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THE NEW SMALL COMPANIES' REGIME (LECTURE A503 – 22.13 MINUTES)

On 26 March 2015, The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) were approved by Parliament and came into force on 6 April 2015. The new Act is as a result of the transposition of the EU Accounting Directive (the Directive), issued on 26 June 2013, into the Companies Act 2006.

The Directive establishes minimum legal requirements for financial statements in the EU as well as striving to achieve 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.

The UK government had until July 2015 in order to incorporate the provisions of the Directive into company law and the new Regulations came into force on 6 April 2015 and have effect in relation to:

- financial years beginning on or after 1 January 2016; and
- a financial year of a company beginning on or after 1 January 2015, but before 1 January 2016, if the directors of a company so decide.

The second bullet point above would generally be applied by a company that would have previously been classed as medium-sized under the previous Companies Act but which would now fall to be classed as small under the revised Companies Act.

The most notable change that the Directive brings with it is an increase in the size thresholds which defines whether a company or group is small, medium or large. With effect for accounting periods commencing on or after 1 January 2016, the following regime will apply:

	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
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

	Turnover	Balance Sheet Total	Average no. of employees
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

Some points to note where the size thresholds are concerned are as follows:

- The qualifying conditions above are met by a company, or a 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 where 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 and is **fixed assets *plus* current assets.** Care must be taken not to use the net assets figure.
- Section 382(6) of the Companies Act 2006 says that the *average number of employees* means the average number of employees employed by the company in the year. This figure is determined as follows:
  - i. 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);
  - ii. add together the monthly totals; and
  - iii. divide by the number of months in the financial year.

The future of financial reporting for small companies

Currently the vast majority of small companies in the UK and Republic of Ireland report under the Financial Reporting Standard for Smaller Entities (the FRSSE). This standard has been a popular standard among practitioners since its introduction in 1997, largely because of its ease of use, relatively light content and reduced disclosure levels for companies that fall under its scope.

The current versions of the FRSSE are the FRSSE (effective April 2008) and (effective January 2015). The former came into effect for accounting periods commencing on or after 6 April 2008 (early adoption was not permitted as this version reflected legislative changes which could not be adopted earlier). The latter version of the FRSSE came into effect for accounting periods commencing on or after 1 January 2015 and earlier adoption of this version is permissible.

There is very little in the way of 'significant' differences between the 2008 and 2015 versions of the FRSSE and to arrive at the 2015 version, the 2008 version was amended as follows:

- reference is no longer made to the Accounting Standards Board, but instead to the Financial Reporting Council;
- reference is made to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland rather than extant FRSs/SSAPs and UITFs;

- goodwill and intangible assets (where management are unable to assign reliably useful economic lives) are amortised over a five-year period;
- there are specific requirements to carry out impairment tests on assets;
- there is no requirement to make disclosure of related party transactions with wholly-owned group members;
- the definitions contained in Part C of the FRSSE are amended for related party issues and the inclusion of the definition of 'public benefit entities'.

It is expected that the FRSSE (effective January 2015) will only have a lifespan of one year. This is because the FRC will withdraw the FRSSE in its entirety for accounting periods commencing on or after 1 January 2016. Small companies who choose not, or are ineligible, to apply the provisions in the micro-entities regime will be moved under the scope of FRS 102.

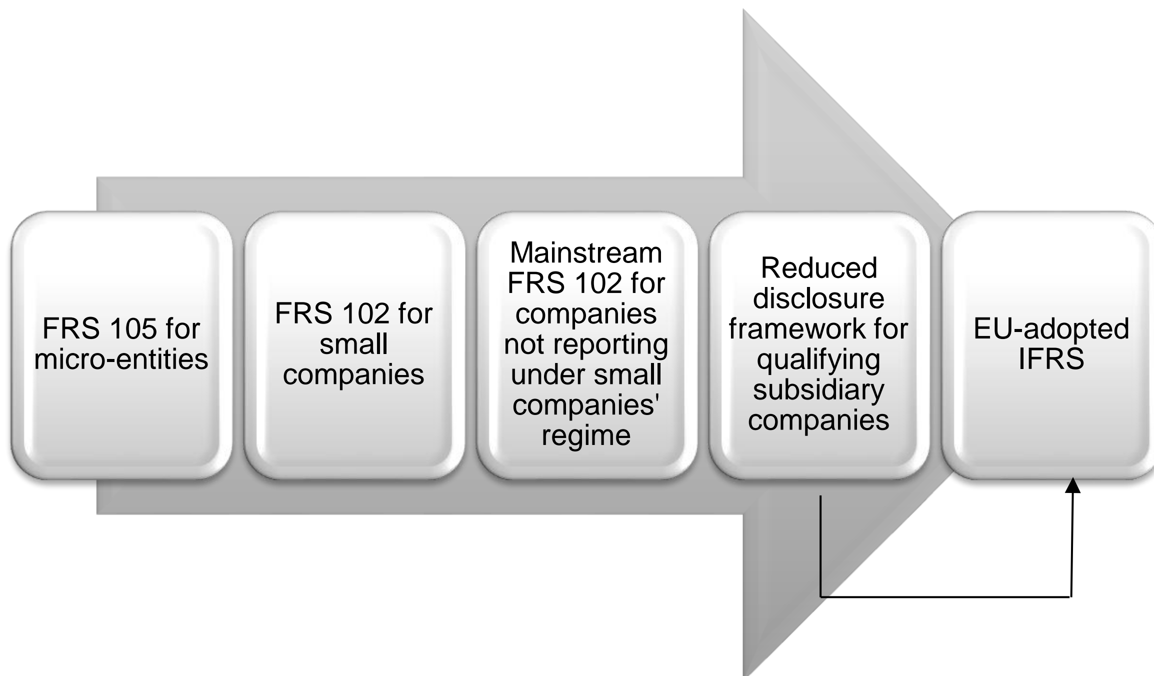
FREDs 58 to 60

On 19 February 2015, the FRC issued the following exposure drafts which outline their intentions for small and micro-entities:

- FRED 58 Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime;
- FRED 59 Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Small entities and other minor amendments; and
- FRED 60 Draft amendments to FRS 100 Application of Financial Reporting Requirements and FRS 101 Reduced Disclosure Framework

A decision was made by the FRC to issue three FREDs in order to make a distinction between the different standards which have been affected by the proposals. In addition to the above FREDs, the FRC issued an 'overview' of the consultation and this gives a brief outline as to the overall intentions by the FRC. In addition to overhauling the financial reporting regime for smaller companies, the FREDs also incorporate other minor amendments to the FRSs.

A diagrammatic summary of the new regime is illustrated below starting with the least complex regime from the left up to the most complex regime to the right:



The above diagram shows that the financial reporting requirements of each regime get progressively more complex and comprehensive the further up the suite of standards that an entity goes. This increase in complexity represents the increasing size and complexity of the entities which are most likely to apply a given standard.

The regime is not fixed; in other words, an entity does have the option of reporting under a more comprehensive framework if it so chooses. For example, a company that may qualify as a micro-entity does not necessarily have to report under FRS 105; it can choose, instead, to report under FRS 102 for small companies (and this may be necessary in some instances). In choosing which regime to report under, practitioners are strongly advised to take the following factors into consideration and not simply report under a specific threshold because it is the least complex standard. Factors which the FRC have suggested should be considered are:

- Whether an entity is eligible to apply that particular regime. Eligibility criteria may include the type of financial statements (i.e. individual or group) being prepared, company size thresholds and entity type.
- Where a choice of regime exists, entities should consider which of the regimes is the most appropriate to the individual circumstances of the entity. Factors to consider will differ from company to company and may relate to certain characteristics or restrictions of a particular regime, the resources available and the information needs of users of the accounts, amongst many others.

An ‘eligibility criteria’ table has been incorporated within the *Consultation Overview* which is reproduced as follows:

Table 2: Eligibility criteria		
Regime	**Micro-entities regime**	**Small entities regime**
Source of eligibility criteria	Sections 384A to 384B of the Companies Act 2006.	Sections 382 to 384 of the Companies Act 2006.
Eligible entities	• Companies only (Note: Whilst the legislation and consequently draft FRS 105 uses the term micro-entities regime, it is only currently available under law to companies).	• Companies • Limited liabilities partnerships • Any other type of entity that would have met the criteria of the small companies regime had it been a company incorporated under company law (for example charities).
Size thresholds	A company qualifies if it does not exceed two or more of the following criteria: • Turnover £632,000 • Balance sheet total £316,000 • No. of employees 10	A company qualifies if it does not exceed two or more of the following criteria: • Turnover £10.2m • Balance sheet total £5.1m • No. of employees 50
Ineligible entities	• Any companies excluded from the small companies regime • Financial institutions including credit and insurance institutions • Charities • Small parent companies that choose to prepare group accounts • Companies that are not parent companies but their accounts are included in consolidated accounts	• Public companies • Financial institutions including insurance companies and banking companies.

FRED 58 Draft FRS 105 Financial Reporting Standard applicable to the Micro-entities Regime

Currently the micro-entities legislation has been incorporated within the FRSSE (effective April 2008) and (effective January 2015). This was never intended to be a long-term solution, but merely a temporary measure so that the micro-entities regime could be made available to entities that are eligible to prepare their financial statements under that framework.

Because of the sheer amount of disclosure reductions which the micro-entities regime brings, the FRC decided it to be appropriate to have micro-entities report under a 'standalone' standard and hence they propose to have a separate standard, FRS 105, for micro-entities.

The FRED itself is 138 pages long and is currently not available to companies in the Republic of Ireland as at the time of writing there was no equivalent micro-entities legislation in the Republic of Ireland. The Irish Department of Jobs, Enterprise and Innovation have consulted on the possible enactment of the micro-entities legislation in its *Consultation on the transposition of the EU Accounting Directive 2013/34/E* and should they introduce this legislation then it is proposed that FRS 105 will be applicable to the Republic of Ireland. The *Consultation Overview* acknowledges that while FRS 105 is the least complex standard, every entity which is eligible to apply it should consider whether the regime meets their individual needs – the regime itself is not mandatory.

The contents of FRS 105 will, at first glance, appear to be similar to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. However, certain sections of FRS 102 are not applicable to micro-entities including:

Section 1A	*Small Entities*
Section 6	*Statement of Changes in Equity and Statement of Income and Retained Earnings*
Section 7	*Statement of Cash Flows*
Section 31	*Hyperinflation*
Section 33	*Related Party Disclosures*

Key features in FRS 105

The exposure draft is 138 pages long, but this is because the FRC have included additional guidance with the objective of helping preparers to understand the new regime. With certain exceptions, FRS 105 is based on FRS 102 (although no fair value or revaluation models can be used) and some of the concepts within new UK GAAP are predominantly new to the SME sector.

Some points to note where FRS 105 is concerned are as follows:

- There are only two primary statements that are required under FRS 105, being the profit and loss account and balance sheet. There is no requirement to prepare a cash flow statement or a statement of total recognised gains and losses. The profit and loss account can only be prepared using Format 2, whereas the balance sheet can be prepared using either Format 1 or Format 2.
- The information presented in the balance sheet and profit and loss account is condensed; for example fixed assets are not disaggregated into intangible, tangible and investment properties. Similarly, current assets are not disaggregated into the order of liquidity (stocks, debtors, bank and cash); they are just combined under one line item.

- No assets can be measured at fair value or revalue amounts. The consequence of this is that any previous revaluations will have to be removed on transition.
- The disclosure requirements are:
    - the total amount of any financial commitments, guarantees or contingencies that are not included in the balance sheet;
    - an indication of the nature and form of any valuable security which has been provided;
    - the amounts of advances and credits granted to members of the administrative, managerial and supervisory bodies with indications of interest rates, main conditions and any amounts repaid or written off or waived; and
    - any commitments entered into on their behalf by way of guarantees of any kind, with an indication of the total for each category.
- There is no restriction on a micro-entity including additional voluntary disclosures if it so chooses.
- Micro-entities' financial statements prepared in compliance with the minimum legal requirements are *presumed* to give a true and fair view as the legislation contains 'deeming provisions'. As a consequence, there is no requirement for directors to consider any additional disclosure information which may be needed in order for the accounts to give a true and fair view.

Further simplifications

In drafting FRS 105, the FRC decided to make further simplifications to the micro-entities regime as follows:

- Micro-entities will not be required to account for deferred tax or equity-settled share-based payment transactions.
- All accounting policy choices have been removed and this includes removing the option to capitalise development and borrowing costs which all must be expensed under FRS 105.

Differences between the FRSSE and FRS 105

The new UK GAAP brings about new ways of accounting for certain transactions and disclosing certain information and practitioners are strongly advised to ensure they have a sound understanding of how the new small companies' regime will affect clients. Practitioners advising small companies should also consider the appropriateness of FRS 105 on a case-by-case basis because while the significant disclosure reductions may, on the face of it, be appealing, some stakeholders may require additional, non-statutory, information (such as banks or HM Revenue and Customs).

Key differences comparing draft FRS 105 to the FRSSE	
Key features of draft FRS 105:	
Presumed true and fair view	Financial statements prepared in accordance with the legal requirements of the micro-entities regime are presumed to give a true and fair view, therefore directors are not required to consider what additional information is required for the financial statements of the entity to give a true and fair view. This is in contrast to the FRSSE where directors are legally obliged to ensure the financial statements provide a true and fair view.
Preparation of only two primary statements required	Micro-entities are only required to prepare a balance sheet and profit and loss account and not a statement of total recognised gains and losses (STRGL) or a cash flow statement.
Significantly condensed formats of statements	The statutory formats for the balance sheet and profit and loss accounts are significantly condensed, for example 'current assets' is not disaggregated into stocks, debtors, investments and cash.
Significantly reduced number of disclosures	Micro-entities are only legally required to provide two disclosures, and are not required to provide any more. However, micro-entities can voluntarily provide more disclosures. This is in contrast to the FRSSE which mandates significantly more disclosures.
Simplified accounting treatment	Draft FRS 105 has simplified the accounting treatment for some transactions, for example there is no requirement to account for deferred tax or equity-settled share-based payments.
Fair value and revaluation accounting not permitted	Micro-entities are not permitted to fair value or revalue any assets or liabilities, therefore all assets and liabilities (such as land and buildings and investment properties) must be held at cost. This is in contrast to the FRSSE which permits certain assets to be revalued.
No accounting policy choices	All accounting policy options have been removed. The mandatory treatments result in earlier recognition of income/expenses in the profit and loss account rather than deferred into the balance sheet. Therefore government grants must be accounted for using the performance, not accruals, method.
More helpful guidance included	In many instances, the requirements of draft FRS 105 do not differ from those of the FRSSE, however more guidance is provided in FRS 105 to help preparers apply and interpret the treatment required.
Not all company law requirements are reproduced	Draft FRS 105 does not reproduce all the reporting requirements from company law applicable to micro-entities unlike the FRSSE, but does incorporate those relating to the financial statements. Micro-entities will need to satisfy themselves that they have met all their legal requirements.

Terminology consistent with FRS 102	Draft FRS 105 uses terminology consistent with FRS 102 such as ‘statement of financial position’ rather than ‘balance sheet’. A Table of Equivalence is included in Appendix II to draft FRS 105 for convenience.

Cross-references to FRS 102

While FRS 105 is primarily based on the principles in FRS 102 (with the removal of revaluation and fair value models), there are a number of areas which have been removed because the Accounting Council do not consider them to be appropriate to micro-entities. The reason the Accounting Council took this decision was to reduce the complexity of FRS 105.

However, as all entities are inherently different, the Accounting Council took the decision to make reference to FRS 102 for micro-entities which have certain types of transactions. This decision was taken because even though a micro-entity may encounter certain transactions throughout its life, these transactions are considered to be infrequent and the areas where this approach has been proposed are:

(a) intermediate payment arrangements (Section 9 *Consolidated and Separate Financial Statements*);

(b) trade and asset acquisitions (Section 19 *Business Combinations*);

(c) puttable instruments an examples of compound financial instruments (Section 22 *Liabilities and Equity*);

(d) cash-generating units (Section 27 *Impairment of Assets*); and

(e) foreign branches (Section 30 *Foreign Currency Translation*).

FRS 102 FOR SMALL COMPANIES (LECTURES A504/ A505 – 29.39/ 12.51 MINUTES)

The current version of FRS 102 in operation is the August 2014 version. This is not specifically written for small companies, which is why most small companies are not adopting FRS 102 for accounting periods commencing on or after 1 January 2015 and are merely moving forward from the April 2008 version of the FRSSE onto the January 2015 version.

The move across to FRS 102 for small companies is a primary concern for some practitioners who may not be familiar with the detailed contents of FRS 102, or who have not experienced undertaking a transition to a new UK GAAP before and practitioners are urged to understand the differences between outgoing UK GAAP and new UK GAAP in order that they can advise their clients accordingly. While accounts production software systems will be able to be of significant help when undertaking a transition (for example dealing with certain disclosures), it will not be able to arrive at the transitional adjustments that will be needed to apply the new regime retrospectively.

To all intents and purposes, it is not expected that the size of the financial statements for a small company reporting under the provisions of FRS 102 will reduce/increase *significantly*, although small entities will be able to benefit from reduced presentation and disclosure requirements that are outlined in Section 1A *Small Entities* of FRS 102. The FRC have also confirmed that small entities which fall under the scope of FRS 102 Section 1A will NOT be required to produce a cash flow statement, a statement of total comprehensive income or a statement of changes in equity (although a statement of changes in equity is encouraged). Small groups will also be exempt from the requirement to produce consolidated financial statements.

FRS 102 is being made applicable to small companies by the insertion of a Section 1A *Small Entities* into the standard. Section 1A will outline the **presentation** and **disclosure** requirements that a small company must make in its financial statements. The **recognition** and **measurement** of amounts in the financial statements will be based on **full** FRS 102. The FRC have taken this decision to improve financial reporting by small entities as there is currently notable differences between FRS 102 and the FRSSE.

Example – Differences between FRS 102 and the FRSSE

<u>Scenario 1</u>

North Ltd is a small company which is run by a husband and wife which both own 50% of the shares of the company. The financial statements for the year-ended 31 December 2015 have been prepared under the FRSSE (effective January 2015) and the company owns an investment property. Information relating to this investment property are as follows:

Market value as at 31 December 2014	£110,000
Market value as at 31 December 2015	£130,000
Revaluation surplus as at 31 December 2015	£40,000

The market value of the investment property as at 31 December 2015 increased by £20,000 (£130,000 less £110,000) and hence in the 2015 year-end financial statements the entries would have been:

DR investment property	£20,000
CR revaluation reserve	£20,000

Under paragraph 6.53 of the FRSSE (effective January 2015), those would have been the only entries required.

Scenario 2

South Ltd is also a husband and wife run company but has chosen to report under FRS 102 for its year-ended 31 December 2015 and pays corporation tax at 20%. The company also owns an investment property and details of the property's valuation are the same as above (i.e. an increase of £20,000 in 2015). Under Section 16 *Investment Property* of FRS 102, the entries in the books of South Ltd would be:

DR investment property	£20,000
CR profit and loss (within operating profit)	£20,000

In addition, South Ltd would have to calculate deferred tax on the revaluation of the investment property which would be calculated at (ignoring the effects of indexation) £4,000 (£20,000 x 20%).

As a result of the differences between the FRSSE and FRS 102, the overall impact on after-tax profit is a higher profit under FRS 102 than under the FRSSE (effective January 2015) as follows:

Fair value gain taken to profit or loss	£20,000
Deferred tax liability on fair value uplift at 20%	(£4,000)
Increase in profit under FRS 102 principles	£16,000

The above example illustrates why the (now defunct) Accounting Standards Board originally wanted to align the FRSSE (rather than withdraw it) to FRS 102, so that there were no significant differences in accounting between the two standards.

The introduction of the EU Accounting Directive has meant that the work plan of the FRC has essentially been accelerated and, taking all factors into consideration, the FRC concluded that the effects of the EU Accounting Directive meant that the FRSSE could not be sustained in its current format and hence would be withdrawn for accounting periods commencing on or after 1 January 2016. The overall effect of this is twofold:

- small companies reporting under FRS 102 for small entities apply the full recognition and measurement principles in FRS 102 but retain the presentation and disclosure requirements which are appropriate for a small company; and
- the need for significant changes in accounting for certain transactions is reduced as the entity grows.

Recognition and measurement differences under FRS 102

FRS 102 is a whole new financial reporting framework which is based on the provisions in *IFRS for SMEs*, which in turn, is based on the provisions in IFRS. It was not surprising that the UK would eventually fully report under an international-based framework because this had been the intention of the previous Accounting Standards Board (ASB) and the current FRC. This was further accentuated by the ASB acknowledging some years ago that UK GAAP, in its outgoing form, had become overly complex, voluminous and disjointed and hence it seemed more appropriate to start with a new UK GAAP.

While the UK's standard-setters have always tried, wherever possible, to align accounting standards with international counterparts, they were constrained in some cases with the boundaries of the Companies Act 2006.

As a result, there are some considerable differences to the way in which certain transactions are accounted for under the provisions in FRS 102 than what practitioners and company

accountants may already be familiar with in outgoing GAAP. Notable differences are found within:

- accounting policies;
- cash flow statement (while small companies often do not include a cash flow statement, there are considerable presentation differences which need explaining);
- deferred tax;
- defined benefit pension schemes;
- employee benefits;
- fair value accounting;
- financial instruments;
- fixed assets;
- goodwill and intangible assets;
- investment property;
- leases;
- prior period adjustments;
- revenue recognition; and
- stock valuations.

Accounting policies

The Glossary to FRS 102 defines accounting policies as:

*'The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting **financial statements**.'*

It follows, therefore, that accounting policies are the 'backbone' of the financial statements and a reporting entity is still required (under the new Companies Act 2006) to disclose its accounting policies (hence there is no change from the FRSSE (effective January 2015)).

A change to an accounting policy is also applied retrospectively under Section 10 *Accounting Policies, Estimates and Errors*. A notable difference where accounting policies are concerned relates to when FRS 102 does not specifically cover a transaction or event. Paragraph 10.4 says that if FRS 102 does not specifically address a transaction, or other event or condition, an entity's management must develop and apply an accounting policy which is:

- **Relevant** – information is relevant to aid the decision-making process of the users.
- **Reliable** – this will result in the financial statements faithfully representing the financial position, performance and cash flows. In addition, the policy must also reflect the economic substance of the transaction(s)/event(s)/condition(s) rather than reflecting the legal form. To achieve reliability the policy adopted must also be neutral, prudent and complete in all material respects.

The FRSSE (effective January 2015) is very similar and where an entity applying the FRSSE undertakes a new transaction which is not dealt with in the FRSSE (effective January 2015) then it is required to develop a new accounting policy, having regard to FRS 102 (not as a mandatory document, but as a means of establishing current practice).

Cash flow statement

Small companies are exempt from the requirement to produce a cash flow statement in the statutory accounts. However, it is worth pointing out the differences in the event that a small company grows to require full FRS 102 to be applied and hence is required to prepare a cash flow statement (unless it applies the provisions in FRS 101 *Reduced Disclosure Framework*).

Old UK GAAP required the cash flow statement to be prepared under several standard headings as follows:

- Operating activities
- Dividends from joint ventures and associates
- Returns on investments and servicing of finance
- Taxation
- Capital expenditure and financial investments
- Acquisitions and disposals
- Equity dividends paid
- Management of liquid resources
- Financing

Section 7 *Statement of Cash Flows* in FRS 102 requires the cash flow statement to be prepared using only three types of cash flow classification:

- Operating activities
- Investing activities
- Financing activities

Operating activities are the day-to-day revenue-producing activities of the business which are not investing or financing activities. The operating activities category is essentially a default category, encompassing all cash flows which do not fall within investing or financing activities.

Example – Classification of corporation tax

Company A Ltd has a year-end of 31 December 2015. It would normally have qualified to use the small companies' regime, but the directors have said that in light of the fact that the FRSSE is going to be withdrawn and they would not qualify as a micro-entity, it would be more beneficial for them in terms of cost to apply FRS 102 and that this would also assist them in terms of consistency because they have derivative financial instruments and an investment property which require considerably different accounting treatments under FRS 102.

The directors have prepared a cash flow statement under FRS 102 principles but the accountant is unsure where to put the corporation tax payment in the year as previously it would have been included under the 'Taxation' cash flow classification of which there is not such a classification under FRS 102.

Under FRS 102, Section 7 at paragraph 7.4(e) says payments or refunds of income tax would fall to be classed as operating activities, unless they can be specifically identified with financing and investing activities.

Investing activities relate to the acquisition and disposal of long-term assets and other investments which are not included in cash equivalents (such as cash payments to acquire a fixed asset or the disposal proceeds from the disposal of a fixed asset).

Financing activities are those activities which change the borrowing and equity composition of the business, such as the proceeds from a loan or the proceeds from a share issue.

Deferred tax

Many practitioners dislike the concept of deferred tax and it is fair to say that some were hoping the standard-setters would withdraw the concept in the rewriting of the new UK standards. This was not the case, and unfortunately for those practitioners that dislike the concept, it does come back with somewhat of a vengeance under FRS 102 principles. However, comfort should be taken in the fact that it could have been a lot worse under the previous exposure drafts of the new UK GAAP.

FRS 102 is based on the principles in IFRS. Under IAS 12 *Income Tax*, deferred tax is calculated using the 'temporary difference' approach. Here in the UK and Republic of Ireland, accountants have always been used to calculating deferred tax under the 'timing difference' approach and there is a considerable difference between the two methods. Under the first round of exposure drafts published by the (now defunct) Accounting Standards Board (ASB), the calculation of deferred tax was based on the temporary difference approach. The temporary difference method calculates the tax that would be paid if the net assets of the reporting entity were sold at book value. A temporary difference is the difference between the carrying amount of an asset or a liability and its 'tax base'. The 'tax base' is basically the amount at which an item is recognised for the purposes of tax.

The timing difference approach, on the other hand, is the difference between an entity's accounting profit and taxable profit. Therefore, the temporary difference method focuses on the balance sheet, whereas the timing difference approach focuses on the profit and loss account. Under the temporary difference approach, the calculation of deferred tax is inherently more complex than under the timing difference approach and hence would have caused accountants more difficulties.

At the time, the ASB took on board feedback from critics of this method and staff were instructed to redraft the contents of Section 29 of FRS 102 under the premise that deferred tax in the UK and Republic of Ireland should continue using the timing difference approach, but that the resulting calculation should not be too different than the calculation of deferred tax under the IAS 12 approach. This instruction was to ensure that there are no significant disparities between the deferred tax principles in FRS 102 and the deferred tax principles in IFRS.

The ASB completed its work on Section 29 and came up with the 'timing difference plus' approach which has now been incorporated into FRS 102. The timing difference plus approach builds on the old timing difference approach, but essentially eradicates some of the exemptions from deferred tax contained in old UK GAAP. As a consequence, there are three additional situations when deferred tax must be calculated and are in respect of:

- revaluations of non-monetary assets (including investment property);
- fair values on business combinations; and
- unremitted earnings in overseas subsidiaries and associates.

Where revaluations of non-monetary assets are concerned (including investment property), there would not have been any deferred tax recognised under the FRSSE unless:

- there was a binding agreement to sell the revalued assets; and
- the gains and losses expected to arise on the sale had been recognised.

Another difference, which is largely going to go unnoticed, is the fact that under Section 29, small companies will not be able to discount deferred tax to present day values.

Defined benefit pension schemes

Very few small companies have defined benefit pension schemes in operation; although there are some small companies which do have them. FRS 102 deals with such schemes (and defined contribution schemes) at Section 28 *Employee Benefits*. Paragraph 28.18 provides a number of simplifications where the valuation basis (the Projected Unit Credit Method) would require undue cost or effort. FRS 102 also does not require the use of an independent actuary to perform the valuation as outgoing UK GAAP does. Comprehensive annual valuations are also not required under FRS 102, provided there has not been any significant change in the assumptions used since the last valuation was completed.

The reality is that where small companies do have a defined benefit pension scheme in operation, they are going to have to engage the services of a professionally-qualified independent actuary to perform the valuations because such calculations are very complex and, unless the client is a trained actuary, it is going to be extremely difficult to come up with the required figures and disclosure information to be incorporated in the entity's financial statements.

Employee benefits

Employee benefits are dealt with in Section 28 *Employee Benefits*. Section 28 requires an entity to make accruals for short-term employee benefits which have been accrued by the employees by the reporting date, but which are paid in the subsequent accounting period. The most notable effect this is going to have is on those entities that have not previously made accruals for unpaid holiday entitlement at the year-end. The difficulty here is potentially in the calculation of holiday pay that is to be carried forward for future use and pulling this information together, especially for the transition to FRS 102 for small companies.

Example – Holiday pay accrual (holiday year coterminous with the financial year)

North Ltd has an accounting reference date and holiday year of 31 July 2015. Employees are allowed 30 days holiday per year and are also allowed to carry forward five days' into the next holiday year. At the year-end 31 July 2015 the employee has taken 26 days' holiday.

The accountant should make an accrual for four days' holiday entitlement which will be taken in the subsequent accounting period.

Example – Holiday pay accrual (holiday year not coterminous with the financial year)

South Ltd has a financial year which ends on 30 June 2015 and a holiday year which ends on 31 December 2015. Employees are allowed 30 days' holiday per year and at the accounting year-end an employee had taken 20 days of their entitlement.

In this case there will be a prepayment of five days' holiday ((30 days x 6/12) – 20 days).

Example – Holiday pay accrual at transition

East Ltd has a year-end of 31 December each year and is transitioning to FRS 102 for small companies for its year-end 31 December 2016 and hence its date of transition is 1 January 2015. The company pays tax at 20%. It is preparing an opening FRS 102-compliant balance sheet as at the date of transition and the HR department has calculated the values of the holiday pay accruals at the following dates:

31 December 2014 £9,000

31 December 2015 £10,200	
31 December 2016 £8,500	
The journals are as follows:	
On transition (i.e. as at 1 January 2015)	
DR accumulated profit and loss	£9,000
CR accruals (balance sheet)	£9,000
Comparative year to 31 December 2015	
DR staff costs (profit and loss)	£1,200
CR accruals (balance sheet)	£1,200
Current year to 31 December 2016	
DR accruals (balance sheet)	£1,700
CR staff costs (profit and loss)	£1,700
There will also be associated tax implications as follows:	
On transition (i.e. as at 1 January 2015)	
DR corporation tax recoverable (balance sheet)	£1,800 (20% x £9,000)
CR profit and loss reserves	£1,800
Comparative year to 31 December 2015	
DR corporation tax recoverable (balance sheet)	£240 (20% x £1,200)
CR tax expense (profit and loss)	£240

Fair value accounting

With the exception of micro-entities that are prohibited in FRS 105 from using any forms of fair value accounting (or revaluation accounting), there are a number of areas within the financial statements which are likely to be affected by the increased use of fair value accounting as follows:

- *Biological assets*: living animals and plants can be measured using fair values (where such values can be obtained reliably) and fluctuations in those fair values will be taken to profit or loss. Such policies must be applied consistently to each class of biological asset and its related agricultural produce. The use of the fair value model is not mandatory and the cost model can be applied instead.
- *Business combinations*: where intangible assets are acquired and whose values can be reliably measured, they need to be separated from goodwill at acquisition (such as intellectual property and customer lists).
- *Financial instruments*: instruments such as derivatives and equity shares whose prices can be reliably measured, must be measured at fair value with fluctuations in fair value going through profit or loss. Examples of derivatives include forward foreign currency contracts, interest rate swaps and options and commodity contracts.
- *Investments*: investments in subsidiaries, associates and jointly controlled entities can be held in the separate financial statements of the parent/investor at either cost less impairment or at fair value with changes in fair value going through either profit or loss or other comprehensive income. The revised Companies Act 2006 also allows the equity method of accounting to be used for participating interests (e.g. investments in associates) in the separate financial statements of the investor.

- *Investment property*: investment property whose fair value can be reliably measured should be carried at fair value at each reporting date with changes in fair value going through profit or loss.
- *Property, plant and equipment*: property, plant and equipment can be measured using the revaluation model or the depreciated historic cost model. On transition to FRS 102 for small entities, a small entity could use fair value as deemed cost and then choose the cost model for subsequent measurement.

Financial instruments

FRS 102 splits financial instruments into two classifications: 'basic' and 'other'. *Basic* financial instruments include items such as:

- trade debtors;
- trade creditors;
- straightforward bank loans; and
- cash.

When a financial instrument falls to be classed as basic they are generally measured at amortised cost. Most debtors and creditors which are classified as current assets or current liabilities are still measured at the undiscounted amount of cash expected to be received or paid. Basic financial instruments are accounted for under the principles of Section 11 *Basic Financial Instruments*.

Other financial instruments are accounted for under the provisions of Section 12 *Other Financial Instruments Issues*. Section 12 financial instruments will include instruments such as foreign exchange contracts and loans which have complex terms attached to them. Section 12 requires all financial instruments which are not basic instruments to be measured at fair value at each balance sheet date with movements in fair value taken to profit or loss. The main difference here between FRS 102 and old UK GAAP is that under the previous GAAP, many of these instruments would not have been recognised on the balance sheet.

The requirement to include instruments such as foreign exchange forward contracts and loans with complex terms attached will affect an entity's balance sheet!

Before transition to FRS 102, it is advisable to scrutinise loan agreements and finance agreements for the presence of any derivative instruments to ensure that they are correctly accounted for under FRS 102 principles. Under the FRSSE they would have been accounted for on settlement and hence at the inception of, say, a forward foreign currency contract, no derivative would have been recognised on the balance sheet.

When it comes to the accounting for basic loans under Section 11, the accounting treatment is again different than would have been the case under UK GAAP. This is because the standard uses the **effective interest method** for interest recognition. This can be a fairly complex method and involves the use of discounting methods to arrive at an effective interest rate.

Amortised cost

The amortised cost of a financial asset or a financial liability at each reporting date is defined as the **net** of the following four amounts:

- the amount at which the financial asset or financial liability is measured at initial recognition;
- *minus* any repayments of principal;

- *plus* or *minus* the cumulative amortisation using the effective interest rate method (see below) of any difference between the amount at initial recognition and the maturity amount; or
- *minus* – in the case of a financial asset – any reduction for impairment or uncollectibility.

Effective interest method

The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability (i.e. the carrying amount of the instrument in the balance sheet) and then allocating the interest income/expense over the relevant period on an actuarial basis using the effective interest rate.

The *amortised cost* of a financial asset and financial liability is the *present value* of future cash receipts/payments which are then discounted at the effective interest rate.

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

Example – Application of the effective interest method

West Ltd borrows £110,000 and incurs costs of £10,000 giving net proceeds of £100,000.

The loan attracts a fixed interest coupon of £5,900 per annum. The loan is to be repaid at the end of five years at a premium of £15,000 (i.e. total to be repaid is £125,000).

Total finance costs are:

Interest	£29,500	
Debt premium	£15,000	£54,500
Transaction costs	£10,000	

The effective interest rate which discounts the above payments to the initial carrying amount of £100,000 is 10% and the interest is allocated over the life of the loan as follows:

Year	Opening balance	Interest (10%)	Cash flow	Closing balance
	£	£	£	£
1	100,000	10,000	(5,900)	104,100
2	104,100	10,410	(5,900)	108,610
3	108,610	10,861	(5,900)	113,571
4	113,571	11,357	(5,900)	119,028
5	119,028	11,872*	(5,900)	125,000
		54,500		

*adjusted for rounding difference

An effective way of arriving at a discount rate to discount the cash flows to the initial carrying amount of the loan is to use the internal rate of return function in Excel as follows:

- Type in the cash flows (note the IRR function will NOT work if there is not at least one negative figure). Therefore, using the example type in the cash flows into cells A1 to A6 as follows:

  A1 (£100,000)

A2 £5,900

A3 £5,900

A4 £5,900

A5 £5,900

A6 £130,900 (£5,900 interest + £125,000 redemption)

- The formula to use will be =IRR(A1:A6) and this will calculate the IRR to be 10%.

Fixed assets

Paragraph 6.22 of the FRSSE (effective January 2015) says that subsequent expenditure shall be capitalised only if:

- it enhances the economic benefits of a **tangible fixed asset** in excess of the previously assessed standard of performance (i.e. if it is an 'improvement'); or
- it replaces or restores a component that has been separately depreciated over its **useful economic life**.

Otherwise it shall be recognised in the profit and loss account as incurred.

Section 17 *Property, Plant and Equipment* does deal with the issue of subsequent expenditure but does not go into anywhere near the same amount of detail that FRS 15/the FRSSE does. Paragraph 17.15 merely states that day-to-day servicing of property, plant and equipment must be recognised in the profit and loss account in the periods in which the costs are incurred. Those preparing financial statements under FRS 102 would therefore be pointed to the *Concepts and Pervasive Principles* in Section 2 of FRS 102 to determine whether, or not, subsequent expenditure should be capitalised. Again, preparers should not under-estimate the increased levels of judgement brought in by FRS 102.

Paragraph 17.5 deals with 'spare parts and standby equipment'. FRS 15 and the FRSSE did not deal with such equipment and hence many reporting entities carried this type of expenditure in the financial statements as inventory, with recognition in profit or loss taking place when the entity used the spare parts/standby equipment. Section 17 at paragraph 17.5 requires 'major' spare parts and standby equipment to be included in the cost of the entity's fixed assets to which the equipment relates when the business is expected to use the equipment for more than one accounting period. The treatment under FRS 102 would essentially mean that the cost of major spare parts/servicing equipment would be recognised within the depreciation charges rather than in the profit and loss account through the consumption of stock (i.e. cost of sales).

Where fixed assets are acquired under a deferred payment arrangement, the cost of the asset must be the present value of all future payments to comply with paragraph 17.13. Such issues were not specifically covered in either FRS 15 or the FRSSE (effective January 2015) and would have resulted in the assets capitalised being understated, giving rise to a lower depreciation charge. FRS 102 addresses this issue, so the net book value of fixed assets accounted for in accordance with paragraph 17.13 would be higher and hence have a consequential increase in the depreciation charges.

Goodwill and intangible assets

The revised Companies Act 2006 has increased the cap on the useful life of goodwill and intangible assets (although the revised Companies Act does not distinguish goodwill from intangible assets). The new Regulations say that intangible assets must be written off over the useful economic life of the intangible asset and says that where, **in exceptional cases**, the useful life cannot be reliably estimated, such assets are written off over a period chosen

by the directors. Regulation 22(3) then goes on to clarify that the period chosen by the directors where a useful economic life cannot be reliably estimated cannot exceed ten years.

In contrast, the FRSSE (effective January 2015) reflects the August 2014 version of FRS 102 and caps the useful economic life to five years where management cannot reliably estimate the useful life.

Investment property

Under the provisions in Section 16 *Investment Property*, an investment property is defined as follows:

*'Investment property is property (land or a building, or part of a building, or both) held by the owner or by the lessee under a **finance lease** to earn rentals or for capital appreciation or both, rather than for:*

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.'

The FRSSE (effective January 2015) requires such properties to be classified in the balance sheet at their market value with changes in the market value being recognised through a revaluation reserve account within equity and reported via the statement of total recognised gains and losses.

Where investment property is carried at fair value, paragraph 16.7 extinguishes the use of the revaluation reserve and requires all changes in the fair value of investment property to be recognised in profit or loss. The upshot of this treatment is that the reported profit or loss would be different than what would have been reported under the old regime. The gain or loss taken to the profit and loss account is ignored for the purposes of tax.

A key point to emphasise where FRS 102 is concerned is that any gains that are taken to the profit and loss account in respect of investment properties are not distributable as a dividend to shareholders. This is because the gain is unrealised for the purposes of dividend distribution.

In addition to the dividend point, it is also worth noting that the requirement to account for deferred tax on the fair value gain is also a requirement of Section 29 *Income Tax*. Paragraph 29.16 says:

*'Deferred tax relating to **investment property** that is measured at **fair value** in accordance with Section 16 Investment Property shall be measured using the tax rates and allowances that apply to the sale of the asset, except for investment property that has a limited **useful life** and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time.'*

Under the FRSSE, deferred tax is ignored unless there is a binding agreement to sell the asset at the balance sheet date and the disposal have been accounted for in the financial statements.

Example – Investment property on transition to FRS 102

North Ltd (North) is preparing its first financial statements for the year-ended 31 December 2016 under FRS 102 for small entities. It has run an opening trial balance as at 1 January 2015 (its date of transition) which shows a revaluation surplus in respect of investment property of £120,000. North pays tax at 20%.

On transition to FRS 102, North should make the following transitional adjustments to its opening balances in order to arrive at an FRS 102-compliant set of opening balances:

DR revaluation reserve	£120,000
CR accumulated profit and loss	£120,000

Being reclassification of investment property revaluation surplus on transition to FRS 102.

Under FRS 102, North will also have to account for deferred tax in respect of the investment property's fair value as follows:

DR accumulated profit and loss	£24,000
CR deferred tax provision	£24,000

Being deferred tax on investment property revaluation surplus (ignoring indexation).

If it is assumed that in 2015 (the comparative year) the value of the investment property had increased by £5,000 the entries (under the FRSSE (effective January 2015)) would have been:

DR investment property	£5,000
CR revaluation reserve	£5,000

Being uplift in the market value of investment property.

The concept of the revaluation reserve does not apply to investment property accounted for under FRS 102 and so a transitional adjustment will also have to be made to the 2015 financial statements as follows:

DR revaluation reserve	£5,000
CR profit and loss account	£5,000

Being reclassification of investment property fair value gain.

DR profit and loss account tax charge	£1,000
CR deferred tax provision	£1,000

Being deferred tax on the investment property revaluation.

From the above worked example, it can be noted that there will be an overall increase in previously reported profit of £4,000 (£5,000 revaluation gain less £1,000 deferred tax). This gain cannot be distributed to shareholders as a dividend.

Alternative treatment

As fair value gains on items such as investment property cannot be distributed to the shareholders as a dividend, directors will have to keep a record of those reserves which are not able to be distributed to shareholders. Some commentators are advising companies to keep a track of such reserves within an 'undistributable reserves' account in the equity section of the balance sheet. While there is nothing in company law that requires this, Section 35 *Transition to this FRS* at paragraph 35.8 does permit an alternative component of equity to take transitional adjustments. It is now becoming generally accepted that companies experiencing gains that are taken to profit and loss which are not distributable to shareholders will maintain such an account to stop undistributable reserves being paid out as a dividend. If such an account is going to be maintained it may be worthwhile renaming the revaluation reserve 'undistributable reserve' as a time-saving mechanism in performing the journal to remove the revaluation surplus into profit and loss reserves.

Leases

SSAP 21 *Accounting for leases and hire purchase contracts* sets out a specific numeric benchmark when determining whether a lease is a finance or an operating lease as is demonstrated in paragraph 22 to the Guidance Notes to SSAP 21. This 'bright line test' is where the minimum lease payments equate to 90% or more of the fair value of the asset subjected to the lease and if they do, the lease is treated as a finance lease. This numeric benchmark is not specifically referred to in Section 7 of the FRSSE (effective January 2015) although the definition of a finance lease in the Glossary to the FRSSE (effective January 2015) does refer to the 90% threshold.

The classification under FRS 102 does not refer to a 90% benchmark, but instead offers examples of the various situations which, individually or collectively, would give rise to a lease being classified as a finance lease as follows:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.
- The lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Three other indicators that the lease could be a finance lease are:

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- Gains or losses from the fluctuations in the residual value of the leased asset accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease).
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The classification criteria are based upon the risks and rewards of ownership of the associated asset and which party retains those risks and rewards. There are a number of factors that can determine whether risks and rewards have, or have not, been transferred from the lessor to lessee and therefore paragraph 20.7 of FRS 102 acknowledges that the examples of indicators contained in paragraphs 20.5 to 20.6 will not be conclusive in every respect and consideration must therefore be given to other indicators that risks and rewards may (or may not) have transferred from lessor to lessee.

In some cases, lessees may receive an incentive payment to take up a lease. Paragraph 20.15A does make reference to the effect of incentive payments relating to operating leases. It says that the lessee must recognise the aggregate benefit of lease incentives as a reduction to the expense over the lease term on a straight-line basis unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset. Under the FRSSE, lease incentives are recognised on a straight-line basis up to the point when the lease payments increase to market rates.

Example – Lease incentive FRS 102 v the FRSSE

On 1 January 2012, West Ltd entered into a ten-year lease to rent a building to house its administration and office facilities. The terms of the lease make provision for a break-clause to be exercised on 31 December 2016. On signing the lease, the landlord agrees to a one-year rent-free period and rent of £230,000 per annum is payable.

Under the FRSSE the charge to the P&L would be as follows:

Year-end	Paid £'000	P&L charge £'000	Balance sheet c/f £'000
31.12.2012	-	184	184
31.12.2013	230	184	138
31.12.2014	230	184	92
31.12.2015	230	184	46

The journal entries in 2012 are:

DR rent expense (P&L) 184

CR balance sheet incentive 184

In the years to 31/12/2013, 14 and 15:

DR balance sheet incentive 46

CR rent expense (P&L) 46

On transition to FRS 102, West Ltd will have a choice. They can either restate as if FRS 102 for small companies has always been the reporting framework; or they continue with the previous UK GAAP treatment and spread the incentive up to the point at which the break-clause will be exercised.

Option 1: restate under FRS 102 for small entities

If West decides to restate as if FRS 102 for small entities has always been the financial reporting framework then a transitional adjustment at the date of transition will be made to the balance at the date of transition together with a prior year adjustment in the comparative year.

Year-end	Paid	P&L charge	Balance sheet c/f

	£'000	£'000	£'000
31.12.2012	-	207	207
31.12.2013	230	207	184
31.12.2014	230	207	161
31.12.2015	230	207	138
31.12.2016	230	207	115
31.12.2017	230	207	92
31.12.2018	230	207	69
31.12.2019	230	207	46
31.12.2020	230	207	23
31.12.2021	230	207	-

Date of transition

At the date of transition an adjustment will be needed as follows:

DR accumulated profit and loss 69k

CR balance sheet incentive 69k

Being the difference between £161k and £92k

In the comparative year an adjustment will be needed as follows:

DR profit and loss expense 23k (£207k less £184k)

CR balance sheet incentive 23k

Being the difference in P&L charge under FRS 102 for small entities v FRSSE

There will also be consequential tax adjustments to factor into account.

Option 2: continue with existing UK GAAP

If West decides to continue with the FRSSE then the position will be as follows:

Year-end	Paid £'000	P&L charge £'000	Balance sheet c/f £'000
31.12.2012	-	184	184
31.12.2013	230	184	138
31.12.2014	230	184	92
31.12.2015	230	184	46
31.12.2016	230	184	-

Date of transition

As can be seen from the above comparisons, there are also tax implications to consider and in the above worked examples, it would be more advantageous from a tax perspective to use option 1 and restate as if FRS 102 had always been the reporting framework because the charge to profit and loss is higher (as the lease incentive is being written off over a longer period) and hence tax relief would be granted on the excess.

Prior period adjustments

The difference in this area relates to error correction. Error correction is dealt with in Section 10 *Accounting Policies, Estimates and Errors*. Paragraph 10.21 of FRS 102 requires an entity to correct a *material* prior period error retrospectively in the first financial statements which are authorised for issue after discovery of the error by way of a prior period adjustment.

This is different than what is the case under outgoing UK GAAP. The Glossary to the FRSSE (effective January 2015) refers to a prior period adjustment being applied to a 'fundamental error' which is derived from the requirements in FRS 3 *Reporting financial performance*. The standard defines fundamental errors as those which destroy the true and fair view of the financial statements as well as the validity of those financial statements.

While the terms 'fundamental' and 'material' could potentially be interpreted differently among accountants, it is expected that more errors will be corrected by way of a prior period adjustment.

Revenue recognition

There are slight variations to the wording relating to the measurement of revenue. For example, paragraph 23.3 refers to revenue being the fair value of the consideration *received or receivable*. The FRSSE (effective January 2015) says that a seller recognises revenue under an exchange transaction with a customer, when, and to the extent that, it obtains the *'right to consideration'* in exchange for its performance. This wording is quite specific when compared to FRS 102's 'received or receivable' approach.

There was no intention of allowing entities to potentially delay revenue recognition under FRS 102 by virtue of the different wording contained in the standard and it is still intended that reporting entities will continue with the recognising revenue at the same time that they would have done under previous GAAP.

Paragraph 23.15 of FRS 102 refers to a 'specific act' and a 'significant act'. The paragraph says that when a specific act is much more significant than any other act, the entity postpones revenue recognition until the significant act is executed. The FRSSE (effective January 2015) is more prohibitive in that it requires revenue to be recognised in line with performance (i.e. passing a 'milestone' or the occurrence of a 'critical event') and hence earning the right to consideration. Again, this different wording is not intended to have any consequential effect to the timing of revenue recognition and entities must still continue recognising revenue when they receive a right to consideration.

Paragraph 23.16 of FRS 102 says that where an entity cannot estimate the outcome of a service contract (which is more likely to apply to construction contracts), then the entity should only recognise revenue to the extent of the costs incurred. In contrast, paragraph 10 of SSAP 9 *Stocks and long-term contracts* says that where the outcome of long-term contracts cannot be assessed with reasonable certainty, no profit should be reflected in the profit and loss account and suggests showing as turnover a proportion of total contract value using a zero estimate of profit.

Please note

The FRC have said that if there is any abuse of the wording in Section 23 *Revenue* by reporting entities (i.e. disproportionately delaying or accelerating revenue recognition due to the additional professional judgement needed in FRS 102), they will issue an Abstract to clarify the position and this will more than likely involve confirming that revenue should be recognised when the company has earned the right to consideration.

Stock valuation

The FRSSE (effective January 2015) allows stock to be valued using the 'last-in first-out' (LIFO) method of stock valuation. However, it does not favour its use citing in Appendix III the fact that the use of LIFO will often result in stocks being stated in the balance sheet at amounts that bear little relationship to recent cost levels.

Paragraph 13.18 follows the same stance as its international counterpart, IAS 2 *Inventories* which outlaws the use of the LIFO method as a basis for inventory valuation.

Section 1A of FRS 102 for small entities

As mentioned previously in these notes, the FRC are proposing to insert a new Section 1A *Small Entities* into FRS 102 which will outline the presentation and disclosure requirements for small companies. In all other respects (i.e. recognition and measurement) full FRS 102 requirements will apply.

Paragraph 1A.3 says that a small entity is to present the following as their *complete* set of financial statements:

(a) a **statement of financial position** as at the **reporting date** in accordance with paragraph 1A.5;

(b) an **income statement** for the **reporting period** in accordance with paragraph 1A.9; and

(c) **notes** in accordance with paragraph 1A.12 to 1A.15.

With regards to a statement of changes in equity, Section 1A encourages this statement to be presented and where a small entity does choose to provide a statement of changes in equity it will do so in accordance with Section 6 *Statement of Changes in Equity and Statement of Income and Retained Earnings*.

Information to be presented in the balance sheet

Small entities are required to present a statement of financial position (balance sheet) in accordance with the requirements for a balance sheet that is set out in Part 1 *General Rules and Formats* of Schedule 1 to the Small Company Regulations. Where the balance sheet is an abridged balance sheet Section 1A still requires the balance sheet to meet the true and fair view requirements of the Companies Act 2006. To achieve this, the directors must also consider the requirements contained in paragraph 1A.12 relating to the disaggregation of the balance sheet.

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 all the members agree**. Members can only agree to prepare an abridged balance sheet for the preceding financial year and hence this agreement is an annual process. One agreement does not cover subsequent years.

An abridged balance sheet will only show those items in either statutory Format 1 or Format 2 preceded by letters and roman numerals (in practice it will not have any major bearing on the face of the balance sheet, it will primarily affect the disclosure notes as less information will be disclosed). 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 Appendix I);
- in the case of a Format 2 balance sheet, notes (5) and (10) of the notes to the formats must be complied with (see Appendix I); and
- all of the members of the company have given their consent to the company drawing up an abridged balance sheet.

If the members have unanimously agreed to prepare an abridged balance sheet, they must consider the requirements contained in paragraph 1A.12 relating to the disaggregation of the balance sheet (hence making additional disclosures in the notes).

If the entity has *adapted* one of the balance sheet formats by applying paragraph 1B(1) of Schedule 1 to the Small Companies Regulations, it must, as a minimum present line items

which show the following and distinguish them between those that are current and those that are non-current:

(a) **cash** and **cash equivalents**;

(b) trade and other receivables;

(c) **financial assets** (excluding amounts shown under (a), (b), (j) and (k));

(d) **inventories**;

(e) **property, plant and equipment**;

(f) **investment property** carried at **fair value** through **profit or loss**;

(g) **intangible assets**;

(h) **biological assets** carried at cost less accumulated **depreciation** and impairment;

(i) biological asses carried at fair value through profit or loss;

(j) investments in **associates**;

(k) investments in **jointly controlled entities**;

(l) trade and other payables;

(m) financial liabilities (excluding amounts shown under (l) and (p));

(n) liabilities and assets for **current tax**;

(o) **deferred tax liabilities** and **deferred tax assets** (these shall always be classified as non-current);

(p) **provisions;**

(q) **non-controlling interest**, presented within equity separately from the equity attributable to the owners of the **parent**; and

(r) equity attributable to the owners of the parent.

Words which are emboldened above mean they are defined in the Glossary to FRS 102.

Section 1A also requires (in either the statement of financial position or within the notes) the following sub-classifications of the line items presented when either of the balance sheet formats have been adapted:

(a) property, plant and equipment in classifications appropriate to the small entity;

(b) trade and other receivables, showing separately amounts due from **related parties** and amounts due from other parties;

(c) trade and other payables, showing separately amounts due to **related parties** and amounts due to other parties;

(d) classes of equity, such as paid-in capital, share premium, retained earnings and items of **income** and **expense** that, as required by this FRS, are recognised in **other comprehensive income** and presented separately in equity.

Words which are emboldened above mean they are defined in the Glossary to FRS 102.

Information to be presented in the profit and loss account

Small entities must still produce an income statement (profit and loss account) in accordance with the requirements for a profit and loss account set out in Part 1 *General Rules and Formats* of Schedule 1 to the Small Companies Regulations.

The revised Companies Act allows an abridged 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 Format 1 or Format 2 (Formats 3 and 4 have been abolished in the revised Act)), the small company can combine under one item called 'Gross profit or loss':

- items 1, 2, 3 and 6 in the case of a Format 1 profit and loss account; and
- items 1 to 5 in the case of a Format 2 profit and loss account.

Where the members have unanimously agreed to produce an abridged profit and loss account, the directors must ensure that it gives a true and fair view and hence must also consider the requirements of paragraph 1A.12 in relation to the presentation of turnover. Again the agreement by members to prepare an abridged profit and loss account can only be in respect of the preceding year.

If the entity has adapted one of the formats of the profit and loss account it must include, as a minimum, the following line items that present the following amounts for the period:

(a) **revenue**;

(b) finance costs;

(c) shares of the profit or loss of investments in associates (see Section 14 *Investments in Associates*) and jointly controlled entities (see Section 15 *Investments in Joint Ventures*) accounted for using the equity method;

(d) tax expense excluding tax allocated to other comprehensive income; and

(e) profit or loss.

Information to be presented in the notes

The FRC are keen to emphasise that small company directors still have a legal duty to prepare financial statements which give a true and fair view. As a result, paragraph 1A.12 requires an entity to present sufficient information to achieve this concept.

It may be the case that the company applies the legal minimum disclosures in its financial statements; however simply by doing this, the financial statements may still fail to achieve a true and fair view and therefore the company's directors will have a legal duty to make disclosures over and above the legally required minimum to achieve a true and fair view. A typical scenario would be where the company has going concern issues. While disclosures in respect of going concern are not legally required, they are an encouraged disclosure in FRS 102 for small companies.

Under the revised Companies Act 2006, the legally required disclosures are as follows:

- Accounting policies adopted
- Fixed assets revaluation table
- Fair valuation note
- Financial commitments, guarantees or contingencies not included in the balance sheet
- The amount of advances and credits granted to members of the administrative, managerial and supervisory bodies (along with supporting information)
- Exceptional items
- Amounts due or payable after more than five years and entire debts covered by valuable security
- Average number of employees during the financial year

NEW

- 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

Section 1A at paragraph 1A.14 contains the disclosure requirements for small companies and, on the face of it, it would appear that there are considerably more than the above 13 disclosures. This is because there are additional situations which apply where disclosures are needed to fulfil the requirements of the Companies Act 2006 and hence the FRC have grouped together all the disclosure requirements to aid preparers. The following are the disclosure requirements under paragraph 1A.14:

(a) **Accounting policies** adopted (in accordance with paragraphs 8.5 and 8.6).

(b) An explanation of the period over which **intangible assets** (including **goodwill**) are written off (in accordance with paragraph 18.27(a) and paragraph 19.25(g)).

(c) When **development** costs are capitalised as an accounting policy choice in accordance with paragraph 18.8H and the entity determines that the carrying amount of those intangible assets is not a realised loss, the reasons for showing development costs as an asset and that the carrying amount is not to be treated as a realised loss.

(d) When there has been a change in accounting policy, the disclosures set out in paragraphs 10.13 and 10.14.

(e) When there has been a correction of a material prior period **error**, the disclosures set out in paragraph 10.23.

(f) When the presentation or classification of items in the financial statements is changed, the disclosures set out in paragraphs 3.12 and 3.13.

(g) Where an asset or liability relates to more than one item in the statement of financial position, the relationship of such asset or liability to the relevant items.

(h) When **fixed assets** are measured at revalued amounts (in accordance with paragraph 9.26(b), paragraph 14.4(c), paragraph 15.9(c), paragraphs 17.15B to 17.15F or paragraphs 18.18B to 18.18H), a table showing:

    (i) movements in the revaluation reserve in the reporting period, with an explanation of the tax treatment of the items therein (for example, as would otherwise be required by paragraph 6.3A and paragraph 29.27(a)); and

    (ii) the carrying amount in the statement of financial position that would have been recognised had the fixed assets not been revalued (for example as set out in paragraph 17.32A(d) and paragraph 18.29A(d)).

(i) When fixed assets (other than listed investments) are measured at revalued amounts (in accordance with paragraphs 17.15B to 17.15F or paragraphs 18.18B to 18.18H):

    (i) the years in which the assets were valued (in accordance with paragraph 17.32A(a)) and the revalued amounts; and

    (ii) for fixed assets that have been revalued during the reporting period, the names of the persons who valued them or particulars of their qualifications and the basis of valuation (in accordance with paragraph 17.32A(c) and paragraph 34.55(e)(ii)).

(j) When **financial instruments** or other assets are measured at **fair value** through profit or loss (in accordance with paragraph 9.26(c), paragraphs 11.14(b) and 11.14(d)(i), paragraph 12.8, paragraph 13.4A, paragraph 14.4(d), paragraph 15.9(d), paragraph 16.7 or paragraph 34.4):

(i) the significant assumptions underlying the valuation models and techniques used where a quoted price in an **active market** is not available (for example, as set out in paragraph 11.43, paragraph 16.10(a) and paragraph 34.7(b));

(ii) for each category of financial instrument or other asset, the fair value, the changes in value included directly in the income statement and changes in value included in equity (for example, as set out in paragraphs 11.41(a), 11.41(d), 11.48(a)(i) and 11.48(a)(ii), paragraphs 12.28 and 12.29(c), paragraph 16.10(e)(ii) and paragraph 34.7(c)(i));

(iii) for each class of **derivative**, the extent and nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future **cash flows**; and

(iv) a table showing movements in equity during the reporting period (for example, as set out in paragraph 6.3A and paragraphs 12.29(c) and (d)).

(k) When financial instruments are measured at fair value and are within the scope of paragraph 11.48A, the disclosures set out in that paragraph.

(l) The total amount of any financial commitments, guarantees and contingencies that are not included in the statement of financial position (for example, as set out in paragraph 15.19(d), paragraph 16.10(d), paragraph 17.32(b), paragraph 18.28(d), paragraph 20.16, paragraphs 21.15 and 21.16, paragraphs 28.40A(a), 28.40(A)(b) and 28.41A(d), paragraph 33.9(b)(ii) and paragraph 34.62), and an indication of the nature and form of any valuable security given in respect of them (for example, as set out in paragraph 11.46, paragraph 13.22(e), paragraph 17.32(a) and paragraph 18.28(c)); any commitments concerning pensions and any commitments concerning the entity's parent, fellow **subsidiaries**, subsidiaries, jointly controlled entities and associates shall be disclosed separately.

(m) The amount of advances and credits granted to its directors, with indications of the interest rates, main conditions and any amounts repaid or written off or waived, as well as commitments entered into on their behalf by way of guarantees of any kind, with an indication of the total for each category (for example, as set out in paragraph 33.9).

(n) The amount and nature of any individual items of income or expenditure of exceptional size or incidence.

(o) Amounts owed by the small entity:

(i) becoming due and payable after more than five years showing separately amounts payable by instalments; and

(ii) covered by valuable security furnished by the small entity, with an indication of the nature and form of the security (for example, in accordance with paragraph 11.46, paragraph 13.22(e), paragraph 17.32(a) and paragraph 18.28(c)).

(p) The average number of employees during the reporting period.

(q) For each class of fixed assets shown in the statement of financial position or in the notes (including fixed asset investments and in accordance with paragraph 16.10(e), paragraph 17.31(d), and (e), paragraphs 18.27(c) and (e) and paragraph 34.55(e)

and (f) (insofar as they relate to heritage asses recognised in the statement of financial position)):

(i) the purchase price or production cost or, where an alternative basis of measurement has been followed, the fair value or revalued amount at the beginning and end of the reporting period;

(ii) additions, disposals and transfers during the reporting period;

(iii) the accumulated **depreciation** and **impairment losses** at the beginning and end of the reporting period;

(iv) separately, depreciation and impairment losses recognised during the reporting period;

(v) movements in accumulated depreciation and impairment losses in respect of additions, disposals and transfers during the reporting period; and

(vi) when an entity adopts a policy of capitalising **borrowing costs** (see paragraph 25.2), the amount capitalised during the reporting period (in accordance with paragraph 25.3A(a)).

(r) For fixed assets, including fixed asset investments, when impairment losses are recognised, or reversed, the disclosures set out in paragraph 27.32;

(s) When the small entity is a subsidiary, the name and registered office of the small entity's parent or, if the parent does not produce **consolidated financial statements**, the next most senior parent that does (for example in accordance with paragraph 33.5).

(t) The nature and business purpose of the small entity's arrangements that are not included in the statement of financial position, provided that the risks and benefits arising from such arrangements are material and insofar as the disclosure of such risks or benefits is necessary for the purposes of assessing the financial position of the small entity.

(u) The nature and the financial effect of material non-adjusting events after the end of the reporting period (in accordance with paragraphs 32.10 and 32.11).

(v) **Related party transactions** that have not been concluded under normal market conditions with the following:

(i) **owners** holding **significant influence** over the reporting entity;

(ii) entities which are associates, jointly controlled entities or subsidiaries of the reporting entity; and

(iii) the entity's directors or equivalent governing body.

Disclosure shall include the amount of the transactions, the nature of the related party relationship and other information about the transactions necessary for an understanding of the financial position of the small entity. Information about individual transactions may be aggregated according to their nature except where separate information is necessary for an understanding of the effects of related party transactions on the financial position of the small entity (for example, as set out in paragraphs 33.9 and 33.14).

Disclosures need not be given of transactions entered into between two or more members of a **group**, provided that any subsidiary which is a party to the transaction is wholly-owned by such a member, as set out in paragraph 33.1A.

The FRC are keen to ensure that company directors of small entities understand the importance of ensuring the financial statements give a true and fair view. In light of this, the FRC encourage the following disclosures to be made in the small entity's financial statements:

(a) a statement of compliance with this FRS as set out in paragraph 3.3;

(b) if relevant, a statement that it is a public benefit entity as set out in paragraph PBE3.3A;

(c) if relevant, the disclosures relating to going concern set out in paragraph 3.9;

(d) dividends declared and paid or payable during the period (for example, as set out in paragraph 6.5(b)); and

(e) on first-time adoption of this FRS an explanation of how the transition has affected its financial position and financial performance as set out in paragraph 35.13.

FRED 60 Draft Amendments to FRS 100 and FRS 101

FRS 100 *Application of Financial Reporting Requirements* outlines which standards different types of entities will use. FRS 101 *Reduced Disclosure Framework* offers reduced disclosures in the individual financial statements of qualifying entities.

In terms of amendments to FRS 100, the FRC are proposing to remove references to the FRSSE (due to its withdrawal) and include references to FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. They are also proposing to remove the word 'Regulations' from paragraph 3 which outlines the terms which are defined in the Glossary to FRS 100 and include the term 'small entity'.

FRS 100 is amended at paragraph 6 to exclude a small entity applying FRS 102 for small entities from referring to a SORP in the preparation of its financial statements. However, for a small entity applying FRS 102 for small entities, disclosures are encouraged where:

- the small entity has not adopted a particular treatment(s) of a relevant SORP together with the reasons why the relevant treatment adopted is more appropriate to the entity's particular circumstances; and
- brief details of any disclosures recommended by the SORP that have not been provided, and the reasons why they have not been provided.

Paragraph 9 of FRS 100 is amended to remove reference to the FRSSE and also to encourage a small entity to make the statement of compliance with FRS 102 for small entities in the notes to the financial statements.

Two paragraphs have been inserted into FRS 100: paragraph 10A to refer to the 'effective from' date of the amended FRS 100 and acknowledging that earlier adoption is permitted. Paragraph 15A is also inserted to make reference to the FRSSE (effective January 2015) being superseded on the early application of the amendments and the fact that it will be withdrawn in its entirety for accounting periods beginning on or after 1 January 2016.

In terms of FRS 101 *Reduced Disclosure Framework*, this has been amended following the revisions to the Companies Act 2006 which now allow the statutory formats of the financial statements to be adapted. This is going to be beneficial for subsidiaries of parents which report under EU-endorsed IFRS.

Prior to the amendments, FRS 101 still required Companies Act accounts to be prepared for qualifying subsidiaries and the problem with this was that it was inherently complicated to consolidate UK Companies Act accounts in with financial statements prepared to EU-endorsed IFRS as IAS 1 *Presentation of Financial Statements* is more flexible in its approach as to the line items contained in primary statements prepared under that standard. By allowing qualifying subsidiaries the option to adapt the statutory formats of the financial statements, this will allow the consolidation of those financial statements to be less burdensome.

HEDGE ACCOUNTING FOR DUMMIES (LECTURE A507 – 22.13 MINUTES)

Hedge accounting in a nutshell

Hedge accounting is a true and fair override, to put it simply.

Sometimes fair valuing assets and liabilities through profit and loss means that the accounts do not make sense. For instance, when a company sells forward currency on a predicted sale they are doing this to reduce the potential volatility of cash flows. So why should reported income become more volatile by recognising gains and losses on the fair value of the currency contract in income?

This arrangement is a hedge. Therefore, FRS 102 gives the option of hedge accounting for it. This involves the gain or loss bypassing the profit and loss account and going to reserves via the statement of other comprehensive income. Note that the contract is still stated at fair value in the balance sheet but the measurement difference is only recognised when the sale actually occurs.

It is usually pointless opting to hedge account when there is a gain or loss on the contract in the same period that the predicted sale occurs as any gains or losses on these arrangements should cancel each other out in the profit and loss account.

Hedge accounting jargon

When hedge accounting is applied, terms like 'hedged item' and 'hedging instrument' are used to describe various transactions and balances.

The hedged item tends to be a balance or transaction which exposes the entity to risk. The hedging instrument is usually a derivative that is being used to manage that risk.

Example – Hedged item and associated hedging instrument

Hedged item	***Hedging instrument***
Predicted sale in $	$ forex contract
Variable rate bank loan	Interest rate swap

Conditions for hedging

The August 2014 update of FRS 102 simplified the conditions for applying hedge accounting. Following this revision the conditions are nothing like as demanding as IFRS. In particular forget any memories that you might have of the corridor method (measure of effectiveness, set at 80% to 125% effective, etc.)

Now the conditions are contained in paragraph 12.18 which says that for an entity to apply hedge accounting the following all have to be in place:

- the hedging relationship consists only of a hedging instrument and a hedged item as described in paragraphs 12.16 to 12.17C;
- the hedging relationship is consistent with the entity's risk management objectives for undertaking hedges;
- there is an economic relationship between the hedged item and the hedging instrument;
- the entity has documented the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified; and

- the entity has determined and documented causes of hedge ineffectiveness.

Para 12.18A goes on to say:

- An economic relationship between a hedged item and hedging instrument exists when the entity expects that the values of the hedged item and hedging instrument will typically move in opposite directions in response to movements in the same risk, which is the hedged risk.

Types of hedging relationships

The accounting for hedging instruments varies depending on the type of hedge

Fair value hedge – where the risk being hedged is related to changes in fair value, for example the fair value risk on a fixed rate loan can be hedged with a fixed for floating interest rate swap.

Cash flow hedge – where the risk related to uncertain cash flows, for example the future uncertainties of interest payments on a variable rate loan can be hedged with a floating for fixed interest rate swap.

Hedge of a net investment in a foreign operation

If practitioners do encounter the need for hedge accounting, it is often a cash flow hedge that is involved, so these notes do not address fair value hedging of a hedge of a net investment in a foreign subsidiary. Look to FRS 102 for guidance and examples in these areas.

Accounting for a cash flow hedge

When the hedge accounting conditions above are met, gains or losses or changes in fair value of the hedging instrument are presented in **other comprehensive income**, not the P&L. Cumulative gain or losses or changes in fair value are held in a **cash flow hedge reserve.**

This slightly oversimplifies matters. For more detail see the examples below and FRS 102.

Disclosures specific to cash flow hedge accounting

Paragraphs 12.27 and 12.29 of FRS 102 contain the relevant disclosure requirements where cash flow hedge accounting is applied:

- General requirement: disclosure for each hedging relationship relating to:
    - a description of the hedge;
    - a description of the hedging instruments and their fair values at the balance sheet date; and
    - the nature of the risks being hedged and a description of the hedged item.
- For cash flow hedges, the entity shall disclose:
    - (a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;
    - (b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;
    - (c) the amount of the change in fair value of the hedging instrument that was recognised in other comprehensive income during the period;

(d) the amount, if any, that was reclassified from equity to profit or loss for the period; and

(e) the amount, if any, of any excess of the fair value of the hedging instrument over the change in the fair value of the expected cash flows that was recognised in profit or loss for the period.

Example – Floating for fixed interest rate swap

On 1 January 2015, A Ltd received a £2m bank loan. Interest is payable at a variable rate of 3% over the Bank of England base rate. On the same day, in order to hedge against variability of future cash flows, the entity enters into an interest rate swap with the same bank to pay 4% fixed and receive the same variable rate as applies to the loan, for a period of 10 years, which is the term of the loan.

The entity will effectively be paying a fixed rate on the debt rather than variable.

The Bank of England base rate is 0.5%, throughout the accounting period.

The settlement value of the swap at 31 December 2015, is (£85,000).

Using hedge accounting for a cash flow hedge the entries are as follows:

Date	**Narrative**	**DR**	**CR**
		£	**£**
01.01.15	Cash	2,000,000	
	Bank loan		2,000,000
	Bank loan advance		
31.12.15	Interest charge	80,000	
	Cash		80,000
	Interest paid at 4% fixed rate		
31.12.15	Remeasurement loss on swap	85,000	
	Interest rate swap liability		85,000
	Remeasurement on interest rate swap to fair value, through OCI		

The reameasurement will be presented as a cash flow hedge reserve. Without hedge accounting the remeasuremnt to fair value will be recognised in the profit and loss account.

Forex contract on a recognised sale

The following example shows a sale matched by a forex contract. Hedge accounting should be unnecessary because the gains on the forex contract are matched by losses on the foreign currency debtor.

Example – Sale in foreign currency

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

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

Under SSAP 20 *Foreign currency translation*, the impact on the P&L would be as follows (using the option to use the **contract rate**):

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

By way of comparison the impact on the P&L (using closing rates/spot rates) would be as follows under FRS 102:

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

Forex contract on a predicted sale

The above example changes significantly if the contract is on a predicted sale rather than a recognised sale.

Example – Sale in foreign currency

Company A enters into discussions to sell goods for €1,000 on 31 July 2016. In preparation for this expected sale, on 1 May 2016 the company sells forward €1,000 at a contract rate of €1.20:£1, using 31 July as the settlement date.

Company A's year end is on 30 June 2016.

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

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

The P&L would be as follows under FRS 102:

1 May 2016	£
No entries	

30 June 2016 – year-end adjustments		
Loss on forex debtor – year end rate €1.30:£1	Nil	No debtor
Gain on forex contract – forward rate at year end €1.28:£1	52	
31 July 2016		
Sale at rate prevailing at year end	763	
Loss on forex debtor – spot rate €1.31:£1	Nil	No debtor
Gain on forex contract – spot rate €1.31:£1	17	

Hedge accounting for a cash flow hedge

The above is without applying hedge accounting. Hedge accounting would effectively more the gain on the forex contract from the P&L to other comprehensive income in the period to 30 June 2016. In the following year the gain would then be removed from the cash flow hedge reserve and pass through P&L.

SMALL BUSINESS, ENTERPRISE AND EMPLOYMENT ACT (LECTURE A508 – 9.12 MINUTES)

In an attempt to deter illegal activity in business, such as money-laundering and tax evasion, there has been a change to UK company law in the form of *The Small Business, Enterprise and Employment Act 2015* which received Royal Assent on 26 March 2015 and forms part of the Government's 'Transparency and Trust' proposals. The Act itself hit the statute books on 26 March 2015 but in recognition of the fact that companies will need time to prepare, a staged timetable has been introduced for implementation of the Act.

Unfortunately the new legislation is going to cause an element of upheaval among companies and the following table highlights the main changes to company law, together with the implementation dates:

Change in the law	Implementation date
The prohibition of 'bearer shares'	26 May 2015, with a nine months' transitional period for existing bearer shares.
Prohibition of corporate directors, with exceptions	October 2015, with a 12 months' transitional period for existing corporate directors
Maintenance of a public register of people with significant control for unquoted companies	January 2016 and details of these people to be provided annually to Companies House from April 2016
Replacement of annual returns	From April 2016 the annual return will be replaced with annual 'confirmation statements'
Ability to keep statutory registers at Companies House instead of having to keep own registers	April 2016

Register of persons with significant control

One of the most controversial aspects of this new piece of legislation is that individuals who have 'significant control' over a private company are to be named on a public register. In broad terms, a person will have significant control where he or she holds or controls more than 25% of the company's shares or voting rights. In addition, a person will have significant control where they have the power to appoint, or remove, a majority of the board (this can be directly, or indirectly, through a majority stake in another company).

While the above test may seem fairly simple to apply, there are already emerging problems that have presented themselves, such as where an individual may have significant influence or control over an unquoted company or exercises control through a partnership or trust. In this respect, the government is expected to issue additional guidance on the definition of 'significant influence or control' by October 2015.

In general, the five specified conditions which constitute 'significant control' are:

- direct/indirect ownership of 25% or more of a company's shares;
- direct/indirect control of 25% or more of a company's voting rights;
- direct/indirect right to appoint/remove a majority of the board's directors;

- exercise/right to exercise significant influence or control over a company; and/or
- exercise/right to exercise significant influence or control over activities of a trust or firm which itself meets one, or more, of the first four conditions.

There will be a legal obligation for an unquoted company to identify and keep up-to-date a register of persons with significant control. Conversely those persons with significant control over the company will be obliged to disclose their identities to the company. Anyone will be able to inspect the register of persons with significant control if they have a 'proper purpose'.

Companies will be required to provide information concerning persons with significant control to Companies House and this information will be available on the public record. To start with, this will be on an annual basis, but from 2017 the government is planning to increase the frequency for Companies House filings to bring the new rules in line with the EU Fourth Money Laundering Directive.

The register of persons with significant control must include similar details to those which are currently on the register of directors along with the nature of the control that the person has over the company. The residential address of a person with significant control will be protected (as is the case now for directors); however other information relating to the person with significant control may only be withheld in very limited circumstances, for example where the person with significant control is at a risk of serious violence or intimidation due to the company's activities. The final details have not yet been published and we are awaiting confirmation of such circumstances.

Failure to comply

At the outset it is important to point out that the new rules only apply to unquoted companies (i.e. private companies). Listed companies (including AIM-listed companies) are exempt from the requirements on the grounds that the disclosure requirements in DTR 5 already apply to shareholders of listed companies.

Problems are likely to emerge for private companies in identifying their significant controllers by serving information requests. In addition, the new regime is likely to be extended to LLPs (although formal proposals for this have not yet been published).

Where persons with significant control do not comply with their disclosure obligations, the company can impose sanctions such as loss of voting rights and transfer restrictions. A similar sort of regime exists with listed companies, but PLCs have to go to court to impose such sanctions, whereas private companies will not have to go to court.

Where a company fails to comply with its obligations under the new law, criminal penalties can also be imposed and such penalties will also extend to the company's directors and company secretary.

Implementation of the register of persons with significant control

The government has confirmed that it plans to issue further guidance on implementing the register of persons with significant control; however, based on the current timetable, companies must start to maintain a register from January 2016. Companies will also be required to file information concerning persons with significant control annually from April 2016.

Bearer shares

Bearer shares are fairly uncommon nowadays and so this issue is unlikely to affect very many companies. However, from 26 May 2015 companies will no longer be able to create bearer shares. Over the years such shares have been criticised because they allow the

shareholders to remain anonymous. From 26 May 2015, existing holders of bearer shares will have nine months' to swap their shares and be listed on the register of shareholders, after which time the shares will be cancelled. It is important, therefore, that companies which have holders of bearer shares, notify such holders as quickly as possible as to the consequences of not surrendering their shares.

Corporate directors

The new Act prohibits companies and other corporate entities from being appointed as directors. The reason for this prohibition is to restrict the use of corporate structures to hide illegal activity. The ban on corporate directors is expected to commence from October 2015 and for companies which currently have a corporate director, they will have a one-year transitional period in which to appoint replacement directors.

Despite the ban being primarily to restrict illegal activity, the government have acknowledged that in some instances corporate directors are appointed for genuine reasons and hence the government have said that they may introduce some exemptions from the prohibition of a corporate director and is currently consulting on whether a corporate director should be permitted if all of its directors (or equivalent officers) are natural persons and their details are held on a public register, such as that held at Companies House.

Shadow directors

The general duties of directors under sections 170 to 177 of the Companies Act 2006 will apply to shadow directors, to the extent that they are capable of applying. Shadow directors are not formally appointed as directors but the board follows the orders of such shadow directors. This change will apply from 26 May 2015 but it is currently unclear how this will operate in practice. Current advice to investors is to avoid 'crossing the line' between board engagement and board control and while the Act does empower the government to introduce further rules in this area, no such proposals have been published as yet.

Insolvency and disqualification of directors

The Act provides for a number of measures which have the objective of making it easier to pursue directors that do not comply with their obligations. The Act will allow liquidators and administrators to bring law suits against directors for acts such as wrongful or unlawful trading as well as applying for creditor compensation orders against directors that have been disqualified.

In addition, the disqualified directors regime is also going to be updated and improved and will allow the Secretary of State to disqualify directors for misconduct in connection with companies that are located overseas. The courts will also be able to take account of a wider range of factors in arriving at a decision whether, or not, to ban a director.

The length of time that the Secretary of State will have in bringing disqualification action against a director following formal insolvency of a company is being extended from two years to three years.

Annual returns

The annual return which is currently lodged at Companies House is being replaced with an annual check-and-confirm 'confirmation statement'. This form will also make the statements of capital easier to complete because the statement of capital is to be amended to remove the requirement for companies to include the amount paid up and unpaid on each share.

Instead, companies will be required to specify the aggregate amount unpaid on the total number of issued shares.

The changes relating to the annual return are scheduled to come into force in April 2016 and companies will have to adjust to the new annual reporting regime. However, a benefit of the new regime is that it should be easier to align the timing of the preparation of the company's confirmation statement with its annual accounts.

Company registers

Private companies will have the option to maintain certain information on the public register rather than on statutory registers. This will include information concerning shareholders, directors, secretaries and persons with significant control being maintained on a register at Companies House rather than maintaining their own registers. While this may sound helpful due to the reduced administration, it may be worthwhile for a private company to maintain their own register where such information changes infrequently, or where there are reduced confidentiality concerns as well as the fact that Companies House will charge for such a service.

Directors' dates of birth

In an attempt to reduce fraudulent activity, the day that a director was born will not be made public at Companies House – only the month and year will be visible on the public register and this is expected to come into force from October 2015. The issue with this is that the new rules do not appear to remove historic data and hence for existing directors, the new rule on dates of birth will probably be of little benefit. In addition, protection will also not be available where a private company opts to keep its register of directors at Companies House. The rules on dates of birth will also extend to persons with significant control.

Director and registered office disputes

When a director is appointed, they will not have to countersign the usual Companies House form to indicate their consent. Instead, Companies House will notify directors that they have been appointed as a company director. This will give the director chance to object and have their names removed if an erroneous appointment has been lodged at Companies House, or if the registration is bogus. These new rules are expected to come into force in October 2015 with additional provisions which will allow Companies House to alter the registered office of a company where the use of the address is disputed.

Striking off companies

The amount of time it takes for a company to be dissolved (whether voluntary or not) is to be reduced from three months to two months following publication of notice in the *Gazette*. This accelerated timescale is expected to come into force in October 2015.

Companies House changes

In light of the above changes brought about by *The Small Business, Enterprise and Employment Act 2015*, there are going to be improvements to Companies House online facilities. Currently there are three services offered by Companies House:

- Webfiling;
- Webcheck; and
- Companies House Direct

The above will all be replaced by one unified online service – *The Companies House Service*. Webfiling, Webcheck and Companies House Direct will all run in parallel during the implementation of the new unified online service. There are some notable changes to the existing offering which include:

- the removal of the subscription-based *Companies House Direct* to a free of charge service;
- access to all document images on a free of charge basis, which will also include mortgage charges;
- removal of the form-based filing to a 'click and confirm' process which will make it easier to maintain company information; and
- an updated and user-friendly interface which will make searching for information more easier and quicker.

AUDIT REPORTING (LECTURE A509 – 13.05 MINUTES)

Audit reports are coming under increasing scrutiny by both regulatory bodies such as the Financial Reporting Council and the professional bodies. Over the years the audit report has been the subject of varying degrees of criticism from commentators and stakeholders who have questioned the usefulness of the audit report in terms of the jargon used and the information which it is conveying. Attempts have been made over the years to simplify the report and to make it more useful in terms of the language used. Indeed, this is evidenced by the International Auditing and Assurance Standards Board's new ISA 700 *(Revised) Forming and Opinion and Reporting on Financial Statements* which will be effective for audits of financial statements for periods ending on or after 15 December 2016 (see *Summary of Developments* at the end of these notes). Such reports will include references to 'key audit matters' and the FRC will consult on changing the UK and Ireland ISA 700.

'Key audit matters' are those matters which, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. They can include issues relating to the valuation of financial instruments, goodwill, going concern, revenue recognition and issues which give rise to a significant risk (such as an accounting estimate(s)).

UK and Ireland audit reports

UK and Ireland audit reports are governed by the ISAs (UK and Ireland) in the 700 series, being:

- ISA (UK and Ireland) 700 The independent auditor's report on financial statements
- ISA (UK and Ireland) 705 Modifications to opinions in the independent auditor's report
- ISA (UK and Ireland) 706 Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report
- ISA (UK and Ireland) 710 Comparative information – corresponding figures and comparative financial statements
- ISA (UK and Ireland) 720A The auditor's responsibilities relating to other information in documents containing audited financial statements
- ISA (UK and Ireland) 720B The auditor's statutory reporting responsibility in relation to directors' reports

The auditor's report on the financial statements must contain a clear written expression of opinion on the financial statements taken as a whole. This opinion is based on the audit evidence obtained by the auditor during the course of the audit. Paragraph 8 of ISA (UK and Ireland) 700 says that the auditor must evaluate the conclusions drawn from the audit evidence obtained, including evaluating whether:

a. Sufficient appropriate audit evidence as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or error has been obtained;
b. Uncorrected misstatements are material, individually or in aggregate. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments;
c. In respect of a true and fair view framework, the financial statements, including the related notes, give a true and fair view; and

d. In respect of all frameworks the financial statements have been prepared in all material respects in accordance with the framework, including the requirements of applicable law.

Paragraph 9 of ISA (UK and Ireland) 700 further expands on the above points and requires the auditor to evaluate whether:

a. The financial statements adequately refer to or describe the relevant financial reporting framework;
b. The financial statements adequately disclose the significant accounting policies selected and applied;
c. The accounting policies selected and applied are consistent with the applicable financial reporting framework, and are appropriate in the circumstances;
d. Accounting estimates are reasonable;
e. The information presented in the financial statements is relevant, reliable, comparable and understandable;
f. The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
g. The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Order of the audit report

ISA (UK and Ireland) 700 outlines the form and content of the audit report and as such the report itself must contain certain elements, including:

Title

The auditor’s report shall have an appropriate title.

Addressee

The auditor’s report shall be appropriately addressed as required by the circumstances of the engagement (the addressee is usually the shareholders of the company).

Introductory paragraph

The introductory paragraph identifies the financial statements which have been audited, including the date of, and the period covered by, the financial statements.

Respective responsibilities of those charged with governance and auditors

The audit report must include a statement that those charged with governance are responsible for the preparation of the financial statements. It must also contain a statement that the auditor’s responsibility is to audit and express an opinion on the financial statements in accordance with the applicable legal requirements and ISAs (UK and Ireland). In addition, the report must also state that those standards require the auditor to comply with the APBs Ethical Standard for Auditors (note the APB (Auditing Practices Board) no longer exists, but ISA (UK and Ireland) 700 still makes reference to the APB).

Scope of the audit

The auditor has three choices in outlining the scope of the audit in the auditor's report. The report must either:

- Cross refer to the applicable version of a 'Statement of the Scope of an Audit' that is maintained on the FRC's website; or
- Cross refer to a 'Statement of the Scope of an Audit' that is included elsewhere in the annual report; or
- Include the following description of the scope of an audit:
- 'An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the [describe nature of entity] circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by [describe those charged with governance]; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the [describe annual report] to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.'

Opinion on financial statements

The opinion paragraph must clearly state the auditor's opinion as required by the relevant financial reporting framework used to prepare the financial statements, including applicable law.

Where the auditor expresses an unqualified opinion on financial statements that are prepared in accordance with a true and fair framework, the opinion paragraph must clearly state that the financial statements give a true and fair view.

Opinion in respect of an additional financial reporting framework

Where the auditor is engaged to form an opinion on the compliance of the financial statements with an additional financial reporting framework, this second opinion must be clearly separated from the first opinion. The auditor will do this by using another appropriate heading.

Requirement specific to public sector entities where an opinion on regularity is given

The auditor shall address other reporting responsibilities in [a] separate section[s] of the auditor's report following the opinion[s] on the financial statements and, where there is one, the opinion on regularity. (This is usually found in a separate regularity report for clients such as an academy school – although a 'conclusion' rather than an 'opinion' is formed on an academy's regularity report due to the limited work required on the regularity report).

Opinion on other matters

When the auditor addresses other reporting responsibilities within the auditor's report, the opinion which arises from such other responsibilities are to be set out in a separate section of the auditor's report which follow the opinion(s) on the financial statements or, where there is one, the opinion on regularity.

Companies reporting under the Corporate Governance Code

For entities reporting under the UK Corporate Governance Code (or those that voluntarily do so), the auditor's report has been amended and for audits of financial statements for periods commencing on or after 1 October 2014, the auditor's report shall:

(a) Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;

(b) Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole; and

(c) Provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risk of material misstatement disclosed in accordance with (a) and was influenced by the auditor's application of materiality disclosed in accordance with (b).

Types of audit opinion

The hope of many (if not all) auditors is that they can express an 'unqualified' opinion on the financial statements. However, situations can present themselves during the course of an audit which, if not resolved, can result in a qualified opinion being expressed (the term 'qualified' is also referred to as a 'modified' opinion in ISA (UK and Ireland) 705 *Modifications to opinions in the independent auditor's report*. It is important at the outset to point out that when the auditor uses an 'emphasis of matter' paragraph, they are not qualifying (or modifying) the audit opinion, rather they are modifying the audit report (an emphasis of matter paragraph alerts users to an issue relevant to the financial statements and cross-refers them to a disclosure in the financial statements – for example going concern).

An audit qualification can be one of three types:

- Qualified opinion
- Adverse opinion
- Disclaimer of opinion

It is important to ensure that the opinion expressed in the financial statements is not only correct, but also appropriate. In practice there are many situations which may present themselves where it might not be as clear cut as to what type of opinion should be expressed.

Closely interrelated to audit qualification is the term 'pervasive'. Paragraph 5 of ISA (UK and Ireland) 705 defines 'pervasive' as:

'A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.'

The following table illustrates a distinction between the types of opinion:

Opinion	Circumstances
Qualified opinion 'except for'	The misstatement giving rise to the opinion, or the lack of evidence, is material but is not pervasive.
Adverse opinion	Misstatements, both individually and collectively, are both material and pervasive.
Disclaimer of opinion	The possible effect of the lack of evidence is both material and pervasive to the extent that the auditor cannot form an opinion.

Qualified 'except for'

This type of opinion is to be expressed when the auditor disagrees with a type of accounting treatment and the treatment applied is material to the financial statements. In addition, the client may not have made adequate disclosure concerning an item which is material to the financial statements.

Example – Qualified opinion 'except for'

The auditor of North Ltd is undertaking the completion phase of the audit for the year-ended 31 March 2015. The company is involved in research and development and during the year has capitalised significant amounts of research expenditure on the balance sheet. The audit senior has discussed the appropriate accounting treatment permitted under SSAP 13 *Accounting for research and development* stating that SSAP 13 does not allow research expenditure to be capitalised; instead it must be written off as incurred. The finance director has refused to make any adjustments to the financial statements. There are no other misstatements that have been found during the course of the audit.

As the company has failed to comply with the requirements of SSAP 13 and has not written off research expenditure to the profit and loss account, the auditor disagrees with the accounting treatment applied and expresses a qualified opinion. The 'Basis for Qualified Opinion' paragraph will explain the reasons for the qualification, including quantitative amounts, and the 'Opinion' paragraph will state that 'except for' the effects of the matter described in the Basis for Opinion paragraph:

(a) the financial statements give a true and fair view; and

(b) have been prepared, in all material respects, in accordance with the applicable financial reporting framework.

Adverse opinion

Such opinions are fairly uncommon, but do arise occasionally. An adverse opinion is expressed by the auditor when they conclude that the financial statements do not give a true and fair view due to material misstatement. A misstatement can be material both individually and when aggregated with other misstatements and the auditor will express an adverse opinion when the effects of the misstatement(s) are both material and pervasive.

Example – Adverse opinion

During the audit of the financial statements of South Ltd for the year-ended 31 March 2015, it became apparent that the company had serious going concern problems. The bank have not renewed the borrowing facilities of the company for the forthcoming year to 30 June 2016 and various suppliers have withdrawn credit facilities and are suing the company for non-payment. The directors have not made any going concern disclosures within the financial statements on the grounds that they believe it may prejudice any potential lender's decision to refinance the company. In addition, the directors do not have any resources themselves to introduce into the company to help the company survive its financial difficulties and it is clear that the company will have to cease trading shortly.

The company has prepared the financial statements on the going concern basis and the auditors disagree that this basis is appropriate in light of the facts and evidence they have obtained during the audit.

As the auditor disagrees with an issue which is both material and pervasive (the going concern presumption), the auditor will express an adverse audit opinion. This also complies with the requirements of ISA (UK and Ireland) 570 *Going concern* at paragraph 21.

The 'Basis for Adverse Opinion' paragraph will outline the reasons why the auditor has expressed such an opinion and the 'Opinion' paragraph will explain that because of the significance of the matter described in the Basis for Adverse Opinion paragraph:

(a) the financial statements do not give a true and fair view; and

(b) have not been prepared, in all material respects, in accordance with the applicable financial reporting framework.

Disclaimer of opinion

Disclaimers are also extremely rare, but have been known to have been issued in certain situations. The auditor will express a disclaimer of opinion when the inability to obtain sufficient appropriate audit evidence is so material and pervasive that they simply cannot form an opinion as to whether the financial statements give a true and fair view.

Example – Disclaimer of opinion

East Ltd (East) has a year-end of 31 December 2014 and on 16 February 2014 appointed a new firm of auditors as relations with the old firm broke down. East manufactures household appliances for the retail industry and always has a material amount of stock and work in progress. No auditor attended the stock count which was held on 31 December 2014. In addition, during the year the company changed accounting systems and the old and the new system were not run in parallel. Unfortunately the new system contained significant errors and the opening balances had not been transferred correctly and whilst management have corrected many of the errors, there is still a major problem with the closing trade debtors which was still be resolved at the date the audit report was to be signed.

The auditor has not been able to determine whether any adjustments may have been necessary to the recorded/unrecorded stocks and cannot quantify the levels of errors to trade debtors. As a consequence they will express a disclaimer of opinion because the issues are so material and pervasive to the financial statements as such balances will affect the profit and loss account, balance sheet and cash flow statement.

The 'Basis of Disclaimer of Opinion' paragraph will explain that the auditor has not been able to obtain sufficient appropriate audit evidence on which to provide a basis for an audit opinion and the 'Opinion' paragraph will state that the auditor does not express an opinion on the financial statements.

Summary of opinions

ISA (UK and Ireland) 705 contains a useful table in the *Application and Other Explanatory Material* at paragraph A1 which outlines how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects (or possible effects) on the financial statements:

Nature of matter giving rise to the modification	**Auditor's judgment about the pervasiveness of the effects or possible effects on the financial statements**	
	Material but not pervasive	**Material and pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Emphasis of matter paragraphs

Emphasis of matter paragraphs are dealt with in ISA (UK and Ireland) 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*.

Over the years firms have been criticised for inappropriately using an emphasis of matter paragraph as a means of (incorrectly) qualifying the audit report or, conversely, not using an emphasis matter of paragraph at all when circumstances would indicate the need for one.

An emphasis of matter paragraph is not a modification to the audit opinion. The auditor uses an emphasis of matter paragraph when they consider it necessary to:

(a) draw users' attention to a matter(s) presented or disclosed in the financial statements which are of such importance that they are fundamental to users' understanding of the financial statements; or

(b) draw users' attention to any matter(s) other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

It follows, therefore, that an emphasis of matter paragraph is used to highlight something of importance that has been appropriately presented or disclosed in the financial statements and the paragraph itself should make it clear that it is not an audit qualification.

Example – Going concern

During the year to 31 December 2014, East Ltd had suffered from serious cash flow difficulties and reduced levels of sales and profits due to adverse publicity concerning one of its major products. In addition, a large customer went into liquidation and the company suffered a bad debt hit on its profit and loss account, the amount of which is material to the financial statements.

The directors have approached their bank with a request for a working capital loan in order to survive. The directors have produced detailed cash flow statements and forecasts which confirm that the company will return to profitability and stability if the loan is made as the company has just been awarded a large contract which is due to start in six months' time. At the date of approval of the financial statements the company had received confirmation from the bank that it would agree to the loan, provided the director-shareholders also introduced funds into the business and agree to provide personal guarantees, which they have.

Despite the bank agreeing to the loan, the directors still have a material uncertainty as to whether the company will survive for the foreseeable future because the contract which they have been awarded is initially 'cost-heavy' in the first couple of months and, in addition, it will also take some time to turn the business around. They have, therefore, made adequate disclosures in the notes to the financial statements about this material uncertainty.

As the directors have made adequate disclosures relating to going concern, the auditor can still express an unqualified audit opinion (provided there are, of course, no other material misstatements which remain uncorrected). However, the auditor will include an emphasis of matter paragraph in the audit report which will cross-refer to the going concern disclosure note in the financial statements as a means of drawing users' attention to the issue relating the material uncertainty about the entity's ability to continue as a going concern.

The use of an emphasis of matter paragraph in the auditor's report

When the auditor considers it necessary to include an emphasis of matter paragraph in the audit report, the auditor shall:

- Include it immediately after the Opinion on Financial Statements paragraph in the auditor's report.
- Use the heading 'Emphasis of Matter' or other appropriate heading.
- Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that full describe the matter can be found in the financial statements.
- Indicate that the auditor's opinion is not modified in respect of the matter emphasised.

Other matter paragraphs

The auditor may consider it necessary to communicate a matter, other than those which are presented or disclosed in the financial statements, which the auditor considers is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report. Where this is not prohibited by law or regulation, the auditor can do this through the use of an 'other matter' paragraph. This paragraph is included immediately after the Opinion paragraph and any emphasis of matter paragraph. Alternatively, the auditor can use an 'other matter' paragraph elsewhere in the auditor's report if the content of the other matter is relevant to the other reporting responsibilities section.

ISA (UK AND IRELAND) 500 *AUDIT EVIDENCE* *(LECTURE A510 – 12.26 MINUTES)*

The most crucial aspect to any audit is audit evidence. Audit evidence is the basis on which the audit engagement partner (senior statutory auditor) forms their opinion as to whether the financial statements give a true and fair view. It is also fair to say that a lack of audit evidence is one of the most frequently criticised areas of audit files during file reviews.

ISA (UK and Ireland) 500 *Audit evidence* deals with the auditor's responsibilities in obtaining audit evidence on which they will form their opinion. ISA (UK and Ireland) clearly outlines its objective at paragraph 4 which says:

'The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.'

The key phrase used in this objective is *'… sufficient appropriate audit evidence'*. 'Sufficiency' is the measure of the quantity of audit evidence, whereas 'appropriateness' is the measure of the quality of audit evidence; that is its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Audit evidence is cumulative in nature and is generated primarily through audit procedures undertaken during the audit (for example substantive procedures and tests of control). Audit evidence can be obtained from prior year audits, but when considering the appropriateness of this evidence, the auditor must determine whether changes have occurred since the previous audit which may affect its relevance to the current audit.

Procedures for obtaining audit evidence

Two of the UK and Ireland planning ISAs directly link into audit evidence; ISA (UK and Ireland) 315 *Identifying and assessing risks of material misstatement through understanding the entity and its environment* and ISA (UK and Ireland) 330 *The auditor's responses to assessed risks*. These two UK and Ireland ISAs say that audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(a) risk assessment procedures; and

(b) further audit procedures, which comprise:

  (i) tests of controls, when required by the ISAs (UK and Ireland) or when the auditor has chosen to do so; and

  (ii) substantive procedures, including tests of details and substantive analytical procedures.

Audit evidence corroborates management's assertions made in the financial statements and can also serve as contradicting such assertions. Audit evidence from external sources is the most reliable form of evidence – however such evidence is also the most time-consuming and costly to obtain and therefore the auditor will apply other procedures to generate audit evidence, including:

- Inspection
- Observation
- Confirmation
- Recalculation
- Reperformance
- Analytical procedures

'Inquiry' is also another audit procedure which can be used (and is often used) in obtaining audit evidence. However, the problem with this source of evidence is that it is the weakest form of evidence and the UK and Ireland ISA acknowledges that inquiry alone does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. As a result, inquiry should complement other forms of audit evidence.

Inspection

Inspection involves the examination of records or documents which can be both internal and external. In addition, inspection can also involve physically inspecting an asset for existence and any evidence of impairment.

Inspection tends to be the most commonly used procedure and involves substantiating amounts in the accounting records by reference to documentation. Revenue, for example, will be audited in part by agreement to related contracts and invoices, together with any proof of delivery of goods or services.

Example – Inspection

The financial statements of Company A Ltd show the addition of a large number of computers during the year amounting to £90,000 which is very material to the financial statements. The audit senior has emailed the purchase ledger clerk and asked for a copy of the invoice to be scanned and sent to the audit firm so that they can verify the rights and obligations assertion relating to this equipment.

The invoice from the supplier could have been altered by the purchase ledger clerk. The audit senior should have inspected the original document whilst carrying out the detailed audit work at the company's premises as ISA (UK and Ireland) 500 considers that original documents are more reliable than photocopies, scanned copies or copies transmitted by facsimile.

Observation

Observation involves looking at a process or procedure being performed by others. The most common observation test is the attendance at stock count. This type of procedure provides audit evidence concerning the performance of a process or procedure but does have inherent limitations. For example observation tests are of limited application because they are only valid at a point in time and in some situations there are no alternative procedures which can be carried out.

Example – Observation

The audit senior has attended the year-end stock count of a company and is observing a team of counters checking the quantities and pricing of stock. The counters are organised into teams of two, with one person counting and another person recording the quantities on the stock sheets.

While errors or omissions may not be made whilst the audit senior is in attendance at the stock count, the procedures adopted by management may not be followed in their entirety once the auditor has left the premises.

Confirmation

Confirmation in this context relates to external confirmations and represents audit evidence because it will ordinarily be a direct written response to the auditor from a third party. The most common type of external confirmation is a bank audit letter (or bank certificate). While in practice it is more common to obtain external confirmations which relate to certain account balances and their elements, external confirmations can also be obtained for non-account balances, such as confirming the terms of agreements or transactions which an entity has with third parties.

Example – Confirmation letter

As part of the normal audit process, the audit senior has undertaken a trade debtors circularisation to confirm the amounts owed by customers.

Trade receivables circularisations are a common audit procedure. However, they are limited in their reliability because while they may satisfy the existence assertion, they do not satisfy the valuation assertion (confirming a debt exists does not confirm that the debt will be recoverable) and hence other procedures will need to be adopted to confirm valuation, such as after-date cash testing.

Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records and this sort of procedure can be carried out manually or electronically.

Example – Recalculation

The accounting policy for the depreciation of assets of East Ltd (East) is to depreciate on a pro-rata basis only in the year of acquisition. East has a year-end of 31 March 2015 and on 1 July 2014 an item of machinery was purchased.

Recalculation will involve checking that the accounting policy in respect of depreciation has been correctly calculated by recalculating the depreciation charge on this asset based on 9/12 of a full year's depreciation charge. This type of test is also known as a 'proof in total' test or a 'reasonableness' test.

Reperformance

Reperformance involves the auditor independently undertaking a procedure which has previously been carried out by the client.

Example – Reperformance

The audit senior wants to confirm that the PAYE and NIC liabilities have been correctly paid over during the year and that the year-end liability is fairly stated. She decides to undertake a PAYE/NIC control account reperformance for the year-ended 31 December 2014.

Reperforming the PAYE/NIC control account for the year will help to identify any potential over- or under-payments of taxes during the year or at the year-end. It will also offer comfort to the auditor if her reperformance of the PAYE/NIC control account agrees to the year-end financial statements.

Analytical procedures

This involves the analysis of the relationships between amounts included within the financial statements, either within the same period, or between comparable amounts from different periods, or in some circumstances through available industry statistics. In carrying out substantive analytical procedures, the auditors will develop their own estimate of the figures they expect to see, compare this estimate with the actual outcome, obtain an explanation for any differences and then corroborate this explanation by reference to other audit evidence or other information available from the entity.

Example – Analytical procedures

The audit senior has undertaken an analytical review of West's profit and loss account. He has noticed that gross profit margins in 2014 were 40% and in 2013 were 55%.

The fluctuation in gross margins would need to be investigated by the audit senior to ensure they are, in fact, correct and no errors (such as cut-off errors) have been made. Ordinarily gross margins remain static from one period to the next and the variation in gross margins could indicate inappropriate revenue recognition policies or errors in stock valuations.

SUMMARY OF DEVELOPMENTS (LECTURE A506 – 4.29 MINUTES)

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

FRC reports on better compliance with UK Corporate Governance Code and need for improved adherence to the UK Stewardship Code

FRC to focus on company culture and behaviour

15 January 2015

Levels of compliance with the UK Corporate Governance Code have continued to increase. Reporting has become more transparent and informative, with audit committee reports and diversity reporting, particularly improved.

The Financial Reporting Council's (FRC) annual review of developments in Corporate Governance and Stewardship for 2014 has seen an increase in signatories to the Stewardship Code with signs of better engagement with large companies by investment managers. However, more needs to be done to ensure asset owners and managers follow-through on their commitment to the principles set out in the Code.

The report highlights the importance of good culture within organisations. Commenting on board culture, FRC Chairman Sir Win Bischoff said:

'The governance of individual companies depends crucially on the culture that is in place. The UK's strong governance culture encourages companies to list in London and provides assurance to investors. Unfortunately we still see examples of governance failings in this area. Boards have responsibility for shaping the culture, both within the boardroom and across the organisation as a whole. This requires constant vigilance.

Changing culture is not an easy task. Our recent guidance on risk management highlighted the need for boards to think hard about how they can better assess whether the culture practised within the company is the same as that which they espouse, particularly under pressure.

During 2015 the FRC will assess how effective boards are at establishing company culture and practices, and embedding good corporate behaviour, and will consider whether there is a need for promoting best practice. We will continue to address emerging governance issues while assessing the impact of recent Code changes.'

Other key messages from the report include:

Governance and reporting:

- Overall levels of compliance with the UK Corporate Governance Code continue to improve with full compliance by the FTSE 350 now at 61.2% and 93.5% complying with all but 1 or 2 provisions.
- There have been improvements in audit committee reports, with good examples of greater transparency and informative reporting. The Financial Reporting Lab 'Reporting of Audit Committees' has been helpful to companies in this matter.
- The UK is on course to reach Lord Davies target of 25% FTSE 100 female directors in 2015, with 22.8% of directorships now held by women. The percentage of female executive directors has started to rise having stagnated at 5-6% for many years.

- Improving the executive pipeline in connection with the wider diversity issue remains a priority. The FRC is currently undertaking a project to identify and spread best practice for high quality succession planning.

Stewardship and engagement:

- The UK Stewardship Code has almost 300 signatories; despite some increases in the quantity and quality of engagement, not all are following through on their stewardship responsibilities.
- There are some signs of improvement, with mandates increasingly referring to stewardship and reports of better proactive engagement by companies and investors over the 2014 AGM season.
- The FRC is concerned that signatories are not reporting effectively across the seven principles of the Code, with appropriate explanations a particular point of weakness, and are not keeping their statements against the Code up to date. Disclosures on conflicts of interest also continue to be of concern.
- Increasing levels of concern have been expressed by companies and investors about the role of proxy advisors, particularly in terms of a perceived lack of engagement with companies and a box-ticking approach by them and investors.

In 2015 the FRC will continue to focus on the issue of company culture and behaviours, as well as the application of the Stewardship Code and the role of proxy advisors.

FRC welcomes IAASB's revised international standards for auditor reporting

22 January 2015

The Financial Reporting Council (FRC) welcomes the International Auditing and Assurance Standards Board's (IAASB) revised standards on the form and content of auditors' reports. They respond to calls from users of audited financial statements for more informative and insightful reports.

The IAASB's revised standards, published on January 16th, include a new requirement for auditors of listed entities' financial statements to communicate 'Key Audit Maters' – those matters that the auditor views as most significant, with an explanation of how they were addressed in the audit. These changes are broadly consistent with the amendments to the FRC's auditing standards to introduce extended auditor reporting, in 2012 and 2013, which responded to the same calls for change and have been widely welcomed.

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

'The IAASB is to be congratulated on leading change to the international standards on auditor reporting. They represent the most significant changes to the auditor reporting model at international level for decades. They have the potential to enhance investor engagement about the audit and to provide a catalyst for audit innovation in the interest of investors and the public.

We hope they will be embraced enthusiastically by auditors and investors internationally, as our recent changes to audit reporting have been in the UK and Ireland. If so, they should herald in an era of greater transparency about the audit for investors in many of the world's largest capital markets.'

FRC publishes Financial Reporting Lab case study on accounting policies

5 February 2015

The Financial Reporting Council's (FRC) Financial Reporting Lab (Lab) has found that investors support fresh approaches to the disclosure of accounting policies.

Building on the Lab's recent report *'Accounting policies and integration of related financial information'*, the Lab has published a case study conducted among some of William Hill Plc's investors, retail shareholders and analysts. The study highlights the company's experimentation with accounting policy disclosure. The company's investors and analysts liked the clear identification of significant accounting policies, and effective disclosure of policy information in order to understand the business and its performance.

This is the first of a series of case studies being run by the Lab to support the FRC's Clear & Concise reporting initiative that promotes transparent and accessible reporting.

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

'Investors support companies improving their accounting policy disclosures and making clear which policies are significant in the context of the company's business. It is encouraging to see that William Hill has had the courage to do things differently. Companies should be encouraged by investor support for appropriate innovation and consider carefully how they might implement similar measures in their own reporting.'

A copy of the report can be downloaded from the FRC website: https://frc.org.uk/Lab/Reports.

FRC CEO comments on publication of the European Commission's Green Paper on Building a Capital Markets Union

18 February 2015

Commenting on the European Commission's Green Paper on Building a Capital Markets Union, Stephen Haddrill, CEO, Financial Reporting Council, said:

'The FRC welcomes today's publication of the European Commission's Green Paper on Building a Capital Markets Union, which opens the discussion on how European Capital Markets can be made more competitive.

In order to remain competitive the EU needs consistent, responsible markets that attract investment internationally. The FRC is pleased to see a focus on long-termism that we currently promote through the UK Stewardship Code and we look forward to working with the Commission on their considerations of the role of investors.

The paper also opens the debate around accounting standards for smaller listed entities, and areas of keen interest for the FRC.'

FRC consults on amendments to UK and Irish GAAP

19 February 2015

Following publication of the Government's decision on the UK implementation of the EU Accounting Directive the FRC has issued its proposals to amend UK and Irish accounting standards.

The proposals will benefit 1.5 million of the smallest companies ('micro-entities') in the UK by simplifying their reporting requirements. There will also be changes for the 1.5 million other companies that fall within the 'small' company size threshold, including improving accounting

for financial instruments and supporting the implementation of legislative changes. Listed groups will benefit from greater flexibility and greater efficiency in reporting formats.

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

'Our proposals support the implementation of the new Accounting Directive in the UK and the Republic of Ireland. They simplify reporting for some entities and are intended to assist the directors of small entities in applying their judgement to the new presentation and disclosure requirements of the Accounting Directive.

Overall we believe our proposals provide a consistent framework for reporting by all entities in the UK and Republic of Ireland, building on the legal framework and proportionately tailored to the size of the entity and users' information needs.'

Key aspects of the proposals include:

- The withdrawal of the FRSSE (Financial Reporting Standard for Smaller Entities) for accounting periods beginning on or after 1 January 2016;
- A new accounting standard for micro-entities offering some simplifications in accounting;
- New recognition and measurement requirements for other small companies aligned with new UK GAAP, and disclosure requirements based on the new legal framework;
- Greater flexibility in relation to the format of the profit and loss account and balance sheet in FRS 101, allowing the use of IFRS-based presentation requirements similar to those used for group accounts.

The proposals are intended to be effective for accounting periods beginning on or after 1 January 2016, with early application permitted for accounting periods beginning on or after 1 January 2015 and the final standards and amendments are expected to be issued in July 2015.

FRC amends FRS 102 relating to pension obligations

27 February 2015

The Financial Reporting Council (FRC) has today issued *Amendments to FRS 102 – Pension obligations* to clarify aspects of the accounting for defined benefit pension plans by UK and Irish entities.

The amendments enable sponsoring employers reporting under UK and Irish GAAP to continue with current practice in accounting for defined benefit pension schemes.

Specifically:

- no additional liability need be recognised for a 'schedule of contributions' that has been agreed in order to address a plan deficit when the deficit itself has already been recognised; and
- the effect of not recognising an irrecoverable surplus in a defined benefit pension plan is shown in other comprehensive income, rather than profit or loss.

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

'The FRC is pleased to be able to clarify for entities applying FRS 102 for the first time that a practical and proportionate reporting basis can be used.'

The amendments have the same effective date as FRS 102, and are applicable to accounting periods beginning on or after 1 January 2015.

FRC finds good take-up of new auditor reporting requirements

2 March 2015

Auditor reports more descriptive and innovative

Take-up of new requirements for extended auditors' reports has been positive; many auditors have made quite radical changes that go beyond the Financial Reporting Council's (FRC) new requirements, first announced in 2013. The requirements for auditors to describe assessed risks of material misstatement, materiality and the scope of the audit are beginning to make a process that had previously been described as a 'black box' by investors more transparent. In time we hope this will lead to improved justifiable confidence in audit.

The FRC has today released its survey *'Extended auditors' reports: A review of experience in the first year'* which confirms that auditors appear not only to have met the new requirements but in many cases to have gone further and reported more widely than required. The FRC considers the extent of innovation and the diversity of approaches adopted by different firms to be very encouraging.

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

'Confidence in UK audits underpins investor confidence in UK capital markets. The tone and tenor of this report is that the response of auditors to changes designed to improve confidence has been most encouraging. We wanted auditors to be more transparent and insightful in the way they report. The diversity of approaches adopted by different audit firms is to be embraced and we are excited to see how firms will continue to innovate and develop their ideas on how to report.

The UK has been one of the first countries to move away from boilerplate auditors' reports that were failing to communicate the auditor's work and insights. We are pleased to see that international standards are now moving in a similar direction.'

Significant innovation was found in the following areas:

- Disclosing the materiality benchmark used.
- Disclosing the magnitude of unadjusted differences being reported to the Audit Committee.
- Reporting of detailed audit findings with respect to identified risks.
- Experimentation with detailed broader explanation of the audit scoping process.
- Improved presentation of auditors' reports through the use of diagrams and graphs.
- Addressing going concern disclosures in auditors' reports.
- Locating the auditor's opinion at the beginning of the report rather than at the end.
- Moving generic descriptions of the scope of the audit to a website.

The survey also suggests areas where further changes might be made. These areas are:

- Increasing the entity specific risk reporting.
- Improving the discussion of the auditor's application of materiality and why a particular benchmark or level was chosen.
- Making a clearer linkage between the discussions of risk and materiality and the description of how these influenced the scope of the audit.

FRC publishes compendium of Audit and Assurance Standards and Guidance 2015

3 March 2015

The FRC has published its compendium of *Audit and Assurance Standards and Guidance 2015*.

The compendium includes the FRC's audit and assurance standards in issue at 1 February 2015, including:

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

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

The compendium includes the revised ISAs (UK and Ireland) that were issued in 2014:

260 Communication with those Charged with Governance

570 Going Concern

700 The Independent Auditor's Report on Financial Statements

These revised standards are effective for audits of financial statements for periods commencing on or after 1 October 2014. The previous versions of the standards are available from the publications section of the FRC website.

The compendium also includes Bulletin 4, *Recent Developments in Company Law, The Listing Rules and Auditing Standards that affect United Kingdom Auditors' Reports*, which was issued in April 2014.

Some minor editorial corrections have been made in the following standards:

ISQC (UK and Ireland) 1:

- Paragraph 12(o) – In the definition of 'professional standards', the references to the IAASB's Preface to its standards and to the FRC Statement on the scope and authority of its pronouncements have been corrected to reflect their current titles (the corresponding definition in the Glossary of Terms has also been corrected).

ISA (UK and Ireland) 260:

- Paragraph 16-1(f) – the word 'about' has been inserted at the start so that this subparagraph flows from the lead in;
- Appendix 1 – a reference to 'ISA (UK and Ireland) 610 (Revised June 2013), 'Using the Work of Internal Auditors' paragraphs 20 and 31 have been included in the summary list of other standards that refer to communication to those charged with governance.

ISA (UK and Ireland) 700

- Paragraph A13A – the cross-reference to paragraph 16A(a) has been corrected to paragraph 19A(a).

The above corrections have also been made in the standalone versions of the standards on the FRCs website.

The Glossary of Terms has also been updated to include the definition of 'direct assistance' from ISA (UK and Ireland) 610.

International audit regulators express concern over continued significant deficiencies in audits of public companies

4 March 2015

IFIAR calls for root cause analysis and responsive action by firms

The recurrence of high levels of deficiencies in key areas of public company audits around the world demonstrates the need for audit firms to pursue initiatives to improve audit quality and the consistency of audit execution, the International Forum of Independent Audit Regulators (IFIAR) reported today.

IFIAR's *2013 Survey of Inspection Findings* found the highest number of audit inspection deficiencies in the areas of fair value measurement, internal control, and revenue – topics among the core building blocks of audited financial statements. The rate of deficiencies in these audited areas, measured as the percentage of all inspected audits for these areas, also is high:

- Internal control testing, 24 percent
- Fair value measurement, 20 percent
- Revenue recognition, 14 percent

For audits of systematically important financial institutions, or SIFIs, including global banks and insurers, the survey found the highest number of deficiencies related to auditing of allowance for loan losses and loan impairments, internal control testing, and auditing the valuation of investments and securities.

'We continue to see high levels of inspection deficiencies in vital areas of public company audits. This is a problem for investors and stakeholders around the world,' said Lewis H Ferguson, IFIAR Chair and Board member of the US Public Accounting Oversight Board (PCAOB).

Report on 2014 Inspection Findings

IFIAR's Report on 2014 Inspection Findings Survey summarises key inspection results from audits of public companies, including systematically important financial institutions, submitted by 29 IFIAR members from around the world.

These results came from inspection reports issued during the members' most recent annual reporting periods that ended by July 2014.

- The areas with most deficiencies in inspected audits of listed public interest entities, or public companies, relate to auditing fair value measurements; internal control testing; and revenue recognition.
- The areas with the most deficiencies in audits of systematically important financial institutions, including global systematically important banks and insurers, relate to auditing of allowance for loan losses and loan impairments; internal control testing; and auditing of the valuation of investments and securities.
- Audit firms' own quality control systems had the highest number of inspection findings in the areas of engagement performance; independence and ethics requirements; and human resources.

Most of these findings are consistent with the results of IFIAR's prior surveys, although the survey does not provide an adequate basis for year-over-year trend analysis of the quality of audit performance.

Inspection findings related to audit engagements are deficiencies in audit procedures that indicate that the firm did not obtain sufficient appropriate audit evidence to support its opinion. Findings identify areas where the auditor's performance fell below the expected level of diligence to satisfy the public interest role the audit is meant to fulfil, and that the audit failed to provide the level of assurance about the financial statements that it purported to do and that is required by professional standards.

The 29 IFIAR member countries reporting 2014 inspection findings inspected 948 public company audits and found deficiencies in 47 percent. Seventeen IFIAR member countries reported 2014 inspection findings on audits of systematically important financial institutions. Those members inspected 148 financial institution audits, of which 41 percent had deficiencies.

IFIAR members also reported their impression as to whether audit quality in their jurisdictions had changed. Although it is encouraging that almost 30 percent of the respondents observed overall improvement, this is offset by almost half of the respondents noting no significant overall changes, and by mixed observations by other respondents. This underscores that further efforts are needed.

Consistency in execution of high quality audit is a priority of IFIAR members, as many audits today involve practitioners from network member firms in a number of countries. The audit of a multinational company may involve significant work performed by many, legally separate audit firms that operate as a network, often with a common name. Through IFIAR, audit regulators seek to coordinate their understanding and assessments of trends in and challenges to audit quality. Still, it is important to keep in mind that the level of deficiencies among individual regulators' jurisdictions can differ significantly.

The findings discussed in the survey are primarily from inspections of audit firms affiliated with the six largest international audit firm networks, which are BDO International Limited, Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Limited, KPMG International Cooperative and PricewaterhouseCoopers International Limited. IFIAR and its members will continue to discuss findings with the networks and the individual member firms in pursuit of audit regulators' mandates to improve audit quality.

In many cases, a regulator's response to an inspection finding is to require the audit firm to perform additional procedures necessary to complete the audit satisfactorily.

Root-Cause Analysis Needed

IFIAR's dialogue with the largest international audit firms has expanded all parties' awareness of the need for deeper understanding of the casual factors of the underlying challenges to audit quality. This requires root-cause analysis and responsive action.

'It is encouraging to see that root-cause analysis is high on the agenda, both in the discussions at the global level between IFIAR and the networks comprising the Global Public Policy Committee, and within individual jurisdictions. I hope that the effects of the analysis of casual factors and the measures taken by networks and member firms in response to those casual factors will increasingly become observable in future surveys,' said Janine Van Diggelen, IFIAR Vice Chair, and Head of the Audit and Reporting Quality Division at the Netherlands Authority for the Financial Markets (AFM).

IFIAR believes that enhancing the professional skepticism of practitioners contributes significantly to quality financial statement audits and should be a high priority for audit firms, given the recurrence of audit deficiencies.

IFIAR encourages audit firms to consider initiatives to improve audit quality and the consistency of audit execution across their national firms and international audit firm networks. This includes reviewing staffing structures to ensure that sufficient and appropriate expertise and experience is available for increasingly complex entities and audits that require significant judgments.

Knowledge Sharing to Improve Audit Quality

IFIAR's report is published as 163 inspectors from 43 of IFIAR's members meet in London for a three-day workshop. The annual IFIAR workshop is a platform for knowledge sharing and collaboration in pursuit of its members' shared objective of high quality audit performance.

The workshops give audit inspectors the opportunity to address recurring, common findings and themes identified by the survey. The workshops help to create awareness among participants of common issues, for consideration in IFIAR members' annual work programs and inspection approaches.

A fact sheet on the 2014 is also available.

The Pre-Emption Group publishes a revised Statement of Principles for disapplication of Pre-Emption Rights

12 March 2015

The Pre-Emption Group has today published a revised Statement of Principles for the disapplication of Pre-Emption Rights, providing guidance to companies and shareholders on the factors to take into account when considering whether to disapply pre-emption rights. The revisions clarify the scope of the Principles to take account of market changes and developments in best practice and provide greater transparency.

Robert Swannell, Chairman of the Pre-Emption Group, said:

'The revised Statement provides a framework for early and effective dialogue between a company and its shareholders. The Statement of Principles is just that – it's not a rule book. The Pre-Emption Group strongly supports this focus on engagement.'

Key amendments to the 2008 Statement of Principles include:

- Clarification of the scope of the Statement, making it clear that it applies to both UK and non-UK incorporated companies whose shares are admitted to the premium segment of the Official List of the UK Listing Authority. Companies whose shares are admitted to the standard segment of the Official List, to trading on AIM, or to the High Growth Segment of the London Stock Exchange's Main Market are encouraged to adopt the Statement.
- Clarification that the Statement applies to all issues of equity securities that are undertaken to raise cash for the issuer or its subsidiaries, irrespective of the legal form of the transaction, including, for example, 'cashbox' transactions.
- Flexibility to undertake non-pre-emptive issuance of equity securities in connection with acquisitions and specified capital investments, consistent with existing market practice.
- Greater transparency on the discount at which equity securities are issued non-pre-emptively.

No changes have been made to the key thresholds for general disapplication of pre-emption rights.

Members of the Pre-Emption Group represent listed companies, investors and intermediaries. The Statement of Principles is supported by the National Association of Pension Funds and The Investment Association as representatives of owners and investment managers.

The Group will monitor and issue a report on the use of the revised Statement of Principles.

The Pre-Emption Group encourages companies and investors to begin to use the revised Statement from now on, but acknowledges that as the 2015 AGM season is imminent some flexibility may be required.

Department for Business, Innovation and Skills issues 'Auditor regulation: supplementary information – the implications of the EU and wider reforms'

12 March 2015

On 12 March 2015 the Department for Business, Innovation and Skills published a Q&A about the auditor tendering and rotation framework on the webpage for its consultation: *Auditor regulation: discussion document on the implications of the EU and wider reforms.*

The purpose of this Q&A is to assist those preparing responses to the discussion document and/or preparing for the application of the requirements of the Regulation as from the application date on 17 June 2016.

You can find more information on the Department's Document at https://www.gov.uk/government/consultations/auditor-regulation-effects-of-the-eu-and-wider-reforms.

The Financial Reporting Council has issued its own consultation related to implementation of the EU Audit Directive and Regulation. You can find more information on this at:

https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/December/FRC-consults-on-EU-Audit-Directive-and-Regulation.aspx.

FRC issues new UK and Irish interim reporting requirements

19 March 2015

The Financial Reporting Council (FRC) has today issued revised interim reporting requirements (FRS 104 *Interim Financial Reporting*). FRS 104 is relevant for entities that apply UK and Irish GAAP and prepare interim financial reports. FRS 104 promotes the publication of informative and understandable interim financial reports and is consistent with the annual reporting requirements in new UK and Irish GAAP (FRS 102).

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

'Half-yearly reports can improve the ability of investors and creditors to understand and assess an entity's capacity to generate earnings and cash flows and its financial position and liquidity.

FRS 104 is based on IAS 34 'Interim Financial Reporting'. Using an IFRS-based standard is consistent with our approach to developing new UK and Irish GAAP.'

The Reporting Statement *'Preliminary announcements'* is also withdrawn today. The FRC will, however, evaluate whether it should develop new guidance on certain aspects of preliminary announcements.

FRS 104 is effective for interim periods beginning on or after 1 January 2015 with early application permitted.

FRC issues its Plan and Budget for 2015/2016

25 March 2015

The Financial Reporting Council (FRC) has today published its Plan and Budget for 2015/2016. The Plan confirms the FRCs mission, highlights progress on its three year strategy for 2013/16 and sets out its priorities for the coming year.

FRC CEO Stephen Haddrill, said:

'The coming year will see the completion of the three year strategy we embarked on in 2013. We have already seen major goals achieved. Auditor reporting has improved and adds greater value for investors.

Long termism has been stimulated by the introduction of the new viability statements, and the strengthening of the UK Corporate Governance Code's provisions on board pay. In the year ahead we will focus on company culture and board succession planning further to promote more forward thinking.

2015/16 will also be a year of change in the way we go about our work. The implementation of the EU Audit Directive and Regulation requires us to review our audit standards and will broaden the scope of our audit inspection work considerably. This comes on top of CMA requirements for an expansion of audit inspection. We are therefore undertaking a thorough review of how we undertake much of our conduct work to ensure we are fit for this new future.'

The FRC will focus on the following areas in 2015/16:

- Corporate governance – Focus on company culture and how to promote good practice and on company succession planning.
- Investor stewardship – Support better engagement between boards and shareholders and ensure that Stewardship Code signatories deliver on their commitments.
- Corporate reporting – Promote reports that are fair, balanced and understandable, and also clear and concise; and continue to help smaller listed and AIM companies with the quality of their reporting.
- Actuarial standards and regulation – Finalise the project to identify and respond to public interest actuarial risks and further work on technical actuarial standards.
- 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 – The FRC will consider the overall effectiveness of its work to review the quality of corporate reporting and auditing; and continue to enhance the pace and effectiveness of our independent disciplinary arrangements.

During 2015/16 the FRC will take on a number of additional responsibilities as a result of the Competition and Markets Authority (CMA) recommendations and the EU Audit Directive and Regulation. These will require the expansion of some FRC teams and widen the range of the work to monitor audit quality.

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.

Budget

The FRC's budget for core operating costs will increase by 6% to enable it to deliver its priorities and support the Department for Business, Innovation and Skills in preparing for the implementation of the new EU Audit Directive and Regulation. The amount raised through the preparers levy will increase by 6.1%. In response to stakeholder feedback on the Draft Plan & Budget the increase in the minimum levy will be limited to 3.2%. The levy payable by larger organisations will vary according to their market capitalisation (or, where applicable, turnover). The contribution from the accountancy professional bodies will increase by 2.5%.

The budget for audit quality reviews will increase by 12.5% in response to the Competition and Market Authority requirements.

FRC responds to IASB's exposure draft 'Disclosure Initiative – Proposed Amendments to IAS 7'

26 March 2015

The Financial Reporting Council (FRC) has responded to the IASB's exposure draft *'Disclosure Initiative – Proposed Amendments to IAS 7'*.

The FRC broadly supports the IASB's proposals for the introduction of disclosures around debt and equity. The exposure draft was issued in response to requests from investors for better information around net debt.

The FRC encourages the IASB to clarify that entities may build upon the disclosure requirements proposed in the ED to provide a net debt reconciliation. The FRC believes this flexibility will result in more meaningful and useful disclosures for investors.

New Charities audit thresholds & Regulations

The Charities Accounts and Audit Order 2015 was made on 19th February 2015 and applies in relation to any financial year of a charity ending on or after 31st March 2015. The Order increases the threshold for audit exemption from £500k to £1m. It should be noted that the effective date is different to that for the other changes to small company reporting and this change will affect some accounts prepared under the 2005 SORP.

There is no change to the thresholds applied in the combined income / asset test for audit exemption. These remain at £250k and £3.26m respectively.

The Charities Group Accounts Regulations 2015 were made on the same date and also apply to periods ending on or after 31 March 2015. These Regulations increase the income threshold above which group accounts are required from £500k to £1m to retain consistency with the audit threshold.

This Act does not apply in Scotland.