a company is already highly geared, all its assets are secured against existing borrowings and it requires additional finance for a long-term project, lenders will inherently demand a higher rate of interest because of the high risk attached to the borrower. Conversely, where a borrower has no existing borrowings and a high level of assets, then the interest rate demanded would be significantly less.

In situation 1 above, when an intra-group loan attracts interest which is a market rate of interest, then no accounting issues arise and the loan is recognised at fair value at the outset

(which is at the value of the loan proceeds). This is because the transaction price reflects fair value.

When an intra-group loan is not charged at a market rate of interest, complexities in accounting for the loan under FRS 102 can arise. Under previous GAAP at FRS 4 *Capital instruments* the issue was fairly straightforward; the company receiving the loan would recognise a creditor at the amount payable and the company making the loan would recognise a debtor at the amount receivable (making provision for any amounts that may not be recoverable).

Example – Loan not charged at a market rate

Parent (P) owns 100% of Subsidiary (S). S's principal activity is that of research and development. It has undertaken a new project which is cost-heavy in the first few years whilst the research phase is being completed. P has agreed to a loan on which it is charging an interest rate which is below market rate. P has issued loan terms which state that the loan is repayable immediately on demand. P has asked its accountant how it should account for the loan on inception.

Where interest rates on intra-group loans are at a below market rate, then it should be initially measured at fair value (which will be the proceeds of the transaction).

In S's books the loan should be recorded at not less than the amount repayable (the loan is repayable on demand). Because the loan is below market rate, S will record the loan at the amount immediately payable. This is to accord with the provision in paragraph 12.11 of FRS 102.

Emerging issues regarding intra-group loans and discounting

Over the last quarter, there have been some points raised concerning loans entered into among group members and the treatment of the excess of the loan proceeds and the present value.

When, say, a parent company makes a fixed-term loan to a subsidiary which does not contain any demand features or the subsidiary has the option to repay the loan early, the lender will recognise the loan at fair value and so does the subsidiary. The question arises as to what happens with the difference between fair value and present value?

If a fixed-term loan is charged at a below market rate of interest and the borrower (i.e. the subsidiary) has the option to repay the loan early, the accounting treatment of this loan would normally be the same as that of a fixed-rate loan without the option of early repayment. This is because a company receiving a below market rate of interest would not normally exercise the option to repay the loan early.

Difference between fair value and present value in the lender's books – fixed-term loan from parent to subsidiary

In the parent's accounts, the difference between fair value of the loan and the present value of the loan will be recognised in the investment in subsidiary.

In the subsidiary's accounts, the difference between fair value of the loan and the present value of the loan will be recognised as a capital contribution in equity.

Example – Fixed-term loan, subsidiary can repay early, terms contain no demand features

A parent (P) agrees to lend its subsidiary (S) an amount of £10,000 on 1 January 2014 for one year. S's bank provided a quotation and would have charged 10% on the same loan and P has agreed to charge an interest rate of 5%.

Workings – present value

Year	Cash flow	Discount factor	Present value
	£		£
2014	500	0.9091	456
2015	10,500	0.8264	8,677
			9,133

Workings – interest charge

Year	Opening balance	Interest (10%)	Payments	Closing balance
	£	£	£	£
2014	9,133	913	(500)	9,546
2015	9,546	954	(10,500)	-

In the parent's accounts the journals will be:

	DR	CR
Loan receivable	9,133	
Investment in subsidiary	867	
Cash at bank		10,000

Being initial recognition of loan to subsidiary

	DR	CR
Cash at bank	500	
Loan receivable	413	
Interest income (P&L)		913

Interest to 31 December 2014

	DR	CR
Cash at bank	500	
Loan receivable	454	
Interest income (P&L)		954

Interest to 31 December 2015

	DR	CR
Cash at bank	10,000	
Loan receivable		10,000

Redemption of capital

In the subsidiary's accounts the journals will be:

	DR	CR
Cash at bank	10,000	
Loan payable		9,133
Capital contribution (equity)		867

Being initial recognition of loan to subsidiary

	DR	CR
Interest expense (P&L)	913	
Cash at bank		500
Loan payable		413

Interest to 31 December 2014

	DR	CR
Interest expense (P&L)	954	
Cash at bank		500
Loan payable		454
Interest to 31 December 2015		
Cash at bank		10,000
Loan payable	10,000	
Redemption of loan		

Taking the difference between the fair value of the loan and the present value of the loan to the investment in the subsidiary in the parent's books (and recognising a corresponding capital contribution in the subsidiary's books) reflects the fact that the parent has contributed to the subsidiary by lending funds at a below market rate of interest.

Subsidiary lending to a parent

It is not always the case that a parent will lend finance to a subsidiary; indeed there could be situations where the role is reversed and the subsidiary will lend funds to its parent. Again, these loans could well be at a below market rate of interest.

Consider the following two scenarios:

Situation 1

Subsidiary (S) lends funds to Parent (P). The loan is a fixed-term loan with no demand features and the parent has an option to repay the loan early. Interest is being charged by S at a rate of 5% with market rates being 10%.

S recognises the loan at fair value and the initial measurement difference is recognised as a distribution to the parent.

P recognises the loan at fair value and the initial measurement difference is recognised as income from the subsidiary.

Situation 2

Subsidiary (S) lends funds to Parent (P). The loan is repayable on demand at the option of the subsidiary. Interest is being charged by S at a rate of 5% with market rates being 10%.

S recognises the loan at fair value with the initial measurement difference being recognised as a distribution to the parent.

P recognises the loan at the amount payable. This amount is to be discounted from the demand date where material.

In the above two situations, the accounting treatment adopted reflects the fact that the subsidiary has essentially made a distribution to the parent by making a loan to the parent at a below market rate of interest.

Example – Loan from subsidiary to parent

Subsidiary (S) agrees to lend its parent (P) an amount of £10,000 on 1 January 2014 for one year. P's bank provided a quotation and would have charged 10% on the same loan and S has agreed to charge an interest rate of 5%.

Workings – present value

Year	Cash flow	Discount factor	Present value
	£		£
2014	500	0.9091	456
2015	10,500	0.8264	8,677
			9,133

Workings – interest charge

Year	Opening balance	Interest (10%)	Payments	Closing balance
	£	£	£	£
2014	9,133	913	(500)	9,546
2015	9,546	954	(10,500)	-

In the parent's accounts the journals will be:

	DR	CR
Cash at bank	10,000	
Loan payable		9,133
Income from subsidiary (P&L)		867

Being initial recognition of loan

	DR	CR
Interest expense (P&L)	913	
Cash at bank		500
Loan payable		413

Interest charge to 31 December 2014

	DR	CR
Interest expense (P&L)	954	
Cash at bank		500
Loan payable		454

Interest charge to 31 December 2015

	DR	CR
Loan payable	10,000	
Cash at bank		10,000

Redemption of loan

In the subsidiary's accounts the journals will be:

	DR	CR
Loan receivable	9,133	
Distribution to parent (equity)	867	
Cash at bank		10,000

Being initial recognition of loan

	DR	CR
Cash at bank	500	
Loan receivable	413	
Interest income (P&L)		913

Interest charge to 31 December 2014

	DR	CR
Cash at bank	500	
Loan receivable	454	
Interest income (P&L)		954
Interest charge to 31 December 2015		
Cash at bank	10,000	
Loan receivable		10,000
Redemption of loan		

Loans between subsidiaries

Situations may arise when a subsidiary lends funds to a fellow subsidiary and these can also be at below market rates of interest.

Consider the following two scenarios:

Situation 1

Subsidiary B lends funds to Subsidiary C. The loan is a fixed-term loan with no demand features and C has an option to repay the loan early. Interest is being charged by B at a rate of 5% with market rates being 10%.

B recognises the loan at fair value and the initial measurement difference is recognised as interest expense. The initial measurement difference could also be recognised as a distribution if the parent instructs.

C recognises the loan at fair value and the initial measurement difference is recognised as interest income. The initial measurement difference could also be recognised as a capital contribution if the parent instructs.

Situation 2

Subsidiary B lends funds to Subsidiary C. The loan is repayable on demand at the option of B. Interest is being charged by B at a rate of 5% with market rates being 10%.

B recognises the loan at fair value and the initial measurement difference is recognised as interest expense or potentially a distribution.

C recognises the amount payable. This amount is to be discounted from the demand date where material.

Example – Loans between subsidiaries

Subsidiary L (lender) agrees to lend Subsidiary B (borrower) an amount of £10,000 on 1 January 2014 for one year. B's bank provided a quotation and would have charged 10% on the same loan and L has agreed to charge an interest rate of 5%.

Workings – present value

Year	Cash flow	Discount factor	Present value
	£		£
2014	500	0.9091	456
2015	10,500	0.8264	8,677
			9,133

Workings – interest charge

Year	Opening balance	Interest (10%)	Payments	Closing balance
	£	£	£	£
2014	9,133	913	(500)	9,546
2015	9,546	954	(10,500)	-

In Subsidiary B's (borrower's) accounts the journals will be:

	DR	CR
Cash at bank	10,000	
Loan payable		9,133
Interest income (or capital contribution if parent instructs)		867

Being initial recognition of loan from Subsidiary L

	DR	CR
Interest expense	913	
Cash at bank		500
Loan payable		413

Interest to 31 December 2014

	DR	CR
Interest expense	954	
Cash at bank		500
Loan payable		454

Interest to 31 December 2015

	DR	CR
Loan payable	10,000	
Cash at bank		10,000

Redemption of loan

In Subsidiary L's (lender's) accounts the journals will be:

	DR	CR
Loan receivable	9,133	
Interest expense (or distribution if parent instructs)	867	
Cash at bank		10,000

Being initial recognition of loan to B

	DR	CR
Cash at bank	500	
Loan receivable	413	
Interest income		913

Interest to 31 December 2014

	DR	CR
Cash at bank	500	
Loan receivable	454	
Interest income		954

Interest to 31 December 2015

	DR	CR
Cash at bank	10,000	
Loan receivable		10,000
Redemption of loan		

TRANSITION TO FRS 102 (LECTURE A495 – 12.54 MINUTES)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* has now come into mandatory effect for accounting periods commencing on or after 1 January 2015 (with earlier adoption permissible).

The transition to FRS 102 can be a complicated task to perform and it is crucial that it is undertaken in a logical manner. Section 35 *Transition to this FRS* at paragraph 35.7 outlines a four-step approach to the transition as follows:

a) recognise all **assets** and **liabilities** whose **recognition** is required by this FRS;
b) not recognise items as assets or liabilities if this FRS does not permit such recognition;
c) reclassify items that it recognised under its previous financial reporting framework as one type of asset, liability or component of **equity**, but are a different type of asset, liability or component of equity under this FRS; and
d) apply this FRS in measuring all recognised assets and liabilities.

The first step is to prepare an opening FRS 102 balance sheet which will involve taking the opening balances under old UK GAAP at the date of transition and then adjusting these to become FRS 102-compliant. For example, including any relevant holiday pay accruals or deferred tax balances on investment property revaluations. It is worth pointing out that Section 35 does not require the opening balance sheet to be presented in the first set of FRS 102 financial statements.

Mandatory exemptions from retrospective application

In dealing with the transition, it is worth pointing out that there are FOUR mandatory exemptions from retrospective application as follows:

Derecognition of financial assets and financial liabilities

Entities cannot recognise financial assets and financial liabilities which were derecognised under previous UK GAAP. For those instruments that would have been derecognised under FRS 102 and arose in a transaction that took place before the date of transition, but were not derecognised under old UK GAAP, there is a choice – either derecognise them on adoption of FRS 102, or continue recognising them until they are disposed or settled.

Accounting estimates

Entities cannot use hindsight to change the value of accounting estimates recognised at the date of transition. Should additional information have come to light about the estimate, this should be treated as a non-adjusting event and accounted for in the current (not previous) accounting period unless there is clear evidence that the accounting estimate is incorrect.

Discontinued operations

On transition to FRS 102, a reporting entity cannot change the accounting it followed under previous GAAP in respect of its discontinued operations and hence there will not be any reclassification or remeasurement for discontinued operations that have been previously accounted for.

Non-controlling interests

Entities cannot retrospectively change the accounting that it followed for measuring non-controlling interests.

Optional exemptions from retrospective application

There are 18 optional exemptions from retrospective application and a client can use all, some or none of them as they so wish. The optional exemptions are as follows:

Business combinations, including group reconstructions

A first-time adopter does not have to apply Section 19 *Business Combinations and Goodwill* to those business combinations that took place before the date of transition. However, where the entity restates any combination so as to comply with Section 19, it must restate all later combinations. Where the provisions in Section 19 are not applied retrospectively, all assets and liabilities acquired or assumed in a past business combination at the date of transition will be recognised and measured in accordance with paragraphs 35.7 to 35.9 (or if applicable paragraphs 35.10(b) to (r)). There are two exceptions to this requirement in respect of:

- intangible assets (other than goodwill): intangible assets subsumed within goodwill should not be separately recognised; and
- goodwill: no adjustment is made to the carrying value of goodwill.

Share-based payment

For equity instruments granted before the date of transition, a first-time adopter need not apply Section 26 *Share-based Payment*. This exemption also applies to liabilities arising from share-based payment transactions which were settled before the date of transition.

Where a first-time adopter has previously applied either FRS 20/IFRS 2 *Share-based Payment* to equity instruments granted before the date of transition, the entity must then apply either FRS 20/IFRS 2 (whichever applies) or Section 26 at the date of transition.

Fair value as deemed cost

For items of property, plant and equipment, investment property or intangible assets (other than goodwill), the first-time adopter can use fair value as deemed cost on transition to FRS 102. The term 'deemed cost' is defined in the Glossary as:

*'An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent **depreciation** or **amortisation** assumes that the entity had initially recognised the **asset** or **liability** at the given date and that its cost was equal to the deemed cost.'*

Revaluation as deemed cost

Again, for items of property, plant and equipment, investment property or intangible assets (other than goodwill), a first-time adopter can use a revaluation amount as deemed cost. This might be of benefit to a client who wishes to cease getting periodic valuations and move back onto the depreciated historic cost model for measuring fixed assets (e.g. a building). Be careful with this exemption; valuations should be obtained at, or before, the date of transition, but not after.

Individual and separate financial statements

Paragraphs 9.26, 14.4 and 15.9 of FRS 102 require an entity to account for investments in subsidiaries, associates and jointly controlled entities at either cost less impairment or at fair value in the individual or separate financial statements. Where cost is used, the first-time adopter must use one of the following amounts in the individual/separate opening balance sheet:

- cost as per Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Investments in Joint Ventures*; or
- deemed cost. In this respect, the deemed cost is the carrying amount at the date of transition which has been determined under previous UK GAAP.

Compound financial instruments

The use of 'split accounting' is adopted for compound financial instruments (an instrument which contains a mix of both debt and equity and the two components are accounted separately). A first-time adopter does not have to use split accounting if the liability portion of the instrument has been settled at the date of transition.

Service concession arrangements

A service concession arrangement is defined in the Glossary as:

*'An arrangement whereby a public sector body or a **public benefit entity** (the grantor) contracts with a private sector entity (the operator) to construct (or upgrade), operate and maintain **infrastructure assets** for a specified period of time (the concession period).'*

For such arrangements, a first-time adopter does not have to apply the provisions in paragraphs 34.12I to 34.16A for service concession arrangements entered into before the date of transition as these arrangements will continue to be accounted for using the same accounting policies applied at the date of transition.

Extractive industries

Where a first-time adopter has previously accounted for exploration and development costs for oil and gas properties which are in the development/production phases in cost centres that included all properties in a large geographical area, it can choose to measure oil and gas assets at the date of transition on the following basis:

- Exploration and evaluation assets at the amount determined under previous UK GAAP.
- Assets in the development/production phase at the amount determined for the cost centre under previous UK GAAP (this amount will be allocated to the cost centre's underlying assets on a pro-rata basis using reserve volumes/values at the date of transition).

First-time adopters must test exploration and evaluation assets and assets in the development and production phases for impairment at the transition date in accordance with either Section 34 *Specialised Activities* or Section 27 *Impairment of Assets*.

Arrangements containing a lease

First-time adopters can choose to determine whether an arrangement that exists at the date of transition contains a lease on the basis of facts and circumstances existing at the date of transition, rather than when the arrangement was originally entered into.

Decommissioning liabilities included in the cost of property, plant and equipment (PPE)

The cost of an item of PPE should include the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. A first-time adopter can choose to measure this portion of cost at the transition date rather than on the date(s) when the obligation initially arose.

Dormant companies

A company which is dormant (as defined in the Companies Act) can retain its accounting policies for reported assets, liabilities and equity at the date of transition until such time that there is a change to those balances or the company enters into new transactions.

Deferred development costs as deemed cost

The carrying amount of development costs capitalised under previous SSAP 13 *Accounting for research and development* can be used as deemed cost on transition to FRS 102.

Borrowing costs

When a first-time adopter decides to capitalise borrowing costs as part of the cost of a qualifying asset, it can treat the transition date as the date on which capitalisation of such costs commences.

Lease incentives

A first-time adopter does not have to apply paragraphs 20.15A and 20.25A to lease incentives provided that the lease was entered into before the date of transition. The first-time adopter can continue to recognise any remaining lease incentive (or cost associated with lease incentives) on the same basis as that applied at the date of transition to FRS 102.

Public benefit entity combinations

A first-time adopter does not have to apply paragraphs PBE34.75 to PBE34.86 to public benefit combinations that had taken place before the transition date. However, if the first-time adopter restates any entity combination to comply with FRS 102, it must restate all later combinations.

Assets and liabilities of subsidiaries, associates and joint ventures

When a subsidiary becomes a first-time adopter later than its parent, the subsidiary measures its assets and liabilities at either:

- the carrying values that would be included in the parent's consolidated accounts. These values would be based on the parent's date of transition to FRS 102 if no consolidation adjustments were made and for the effects of the business combination in which the parent acquired the subsidiary; or

- the carrying values required by the rest of FRS 102 which are based on the subsidiary's date of transition.

The carrying values in the second bullet could be different from the carrying values in the first bullet where the exemptions result in measurements which are dependent on the transition date. In addition, differences could also arise where the accounting policies used by the subsidiary differ from those in the consolidated accounts.

Similar exemptions are available for an associate or joint venture which becomes a first-time adopter later than the entity which holds significant influence or joint control over it.

Conversely, when the parent or investor becomes a first-time adopter later than its subsidiary, associate or joint venture, the parent/investor will, in the consolidated accounts, measure the assets and liabilities of the subsidiary, associate or joint venture at the same carrying amount as in the subsidiary's associate's or joint venture's financial statements which takes into account consolidation and equity accounting adjustments as well as the effects of the business combination in which the parent acquired the subsidiary or transaction in which the entity acquired the associate or joint venture.

Where the parent becomes a first-time adopter in respect of its separate financial statements earlier or later than for its consolidated accounts, the parent measures its assets and liabilities at the same values in both sets of accounts, except for consolidation adjustments.

Designation of previously recognised financial instruments

FRS 102 allows a financial instrument to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss, provided certain criteria are met. Section 35 allows an entity to designate any financial asset or financial liability at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 11.14(b) at the date of transition.

Hedge accounting

There are exemptions available in respect of hedge accounting that may be applied in respect of:

- a hedging relationship existing at the date of transition;
- a hedging relationship which ceased to exist at the date of transition because the hedging instrument had expired, was sold, terminated or exercised before the date of transition;
- a hedging relationship which commenced subsequent to the date of transition; and
- entities that choose to take the accounting policy choices under paragraphs 11.2(b) or (c) and apply IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*.

TRANSITION CASE STUDY (LECTURES A496/ A497 – 20.46/ 18.22 MINUTES)

Introduction

This case study is designed to demonstrate how a transition will work in practice for a typical medium-sized company. It should go without saying that this is not intended to be a model. The requirements of a transition will need to be applied in different ways to different reporting entities. Also, there are a number of areas that are problematic in practice or unclear and it is possible that FRC, ICAEW or a similar body might issue clarifying guidance that is different to these notes. Dealing with the useful economic life of goodwill is a particular problem area. Be warned!

The example company

S&S ski holidays Ltd has been trading for many years. They arrange ski accommodation, predominantly in Europe, for customers based in the UK. The example company has a few interesting issues for FRS 102 purposes:

- It owns an investment property.
- It wishes to revalue its fixed asset property on transition to FRS 102.
- It has derivatives in the form of foreign exchange contracts and an interest rate swap.
- There was a recent acquisition giving rise to goodwill that is currently being amortised over a long period.

The example does not include the following which also leap to mind as major problem areas on transition:

- It is not a holding company.
- It does not own a property occupied by a group company.
- It does not hold intangibles other than goodwill.
- It does not intend to hedge account.
- There are no unremitted earnings from foreign subsidiaries.
- It does not have a holiday pay provision.
- There is no change to its foreign exchange accounting policy (i.e. it did not use the SSAP 20 *Foreign currency translation* option of translating transactions at the contract rate).
- There are no loans at below market interest rates.
- The company has not chosen to use hedge accounting for its interest rate swap, although it might choose to in reality.

In short, this example may have its fair share of complexities but in practice you may encounter significantly more complex issues.

Opening position

		S&S ski holidays Ltd	
		At 1 July 2014	**At 30 June 2015**
		As previously stated (£'000)	As previously stated (£'000)
Fixed assets			
Investment property		800	850
Freehold property		2,300	2,200
Plant and equipment		28	14
Goodwill		1,600	1,500
Current assets		4,300	5,200
Creditors: amounts falling due within one year		(2,200)	(2,300)
Net current assets		2,100	2,900
Total assets less current liabilities		6,828	7,464
Creditors: amounts falling due after more than one year		(1,250)	(1,350)
Provisions for liabilities – deferred tax		(2)	(1)
Net assets		**5,576**	**6,113**
Capital and reserves			
Share capital		1	1
Profit and loss account		5,175	5,662
Revaluation reserve		400	450
		5,576	**6,113**

1. Transition date

The first day in the earliest period of comparatives is 1 July 2014, being the date of transition to FRS 102. Any changes to the recognition and measurement of assets occur at that date, subject to the applicable exemptions and exceptions.

2, 3 and 4. Changes to accounting policies, exceptions and exemptions

This is the most important stage of the transition process. The accounts preparer needs to work through the assets, liabilities and equity presented on the balance sheet and restate them as if the entity had always adopted FRS 102. Just as importantly, there has to be regard for assets and liabilities required to be recognised by FRS 102 that have not previously been recognised in the financial statements, such as derivatives and certain deferred tax provisions.

Working logically through the various aspects of the financial statements the impact of FRS 102 on S&S ski holidays Ltd, is as follows:

Investment property

The investment property will be revalued annually to fair value instead of market value. In practice this makes very little difference.

What is much more significant is that revaluation gains and losses will pass through the profit and loss account. There is no requirement to maintain an investment property revaluation reserve but that does not mean that any gains on the investment property are now distributable.

The directors either need to keep a record of the distributable element of reserves and disclosure it, or they might choose to maintain a separate investment property revaluation reserve. S&S decide to present a single reserve on the face of the balance sheet and present the element that is not distributable in the notes.

A deferred tax provision will be required on the gain (see below).

Tangible assets/property plant and equipment

Under FRS 102, there are no required changes to the carrying value or depreciation of property, plant and equipment.

The directors of S&S point out that much of the office equipment has been depreciated to £1 and that the over-depreciation should be reinstated at transition. FRS 102 does not permit this as it is a retrospective change to accounting estimates.

S&S could use the exemption in FRS 102 to adjust the value of the office equipment to deemed cost (i.e. market value), on transition, without the need to adopt a policy of revaluation but they choose not to do so.

The directors, however, have always been eager to revalue the freehold property in the past. What has stopped them is the requirement in FRS 15 *Tangible fixed assets* to adopt a policy of revaluation and the consequent need for regular revaluations, whether they want to or not!

On transition to FRS 102, they acquire a professional valuation of the property at 1 July 2014, of £6.4m (the land is valued at £1.8m) and they use the FRS 102 transitional exemption to value the property at deemed cost without adopting a policy of revaluation.

This creates a revaluation reserve at transition. S&S assess that the estimated useful life of the property is unchanged.

Goodwill

To say that this is a difficult area is an understatement. Even those who have spent a lot of time looking at FRS 102 disagree on the interpretation.

In this example, the goodwill arose on acquisition of the business of a competitor on 31 March 2011. At acquisition the goodwill was £2m and the estimated useful life was determined to be 20 years, which was considered acceptable under FRS 10 *Goodwill and intangible assets*.

In reality life might be more complex than this but let us assume that S&S did a good job at determining the life of goodwill on acquisition, so the useful life is not amended.

Current assets

FRS 102 does not significantly affect the recognition and measurement requirements for current assets like stock, trade debtors, prepayments and cash, which make up the balance for current assets currently presented in S&S's accounts.

However, S&S buy-forward Euros, as they sell skiing holidays to UK customers, for accommodation predominantly in Europe. Their customers tend to pay in Sterling and the hotels and chalet owners are paid in Euros

As a hedge they purchase forward contracts for Euros as follows:

31 March 2014	€1.2M at €1.10:£1 on 31 December 2014
31 May 2014	€2.0M at €1.12:£1 on 28 February 2015

The forward rates for the above at 30 June 2014 are €1.20 and €1.21 respectively.

These derivatives are now required to be recognised on S&S's balance sheet at fair value through profit and loss. They are valued as follows:

31 March 2014	(€1.2M/1.2) – (€1.2M/1.1) = £90,909 asset
31 May 2014	(€2.0M/1.21) – (€2.0M/1.12) = £132,822 asset

This is rounded to £224k in the workings to this example.

Notice that this valuation compares the contract rate to the forward rate that was available at the valuation date for the relevant settlement date. It is now the spot rate that is relevant.

Alternatively, the value of the derivative could be derived from market data obtained from the counterparty or another financial institution.

Note: S&S uses a simplistic way of valuing forex contracts but given the short lives of the assets it will often be acceptable. The counterparty might use more sophisticated methods if asked to provide a year-end valuation.

There were similar contracts in existence at 30 June 2015 and 2016 but for simplicity these notes will ignore the details and they have been valued as follows:

At 30 June 2015	£94,000	asset

Note: S&S might qualify to use hedge accounting to reduce the resulting volatility in the profit and loss account. Hedge accounting, though, will only be needed if the movements on the hedging instrument (forex contracts) are not matched against movements on the hedged items (creditors in foreign currency). In this example they should match making hedge accounting irrelevant.

Creditors

Like current assets there are few changes to the recognition and measurement requirements relating to creditors as they are currently presented in the accounts of S&S. However, interest is paid on the bank loan at a variable rate. In 2008, S&S were encouraged by the bank to enter into a fixed for floating interest rate swap, with a term of 25 years. Given the current low rates of interest this has proved to be an onerous commitment for S&S, but previous UK GAAP only requires the disclosure of these derivatives, not their recognition.

The bank has provided the following figures for S&S to buy itself out of the interest swap:

1 July 2014	£245,000	liability
30 June 2015	£232,000	liability

For the purposes of this example these will be assumed to be the fair value of the swaps. The fair value could be lower and this might be evidenced through a review of the market for floating for fixed interest rate swaps.

Note: S&S might also qualify to use hedge accounting here and there is a good argument to use it. However, it is unclear whether companies will take this option in practice and to keep things simple this example will ignore it.

Deferred tax

FRS 102 adopts a 'timing differences plus', approach. The existing S&S deferred tax provision remains with the addition of a provision for the tax on the capital gain relating to the investment property and the new revalued trading premises.

This is usually relatively straightforward to calculate and for S&S the deferred tax provisions are:

Investment property

1 July 2014	£100,000	liability
30 June 2015	£110,000	liability

Fixed asset property

1 July 2014	£140,000	liability
30 June 2015	£140,000	liability

Workings

The effect of the above adjustments are as follows;

	S&S ski holidays Ltd					
	At 1 July 2014			**At 30 June 2015**		
	As previously stated (£'000)	Effect of transition (£'000)	FRS 102 as restated (£'000)	As previously stated (£'000)	Effect of transition (£'000)	FRS 102 as restated (£'000)
Fixed assets						
Investment property	800		800	850		850
Freehold property	2,300	4,100	6,400	2,200	4,000	6,200
Plant and equipment	28		28	14		14
Goodwill	1,600		1,600	1,500		1,500
Current assets	4,300	224	4,524	5,200	94	5,294
Creditors: amounts falling due within one year	(2,200)	(25)	(2,225)	(2,300)	(14)	(2,314)
Net current assets	2,100	199	2,299	2,900	80	2,980
Total assets less current liabilities	6,828	4,299	11,127	7,464	4,080	11,453
Creditors: amounts falling due after more than one year	(1,250)	(220)	(1,470)	(1,350)	(218)	(1,568)
Provisions for liabilities – deferred tax	(2)	(240)	(242)	(1)	(250)	(251)
Net assets	**5,576**	**3,839**	**9,415**	**6,113**	**3,612**	**9,725**
Capital and reserves						
Share capital	1		1	1		1

Profit and loss account		5,175	279	5,454	5,662	202	5,864
Investment property revaluation reserve		400	(400)	0	450	(450)	0
Fixed asset revaluation reserve		0	4100 (140)	3,960	0	4000 (140)	3,860
		5,576	**3,839**	**9,415**	**6,113**	**3,612**	**9,725**

5. *Example reconciliations and disclosures*

The FRC guidance suggests that there are two alterative formats that could be used for the reconciliations. FRS 102 does not specify the format of the reconciliations of equity and profit or loss and the FRC suggest that entities will need to determine the most suitable format for their reconciliations taking into account the nature and amount of their own adjustments.

In practice most entities and their accountants will probably favour simplicity and the format shown below is likely to be very popular.

S&S ski holidays Ltd

Reconciliation of capital and reserves	**Notes**	**At 1 July 2014 (£'000)**	**At 30 June 2015 (£'000)**
Capital and reserves (as previously stated)		5,576	6,113
Restatement of freehold property at deemed cost		4,100	4,000
Deferred tax on freehold property revaluation		(140)	(140)
Recognition of foreign exchange contracts derivatives		224	94
Recognition of interest rate swap derivatives		(245)	(232)
Deferred tax provision on revaluation of investment property		(100)	(110)
Capital and reserves (as restated)		9,415	9,725

Reconciliation of profit for the year	Note		Year ended 30 June 2015 (£'000)
Profit on ordinary activities after taxation and for the financial year (as previously stated)			487
Increase in depreciation on revalued freehold property			(100)
Change in value of foreign exchange contract derivatives			(130)
Change in value in interest rate swap derivatives			13
Change in deferred tax provision on investment property revaluation			(10)
Gain on investment property			50
Profit on ordinary activities after taxation and for the financial year (as restated)			310

Other disclosures

FRS 102 also requires a description of how FRS 102 has affected the accounts and a description of the various changes to accounting policies. This disclosure will tend to be narrative and cross-referenced to the reconciliations above.

THE GOODWILL PROBLEM (LECTURE A498 – 12.25 MINUTES)

The following is an extract from the ICAEW Audit & Assurance Faculty publication, *Audit & Beyond*. It deals with the issue of goodwill on transition and it considers it from the audit angle which accentuates the practical problems involved.

This month John returns to the thorny audit issues arising from the transition to FRS 102 and the useful economic life of goodwill

My audit client has goodwill on their balance sheet where the useful economic life (UEL) has previously been determined at 20 years. Does FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* require the entity to reduce the UEL to five years and what are the mechanics of reducing this to five years? In particular, when does the five years begin and when should the amortisation first be accelerated?

As this was the most common question from delegates at the faculty roadshows during 2014, I have tried to answer it on a number of occasions. I use the word 'tried' because I am never entirely satisfied with the answer and it often seems a little simplistic. But this continues to be a hot topic, so I will try to make things as clear as possible or, failing that, to give some sort of structure to the uncertainties.

In my view, an easy mistake that auditors make in these situations is thinking that every entity using a UEL of 20 years has the same problem with the same solution. I see four different scenarios that are possible and some of them have multiple solutions. The key to auditing this area is looking at the evidence to determine which scenario is present.

In all these scenarios I have assumed that management have elected to use the FRS 102, Section 35 exemption not to restate goodwill at transition, which will usually be the case.

Scenario 1: 20 years remains the appropriate UEL and there is sufficient evidence to support it.

I hope that this is the most common scenario. From the original acquisition, management should have been diligent in their assessment of the UEL of goodwill and auditors should have been challenging when obtaining audit evidence to support the life.

I know that this might seem a slightly idealistic view but nevertheless it should be relatively common for entities to continue with their existing UEL. FRS 102 does not impose a maximum life of five years in all circumstances. It merely asks that the estimate of a longer UEL be reliable and if it is not then the five-year limit applies.

I have covered this ground before in a Q&A in the October 2014 issue of *Audit & Beyond* (http://www.icaew.com/en/technical/audit-and-assurance/faculty/audit-and-beyond/audit-and-beyond-2014/audit-and-beyond-october-2014), so I refer you to this.

Additionally, many entities did not choose the 20 year maximum imposed by FRS 10 *Goodwill and Intangible Assets* and I would expect that if a UEL of 10, 15 or 18 years, for example, were used, then there would be plenty of evidence to support these more precise figures.

Scenario 2: The 20-year life is unsupported and on closer inspection is unsupportable.

This looks like an error to me and should be accounted for as such. If the facts on acquisition suggest that the UEL of 20 years is wrong then this is not a transitional adjustment. It should be dealt with in the transition accounts as a prior year adjustment resulting from an error, rather than as part of the first time adoption of FRS 102.

More realistically, entities will be considering this issue now and addressing the problem in financial statements prior to transition, which seems very sensible to me.

Scenario 3: There was sufficient information to support the 20-year life on acquisition but circumstances have changed since then and a shorter life is now thought to be more appropriate.

This is neither an error nor a transitional adjustment. Instead it is the revision of an accounting estimate and should be accounted for prospectively. Management will assess the UEL of goodwill from the beginning of the accounting period and the new rate of amortisation will not lead to revisions to the comparatives or opening balances. Prior year adjustments are only appropriate for changes to accounting policies, transitional adjustments or the correction of errors, and as this is a change of accounting estimate it does not fall into those categories.

The new UEL is whatever management determines it to be, subject to FRS 102's requirement that it can only exceed five years if the estimate is reliable.

Scenario 4: Management suggest that there was sufficient information to support the 20-year life on acquisition, under the requirements of FRS 10, and they say that circumstances have not changed since then. However, management now determine that the evidence to support the 20-year UEL is now insufficient, for the purposes of the FRS 102, and the five year maximum now applies.

This scenario is not without controversy. Part of the problem is that management might think, or indeed hope, that this is the scenario in which they find themselves, when the facts point to one of the above scenarios. Another part of the problem is that views differ on how big a gap exists between FRS 10 and FRS 102, when in comes to the reliability of, or certainty over, UELs. Many believe that this scenario is the least likely. And where management have previous selected a UEL of 20 years, it probably is the least likely, because 20 years was often used as a default.

The received wisdom among commentators is that the impact of FRS 102 on setting finite useful lives is either small or nothing at all. Therefore, if management say that they are reducing their UEL only because of the application of FRS 102 then there needs to be some robust challenge of this.

There is no specific guidance from the Financial Reporting Council (FRC) on this particular scenario, so professional judgement by management and auditors alike is necessary. However, if it is FRS 102 that is driving the change then it would be accounted for as a transitional adjustment. The balance at transition should not be amended and the increased rate of amortisation would be reflected in the comparatives and the current period.

As for whether the five years should run from date of acquisition or transition, different views continue to be expressed.

The FRC view seems to be that professional judgement should be applied. In these situations, that is rarely bad advice and I am happy to promote that approach.

DIS-APPLYING THE FRS 102 EXEMPTION

As stated above, most of the time entities are applying the FRS 102 transitional exemption, in Section 35 of the standard, on business combinations, which permits the entity to not revisit the fair values on acquisitions prior to transition.

Another option for management is to choose to ignore this exemption and apply the approach in Section 19 of FRS 102 to the valuation of intangibles, previously acquired. This can sometimes be a good option. But if you apply Section 19 of the standard for one acquisition, it has to be done for every subsequent acquisition.

EVIDENCE, INDEPENDENCE AND SCEPTICISM

Auditors need to identify which scenario applies. Management might be inclined to push for a particular accounting treatment, which might be in some way advantageous to them. They might then try to make the facts fit the answer that they want.

Auditors should also be wary when providing non-audit services such as accountancy and advice on the impact of new standards. In an attempt to help the client, it could be very easy to offer advice that might make life more difficult down the line.

As always, the challenges faced by auditors in this area can be overcome through the proper application of independence and scepticism.

ONE MORE THING

At the time of writing the Department for Business, Innovation and Skills is proposing that the five-year limit on UELs be extended to 10 years, which in practice might make this issue more straight forward to deal with, for some entities.

THE TROUBLE WITH MORTGAGE REFERENCES (LECTURE A499 – 9.39 MINUTES)

It is one of the profession's best kept secrets that providing mortgage or loan references for clients can be difficult and time-consuming. Often you never get involved with references until you reach partnership level; but once you do, you realise that they are not straightforward.

The balancing act that the accountant has to perform is between protecting themselves and their firm from risk whilst being as helpful as possible for the client. The bottom line is that you need to avoid making representations or forming relationships where the client or lender could place more reliance on you than is appropriate. You do not want to be in a position where the lender can pursue you should the client default on their loan. Equally, you want to avoid being responsible should the client be refused the loan.

In this area, guidance from the professional bodies, such as ICAEW, is meant to be helpful rather than prescriptive. The focus, naturally, is on minimising risk.

Standard forms

What can significantly complicate matters is when the lender insists that you complete a standard form as the applicant's accountant. There is nothing wrong with these forms in themselves, but many lenders use standard wording on their forms that accountants should be wary about, using words such as 'confirm', 'certify' or, worst of all, 'guarantee'!

Accountants need to read these forms very carefully before completing and signing them. Just because the lender is large and well-known, does not mean that the wording has been somehow 'approved' and is safe to sign. You are not providing any assurance on the information that you provide so make sure that the wording on the form neither states, nor implies, that you have.

What you can say

If possible you are usually safer providing a written reference on your own headed notepaper. This gives much more control over your wording. ICAEW provides guidance in this area which includes an example letter than you could use (Audit 2/01 *Requests for References on Clients' Financial Status and their Ability to Service Loans)*.

The information that you would usually provide is:

- how long you have acted;
- the net income or profit declared to HMRC; and
- based on the accountant's experience, and having exercised judgement, a statement that you have no reason to suppose that the client would be likely to enter into a commitment, such as that proposed, that the client did not expect to be able to fulfil.

If you do not feel able to make this last statement then you should not. Indeed, perhaps you should not be providing the reference at all.

If you provide your own wording for the reference you also get the opportunity to add in your own risk management paragraphs. ICAEW suggests the following wording in their guidance, which can be included in the appropriate places:

'However, it should be noted that our knowledge of our client's affairs may not be fully up-to-date. In addition, we have not carried out any specific work with regard to this statement.

'Whilst the information provided above is believed to be true, it is provided without acceptance by [name of firm/signatory] *of any responsibility whatsoever, and any use you wish to make of the information is, therefore, entirely at your own risk.'*

Should you charge a fee?

This is very contentious! ICAEW guidance suggests that charging a fee implies that you have done some work to support the information in the reference. However, clearly no assurance work is being performed and the fee could create an implied contract that exposes you to risk. Whether you charge a fee or not is clearly up to you, but ICAEW advises against it.

Your attitude to risk

Your overall objective should be to avoid either an implied contract or a duty of care. Accountants do not typically do any assurance work to support references so their communications need to make that abundantly clear so that no third party assumes that you have.

Sometimes things can turn ugly whilst preparing a reference. The accountant might refuse to sign a standard form and the lender accepts neither an amendment to their standard wording or a separate reference on the accountant's own letterhead. In some situations the client's loan application could be rejected because the accountant did not provide the reference in the form that the lender requested.

When the accountant has followed their professional body's guidance and this happens it is unfortunate and often has deeply negative effects on client relationships. How accountants respond to these situations depends upon their attitude to risk. Are they willing to say more than they are required to or sign off on something that is not true?

Hopefully these worst case scenarios are rare, but do not forget that if the lender defaults, the bank may look at your reference to see if you have given sufficient assurance to sue! If in doubt, don't forget your professional body is there to help; use their technical helpline. Failing that, call your lawyer!

PROFESSIONAL CONDUCT IN RELATION TO TAXATION (LECTURE A500 – 10.43 MINUTES)

Taxguide 02/14

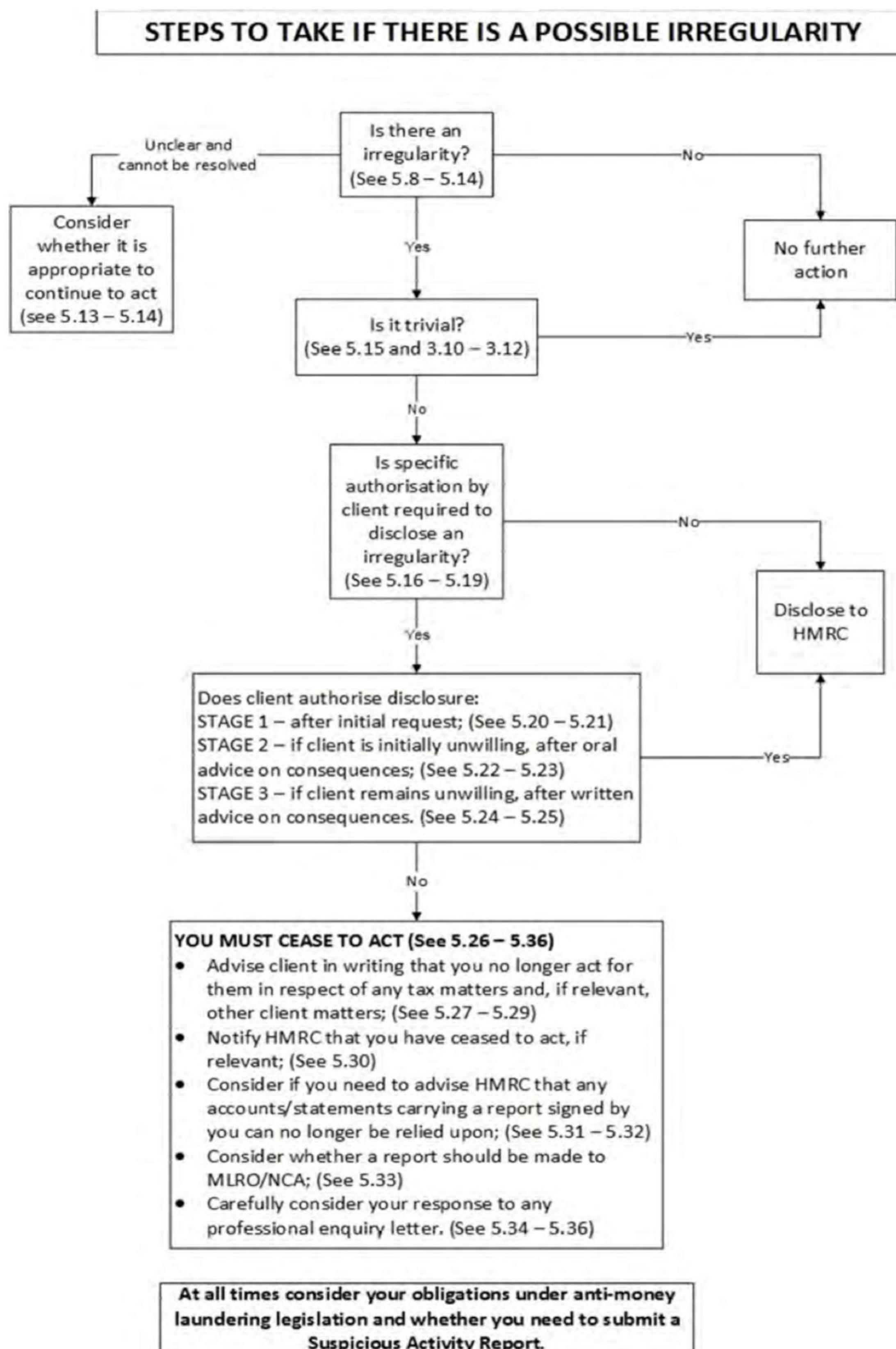
The following guidance was published on 24 February 2014 by ICAEW, jointly with ACCA, ATT, CIOT, ICAS and STEP.

These notes are not meant to be for the purposes of specialist tax practitioners. Instead the objective is to help general practitioners understand how their professional obligations, in relation to providing tax services and interact with their Suspicious Activity Reports (SAR) reporting obligations.

Dealing with irregularities in a client's tax affairs - summary

The scope of the Taxguide 02/14 is broad. These notes will look at how to deal with irregularities in a client's tax affairs.

Taxguide 02/14 gives very clear guidance on how practitioners should respond to discovering irregularities. In particular the following flowchart is included in the guidance, and it is a very useful tool.



The central issue is that practitioners cannot tolerate unresolved irregularities in a client's tax affairs and ultimately if the client continues to refuse to rectify the situation the practitioner will have to cease to act.

Is there an irregularity?

In practice this can sometimes be very difficult. A mere suspicion, on its own, is not enough and the practitioner should discuss the matter with their client to either confirm or remove the suspicion. If the suspicion is confirmed then the practitioner has to take steps to ensure that the irregularity is rectified.

If the client denies that there is an irregularity, or otherwise clarifies the situation and the practitioner's suspicion is removed, then that is the end of the matter, and no further action is required.

If, despite the client's denials, there remains suspicion or a lack of clarity then the practitioner needs to consider whether the relationship of trust with the client is still sufficiently strong to continue to act.

MLR point: These sorts of discussions will hardly ever constitute a 'tipping off' offence for MLR purposes but some care is needed.

Triviality

Whilst all irregularities should be corrected, if the irregularity is trivial then no further action is required. The guidance describes triviality in the following way:

'However, a member should exercise judgement over whether the cost of remedying the error might exceed the tax involved. In the opinion of the professional bodies it is reasonable for a member to take no steps to advise HMRC of isolated errors where the tax effect is no more than minimal, say up to £200, as these will probably cost HMRC and the client more to process than they are worth to the Exchequer.'

Correcting an irregularity

The practitioner needs the client's authority to disclose the irregularity to HMRC. If this is in place then the practitioner should make the disclosure. It goes without saying that great care is needed to respect client confidentiality in this situation. Whilst, blanket authority to disclose errors might exist in the terms contained in the engagement letter, practitioners should exercise caution. They should consider discussing the disclosure with the client and it is possible that the client might withdraw authority to disclose, at that point in time.

Without authority, the guidance recommends a three stage approach.

STAGE 1 – The practitioner should encourage the client to authorise them to make a timely disclosure to HMRC.

STAGE 2 – If the client fails to initially give authority the practitioner should, to paraphrase the guidance, 'have a sit down with them'. This involves orally explaining the repercussions of not making the disclosure, such as:

- the fact that HMRC have wide-ranging powers to demand information in any event;
- the consequences of non-disclosure and benefits of voluntary disclosure;
- the practitioner will not be able to continue to act and might have to distance himself or herself from their work (this might prompt HMRC to make enquiries); and
- if the practitioner does cease to act then there will be professional obligations that they will need to observe when communicating with the client's new adviser.

If the client is a company or similar organisation, the practitioner could choose to take the issue to higher level within it.

STAGE 3 – If authority is still not forthcoming these issues should be put in writing to the client. The practitioner needs to ensure that the client is entirely clear on the consequences of failing to disclose the irregularity to HMRC. Also, the practitioner is protecting their own position by putting the issues in writing to show that they acted properly.

The guidance suggests that if the client prevaricates then professional judgement must be used to decide when prevarication should be treated as a refusal to disclose.

Where the client refuses to disclose

Just in case anybody was confused what to do at this stage, notice that the flowchart in the guidance states in bold and in capitals:

YOU MUST CEASE TO ACT!

No practitioner wants things to go this far but sometimes it is the only thing that can be done. There are a number of things for the practitioner to do once that decision has been made:

- Notify the client in writing that you are ceasing to act.
- Notify HMRC in writing.
- Do you need to advise HMRC that previously filed documents cannot be relied upon, such as audited accounts? Watch out for client confidentiality. Legal advice will often be needed in these situations.
- Ensure SAR reporting requirements have been complied with.
- Carefully respond to professional enquires from any new advisors.

Interaction with MLR requirements

The above professional requirements are nearly entirely separate from the requirements of the anti-money laundering legislation. Whether a practitioner acts or ceases to act is almost entirely unrelated to whether an SAR report is required.

Case study

Mr Bloom is the tax advisor for Miss Fowler. Mr Bloom discovers a source of income that Miss Fowler has omitted from the 5 April 2012 and 2013 tax returns. Mr Bloom discusses this with his client who claims that she did not know the earnings from media appearances were taxable and claims that her friends in the business do not pay tax on that income.

Mr Bloom knows his client is wrong and meets with her to explain the position and the consequences of non-disclosure. Miss Fowler refuses to make the disclosures to HMRC so Mr Bloom puts the position in writing.

Miss Fowler suggest that the income can go on future tax returns but she cannot afford to pay the necessary tax, so she continues to refuse to give Mr Bloom authority to disclose the irregularity to HMRC. Mr Bloom decides to cease to act and follows the appropriate procedures.

In this situation Mr Bloom would have to consider whether a SAR is required as soon as he was aware that Miss Fowler's actions were criminal. If this was a genuine misunderstanding on the client's part then it is not reportable, but once she knows that the income was taxable and decides not to make the disclosure, it becomes reportable. If, however, it is clear to Mr Bloom from the outset that despite her protestations, Miss Fowler was doing this deliberately then a SAR report would have been required immediately. This illustrates that the point at which Mr Bloom ceases to act is not necessarily the time to make a SAR report.

Also, it is possible that Miss Fowler had deliberately omitted the income but Mr Bloom had persuaded her to make the disclosure and pay the tax. In this situation Mr Bloom would have continued to act despite having made a SAR.

AUDITOR AND FRS 102 TRANSITION (LECTURE A501 – 22.11 MINUTES)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* is considered to be the most significant change in financial reporting for a generation. Professional bodies are encouraging firms around the country to begin to plan for the transition as soon as possible as the rules are retrospective to the date of transition. Auditors, of course, must also carefully consider their position when it comes to the transition process – particularly in light of any ethical threats that may arise (for example where the auditor is actively involved in a client's transition process).

Factors the auditor should consider

Whilst the Financial Reporting Council has always foreseen the UK and Republic of Ireland reporting under an international-based framework, and hence has, wherever possible, aligned UK GAAP in many respects to international counterparts, there are notable differences between old UK GAAP and FRS 102. Auditors must familiarise themselves with these differences and understand the impact that the transition will have on audit clients. Consideration should be given to (among other client-specific issues):

- the environment in which the client operates;
- the technical ability of the staff undertaking the conversion;
- the resources which the client has available to deal with the conversion;
- how the accounting system will be tested to ensure compliance with FRS 102;
- whether there have been any exceptions reported by the financial reporting system which the auditor should be aware;
- changes to accounting policies as a result of FRS 102; and
- the adequacy of the disclosures in the first year reporting under FRS 102.

It is the responsibility of the directors of the company to ensure that the conversion process is undertaken without a material impact on the business. Whilst auditors may inevitably be advising clients on the conversion process, they should also be advising clients to start preparing for the transition as early as possible. This is because some companies will be more affected than others when it comes to the conversion and thus there will be varying degrees of work performed by auditors depending on the impact that the conversion has on the entity. For example, if a client values stock using last-in first-out, they will not be able to do so under FRS 102 and so this could have a material impact on previously reported figures. In addition, FRS 102 allows a choice in accounting policy in some areas (for example writing off borrowing costs to profit or loss or capitalising them) and the auditor should be considering the appropriateness of the accounting policy choices of the entity and whether such choices are appropriate in the company's circumstances and consistently applied.

Impact of the transition

Once the client's accounting policies have been considered, the auditor should then be focussing their attention on the impact that the transition process has had on the business. Of particular concern might be bank covenants which should be reviewed in case they have been breached once the accounting policies of the client have been aligned so as to be FRS 102-compliant. The impact on the conversion on issues such as the reserves and dividend policies of the business should also be carefully considered (especially where dividends previously voted on pre-FRS 102 profits may have become illegal following the transition). In addition the impact of tax on the transitional adjustments needs to be considered.

There is no prescriptive list as to the factors which auditors should have with regards to their clients and the levels of work involved on the transition process and the sufficiency and the appropriateness of the audit evidence gathered is clearly a judgement call on the part of the auditor. Whilst audit programmes will cater for the transition to FRS 102, such programmes should be tailored to be client-specific as much of the work detailed on audit programmes is inherently generic and certain transactions or events may be so client-specific that off-the-shelf audit programmes may not deal with such (material) issues.

The transition process involves retrospective application of FRS 102. Auditors will need to ensure that their work programmes are tailored with the objective of being to ensure that the risk of material misstatement due to the transition process is reduced to an acceptable level.

The suitability of audit staff deployed on the assignment to audit the transition must also be carefully considered. In cases where the conversion process is particularly complex, suitable appropriate judgements will need to be made by the auditor so as not to compromise audit quality. Audit firms will need to ensure that the staff deployed on the assignment in the year of transition are competent to perform such assignments bearing in mind that UK GAAP under FRS 102 is markedly different in a lot of areas and this, in itself, will increase the risk of material misstatement.

Specific issues to consider at the planning stage

At the planning stage, the auditor will gain an understanding of how smoothly the transition process has been undertaken by the client and the impact that the transition has had on the financial statements. If the client has had considerable difficulties dealing with the transition, or if exceptions have been reported by the accounting system during the process, this is going to have an impact on the overall risk assessment (i.e. there is an increased risk of material misstatement) and procedures should be tailored specifically to address these risks. Discussions with management at the planning stage should involve clearly identifying the information that the auditor will require and instructions from the engagement partner to the team in ensuring that the audit evidence gathered over the transition is both sufficient and appropriate to meet the requirements in ISA (UK and Ireland) 500 *Audit evidence*.

Issues that should be considered by the auditor at the planning stage of the audit include:

- Valuations of fixed assets: does the client wish to switch from revaluation to depreciated historic cost? If a previous GAAP revaluation has been used (i.e. a valuation which took place before the date of transition), has the client accounted for depreciation between the date of the valuation and the date of transition? Is an auditor's expert needed?
- Has the client considered deferred tax implications on revalued assets under FRS 102 at the date of transition?
- Are short-term employee benefits accrued by employees, but not paid until the subsequent accounting period material? If not, would they become material when aggregated with other misstatements identified during the audit?
- Does the client have any financial instruments that need to be measured at fair value in the scope of Section 12 *Other Financial Instruments Issues*? If so, who has valued these? Will the auditor need to use the services of an expert to corroborate the valuation (especially if they are complex financial instruments)?
- Are there any ethical threats to independence and objectivity (for example if the audit firm has been actively involved in the transition process)? If so, what safeguards can be put in place to reduce these threats to an acceptable level?

- Are there any particular areas of concern which have been identified at the planning stage relating to the conversion process? For example, has the client had particular difficulty with the conversion?
- How will professional scepticism be maintained by the audit firm in auditing the transition – particularly where the audit firm has been actively involved?
- Are there any increased pressures on the client to deliver a certain level of results? If so, how does the risk assessment at the planning stage deal with this risk of material misstatement?
- How reliable is the client's accounting system? If it is not reliable, or there are ongoing problems with the system, this will increase the risk of material misstatement due to the conversion.
- Are there significant estimates used in the preparation of the financial statements? If so the auditor will need to consider that the client might want to use hindsight to change the previous estimate to improve results (which is not allowed under paragraph 35.9(c) of FRS 102).

This list is by no means exhaustive and is merely intended as a prompt as to some of the main issues which auditors might wish to consider, over and above those that may already have been included in the audit programme.

Audit documentation

Auditors will need to carefully consider the procedures generated by their audit software programmes. This is an important point to emphasise because the audit procedures adopted must ensure that sufficient and appropriate audit evidence is generated to enable the auditor to form an overall conclusion as to the effectiveness of the transition process. In turn, the transition process may require the auditor to rely on the work of experts (for example when it comes to property valuations, pension funds or financial instruments) and hence the provisions in ISA (UK and Ireland) 620 *Using the work of an auditor's expert* might become particularly relevant when auditing the transition. Key judgements and decisions made by the team must be recorded adequately within the working papers.

The work undertaken on the conversion process must be clearly documented in order that the audit engagement partner can form an overall conclusion as to whether the financial statements are free from material misstatement due to the transition process. This will also include forming a conclusion as to whether the transitional disclosures are adequate and enable the users of the financial statements to understand the impact that the transition process has had on the entity's financial performance, financial position and cash flows. The use of an up-to-date disclosure checklist in ensuring disclosures are adequate is strongly advised!

What auditors need to consider NOW

Some audit clients may want their auditors to offer some form of assurance at an early stage in the conversion process (for example on the appropriateness of accounting policies). Some assurance work at an early stage in the conversion process may go to serve as forms of audit evidence provided they are adequately documented. This may be the case if, for example, the client requests the auditor to review the opening FRS 102 balance sheet after transition to offer comfort to the client that the transition process has been undertaken properly. Care should be taken by the auditor if a review engagement is undertaken before the detailed audit work because the procedures in a review engagement are limited and may not generate sufficient appropriate audit evidence over the transition process in isolation and hence additional procedures should be implemented to ensure the sufficiency and appropriateness of the audit evidence.

When dealing with the transition process, auditors must also have consideration as to the quality of the information from which the FRS 102 information has been generated. In addition, the auditor should also factor into their planning specific procedures to audit the information system that processes the FRS 102 information and consider the controls over that information.

Preliminary analytical review procedures can also be invaluable in the context of a transition because these may highlight trends or fluctuations which the auditor is not expecting and therefore appropriate attention should be devoted to these areas which will invariably mean further audit procedures are needed and hence giving rise to a change in the audit plan. Changes to the audit plan should be adequately documented.

For clients with specific reporting requirements (e.g. deadlines for submission of the financial statements to a regulatory body), auditors will need to have specific reporting timeframes factored into the overall audit plan. As the transition process will inevitably require more work, careful consideration must be given to reporting dates to discuss the audit with the client. This may involve additional resources being assigned to certain audit areas to ensure compliance with the reporting timetable and hence an impact on the firm's resources.

Audit methodologies

Finally, auditors should consider their own processes and audit methodologies. For example, ensuring the firm's procedures are adequate to address the risk of fraud, keeping in mind the increased emphasis on fair value accounting in FRS 102, accounting policy choices and the restatement of prior year's financial statements, all of which give opportunity to the increased risk of material misstatement due to fraud. Additional representations may also be considered necessary, especially where management's assumptions relating to the valuation of assets and liabilities are considered crucial.

ACCESS TO INFORMATION BY SUCCESSOR AUDITORS (LECTURE A502 – 7.55 MINUTES)

Changes to the law for accounting periods commencing on or after 6 April 2008 gave rise to a requirement for an outgoing auditor to give access to an incoming auditor to relevant information pertaining to the client's audit, where this request is made. This will usually involve the incoming auditor inspecting the outgoing auditor's working paper files and was recognised in the Statutory Audit Directive (2006/43/EC). Article 23(3) of the Statutory Audit Directive says:

'Where a statutory auditor or audit firm is replaced by another statutory auditor or audit firm, the former statutory auditor or audit firm shall provide the incoming statutory auditor or audit firm with access to all relevant information concerning the audited entity.'

Audit Regulation 3.09 reflects the same requirement as Article 23(3) of the Statutory Audit Directive and the request for access to information by the incoming auditor must be in writing. All information obtained by the successor auditor in respect of the audit is not to be disclosed to a third party unless the successor is required to do so by a legal or professional obligation.

Procedures for making a request

Before a request is made for information by a successor auditor, the successor should consider whether there is a need to make such a request and, if so, the extent of that request (in some cases it may not be necessary for a request to the outgoing auditor for access to audit information to be made). Where a successor deems such a request to be required, it does not follow that the successor has to make a request for extensive information in a case where only limited information is needed.

Where a request has been made, the incoming auditor should pay particular attention to the outgoing auditor's work in respect of the following ISA+s because information is likely to be needed to satisfy the requirements of these ISA+s:

- ISA (UK and Ireland) 510 *Initial audit engagements – opening balances*
- ISA (UK and Ireland) 710 *Comparative information – corresponding figures and comparative financial statements*
- ISA (UK and Ireland) 300 *Planning an audit of financial statements*

In making their request for access to audit information from the incoming auditor, the outgoing auditor should be as specific as possible because time will be limited. Therefore requests for 'all relevant audit information' should be avoided and the successor should try to identify the relevant information they require (or the type of information required).

Some of the ISA+s stipulate the relevant working papers that need to be prepared and the incoming auditor may make a request to see these working papers as part of their request. Other aspects of the audit may require audit-specific working papers to be produced. Information may also be relevant to the last audit performed by the outgoing auditor which may not be stored on that year's audit file, but instead it may be placed on the permanent audit file; it is usual practice for an outgoing auditor to provide the incoming auditor with access to the permanent audit file so they can have access to relevant audit information.

Period of information requested

Because time is often of the essence, the incoming auditor would normally make a written request to see the last finalised audit file (and the permanent audit file) so as to gather the relevant information for their audit.

In some cases an incoming auditor might initially require to see more than one year's audit file and this will clearly result in more time gathering various information. Whilst there is nothing in the guidance to prohibit incoming auditors from wishing to see more than one year's worth of audit files, in the interests of cost and efficiency, the incoming auditor should first review the information that has already been provided (namely the last audit file prepared by the outgoing auditor together with the permanent audit file) and then make a judgement as to whether further information from previous years files is needed. Again, should the incoming auditor judge additional information to be necessary, then they should ensure that they describe, in writing, as precisely as possible, the additional information needed. In addition, the incoming auditor should also explain, in writing, the reasons why the additional information is relevant.

Entities to which the legislation applies

The requirements apply to all statutory audits (the meaning of 'statutory auditor' etc) are contained in section 1210 of Companies Act 2006. Statutory audits include audits of the following types of entity:

- companies;
- building societies;
- various categories of insurer and insurance undertaking;
- banks;
- qualifying partnerships (each partner being a company or a Scottish partnership in which each partner is a limited company); and
- Limited Liability Partnerships.

Example – Small company audit

A company meets the qualification criteria to be classed as 'small' and would also be able to claim audit exemption. However, the shareholders have decided that the company should have an audit.

Where an audit exempt company voluntarily chooses to have an audit, this will fall to be classed as a statutory audit and the requirements to allow incoming auditors access to the outgoing auditors files will apply.

There are certain entities, however, to which the legislation does not apply and these are:

- unincorporated charities;
- pension schemes; and
- general partnerships which are not qualifying partnerships.

Notwithstanding the fact that the ICAEW Guidance on Auditing and Reporting and the requirements in Companies Act 2006 do not extend to the above entities, it may well be the case that the outgoing auditor agrees to allow the incoming auditors access to their working papers for the purposes of obtaining information. However, the outgoing auditors should bear in mind that the range of matters requiring consideration by the incoming auditors may well extend beyond those addressed in AAF 01/08.

Group audits

AAF 01/08 says that if the outgoing auditor was the principal auditor of a group of companies the requirement to have access to audit information only applies to the relevant information in respect of the audit of the parent's single entity and consolidated financial statements.

Information relating to individual subsidiary companies will not be made available unless the incoming principal auditor is appointed as auditor to the subsidiary companies.

Relevant auditing standards

There are three specific ISA+s which the Guidance under the Audit Regulation refers:

- ISA (UK and Ireland) 300 *Planning an audit of financial statements*
- ISA (UK and Ireland) 510 *Initial audit engagements – opening balances*
- ISA (UK and Ireland) 710 *Comparative information – corresponding figures and comparative financial statements*

AAF 01/08 refers to the above ISA+s in the context of underpinning the work of the incoming auditor, recognising the need that the incoming auditor will have to develop the overall audit strategy and audit plan as well as having to obtain sufficient appropriate audit evidence concerning opening balances and the consistency of the entity's accounting policies.

ISA (UK and Ireland) 300 *Planning an audit of financial statements*

ISA (UK and Ireland) 300 at paragraph 13 says:

'The auditor shall undertake the following activities prior to starting an initial audit:

(a) Performing procedures required by ISA (UK and Ireland) 220 regarding the acceptance of the client relationships and the specific audit engagement; and

(b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements (Ref: Para. A20)'

In addition, the *Application and other explanatory material* at paragraph A20 goes on to say:

'The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the experience with the entity that is considered when planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- *Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.*
- *Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.*
- *The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances.*
- *Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).'*

SUMMARY OF DEVELOPMENTS

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

FRC formalises increased transparency of its review of company accounts

7 October 2014

The Financial Reporting Council (FRC) today published revised operating procedures for its review of company reports and accounts for compliance with relevant reporting requirements. As a result, those companies that make a significant change to their report and accounts, and at the request of the FRC refer to its intervention, a 'Committee Reference', will be identified in its Corporate Reporting Review annual report.

David Childs, Chairman of the FRC's Conduct Committee said:

'These amendments to the operating procedures will provide greater transparency to investors who rely on company reports and accounts to make and justify their long term investment decisions. They will help us to meet the expectations of a regulatory environment where increased transparency is both expected and required in order to enhance trust in corporate reporting.'

Following public consultation and approval by the Department for Business Innovation and Skills (BIS), other amendments to the procedures include:

- An explanation when a Committee Reference may be requested or a press notice issued by the FRC's Conduct Committee in respect of an individual case.
- An expectation that, where a company voluntarily refers to its exchange of correspondence with the Conduct Committee, it will invite the Committee to comment on its proposed text in advance of publication. This is to ensure that any such reference that a company may make in its report is factually correct, fair and balanced.
- An explanation that the Conduct Committee's letter to a company may include comments on aspects of reporting, other than compliance with mandatory requirements, to encourage improvements to the quality of its future reporting. For example, comments may be made in the context of the FRC's objective that financial reporting is clear and concise.
- An enhanced description of how the Conduct Committee manages complaints.

The feedback statement, also published today, provides additional information about the Conduct Committee's consideration of points raised by respondents to the consultation paper.

The revised operating procedures apply with immediate effect.

FRC's Corporate Reporting Review Annual Report emphasises areas of reporting focus for boards

14 October 2014

This year's annual report of the Financial Reporting Council's (FRC) Corporate Reporting Review (CRR) activities, has found that corporate reporting by large companies is generally of a high standard, particularly among FTSE 350 companies. However, the FRC continues to see a higher proportion of poorer quality accounts produced by smaller listed and AIM quoted companies. In April 2014, it established a project to help improve the quality of reporting by smaller companies within the next three years.

The FRC's assessment is based on a review of 271 sets of reports and accounts in the year to 31 March 2014, of which 100 (37%) companies were approached for further information and explanation.

Richard Fleck, Chair of the FRC's Financial Reporting Review Panel, said:

'We believe that trustworthy information engenders trustworthy behaviour, which in turn encourages investors to continue providing long term finance in capital markets.

The CRR Annual Report identifies the areas likely to pose future areas of challenge for preparers and where Finance Directors and Audit Committee members should have particular focus when planning their next report and accounts.

The Report supports the FRC's wider initiative of promoting Clear & Concise reports that are relevant and useful to investors.'

As well as summarising the FRC's findings, this year the report emphasises areas of reporting focus for Boards in the next reporting season. These include the need to:

- Assess the accounting effect of any changes in the structure of pension arrangements;
- Analyse the effect of new accounting standards that will apply in the next few years, in important areas such as consolidation and revenue;
- Take account of the FRC's press notice on 'Exceptional Items';
- Make a step change in the quality of disclosure of critical judgements and estimates around accounting policies; and
- Identify all the relevant intangible assets arising in recently acquired businesses.

The CRR report contributes to the FRC's Clear & Concise initiative by providing examples of where it has challenged companies on whether their reports contained immaterial or unnecessary disclosures.

Joint Forum on Actuarial Regulation publishes risk perspective

28 October 2014

The Joint Forum on Actuarial Regulation (JFAR), through its discussion paper issued by the FRC *'Joint Forum on Actuarial Regulation: A risk perspective'* is seeking views on its identification of risks to the public interest where actuarial work is relevant. The JFAR will use feedback to guide its further analysis.

Actuarial work is central to many financial decisions in insurance and pensions and is an important element in other areas requiring the evaluation of risk and financial returns. High quality actuarial work promotes well-informed decision-making and mitigates risks to users and the public; poor quality actuarial work can result in decisions being made which are detrimental to the public interest.

Stephen Haddrill, CEO of the FRC and Chair of the JFAR, said:

'Actuarial work is vital in promoting trust in financial markets among the millions of UK pensioners and savers and the many investors and investor groups who allocate capital. We want to build justifiable confidence in that work. This paper is very much a 'think-piece' –

a vehicle for seeking wider input at this preliminary stage on the JFAR's analysis. In particular we are seeking:

- *to improve our analysis of risks to the public interest to guide our future work;*
- *to raise awareness of the risks to help mitigate them; and*
- *to inform stakeholders about what regulators are doing.*

Actuarial involvement is central to some of the risks (for example in modelling in insurance and pensions). In some areas actuarial work supports decisions that have the potential to create a risk to the public interest (for example in the design and distribution of insurance products). Some of the risks we consider are very broad (for example environmental concerns) and actuarial work is just one strand among many that have an impact on the public interest.'

Roundtable events will be organised by the FRC and IFoA to discuss the Risk Perspective. Comments are invited by 20 February 2015 via email to jfar@frc.org.uk or by post to Natasha Regan, Financial Reporting Council, 8th Floor, 125 London Wall, London EC2Y 5AS.

Lab reminders for the 2014 reporting season

5 November 2014

With the 2014 reporting cycle fast approaching the FRC's Financial Reporting Lab has today published its 'Lab reminders for the 2014 reporting season'. The reminder summarises the Lab's published reports and highlights areas where relatively simple changes could improve corporate reporting, enhancing the usefulness of reports for investors. The summary brings together key findings from the reports:

- Towards Clear & Concise Reporting
- Accounting policies and integration of related financial information
- Reporting of Audit Committees
- Reporting of pay and performance
- A single figure for remuneration
- Presentation of market risk disclosures
- Debt terms and maturity tables
- Net debt reconciliations
- Operating and investing cash flows

FRC consults on new UK and Irish interim reporting requirements

12 November 2014

The Financial Reporting Council (FRC) has today issued an Exposure Draft, FRED 56 *Draft FRS 104 Interim Financial Reporting* which would revise the FRC's existing guidance on interim financial reports for consistency with new UK and Irish GAAP (FRS 102).

These proposals are relevant for entities that apply UK and Irish GAAP and prepare interim financial reports and aim to promote the publication of informative and understandable interim financial reports.

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

'The publication of reliable interim financial reporting improves the ability of investors, creditors or others to understand an entity's capacity to generate earnings and cash flows and its financial position and liquidity.

Draft FRS 104 is based on IAS 34 'Interim Financial Reporting'. Using an IFRS-based solution is consistent with the approach adopted for developing new UK and Irish GAAP.'

The FRC is also proposing to withdraw the Reporting Statement 'Preliminary announcements.'

Comments on the proposals are invited by 12 January 2015. The FRC intends to finalise the new interim reporting requirements by the end of the first quarter of 2015.

A new framework for Technical Actuarial Standards

18 November 2014

The Financial Reporting Council (FRC) is consulting on a new framework for Technical Actuarial Standards (TASs). The changes aim to ensure that users of actuarial information (such as pension scheme trustees, pension scheme sponsors and insurance company directors) can rely on the quality of actuarial work, including in developing areas of actuarial work where risks to the public interest may not yet have been identified or manifested.

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

'High quality actuarial work is vital in promoting trust in financial markets among the millions of UK pensioners and savers and the many investors and investor groups who allocate capital.

The proposed changes to our standards will support high quality actuarial work, and ensure that our standards remain fit for purpose and users continue to receive reliable actuarial information as the nature and range of actuarial work changes over time.'

The proposals in the consultation include:

- the introduction of a new FRC actuarial standard (Technical Actuarial Standard 100: Principles for Actuarial Work 'TAS 100') which includes high-level principles applicable to all actuarial work – TAS 100 will in time replace the FRC's Generic TASs; and
- a review of the scope and content of the FRC's Specific TASs building on the feedback on our recently published discussion paper *Joint Forum on Actuarial Regulation: A Risk Perspective*.

The FRC welcomes feedback on the proposals.

Responses to the consultation are invited by 8 March 2015 by email to TASReview@frc.org.uk or by post to, Robert Inglis, Financial Reporting Council, 8th Floor, 125 London Wall, London EC2Y 5AS.

FRC Statement: Transparency of AQR Findings

20 November 2014

The Financial Reporting Council (FRC) outlines how it intends to implement proposals to enhance transparency of its Audit Quality Review (AQR) findings recommended by the Competition Commission (now the Competition and Markets Authority) following its investigation of the Statutory Audit Services Market. The CMA recommended that audit committees of FTSE 350 companies whose audit had been reviewed by the FRC should disclose the principal findings and grade assigned to it in the annual report and accounts together with how they and the auditors were responding to the issues raised.

The FRC announced in April 2014 that it will consult on the CMA's recommendations in time for updates to the UK Corporate Governance Code to be made in 2016. This is in line with

the FRC's commitment not to amend the Code more than once every two years. That consultation will also address other changes to the Code that might be needed as part of the implementation of the CMA's report and the EU Audit Directive, in order to avoid making piecemeal changes to the Code. It will take place in the latter part of 2015 and 2016, and will take account of any experience gained from any early adoption as described below.

Some audit committees have indicated that they may wish to implement aspects of the CMA's recommendation in advance of any changes to the Code in 2016, and the FRC is supportive of investors having additional and better information about the quality of an audit. However, Audit Committees should take into account, in making such disclosures, that the AQR's work is focussed on the audit. It is not designed to comment on the contents of the report and accounts. The inspections also generally cover selected aspects of the audit and are also not designed to confirm the audit opinion. Therefore in considering how to report on an inspection it is important that companies do not give false assurance to investors or raise unnecessary concerns.

Our advice to Audit Committees is that in accordance with the Code they should report how they have made their own assessment of the effectiveness of the audit process. Where a company's audit has been reviewed by the AQR, the FRC would expect audit committees to discuss the findings with their auditors and consider whether any of those findings are significant for these purposes and, if so, make appropriate disclosures. Such disclosures should be in the audit committee's own words and deal with what action they and the auditors plan to take. It is important that investors understand what the company itself believes to be important and how it has applied its judgement. Such reports should meet the Code's expectation of reports being fair, balanced and understandable.

In making their report Audit Committees should not disclose the inspection grade. The current grading system was designed to help audit committees understand the significance of the issues identified and their implications. As noted above, the grades are not intended to provide an assessment as to the reliability of the financial statements as a whole or the audit opinion and we are concerned that the publication of such a 'single figure' could mislead and distract attention from the key issues identified by the Committee. The question of whether these grades should be published will therefore be considered more fully throughout the consultation in 2015 and 2016.

AQR reports are confidential and currently shared only with the audit committee and auditor. In line with the above advice the FRC will waive its confidentiality rights to the information, other than the grade awarded to audit, contained in its reports for the sole purpose of allowing the company and its auditor (who also has confidentiality rights) to determine how and what information arising from the inspection is reported to shareholders.

Background

1. The CMA recommended that audit committees of FTSE 350 companies should report on:
    - Whether the AQR team has concluded a review of the audit of the company's financial statements in the reporting period;
    - What the principal findings were, including grade; and
    - How both the audit committee and auditor are responding to these findings.

    Implementation of the CMA's recommendation would significantly increase the transparency of the FRC's inspections of individual audit engagements, with the existence of an AQR audit engagement review and the key findings (including the grade) becoming public information for the first time, together with details of how the audit committee and the auditor had responded to these findings.

    The FRC recognises that there are a number of risks that could arise from the adoption of the CMA's recommendation, and in particular how it is implemented. The CMA itself identified a number of risks and explained how it had considered them in designing its recommendation.

2. The FRC considers the risk factors to include:

- The potential for misunderstanding (by audit committees or users of audit committee reports) about:
  - limitations in the scope of AQR reviews;
  - the significance of particular grades for the quality of the audit;
  - the relevance of the grade to the quality of the financial statements.
- The potential for public reporting of AQR findings and grades for particular audit engagements to reduce user confidence in the particular audited financial statements.

3. The FRC's Audit Quality Review Team (AQR) assesses whether the group auditor has complied with the requirements of relevant auditing and ethical standards and other aspects of the regulatory framework for auditing. An AQR review covers only selected aspects of the audit. It is not designed, nor would it be possible for a review, to identify all weaknesses which may exist in the audit approach, inappropriate audit judgements or failures to follow the requirements or underlying principles of professional standards or the firm's audit methodology. For example it is not a comprehensive inspection of all subsidiary audit working papers, particularly overseas papers and is not a technical review of the accounts.

FRC consults on Guidelines for Enforcement Measures

28 November 2014

The Financial Reporting Council (FRC) is issuing for consultation Guidelines on how it proposes to impose enforcement measures set out in the Companies Act 2006 to address non-compliance by the audit recognised supervisory bodies and recognised qualifying bodies with their Companies Act obligations. The FRC believes that upholding high standards within the audit regulation promotes trust in financial reporting which in turn gives shareholders and savers confidence to invest in UK capital markets.

The new Guidelines indicate when and how the statutory enforcement measures will be applied by the FRC and will assist its Board when considering when and which enforcement measures to impose. The Guidelines will promote transparency and consistency of the FRC's likely approach and consideration when imposing enforcement measures. The enforcement measures are not intended to be compensatory or punitive; instead they are a means of correcting non-compliance and encouraging future compliance by those bodies.

The consultation period in respect of the Guidelines closes on 20 February 2015.

FRC activities related to SORPs

1 December 2014

On November 25th, the Pensions Research Accountants Group (PRAG) published a Statement of Recommended Practice (SORP) for the preparation of accounts of pension funds. SORPs are sector-driven recommendations on accounting practices, supplementing accounting standards and other legal and regulatory requirements in light of the special factors prevailing or transactions undertaken in that sector.

PRAG is an independent research group for the development and exchange of ideas in the pension field. The FRC does not issue SORPs but it must confirm that a SORP does not contain any fundamental points of principle that conflict with accounting practice or standards. The FRC also approves the SORP making bodies.

Trustworthy information

The FRC undertakes a wide range of activities that affect pension schemes and which promote trustworthy information.

We set the UK GAAP Standard, FRS 102, which provides succinct accounting and reporting requirements for unlisted entities. It gives guidance on how pension schemes should produce their financial reports. FRS 102 also requires the entity that is legally responsible for a group pension plan to recognise the entire net defined benefit cost in its individual financial statements.

A major area of work affecting pensions is actuarial policy. Here we set the technical actuarial standards that actuaries must follow and the bar for the quality of information provided by actuaries.

In 2013, the FRC established the Joint Forum on Actuarial Standards (JFAR) with the IFoA, the Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA) and the Pensions Regulator (PR). The JFAR is a unique collaboration between regulators to co-ordinate, within the context of its members' objectives, the identification of and response to public interest risks to which the actuarial work is relevant. The forum has recently published a consultation paper that identifies a number of these risk areas entitled, 'The Joint Forum on Actuarial Standards: a Risk Perspective'. This paper seeks input on a range of risks including those relating to pension schemes.

Through the UK Corporate Governance Code and the Stewardship Code, which are both set by the FRC, the Boards of UK companies are encouraged to focus on the needs of their long-term investors including disclosure of strategic risks. Likewise, investors (and their representatives) are encouraged to engage in meaningful dialogue with Boards. Pension schemes, which are sometimes larger than the company itself, can affect profit more than any other aspect of the company's finances. Knowing that the board is managing and mitigating risks relating to pensions is important to investors.

Pension funds are asset owners and we encourage them to be signatories to the Stewardship Code. Currently the Code has about 300 signatories, with over 60 of them being asset owners. Asset owners can sign up to the Stewardship Code even if they are not necessarily handling investments on a day-to-day basis, but delegate this management to asset managers. If they do this, they should make this distinction clear and monitor and follow up with their asset managers to check what is being done in their name.

We also specify methods and assumptions used by insurance companies and pension schemes to calculate the projected pensions shown on annual statements. Many millions of these statements are issued each year to members of pension schemes.

Trustworthy Behaviour

In promoting trustworthy information we also undertake a variety of work which encourages trustworthy behaviour.

The FRC has published Audit of Occupational Pension Schemes in the United Kingdom, more commonly known as Practice Note 15. The purpose of this Practice Note is to assist auditors in applying standards to particular circumstances when auditing a pension scheme. In its role monitoring the quality of the audits of listed and other major public interest entities, the FRC's Audit Quality Review team inspects the audits of some of the largest private pension schemes.

Returning to actuarial work, we monitor the IFoA's regulatory activities to ensure they are conducted effectively. Through the Conduct Division, disciplinary action can also be undertaken against individual actuaries.

The FRC's Corporate Reporting Review team reviews the annual reports of listed companies and identifies issues regarding pension schemes which, where relevant, will include assessment of the advocacy of their disclosures of pension obligation.

The FRC's objective is to promote and encourage the provision of reliable, trustworthy information that can be relied upon with justifiable confidence by investors. We wish to advocate professional, transparent behaviour by auditors, accountants and actuaries. Focusing on pension schemes ensures security in the financial markets for the millions of UK pensioners and savers and the many investors and investor groups who allocate capital into the economy.

FRC publishes review of audit of banks' loan loss provisions

2 December 2014

The Financial Reporting Council's (FRC) thematic report notes improvements in the quality of aspects of the audit of loan loss provisions and related IT controls. These improvements are most noticeable at firms where the FRC has in recent years identified significant issues. Improvements were not consistent across all audits and the report identifies areas where further improvement is necessary.

Paul George, Executive Director at the FRC, said:

'I am pleased to note the improvements achieved by many audit teams outlined in this report. This reflects investment in sector specific procedures and focus by the firms in addressing concerns previously highlighted by the FRC. There is no room for complacency and we expect all audit firms to achieve consistently high quality.'

The FRC's thematic review of bank and building society audits, announced in December 2013, followed concerns that the pace of improvements in the quality of the audit of these organisations had not been sufficient, particularly in the area of loan loss provisions and related IT controls. The FRC's annual Audit Quality Inspection report in 2013 identified the need for improvements in the quality of auditing of financial institutions as a key concern.

The FRC reviewed 13 audits of banks and building societies for its thematic review. Ten were classified as either good or requiring limited improvements, one required improvements and two required significant improvements.

The report highlights that firms have in the main demonstrated that, with appropriate focus and resources, good quality audits can be achieved. It is clear that firms with sufficient banking sector experience and access to up-to-date specialist knowledge in IT and other relevant areas, such as real estate valuation, are able to audit loan loss provisions to a good standard.

In the majority of audits reviewed the FRC raised issues about consistency in the quality of audit testing, encompassing controls, substantive and IT testing. In most cases the impact was not significant to the audit overall, but these issues demonstrate that auditors are not consistently applying a sufficient degree of challenge, and that such improvements are not being identified by internal quality control procedures.

The FRC's report summarises a number of key messages for firms performing an audit of loan loss provisioning and related IT controls that it believes should contribute to an overall increase in audit quality:

- Be proactive in monitoring and enhancing bank audit quality, as well as being reactive to regulatory concerns and ensure that bank audit initiatives and procedures remain fit for purpose.
- Revisit procedures to ensure that all regulatory and market risks are captured by risk assessment methodology and sector training, and consider or enhance the use of

benchmarking and data analytics as effective audit tools in the audit of loan loss provisions.

- Ensure audit teams apply an appropriate degree of challenge and professional scepticism in the audit of loan loss provisions, rather than seeking to corroborate management's views.
- Make sector training mandatory for partners and staff engaged in bank audits where this is not already the case and monitor attendance at, and effectiveness of, those training courses.
- Fast track the integration of non-IT specialists into the audit team using lessons learned in integrating IT specialists into audit teams.
- Perform root cause analysis to understand why current quality control processes did not identify weaknesses highlighted by our reviews.

The report also offers advice to audit committees to ensure the quality of financial reporting:

- Discuss with their auditors their proposed actions in response to this thematic review.
- Understand the implications of the firm's benchmarking and other data analytics on the quality and robustness of the audit of the financial statements.
- Seek assurance annually that the sector expertise and competence levels of the audit team and the firm are appropriate in relation to the bank's business activities.
- Consider with the auditors the effectiveness of the bank's relevant internal controls, and the extent to which the auditors review and are able to place reliable on them.
- Ensure management is assessing the impact of current and emerging issues on a timely basis and that the auditor and the bank jointly understand how these issues affect the assessment of significant risk.
- Consider the timing of planning with group auditors and check it is sufficiently early in the process to obtain appropriate and relevant information from group or other component auditors.

The banking sector will remain a priority area for the FRC's routine audit inspection work. The FRC will also undertake follow-up work on audits where significant improvements are required as part of next year's inspection cycle to ensure appropriate actions have been taken.

FRC publishes new disciplinary arrangements for accountants and actuaries

5 December 2014

The Financial Reporting Council (FRC) has today published The Accountancy Scheme and The Actuarial Scheme which update the independent disciplinary arrangements applying to members and member firms of the participating accountancy and actuarial bodies. The FRC deals with cases of potential misconduct which raise or appear to raise important issues affecting the public interest in the UK.

The updated Schemes introduce provisions to enable a joint tribunal to be convened when Formal Complaints delivered under both Schemes address a common question of law or fact, arise out of the same events, or there is some other compelling reason for the Formal Complaints to be heard together. The joint tribunal provisions are intended to make the Schemes more efficient and effective by streamlining procedure, facilitating consistent tribunal decision-making and ultimately reducing costs in such cases.

The new provisions incorporate a number of suggestions put by respondents to the consultation process earlier in 2014. A consultation feedback statement is available on the FRC website.

FRC urges clarity in the reporting of complex supplier arrangements by retailers and other businesses

8 December 2014

The Financial Reporting Council (FRC) today calls on Boards of retailers, suppliers and other businesses to provide investors with sufficient information on their accounting policies, judgements and estimates arising from their complex supplier arrangements. Investors need to receive enough clear and relevant information to be able to evaluate the company's performance and financial position where such amounts are, or could become, material.

The FRC's Conduct Committee expects to see high quality disclosure of this area of reporting in forthcoming annual and interim reports and accounts and plans to include it as an area of focus when it reviews audits and accounts during 2015.

Fees, contributions, discounts, multiple offers and volume rebates (collectively referred to in this announcement as 'complex supplier arrangements') are regular features of supplier contracts in a number of industry sector, including retail.

The amounts involved are often significant in aggregate to operating margins and other key metrics. Many arrangements require significant judgements to be made by companies when estimating period end amounts receivable and payable for both annual and interim reporting.

Richard Fleck, Chairman of the FRC's Financial Reporting Review Panel, said:

'Complex supplier arrangements such as fees and discounts may have a significant impact on the reported margins and other results of a company and on investors' views of its performance. Where this is the case, it is essential that investors are able to understand the basis and extent of judgement and estimation involved and the potential uncertainties affecting the accounts and future prospects. Today's announcement is a reminder to Boards of retail companies in particular of what they should consider and encourages them to review their reporting in this area as many have already announced.'

There is no single standard within IFRS which addresses the required accounting or disclosures for these types of commercial arrangements. This, together with an absence of well-known industry norms, underscores the benefits of clear information about the extent to which the results and KPIs of retail and other businesses are reliant on judgements and estimates surrounding their complex supplier arrangements. The FRC observes that IFRS, in addition to providing a clear set of principles on how to develop relevant accounting policies, also includes explicit requirements on disclosure of material judgements and significant uncertainties.

The recent report by the FRC's Financial Reporting Lab on accounting policies pointed to a need for companies to provide more detail than at present to help investors understand how a company accounts for its material transactions and business streams. It also reinforced the value investors place on understanding each judgement and each estimate which has an impact on the reporting of a company's results and financial position.

FRC consults on amendments to FRS 101

15 December 2014

The Financial Reporting Council (FRC) has today issued proposals to make financial reporting for entities within groups more streamlined and efficient. In its consultation the

FRC proposes a small number of modest additional disclosure exemptions to FRS 101 which have arisen in the last year.

Melanie McLaren, Executive Director Codes and Standards at the FRC, said:

'FRS 101 provides a cost-effective method for groups to apply accounting policies to the individual financial statements of entities across the group, consistent with those of the consolidated financial statements. The 2014/15 review of FRS 101 reflects careful consideration of a number of important developments in IFRS that have occurred during the last 12 months.'

Today's announcement is in line with the FRC's commitment to update FRS 101 annually to ensure that the reduced disclosure framework remains consistent with IFRS.

The comment period closes on 20 March 2015.

FRC updates pension communications standard

16 December 2014

The Financial Reporting Council (FRC) has today published a revised version of Actuarial Standard Technical Memorandum 1 (AS TM1) to reflect the implementation of automatic enrolment, legislation on same-sex marriage and to enable pension providers to more effectively take account of the impact of guaranteed annuity terms. AS TM1 sets out the basis on which annual statutory money purchase illustrations (SMPIs) should be determined. Over 18m SMPIs are sent to individuals annually providing information on the potential size of their pensions.

The revised standard is effective from 6 April 2015.

FRC consults on EU Audit Directive and Regulation impact on auditing and ethical standards

18 December 2014

The Financial Reporting Council (FRC) has today issued a consultation on options for amending its framework of auditing and ethical standards for auditors to give effect to the EU Audit Directive and Regulation.

In May 2014 the European Commission published a new Audit Directive and Audit Regulation. The Directive establishes requirements for the audit of annual consolidated financial statements. The Regulation establishes further requirements in relation to the audit of Public Interest Entities. The new requirements come into effect on 17 June 2016 and will apply to financial years starting on or after that date.

Stephen Haddrill, Chief Executive of the FRC, said:

'The FRC will consider the effect of the Directive and Regulation to ensure that its auditing and ethical standards play their part in ensuring that the roles and responsibilities of auditors are clear and aligned with the interests and needs of investors, and that auditors act with integrity, serve the public interest and consistently meet high standards. The new provisions are complex and we have significant decisions to take about how to reshape the UK regime. We therefore hope to hear from all stakeholders, and particularly from investors as the leading beneficiaries of high quality audit.'

The FRC's Consultation Document seeks stakeholder views on a range of Member State options allowed under the EU's legislation. In some respects, the UK's current requirements go beyond those of the legislation. In those cases, and where the Member State options allow, the FRC seeks views on whether or not to retain current provisions, or to extend them further, or to align with the new legislation:

- **Entities not covered by the definition of Public Interest Entities** – The EU definition of a public interest entity (PIE) is different to the current requirements of the FRC's auditing and ethical standards;
- **Non-audit services** – The Regulation prohibits the provision of certain non-audit services by auditors of PIEs through a 'black list' and places a cap on permitted services. The FRC is considering on how to apply the cap and the list most effectively in the UK; and
- **The geographic extent of application** – Under the Regulation, the prohibitions on non-audit services to PIEs or their controlled entities within Europe, apply to auditors and their network firms. The consultation seeks views on whether these prohibitions should apply in relation to all audited group entities, irrespective of their location.

The FRC will consult on specific changes to its standards during 2015, taking into account responses received to this initial consultation. The closing date for this consultation is 20 March 2015.

FRC publishes draft plan and budget for 2015/16

The Financial Reporting Council (FRC) today publishes its Draft Plan, Budget and Levy Proposals for 2015/16, the final year of its current three year strategic performance. The consultation will be open until 16 February 2015.

Stephen Haddrill, FRC Chief Executive, said:

'Over the last year the FRC has taken major new steps to enhance corporate reporting and governance. We have reported on the quality of bank and building society audits, revised the UK Corporate Governance Code, including introducing the new viability statements, issued guidance on the new strategic report and brought together a new form on actuarial regulation.

As we complete our three year strategic performance we will promote Clear & Concise reporting and begin the implementation of the EU Audit Directive. We will at all stages continue to work with stakeholders in the UK and beyond.

In July 2015 it will be three years since the FRC's reforms of 2012. We will take stock of how effective those reforms have been. We will continue to enhance the effectiveness, efficiency and coherence of our monitoring and disciplinary roles. Our aim overall is to avoid large numbers of new initiatives so we can concentrate on ensuring the recent reforms are effectively established and deliver the outcomes sought.'

The FRC proposes to focus on four areas where its work will have significant impact. These are:

- Investor stewardship – Support better quality engagement between boards and shareholders and ensure that signatories to the Stewardship Code deliver on the commitments they have given.
- Corporate reporting – Promote reports that as well as being fair, balanced and understandable are clear and concise.
- Audit – Support the Department for Business Innovation and Skills (BIS) in implementing the amended EU Audit Directive and Regulation, and continue the programme of work to promote audit that is of a consistently high standard and meets investor needs.

- Conduct activities – Enhance their impact and overall effectiveness, including the pace and effectiveness of the FRC's independent disciplinary arrangements for public interest cases involving accountants and auditors.

The FRC will, in addition, take forward its work in corporate governance and actuarial standards and regulation. On the latter, the FRC will work with the new Joint Forum on Actuarial Regulation (JFAR) to identify and respond to public interest actuarial risks. Across all its responsibilities the FRC will promote the UK interest in high quality EU and international regulation, including both standard-setting and cooperation to address issues that cut across jurisdictions.

During 2015/16 the FRC will develop its next three year strategy, for 2016/19, and will consult stakeholders on the areas on which it should focus and on its regulatory approach.

Draft budget

The FRC proposes an overall expenditure of £33.3m in 2015/16 compared to the £31.2m estimated spend in 2014/15. The most significant increase in expenditure, £1.2m, will be the cost of audit quality reviews, an increase of 12.5%, which results from Competition and Markets Authority (CMA) recommendations.

The FRC will look for an increase of 3.9% in the amount sought through the levy on preparers of accounts for core operating costs and of 2.5% in the costs.

The FRC will undertake outreach activities to gather views on its plan and budget including a public meeting in February 2015. The formal consultation will close on 16 February 2015 and comments should be sent to plan@frc.org.uk.