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FRC ISSUES NEW STANDARDS FOR SMALL AND MICRO-ENTITIES (LECTURE A511 – 26.04 MINUTES)/(LECTURE A512 – 17.58 MINUTES)

On 16 July 2015, the Financial Reporting Council (FRC) issued the final standards which will be applied by small and micro-entities in the UK and Republic of Ireland. This marked the end of several years of work by the FRC in developing a financial reporting framework which is based on international standards.

The new regime will apply to accounting periods commencing on or after 1 January 2016 and earlier adoption is permissible. However, if a small company or a micro-entity wishes to early-adopt the new regime it must adopt the new package of standards – in other words a company which is now small under the new framework cannot take advantage of early-adoption and use the FRSSE (effective January 2015) – it must apply the new rules.

The FRSSE (effective January 2015) will be withdrawn in its entirety for accounting periods commencing on or after 1 January 2016 and new UK GAAP will be structured as follows:

- EU-adopted IFRS
- FRS 100 *Application of Financial Reporting Requirements*
- FRS 101 *Reduced Disclosure Framework*
- FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*
- FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* with reduced disclosures
- FRS 103 *Insurance Contracts*
- FRS 104 *Interim Financial Reporting*
- FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*

Small companies' regime

The small companies' regime as we know it has now been split into two distinct parts:

- small companies; and
- micro-entities.

Small companies that currently report under the FRSSE (effective January 2015) will be moved under the scope of FRS 102. Some in the profession have questioned the need for withdrawing the FRSSE and have suggested that FRS 102 may not be suitable for small companies on the basis that it is a framework which is based on IFRS.

The FRC had originally planned to move all companies that do not apply the small companies' regime onto FRS 102 and this came into effect for such companies for accounting periods commencing on or after 1 January 2015. Small companies would continue to report under the FRSSE (effective January 2015) and the FRC suggested aligning the FRSSE with FRS 102 in the future.

The EU Accounting Directive (the Directive) was issued on 26 June 2013 and the UK was given until July 2015 in which to transpose the Directive into company law. This completed in January 2015 and the revised Companies Act 2006 became effective on 6 April 2015 and applies to accounting periods commencing on or after 1 January 2016 or to accounting periods commencing on or after 1 January 2015, but before 1 January 2016, if the directors so wish. An early-adoption clause was incorporated into the legislation as the government estimated that some 11,000 medium-sized businesses would fall to be classed as small under the revised small companies' regime and hence be able to take advantage of a less burdensome financial reporting regime.

It became apparent that the FRSSE in its current form would not be compatible with the revised legislation because it requires more disclosures in the financial statements than is permissible under the Companies Act 2006 following the transposition of the Directive.

Having considered the various possibilities, it became clear that the most sensible option would be to withdraw the FRSSE, move small companies under the scope of FRS 102 and have micro-entities report under a separate standard. A separate standard was deemed necessary for micro-entities because of the sheer reduction in disclosure requirements and the rigidity of the primary financial statements.

FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime

FRS 105 is based on FRS 102 because the Accounting Council of the FRC wants consistency across the financial reporting framework in the UK and Republic of Ireland. It is to be noted that at the time of writing these notes there was no equivalent legislation in the Republic of Ireland for micro-entities and hence a company which might fall to be classed as a micro-entity in the Republic of Ireland cannot use FRS 105 until the legislation is enacted.

FRS 105 has significantly simplified financial reporting for micro-entities and the Accounting Council acknowledged that it would not have gone as far as the Directive has gone in making these simplifications. Many of the disclosures that have traditionally been necessary to enable a true and fair view have been removed in FRS 105 because the EU Accounting Directive does not require certain disclosures to be made. In addition certain accounting options have been removed; for example a micro-entity cannot carry investment property at fair value; it must carry the property at cost less accumulated depreciation and accumulated impairment losses. This is one of the accounting treatments which the Accounting Council does not support as it views the revaluation model as being more appropriate to investment property as such a model provides more relevant and reliable information.

Key differences: FRSSE versus FRS 105

Some of the key differences between the FRSSE (effective January 2015) and FRS 105 are outlined in the following table:

FRSSE (effective January 2015)	FRS 105
The directors have a legal obligation to ensure the financial statements give a true and fair view and hence must make appropriate disclosures where necessary.	Financial statements prepared to the minimum legal requirements are presumed to give a true and fair view. The directors do not need to consider any additional disclosures needed for the financial statements to give a true and fair view.
A Format 1 or a Format 2 profit and loss account can be prepared.	Only a Format 2 profit and loss account is permitted, structured as follows: • Turnover • Other income • Cost of raw materials and consumables • Staff costs • Depreciation and other amounts written off assets • Other charges • Tax • Profit or loss

A statement of total recognised gains and losses is needed where amounts have been taken to equity.	No statement of total recognised gains and losses is required.
The balance sheet is disaggregated e.g. tangible fixed assets are split into various components (intangible, tangible and investment property).	No disaggregation of the balance sheet is permitted hence there will only be one line item showing 'Fixed assets'. Current assets are not split into the order of liquidity (stock, debtors, bank and cash); only one line item showing 'Current assets' is required.
More disclosures are needed for the financial statements to give a true and fair view.	Only disclosures in respect of advances, credit and guarantees granted to directors and financial commitments, guarantees and contingencies are disclosed at the **foot of the balance sheet**.
The FRSSE allows fair value accounting or amounts to be carried at revaluation.	No fair values or revaluation amounts are allowed under FRS 105. All previous fair values/revaluation amounts must be removed on transition and in the comparative year.
More accounting policies are allowed in the FRSSE (e.g. capitalisation of development costs and borrowing costs).	No accounting policy choices exist in FRS 105 and hence most transactions will be recognised in profit or loss rather than deferred in the balance sheet.
Company law requirements are reproduced in the FRSSE.	Not all company law requirements have been reproduced – only those which relate to the financial statements themselves have been reproduced.
Deferred tax is recognised using the timing difference approach.	Deferred tax is prohibited.
Equity-settled share-based payment transactions are disclosed in the notes.	No equity-settled share-based payment transactions are either accounted for or disclosed.

Issues to be considered where FRS 105 is concerned

The FRC are keen to emphasise that while FRS 105 is the least complex framework, accountants should consider the 'bigger picture' when advising a client as to which framework to apply in the preparation of their financial statements. While a micro-entity may qualify to use FRS 105, it might not necessarily be the most appropriate framework – particularly if the entity has borrowings, or is trying to obtain finance, because the disclosure requirements are significantly reduced.

Other factors to consider include:

- the eligibility criteria – for example a company whose financial statements are included in group accounts cannot apply the micro-entities regime; eligibility criteria is very restrictive;

- the scope for producing non-statutory information; for example if the client undergoes an enquiry from HMRC or the bank require more details about the financial statements;
- the pace of growth of the company; for example if the client is expected to grow at a rapid rate it might be more beneficial to choose a more comprehensive financial reporting framework; and
- the impact that the prohibition of fair values/revaluation amounts might have on the company's balance sheet and credit-rating.

Additional simplifications made in FRS 105

The micro-entities regime is intended to be deregulatory and in recognition of this, the Accounting Council have made additional simplifications as follows:

- Prohibition of the requirement for a micro-entity to account for deferred tax as the Accounting Council believes that this is a complex area of accounting and the lack of disclosures in a micro-entity's financial statements would make it impossible to distinguish between current and deferred tax.
- Prohibition of the requirement to account for equity-settled share-based payment transactions before the shares are issued. This was done because no fair values can be used under the micro-entities regime and there are no associated disclosure requirements.
- Contributions payable to a post-employment benefit plan are accounted for as an expense (this applies even if the plan is a defined benefit pension plan). However, a liability will be recognised by the micro-entity for a schedule of contributions to the extent that it relates to the deficit in the plan.
- The distinction between a micro-entity's 'functional currency' and 'presentation currency' is removed because the Accounting Council acknowledge that it is very rare for a micro-entity to have a different functional and presentational currency.
- A micro-entity can use contracted rates to translate foreign currency denominated assets and liabilities as opposed to spot rates. This will be easier for micro-entities if they enter into foreign currency transactions.
- All borrowing and development costs are to be written off as expenses in profit or loss as this is considered to be the simplest method.
- Government grants are to be accounted for using the accrual method. This is a revision from the previous Exposure Drafts which required the use of the performance method. The accrual method was a welcome change as it is considered to be the simplest method and is well-known.
- Simpler requirements for financial instruments in allocating the interest and transaction costs. There is no requirement to use the 'effective interest method' under FRS 105 as this is considered to be too onerous for a micro-entity.
- Removal of the requirement to impute a market-rate of interest where the micro-entity enters into lending arrangements at non-market rates. It was concluded that the costs of imputing market-rates of interest would outweigh the benefits.
- Simplifications for classifying financial instruments as debt or equity because micro-entities will issue simple equity instruments.

- Prohibition of the requirement to separately identify intangible assets in a trade and asset acquisition as these are not required items in the format of micro-entities' financial statements.
- No requirement to account for hyperinflation as this is unlikely to be an issue for micro-entities.
- Removal of accounting requirements for specialised activities (such as extractive industries, service concessions, heritage assets and funding commitments). This is because micro-entities will not typically enter into such transactions.

Removal of fair values/revaluations on transition to FRS 105

One of the most significant changes which FRS 105 brings is the prohibition to recognise items at fair value or at revaluation. This is because the legislation does not recognise any of the alternative accounting rules or fair value accounting rules. Instead, the regime requires micro-entities to apply the historical cost accounting rules and hence fixed assets are recognised at cost less accumulated depreciation and any accumulated impairment losses. 'Cost' will be the purchase price or production cost.

Example – Investment property at fair value on transition

Microco Ltd has a year-end of 31 December 2016 and has previously reported under the FRSSE. It has an investment property on its balance sheet which was carried at open market value in accordance with paragraph 6.51 of the FRSSE (effective January 2015).

The company has decided to use FRS 105 as its financial reporting framework because it believes this is the most suitable standard in the company's circumstances. The financial controller has undertaken the transition and decided to use the valuation obtained as at 31 December 2015 as deemed cost going forward.

It is not possible to use a previous valuation for investment property as deemed cost because this would be inconsistent with the legal framework. Instead there is a transitional exemption contained in Section 28 *Transition to this FRS* which can be applied (see below).

The rules in FRS 105 are retrospective (as is the case with FRS 102). This is to ensure that consistency and comparability are achieved and hence the financial statements of a micro-entity are restated as far back as the date of transition. The 'date of transition' is the start date of the comparative period; therefore assuming a 31 December 2016 year-end, FRS 105 will be applied as at 1 January 2015 as this is the start date of the comparative period reported in the accounts. This is to ensure that the financial statements reflect the requirements of FRS 105 as if FRS 105 had always been the financial reporting framework.

In respect of investment property, a transitional provision is included in FRS 105 at paragraph 28.10(c) which says:

*'A first-time adopter is not required to retrospectively apply paragraph 12.15 to determine the depreciated cost of each of the major components of an **investment property** at the date of transition to this FRS. If this exemption is applied, a first-time adopter shall:*

*(i) Determine the total cost of the investment property including all of its components. Where no **depreciation** had been charged under the micro-entity's previous financial reporting framework, this can be calculated by reversing any revaluation **gains** or losses previously recorded in equity reserves.*

(ii) The cost of land, if any, shall be separated from buildings.

(iii) Estimate the total depreciated cost of the investment property (excluding land) at the date of transition to this FRS, by recognising accumulated depreciation since the date of initial acquisition calculated on the basis of the ***useful life*** *of the most significant component of the item of investment property (eg the main structural elements of the building).*

(iv) A portion of the estimated total depreciated cost calculated in paragraph (iii) shall then be allocated to each of the other major components (i.e. excluding the most significant component identified above) to determine their depreciated cost. The allocation should be made on a reasonable and consistent basis. For example, a possible basis of allocation is to multiply the current cost to replace the component by the ratio of its remaining useful life to the expected useful life of a replacement component.

(v) Any amount of the total depreciated cost not allocated under paragraph (iv) shall be allocated to the most significant component of the investment property.'

Example – Investment property on transition

Microco Ltd has an investment property on its balance sheet as at 1 January 2015 (the date of transition) with a carrying amount of £150,000 and an associated revaluation surplus of £25,000. Microco previously applied the provisions in the FRSSE (effective January 2015) at paragraph 6.51 and carried the investment property at open market value. The investment property was purchased on 1 January 2011 and the financial controller is unsure as to how to get the investment property back to historical cost for the purposes of transitioning to FRS 105. The value of the land is £30,000.

For the purpose of FRS 105, the financial controller can apply the transitional provision in paragraph 28.10(c)(i) to arrive at a cost for FRS 105 at the date of transition. The revaluation surplus of £25,000 can be reversed against the cost of the investment property and hence at the date of transition the investment property will have a cost of £125,000 (£150,000 less £25,000).

Once a cost has been established for the purpose of FRS 105, the value of any land is taken into consideration and accounted for separately (as land does not generally depreciate).

Example – Calculating depreciation at transition

The financial controller has removed the previous revaluation amounts in respect of investment property to arrive at a cost price of £125,000. The depreciation policy in respect of investment property will be the same as for its owned building (i.e. 2% on a straight-line basis). The depreciation charge at the date of transition is calculated as follows:

Date of purchase:	1 January 2011	
Depreciable amount:	Total land and buildings	£125,000
	Less land element	(£30,000)
	Depreciable amount	£95,000

Depreciation to the date of transition = £95,000 x 2% x 4 years = £7,600

A transitional adjustment will be made as at 1 January 2015 as follows:

DR accumulated profit and loss	£7,600
CR accumulated depreciation (investment property)	£7,600

Being four years depreciation from the date of acquisition to the date of transition

At transition, the investment property has a total depreciated cost of £87,400 (£95,000 less £7,600). This depreciated cost then needs to be allocated to each of the other major components (i.e. excluding the most significant component) to determine their depreciated cost.

Example – Component accounting

Continuing with the above example the financial controller has been informed that the central heating system in the investment property will need replacing in three years' time from the date of transition to FRS 105. The current cost to replace the central heating system is £12,000.

The central heating system has a considerably shorter life than the main structure of the investment property and hence should be depreciated over a three-year period from 1 January 2015 (i.e. separately from the rest of the property). Therefore the depreciation charge in the 2015 comparative year will be calculated as follows:

	Investment Property	Central Heating	Total
	£	£	£
Depreciable amount	75,400	12,000	87,400
Depreciation charge	1,508*	4,000**	5,508

*£75,400 x 2% = £1,508
**£12,000 / 3 years = £4,000

The micro-entities' regime is optional and if a micro-entity wishes to continue measuring investment property (or other assets) at fair value, then it will need to report under FRS 102 with reduced disclosures as a minimum.

Structure of FRS 105

While FRS 105 is based on FRS 102 requirements, there is some inconsistency in the way that each section has been structured. This is because some of the requirements of FRS 102 are not applicable to micro-entities as can be seen in the following table:

Section	FRS 105	FRS 102
1	Scope	Scope
2	Concepts and Pervasive Principles	Concepts and Pervasive Principles
3	Financial Statement Presentation	Financial Statement Presentation
4	Statement of Financial Position	Statement of Financial Position
5	Income Statement	Statement of Comprehensive Income and Income Statement
6	Notes to the Financial Statements	Statement of Changes in Equity and Statement of Income and Retained Earnings
7	Subsidiaries, Associates, Jointly Controlled Entities and intermediate Payment Arrangements	Statement of Cash Flows

8	Accounting Policies, Estimates and Errors	Notes to the Financial Statements
9	Financial Instruments	Consolidated and Separate Financial Statements
10	Inventories	Accounting Policies, Estimates and Errors
11	Investments in Joint Ventures	Basic Financial Instruments
12	Property, Plant and Equipment and Investment Property	Other Financial Instruments Issues
13	Intangible Assets other than Goodwill	Inventories
14	Business Combinations and Goodwill	Investments in Associates
15	Leases	Investments in Joint Ventures
16	Provisions and Contingencies	Investment Property
17	Liabilities and Equity	Property, Plant and Equipment
18	Revenue	Intangible Assets other than Goodwill
19	Government Grants	Business Combinations and Goodwill
20	Borrowing Costs	Leases
21	Share-based Payment	Provisions and Contingencies
22	Impairment of Assets	Liabilities and Equity
23	Employee Benefits	Revenue
24	Income Tax	Government Grants
25	Foreign Currency Translation	Borrowing Costs
26	Events after the End of the Reporting Period	Share-based Payment
27	Specialised Activities	Impairment of Assets
28	Transition to this FRS	Employee Benefits
29	N/A	Income Tax
30	N/A	Foreign Currency Translation
31	N/A	Hyperinflation
32	N/A	Events after the End of the Reporting

		Period
33	N/A	Related Party Disclosures
34	N/A	Specialised Activities
35	N/A	Transition to this FRS

An important aspect where FRS 105 is concerned is that it should be as easily accessible and understandable as possible in view of its target audience. The version of FRS 105 which was released as an Exposure Draft was quite cumbersome as a document because it included section and paragraph numbering which mirrored that of FRS 102. The problem with this approach was that FRS 105 included sections which simply said 'not used' and paragraph number which also said 'not used'. In light of the feedback received, the FRC decided that FRS 105 should maintain the language and terminology used in FRS 102, but use its own structure (i.e. section and paragraph numbering).

Disclosure requirements for micro-entities

The disclosure requirements under FRS 105 are contained in Section 6 *Notes to the Financial Statements*. Section 6 also includes a useful Appendix which outlines the company law disclosure requirements which should be referred to when completing the micro-entity's financial statements to ensure the disclosure requirements are complete. This is because other areas of company law require disclosure to be made and hence the Appendix aims to be a 'catch all' where these disclosures are required.

Paragraph 6.2 says that the notes are to be presented at the **foot of the balance sheet** – they are not contained in a separate section of the financial statements as is the case currently in the FRSSE (effective January 2015). The following are disclosed at the foot of the balance sheet:

(a) advances, credit and guarantees granted to directors as required by section 413 of the Act (see paragraph 6A.1 in the Appendix to Section 6);

(b) financial commitments, guarantees and contingencies as required by regulation 5A of, and paragraph 57 of Part 3 of Schedule 1 to, the **Small Companies Regulations** (see paragraphs 6A.2 and 6A.3 in the Appendix to Section 6).

FRS 102 for small companies

The Department for Business, Innovation and Skills (BIS) completed the transposition of the EU Accounting Directive into company law earlier this year and they took advantage of the maximum thresholds available in the Directive. In recognition of this, the turnover and balance sheet totals for a small company have been significantly increased from £6.5m and £3.26m respectively to £10.2m and £5.1m respectively. According to BIS this will result in an addition 11,000 medium-sized businesses being eligible to be re-classified as small and hence take advantage of the new small companies' disclosure regime.

In contrast to FRS 105, the disclosure requirements for a small company under FRS 102 are more onerous, which is understandable as the accounting methodologies and disclosure requirements increase in complexity the further up the suite of standards you go.

The presentation and disclosure requirements for small companies under FRS 102 are contained in a separate section, being that of Section 1A *Small Entities*. This was the case when the standard was released as an Exposure Draft, but the FRC have significantly overhauled Section 1A following feedback.

An important concept to emphasise is that while the presentation and disclosure requirements are contained in a separate section of FRS 102, the **full recognition and measurement** principles apply across the board. For example, if a company has an investment property carried at fair value through profit or loss, it must apply the full recognition and measurement principles in Section 16 *Investment Property* but make the disclosures in respect of this property in accordance with Section 1A.

The revised Companies Act 2006 restricts the specific disclosures which are required of a small company. However, the FRC are keen to emphasise that the directors of a small company still have a legal obligation to ensure that the financial statements give a true and fair view. To that end, the directors must make additional disclosures where these will enable the financial statements to give a true and fair view.

Unincorporated entities and LLPs

Eligibility for applying the small companies' regime is outlined in the Companies Act 2006. Section 1A of FRS 102 can be used by all companies who are eligible to apply the small companies' regime and LLPs which are eligible for the small LLPs regime. Other entities that would have met the criteria for the small companies' regime had they been companies can also follow the principles in FRS 102.

Important point regarding LLPs

At the time of writing these notes, there are different thresholds which apply to the small LLPs regime than the small companies' regime as the LLP Regulations have not yet been updated and BIS has not indicated any intention to update these Regulations in the foreseeable future. Therefore entities which are not companies that choose to apply FRS 102 Section 1A will need to ensure that they are eligible to do so in light of any Regulations which they may be governed by. FRS 102 (or FRS 105) does not prevail over the requirements of legislation.

Section 1A of FRS 102

Section 1A *Small Entities* outlines the presentation and disclosure requirements which a small entity is required to make in its financial statements. As mentioned earlier in these notes, the FRC have significantly redrafted the way that Section 1A is structured from what was seen in the Exposure Drafts. The result of this redrafting is a more concise section and the disclosure requirements are split into two appendices as follows:

- Appendix C *Disclosure requirements for small entities*
- Appendix D *Additional disclosures encouraged for small entities*

The structure of Section 1A is as follows:

- Scope of Section 1A
- True and fair view
- Complete set of financial statements of a small entity
- Information to be presented in the statement of financial position (balance sheet)
- Information to be presented in the income statement (profit and loss account)
- Information to be presented in the notes to the financial statements
- Voluntary preparation of consolidated financial statements

Scope of Section 1A

Section 1A can be applied by all companies that are eligible to apply the small companies' regime except a small company which chooses to apply EU-adopted (IFRS), or if eligible, FRS 101 *Reduced Disclosure Framework*. Where a small company chooses not to apply the small entities regime, it must apply FRS 102 in full (i.e. excluding Section 1A).

Section 1A applies to all small entities which apply the small entities regime, whether or not they applying the provisions in the Companies Act 2006. Small entities which do not apply the provisions in the Companies Act 2006 must comply with Section 1A and with the Small Companies Regulations (or, where applicable, the Small LLP Regulations) where Section 1A refers to such, except to the extent that these requirements are not permitted by any statutory framework under which such entities report.

True and fair view

Directors of small companies have a legal obligation to ensure the financial statements they prepare give a true and fair view of the assets, liabilities, financial position and profit or loss for the reporting period. This requirement is incorporated into the Companies Act 2006 at Section 393.

In recognition of the legal obligations for the financial statements to give a true and fair view, paragraph 1A.6 acknowledges that a small company may need to provide disclosures over and above those required by Section 1A.

Complete set of financial statements of a small entity

A complete set of financial statements for a small entity is outlined in paragraph 1A.8 which says that the financial statements must include all of the following:

(a) a **statement of financial position** as at the **reporting date** in accordance with paragraph 1A.12;

(b) an **income statement** for the reporting period in accordance with paragraph 1A.14; and

(c) **notes** in accordance with paragraphs 1A.16 to 1A.20.

Where the small entity recognises gains or losses in other comprehensive income (for example a revaluation gain on freehold property), it is encouraged to present a statement of total comprehensive income.

Where the small entity enters into transactions with its shareholders it is encouraged to present a statement of changes in equity, or a statement of income and retained earnings. A statement of income or retained earnings is presented in place of a statement of changes in equity if the only changes to its equity during the period arise from profit or loss, payment of dividends, corrections of prior period material errors and changes in accounting policy.

Comparative information must also be shown in the financial statements for all amounts presented, except where FRS 102 permits, or requires, otherwise.

FRS 102 uses terminology which is consistent with that of IFRS (for example 'statement of financial position' rather than 'balance sheet'). Paragraph 1A.11 allows a small entity to use alternative titles for the financial statements as long as they are not misleading. As the names of the financial statements are derived from company law, it is likely that we will still continue to refer to balance sheets and profit and loss accounts.

Information to be presented in the statement of financial position

A small entity must present a statement of financial position (balance sheet) in accordance with the requirements of Part 1 *General Rules and Formats* of Schedule 1 to the Small Companies Regulations or Part 1 *General Rules and Formats* of Schedule 1 to the Small LLP Regulations.

Information to be presented in the income statement

A small entity is required to present a profit and loss account in the form of an income statement in accordance with the requirements for a profit and loss account set out in either Part 1 *General Rules and Formats* of Schedule 1 to the Small Companies Regulations or Part 1 *General Rules and Formats* of Schedule 1 to the Small LLP Regulations.

Information to be presented in the notes to the financial statements

Sufficient information must be disclosed in the notes to the financial statements to achieve a true and fair view. In contrast to FRS 105, there are no 'deeming provisions' in the Companies Act 2006 applicable to small companies. A small entity is not required to comply with the disclosure requirements in Section 3 of FRS 102 *Financial Statement Presentation* (to the extent set out in paragraph 1A.7), nor does a small entity have to comply with the disclosure requirements in Sections 8 to 35 of FRS 102.

In order to enable the financial statements to give a true and fair view, directors are required to consider and provide any of the disclosures in Sections 3, 8 and 35 of FRS 102 where they are relevant to material transactions, other events or conditions of the small entity. Specific disclosures are not required where the information is immaterial.

As a minimum, however, the relevant disclosures contained in Appendix C of Section 1A must be made. The disclosures contained in Appendix D of Section 1A are encouraged. Notwithstanding the term 'encouraged' being included in Appendix D, the disclosure requirements may nevertheless be necessary so that the financial statements give a true and fair view.

Voluntary preparation of consolidated financial statements

To address a point raised by some respondents during the comment period on the Exposure Drafts of Section 1A, the Accounting Council have addressed the situation where a small entity voluntarily chooses to prepare consolidated financial statements. Small groups can choose to apply the exemption in the Companies Act 2006 from preparing group accounts and whilst the majority of small groups choose not to prepare consolidated financial statements, some small groups choose to voluntarily prepare group accounts.

Where the small group chooses to voluntarily prepare consolidated financial statements it:

(a) shall apply the consolidated procedures set out in Section 9 *Consolidated and Separate Financial Statements*;

(b) is encouraged to provide the disclosures set out in paragraph 9.23;

(c) shall comply so far as practicable with the requirements of Section 1A as if it were a single entity (Schedule 6 of the Small Companies Regulations, paragraph 1(1)), subject to any restrictions or exemptions set out in legislation; and

(d) shall provide any disclosures required by Schedule 6 of the Small Companies Regulations.

Abridged and adapted balance sheets

The revised Companies Act 2006 introduced the concept of 'abridged' and 'adapted' balance sheets and profit and loss accounts (abridged and adapted profit and loss accounts are examined in the next section of these notes). Abridged balance sheets (and profit and loss accounts) can be prepared by the company provided that **all the members unanimously agree to the abridgement**. In addition, abridged financial statements can only be prepared in respect of the preceding financial year and hence the consent by all members must be an annual process (one resolution to prepare abridged financial statements cannot be for subsequent accounting periods).

The concept of abbreviated financial statements has been abolished in the revised Companies Act 2006 and essentially the company will file what they prepare for the members. Section 444(1) of the Companies Act 2006 says:

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

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

(b) may also deliver to the registrar—

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

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

Therefore this is taken to mean that the small company can file the accounts as they prepare for the shareholders; or alternatively they can file just the balance sheet and the notes to the balance sheet (i.e. without filing the profit and loss account and directors' report).

Abridged financial statements allow less analysis to be made for the balance sheet. However, paragraph 1AA.2 of FRS 102 requires the directors to consider the requirements of paragraph 1A.16 (disaggregation of the balance sheet) and provide additional disclosures which are considered necessary to give a true and fair view.

Adapted balance sheet

The term 'adapted' means that one of the statutory formats used in the preparation of the company's balance sheet has been adapted accordingly. This could happen, for example, when the small company's financial statements are being consolidated with a parent which reports under EU-adopted IFRS. Flexibility was introduced in adapting the statutory formats of the financial statements to allow for less complex consolidations.

Where the small company adapts one of the balance sheet formats, it must, as a minimum, include line items which present the following, distinguishing between those items which are current and those which are long-term (non-current). Note – emboldened words mean the term is defined in the Glossary to FRS 102.

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

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

(c) **intangible assets**;

(d) **financial assets** (excluding amounts shown under (e), (f), (j) and (k));

(e) investments in **associates**;

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

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

(h) biological assets carried at fair value through profit or loss;

(i) **inventories**;

(j) trade and other receivables;

(k) **cash** and **cash equivalents**;

(l) trade and other payables;

(m) **provisions**;

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

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

(p) **deferred tax liabilities** and **deferred tax assets** (classified as non-current);

(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.

In addition to the above, paragraph 1AA.4 requires the following sub-classifications of the line items to be disclosed separately (either on the face of the balance sheet or in the notes):

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

(b) **goodwill** and other intangible assets;

(c) investments, showing separately shares and loans;

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

(e) trade and other payables, showing separately amounts payable to trade suppliers and amounts payable to related parties; and

(f) classes of equity, such as called up share capital, share premium, retained earnings, revaluation reserve, fair value reserve and other reserves.

Abridged and adapted profit and loss accounts

An abridged profit and loss account can be prepared whereby turnover and cost of sales are combined and hence the profit and loss account will start with gross profit. As with the abridged balance sheet, all members must unanimously agree to the abridgement and this agreement must be annual process.

Abridged profit and loss accounts must still give a true and fair view and to that end, the entity must also consider the requirements of paragraph 1A.16 of FRS 102 and provide additional disclosures which it considers are necessary in the notes to the financial statements. A typical example of an additional note the small company directors should consider including is in relation to disaggregating gross profit or loss and disclosing turnover.

Important point relating to abridged financial statements

Section 444 (2A) of the Companies Act 2006 says:

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

Adapted profit and loss accounts

Where one of the profit and loss account formats have been adapted, the company must, as a minimum, include line items which present the following amounts for the period:

(a) **revenue**;

(b) finance costs;

(c) share 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) profit or loss before taxation;

(e) **tax expense** excluding tax allocated to other comprehensive income or equity; and

(f) profit or loss.

Disclosure requirements for small companies

The disclosure requirements for small companies are found in Appendix C and Appendix D to Section 1A. Appendix C outlines the disclosure requirements for small entities required by law, and Appendix D outlines those disclosure requirements which are encouraged.

The notes to the financial statements must be presented in the order in which, where relevant, the items to which they relate are presented in the balance sheet and profit and loss account.

Appendix C requires the following to be disclosed:

Accounting policies

1AC.3 The accounting policies adopted by the small entity in determining the amounts to be included in respect of items shown in the statement of financial position and in determining the profit or loss of the small entity must be stated (including such policies with respect to the depreciation and impairment of assets). (Schedule 1, paragraph 44).

Paragraph 8.5 addresses similar requirements. Including information about the judgements made in applying the small entity's accounting policies, as set out in paragraph 8.6, may be useful to users of the small entity's financial statements.

1AC.4 If any amount is included in a small entity's statement of financial position in respect of development costs, the note on accounting policies must include the following information:

(a) the period over which the amount of those costs originally capitalised is being or is to be written off; and

(b) the reasons for capitalising the development costs in question. (Schedule 1 paragraph 21(2)).

Paragraph 18.27(a) addresses similar requirements to paragraph 1AC.4(a).

1AC.5 Where development costs are shown or included as an asset in the small entity's financial statements and the amount is not treated as a realised loss because there are special circumstances justifying this, a note to the financial statements must state the reasons for showing development costs as an asset and that it is not a realised loss. (Section 844 of the Act).

1AC.6 Where in exceptional cases the useful life of intangible assets cannot be reliably estimated, there must be disclosed in a note to the financial statements the period over which those intangible assets are being written off and the reasons for choosing that period. (Schedule 1, paragraph 22(4)).

Intangible assets include goodwill. Paragraph 18.27(a) and 19.25(g) address similar requirements.

Changes in presentation and accounting policies and corrections of prior period errors

1AC.7 Where there is a change in the presentation of a small entity's statement of financial position or income statement, particulars of any such change must be given in a note to the financial statements in which the new presentation is first used, and the reasons for the change must be explained. (Schedule 1, paragraph 2(2)).

Paragraphs 3.12 and 3.13 address similar requirements.

1AC.8 Where the corresponding amount for the immediately preceding financial year is not comparable with the amount to be shown for the item in question in respect of the reporting period, and the corresponding amount is adjusted, the particulars of the non-comparability and of any adjustment must be disclosed in a note to the financial statements. (Schedule 1, paragraph 7(2)).

This is likely to be relevant where there has either been a change in accounting policy or the correction of a material prior period error. Paragraphs 10.13, 10.14 and 10.23 address similar requirements.

1AC.9 Where any amount relating to a preceding reporting period is included in any item in the income statement, the effect must be stated. (Schedule 1, paragraph 61(1)).

True and fair override

1AC.10 If it appears to the small entity that there are special reasons for departing from any of the principles set out in company law in preparing the small entity's financial statements in respect of any reporting period, it may do so, in which case particulars of the departure, the reasons for it, and its effects must be given in the notes to the financial statements. (Schedule 1, paragraph 10(2)).

This is only expected to occur in special circumstances. Paragraphs 3.4 and 3.5 address similar requirements.

Notes supporting the statement of financial position

1AC.11 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 must be disclosed either under those items or in the notes to the financial statements. (Schedule 1, paragraph 9A).

Fixed assets

1AC.12 In respect of each item which is shown under the general item 'fixed assets' in the small entity's statement of financial position the following information must be given:

(a) the aggregate amounts (on the basis of cost or revaluation) in respect of that item as at the date of the beginning of the reporting period and as at the reporting date respectively;

(b) the effect on any amount shown in the statement of financial position in respect of the item of:

(i) any revision of the amount in respect of any assets included under that item made during the reporting period as a result of revaluation;

(ii) acquisitions during the reporting period of any assets;

(iii) disposals during the reporting period of any assets; and

(iv) any transfers of assets of the small entity to and from that item during the reporting period. (Schedule 1, paragraphs 48(1) and 48(2)).

1AC.13 In respect of each item within paragraph 1AC.12 there must also be stated:

(a) the cumulative amount of provisions for depreciation and impairment of assets included under that item as at the date of the beginning of the reporting period and as at the reporting date respectively;

(b) the amount of any such provisions made in respect of the reporting period;

(c) the amount of any adjustments made in respect of any such provisions during the reporting period in consequence of the disposal of any assets; and

(d) the amount of any other adjustments made in respect of any such provisions during the reporting period. (Schedule 1, paragraph 48(3)).

These two paragraphs apply to all fixed assets, including investment property, property, plant and equipment, intangible assets (including goodwill), fixed asset investments, biological assets and heritage assets recognised in the statement of financial position.

Each item refers to a class of fixed assets shown separately either in the statement of financial position, or in the notes to the financial statements.

These reconciliations need not be presented for prior periods.

Paragraph 16.10(e) addresses similar requirements for investment property. Paragraphs 17.31(d) and (e) address similar requirements for property, plant and equipment. Paragraph 18.27(c) and (e) address similar requirements for intangible assets other than goodwill. Paragraph 19.26 addresses similar requirements for goodwill. Paragraphs 34.7(c) and 34.10(e) address similar requirements for biological assets. Paragraph 34.55(e) and (f) address similar requirements for heritage assets recognised in the statement of financial position.

Fixed assets measured at revalued amounts

1AC.14 When fixed assets are measured at revalued amounts the items affected and the basis of valuation adopted in determining the amounts of the assets in question in the case of each such item must be disclosed in the note on accounting policies. (Schedule 1, paragraph 34(2)).

These requirements apply when:

- investments in subsidiaries, associates and joint ventures are measured at fair value with changes in fair value recognised in other comprehensive income. Paragraph 9.27(b) addresses a similar disclosure requirement;
- property, plant and equipment are revalued using the revaluation model set out in paragraphs 17.15B to 17.15F. Paragraph 17.31(a) addresses a similar disclosure requirement; and

- intangible assets other than goodwill are revalued using the revaluation model set out in paragraphs 18.18B and 18.18H.

These requirements do not apply to investment property and biological assets measured at fair value through profit or loss.

1AC.15 Where any fixed assets of the small entity (other than listed investments) are included under any item shown in the small entity's statement of financial position at a revalued amount, the following information must be given:

(a) the years (so far as they are known to the directors) in which the assets were severally valued and the several values;

(b) in the case of assets that have been valued during the reporting period, the names of the persons who valued them or particulars of their qualifications for doing so and (whichever is stated) the bases of valuation used by them. (Schedule 1, paragraph 49).

Paragraphs 17.32A(a) and (c), 18.29A(a) and (c) and 34.55(e)(ii) address similar requirements. These paragraphs do not require the names or qualifications of the persons who valued the fixed assets to be disclosed; paragraphs 17.32(A)(b) and 18.29A(b) address only whether or not the valuer was independent.

These requirements apply in the same circumstances as those set out in paragraph 1AC.14.

1AC.16 In the case of each item in the statement of financial position measured at a revalued amount, the comparable amounts determined according to the historical cost accounting rules must be shown in a note to the financial statements. (Schedule 1, paragraph 34(3)).

The comparable amounts refers to the aggregate amount of cost and the aggregate amount of accumulated depreciation and accumulated impairment losses that would have been required according to the historical cost accounting rules (Schedule 1, paragraph 34(4)).

Paragraphs 17.32A(d) and 18.29A(d) address similar requirements.

These requirements apply in the same circumstances as those set out in paragraph 1AC.14.

1AC.17 Where fixed assets are measured at revalued amounts the following information must be given in tabular form:

(a) movements in the revaluation reserve in the reporting period, with an explanation of the tax treatment of items therein; and

(b) the carrying amount in the statement of financial position that would have been recognised had the fixed assets not been revalued. (Schedule 1, paragraph 54(2)).

Paragraphs 6.3A, 17.32A(d) and 29.27(a) address similar requirements.

These requirements apply in the same circumstances as those set out in paragraph 1AC.14.

1AC.18 The treatment for tax purposes of amounts credited or debited to the revaluation reserve must be disclosed in a note to the financial statements. (Schedule 1, paragraph 35(6)).

Paragraph 29.27(a) addresses similar requirements.

These requirements apply in the same circumstances as those set out in paragraph 1AC.14.

Capitalisation of borrowing costs

1AC.19 When a small entity adopts a policy of capitalising borrowing costs, the inclusion of interest in determining the cost of the asset and the amount of the interest so included is disclosed in a note to the financial statements. (Schedule 1, paragraph 27(3)).

Paragraph 25.3A(a) addresses a similar requirement to the second part of this.

Impairment of assets

1AC.20 Provisions for impairment of fixed assets (including fixed asset investments) must be disclosed separately in a note to the financial statements if not shown separately in the income statement. (Schedule 1, paragraph 19(3)).

Paragraph 27.32(a) addresses similar requirements.

1AC.21 Any provisions for impairment of fixed assets that are reversed because the reasons for which they were made have ceased to apply must be disclosed (either separately or in aggregate) in a note to the financial statements if not shown separately in the income statement. (Schedule 1, paragraph 20(2)).

Paragraph 27.32(b) addresses similar requirements.

Fair value measurement

1AC.22 Where financial instruments or other assets have been measured at fair value through profit or loss there must be stated:

(a) the significant assumptions underlying the valuation models and techniques used to determine the fair values;

(b) for each category of financial instrument or other asset, the fair value of the assets in that category and the change in value:

  (i) included directly in the income statement; or

  (ii) credited to or (as the case may be) debited from the fair value reserve,

in respect of those assets. (Schedule 1, paragraphs 51(2)(a) and (b)).

This does not apply where financial instruments or other assets are measured at fair value only on initial recognition.

This applies where financial instruments, certain inventories, investment property and biological assets are subsequently measured at fair value through profit or loss, which is permitted or required by paragraphs 9.26(c), 11.14(b), 11.14(d)(i), 12.8, 13.4A, 14.4(d), 15.9(d), 16.7 and 34.4.

Paragraphs 11.41(a), 11.41(d), 11.43, 11.48(a)(i), 11.48(a)(ii), 12.28, 12.29(c) and 12.29(e) address similar disclosure requirements for financial instruments. Paragraphs 16.10(a) and 16.10(e)(ii) address similar disclosure requirements for investment property. Paragraphs 34.7(c)(i) and 34.7(b) address similar disclosure requirements for biological assets.

1AC.23 Where financial instruments or other assets have been measured at fair value through profit or loss there must be stated for each class of derivatives, the extent and nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows. (Schedule 1, paragraph 51(2)(c)).

1AC.24 Where any amount is transferred to or from the fair value reserve during the reporting period, there must be stated in tabular form:

(a) the amount of the reserve as at the beginning of the reporting period and as at the reporting date respectively; and

(b) the amount transferred to or from the reserve during that year. (Schedule 1, paragraph 51(3)).

Paragraphs 6.3A, 12.29(c) and 12.29(d) address similar requirements.

1AC.25 The treatment for taxation purposes of amounts credited or debited to the fair value reserve must be disclosed in a note to the financial statements. (Schedule 1, paragraph 41(2)).

Paragraph 29.27(a) addresses similar requirements.

Financial instruments measured at fair value

1AC.26 Financial instruments which under international accounting standards may be included in accounts at fair value, may be so included, provided that the disclosures required by such accounting standards are made. (Schedule 1, paragraph 36(4)).

This only applies in certain circumstances; for example, it does not apply to derivatives. It applies where investments in subsidiaries, associates and joint ventures are measured at fair value through profit or loss. When it applies, the disclosures required by Section 11 that relate to financial assets and financial liabilities measured at fair value, including paragraph 11.48A, shall be given.

Indebtedness, guarantees and financial commitments

1AC.27 For the aggregate of all items shown under ‘creditors’ in the small entity’s statement of financial position there must be stated the aggregate of the following amounts:

(a) the amount of any debts included under ‘creditors’ which are payable or repayable otherwise than by instalments and fall due for payment or repayment after the end of the period of five years beginning with the day next following the reporting date; and

(b) in the case of any debts so included which are payable or repayable by instalments, the amount of any instalments which fall due for payment after the end of that period. (Schedule 1, paragraph 55(1)).

1AC.28 In respect of each item shown under ‘creditors’ in the small entity’s statement of financial position there must be stated the aggregate amount of any debts included under that item in respect of which any security has been given by the small entity with an indication of the nature and form of any such security. (Schedule 1, paragraph 55(2)).

Paragraphs 11.46, 13.22(e), 16.10(c), 17.32(a) and 18.28(c) address similar requirements.

1AC.29 The total amount of any financial commitments, guarantees and contingencies that are not included in the balance sheet must be stated. (Schedule 1, paragraph 57(1)).

The total amount of any commitments concerning pensions must be separately disclosed. (Schedule 1, paragraph 57(3)).

The total amount of any commitments which are undertaken on behalf of or for the benefit of:

(a) any parent, fellow subsidiary or any subsidiary of the small entity; or

(b) any undertaking in which the small entity has a participating interest,

must be separately stated and those within (a) must also be stated separately from those within (b). (Schedule 1, paragraph 57(4)).

Such commitments can arise in a variety of situations, including in relation to group entities, investments, property, plant and equipment, leases and pension obligations. Paragraphs 15.19(d), 16.10(d), 17.32(b), 18.28(d), 20.16, 21.15, 28.40A(a), 28.40A(b), 28.41A(d), 33.9(b)(ii) and 34.62 address similar requirements.

1AC.30 An indication of the nature and form of any valuable security given by the small entity in respect of commitments, guarantees and contingencies within paragraph 1AC.29 must be given. (Schedule 1, paragraph 57(2)).

Paragraphs 11.46, 13.22(e), 16.10(c), 17.32(a) and 18.28(c) address similar requirements.

1AC.31 If in any reporting period a small entity is or has been party to arrangements that are not reflected in its statement of financial position and at the reporting date the risks or benefits arising from those arrangements are material the nature and business purpose of the arrangements must be given in the notes to the financial statements to the extent necessary for enabling the financial position of the small entity to be assessed. (Section 410A of the Act).

Examples of off-balance sheet arrangements include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase arrangements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate entities, pledged assets, operating lease arrangements, outsourcing and the like. In many cases the disclosures about financial commitments and contingencies required by paragraphs 1AC.29 and 1AC.30 will also address such arrangements.

Notes supporting the income statement

1AC.32 The amount and nature of any individual items of income or expenses of exceptional size or incidence must be stated. (Schedule 1, paragraph 61(2)).

Paragraph 5.9A addresses a similar requirement in relation to material items.

1AC.33 The notes to a small entity's financial statements must disclose the average number of persons employed by the small entity in the reporting period. (Section 411 of the Act).

Related party disclosures

1AC.34 Where the small entity is a subsidiary, the following information must be given in respect of the parent of the smallest group for which consolidated financial statements are drawn up of which the small entity is a member:

(a) the name of the parent which draws up the consolidated financial statements;

(b) the address of the parent's registered office (whether in or outside the UK); or

(c) if it is unincorporated, the address of its principal place of business. (Schedule 1, paragraph 65).

Paragraph 33.5 addresses a similar requirement to paragraph (a).

1AC.35 Particulars must be given of material transactions the small entity has entered into that have not been concluded under normal market conditions with:

(a) owners holding a participating interest in the small entity;

(b) companies in which the small entity itself has a participating interest; and

(c) the small entity's directors [or members of its governing body].

Particulars must include:

(a) the amount of such transactions;

(b) the nature of the related party relationship; and

(c) other information about the transactions necessary for an understanding of the financial position of the 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 the related party transactions on the financial position of the small entity.

Particulars 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. (Schedule 1, paragraph 66).

Although disclosure is only required of material transactions with the specified related parties that have not been concluded under normal market conditions, small entities disclosing all transactions with such related parties would still be compliant with company law.

Transactions with directors, or members of an entity's governing body, include directors' remuneration and dividends paid to directors.

Paragraphs 33.9 and 33.14 address similar requirements for all related parties.

1AC.36 Details of advances and credits granted by the small entity to its directors and guarantees of any kind entered into by the small entity on behalf of its directors must be shown in the notes to the financial statements.

The details required of an advance or credit are:

(a) its amount;

(b) an indication of the interest rate;

(c) its main conditions;

(d) any amounts repaid;

(e) any amounts written off; and

(f) any amounts waived.

There must also be stated in the notes to the financial statements the totals of amounts stated under (a), (d), (e) and (f).

The details required of a guarantee are:

(a) its main terms;

(b) the amounts of the maximum liability that may be incurred by the small entity; and

(c) any amount paid and any liability incurred by the small entity for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

There must also be stated in the notes to the financial statements the totals of amounts stated under (b) and (c). (Section 413 of the Act).

Paragraph 33.9 addresses similar requirements for all related parties.

A small entity that is not a company shall provide this disclosure in relation to members of its governing body.

Other

1AC.37 The financial statements must state:

(a) the part of the UK in which the small entity is registered;

(b) the small entity's registered number:

(c) whether the small entity is a public or a private company and whether the small entity is limited by shares or by guarantee;

(d) the address of the small entity's registered office; and

(e) where appropriate, the fact that the entity is being wound up. (Section 396 of the Act).

Paragraph 3.24(a) addresses similar requirements.

1AC.38 Where items to which Arabic numbers are given in any of the formats have been combined, unless they are not material, the individual amounts of any items which have been combined must be disclosed in a note to the financial statements. (Schedule 1, paragraph 4(3)).

1AC.39 The nature and financial effect of material events arising after the reporting date which are not reflected in the income statement or statement of financial position must be stated. (Schedule 1, paragraph 64).

Paragraphs 32.10 and 32.11 address similar requirements.

Encouraged disclosures for small entities

Appendix D to Section 1A *Additional disclosures encouraged for small entities* is an integral part of FRS 102. There are certain disclosures which the FRC encourage small entities to make, over and above those required in law, to enable the financial statements to give a true and fair view. Appendix D says:

1AD.1 Where relevant to its transactions, other events and conditions, a small entity is encouraged to provide the following disclosures:

(a) a statement of compliance with this FRS as set out in paragraph 3.3, adapted to refer to Section 1A;

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

(c) 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.

FRS 102: BUSINESS COMBINATIONS AND GOODWILL (LECTURE A513 – 14.48 MINUTES)

A business may enter into a 'business combination' by acquiring a subsidiary. The Glossary to FRS 102 defines a 'business combination' as:

*'The bringing together of separate entities or **businesses** into one reporting entity.'*

When an acquirer (a parent) acquires a target (a subsidiary), the parent may acquire it in whole or in part. In other words the parent might acquire 100% of the net assets of the subsidiary, or it could acquire a controlling stake (i.e. more than 50% but less than 100%). Section 19 *Business Combinations and Goodwill* in FRS 102 outlines the accounting for a business combination and any associated goodwill which might arise following an acquisition of a subsidiary.

Section 19 does not deal with:

- the formation of a joint venture; and
- the acquisition of a group of assets which does not constitute a business.

An important point to emphasise where the definition of a business combination is concerned is that it is the bringing together of separate entities or 'businesses' into one reporting entity. Sometimes it may not be clear as to whether an investee is a business and is often a situation which may need further analysis because of the inherent differences in accounting for an asset purchase and a business combination.

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

*'An integrated set of activities and **assets** conducted and managed for the purpose of providing:*

(a) a return to investors; or

(b) lower costs or other economic benefits directly and proportionately to policyholders or participants.

*A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate **revenues**. If **goodwill** is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.'*

Example – Identifying a business

Company A Ltd operates in the disposable clothing sector and has been an established business for several years. Whilst it does not manufacture the disposable clothing it purchases it from its main supplier in China and has a workforce of warehouse staff, sales people, management, finance staff and directors. It has various types of assets such as delivery trucks, machinery to pack the goods and IT equipment. It operates out of its main premises in the North-West of England and has a large customer base spread across the UK, Ireland, America and the Far East.

On 1 September 2014, Blue Chip PLC paid £4.5 million to acquire 100% of the net assets of Company A Ltd. The consideration was paid in cash and the board of directors took on various roles in Blue Chip PLC.

In this example it is clear that Company A is a business. It has been established for several years, has a clear set of activities in which it trades and has assets and a workforce which are necessary for the business to trade and hence will satisfy the definition of a business in the Glossary to FRS 102.

The example above was pretty straightforward in that it was clear that a business was in existence. However, it might not always be so conclusive and hence further analysis may well be needed.

Example – Establishing whether a business exists

Company B Ltd has been set up by two directors who are also the shareholders. The principal activity of Company B is the development of mobile applications to assist companies in being more efficient with their bookkeeping by automating as much of the process as possible.

The company has not started to generate revenues as the applications are still in the research phases, although the research phases for the applications are at an advanced stage. Company B employs six developers and the patents for the applications are in the process of being applied for.

The directors have been actively sourcing customers for its new applications and negotiations with a number of accountancy and bookkeeping firms are at an advanced stage, with a number of these firms saying they would like to purchase the application once it is available.

The research and patent application stages have cost Company B more than was originally budgeted for and it now requires additional finance to complete the project.

Company C Ltd has agreed to make funds available in return for a 55% ownership interest in Company B to which the shareholders have agreed. The net assets of Company B are £40,000 and Company C agrees to pay £28,000 in exchange for a 55% stake in the company.

Whilst Company B is not yet earning revenues, there are indicators that it has an integrated set of activities which can provide a return to investors. It also employs developers and it is clear that the company has a plan to complete the development work and make the applications available for sale because it has identified customers who are willing to buy the applications.

Company C has also paid for goodwill in its share of the net assets of £6,000 ((£40,000 x 55%) - £28,000).

As a result it can be concluded that Company B is a business for the purposes of Section 19 of FRS 102.

Concept of 'control'

When a business combination takes place, one party obtains control of another party (or parties). Control is usually evidenced by the parent acquiring more than 50% of the net assets of the subsidiary.

However, this is not always the case and control may be obtained with a holding of less than 51% if the parent can, for example:

- cast the majority of the votes at the meeting of the board of directors;
- appoint or remove the majority of the members of the board of directors;
- govern the financial and operating policies of the entity under statute or agreement; or
- hold power over more than 50% of the voting rights by virtue of agreement with other investors.

It is important, therefore, to consider the wider picture (i.e. the substance of the arrangement) to establish whether control has, or has not, been obtained where the ownership interest is less than 51%.

The purchase method

Section 19 uses the 'purchase method' to account for business combinations. This method used to be called the 'acquisition method' in outgoing UK GAAP and is applied to all business combinations except:

- group reconstructions which are accounted for using the merger accounting method; and
- public benefit entity combinations which are in substance a gift or which are a merger and hence are accounted for in accordance with Section 34 *Specialised Activities*.

There are three steps in applying the purchase method:

1. identify an acquirer;
2. measure the cost of the business combination; and
3. allocate, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and provisions for contingent liabilities assumed.

Identify an acquirer

The acquirer in a business combination is the party which obtains control of the other entity (or entities).

For the purpose of Section 19 the term 'control' is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities.

Quite often it is clear which party is the acquirer in a business combination. However, if a complex group structure exists it may not be as apparent.

In light of this, paragraph 19.10 of FRS 102 offers examples of three indicators that an acquirer exists (note – emboldened words are defined in the Glossary to FRS 102):

a) If the **fair value** of one of the combining entities is significantly greater than that of the other combining entity, the entity with the greater fair value is likely to be the acquirer.
b) If the business combination is effected through an exchange of voting ordinary equity instruments for cash or other assets, the entity giving up cash or other assets is likely to be the acquirer.
c) If the business combination results in management of one of the combining entities being able to dominate the selection of the management team of the resulting combined entity, the entity whose management is able so to dominate is likely to be the acquirer.

Example – Identifying an acquirer

Company D Ltd owns two business, Company E and Company F. The board of Company D have decided to spin-off these two existing businesses by incorporating a new company (Company G). Company G has four directors who are all independent. The terms of the agreement say that Company G will agree to purchase Company E and Company F, in cash, subject to obtaining funding.

The bank refused the application for funding but three external investors decided they would introduce the funds by subscribing to shares in Company G in an arm's length transaction with each of the investors holding 33% each in the issued share capital. Company D owns the remaining 1%.

In this example the three investors have paid cash to obtain a controlling stake in Company G. Once this transaction took place, Company G then acquired 100% of Company E and Company F, also by way of a cash purchase, resulting in Company D losing control of E and F.

Company G is the acquirer on two levels. Firstly it now wholly-owns Company E and Company F. In addition, the new shareholders of Company G have obtained control of E and F from D.

Cost of a business combination

The cost of the business combination is measured as the total of:

(a) the fair values at the date of acquisition of:

- assets given;
- liabilities incurred or assumed; and
- equity instruments granted; *plus*

(b) any costs which are directly attributable to the business combination.

If control is achieved in stages (also referred to as a 'piecemeal acquisition' or a 'step acquisition') then the cost of the business combination is the total of the fair value of assets given, liabilities assumed and equity instruments issued by the acquirer at the date of each transaction in the series.

In a business combination it is not necessarily just cash that changes hands in exchange for ownership interest, consideration can also include:

- property, plant and equipment;
- another business;
- shares (including preference shares); and
- contingent consideration.

Example – Contingent consideration

Company H Ltd acquires Company I Ltd and the consideration is split as follows:

- £3 million to be paid at the date of acquisition (i.e. the date on which control passes); and
- A further £100,000 if a tenancy agreement has not been entered into between Company H and a third party to rent the building occupied by Company H within 12 months of the completion date of the sale. If a tenancy agreement has been entered into between Company H and a third party within 12 months of the completion date, deferred consideration is paid amounting to £50,000. Any amounts of contingent consideration will be paid 395 days after the date of completion.

The directors have said it is probable that a tenancy agreement will be entered into with a third party within 12 months of the date of completion as demand for such premises in the area is quite high.

The cost of the business combination in this example is £3,050,000, representing £3m consideration and £50,000 deferred consideration. This is because paragraph 19.12 says that the acquirer must include the estimated amount of the contingent consideration in the cost of the combination at the date of acquisition if the adjustment is probable and can be measured reliably. As the directors have assessed it is probable that a tenancy agreement will be entered into with a third party, the probability is that £50,000 will be paid at a later date.

Where any adjustments to the cost of the business combination are not recognised at the date of acquisition, but then become probable and can be measured reliably, the additional consideration is treated as an adjustment to the cost of the combination.

Allocating the cost of the business combination to the assets acquired and the liabilities and contingent liabilities assumed

The cost of the business combination is then allocated to the acquiree's identifiable assets and liabilities and contingent liabilities (those contingent liabilities which satisfy the recognition criteria) at their fair values at the date of acquisition. However, care must be taken here because Section 19 refers to other areas of FRS 102 where different provisions apply to certain assets and liabilities, notably:

- A deferred tax asset or liability arising from the assets acquired and liabilities assumed is recognised and measured in accordance with Section 29 *Income Tax*.
- A liability (or, where applicable, an asset) in respect of an acquiree's employee benefit arrangements is recognised and measured in accordance with Section 28 *Employee Benefits*.
- Share-based payment transactions are recognised and measured in accordance with Section 26 *Share-based Payment*.

Paragraph 19.15 requires the acquirer to separately recognise the acquiree's identifiable assets, liabilities and contingent liabilities at the date of acquisition but only where they satisfy the following criteria at that date:

- In the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably.
- In the case of a liability other than a contingent liability, it is probable that an outflow of resources will be required to settle the obligation, and its fair value can be measured reliably.
- In the case of an intangible asset or a contingent liability, its fair value can be measured reliably.

In the consolidated financial statements, the acquiree's profits or losses after the date of acquisition are included based on the cost of the business combination to the acquirer.

Example – Fair value versus net book value

On 1 April 2015, Topco Ltd acquired 100% of the net assets of Subco Ltd. On that date the fair value of the plant and machinery amounted to £125,000 and the net book value of the same plant and machinery was £90,000. For the year ended 31 March 2016, Subco has based its depreciation calculation on net book values rather than fair values.

In the consolidated financial statements, the depreciation expense should be based on the fair values of those depreciable assets at the acquisition date – in other words at cost to Topco Ltd.

When a business combination takes place there is usually an element of disruption in the acquiree's business. Staff may, unfortunately, be made redundant or operations may be discontinued.

At the date of acquisition, the acquirer must separately recognise only the identifiable assets, liabilities and contingent liabilities of the acquiree which existed at the date of acquisition and which satisfy the recognition criteria in paragraph 19.15. To that end:

- the acquirer shall recognise liabilities for terminating or reducing the activities of the acquiree as part of allocating the cost of the combination but only to the extent that the acquiree has, at the date of acquisition, an existing liability for restructuring recognised in accordance with Section 21 *Provisions and Contingencies*; and
- the acquirer, when allocating the cost of the combination, shall not recognise liabilities in respect of future losses, or other costs to be expected, in respect of the business combination.

Identifying the date of acquisition

Section 19 requires the purchase method to be applied to a business combination from the date of acquisition. The date of acquisition is the date on which control passes to the acquirer and is often ascertainable in the sale and purchase agreement. However, this is not always the case, particularly in a complicated business combination. Where difficulties are encountered there is no 'one-size-fits-all' approach and the definition of 'control' must be applied to the specific facts and circumstances, which will invariably require a degree of judgement.

Complications in ascertaining the date of acquisition can arise where:

- the sale and purchase agreement states that control is transferred on a date that is not the date on which the sale completes;
- control is passed subject to regulatory approval and/or shareholder approval;
- other conditions have to be satisfied after the date of completion prior to control passing;
- where the transaction is not subject to a sale and purchase agreement and hence there is no closing date for the transaction.

Incomplete accounting at the year-/period-end

Business combinations can take a long time to complete and it may be the case that a combination is incomplete by the year-/period-end. When this is the case, the acquirer must recognise a best estimate for the amounts for which the accounting is not complete.

Within 12 months after the date of acquisition, a retrospective adjustment must be made to the provisional amounts recognised to take account of the new information obtained (i.e. actual values). Beyond this 12-month time limit, any adjustments to the initial accounting for a business combination should only be recognised in order to correct a material error and the provisions in Section 10 *Accounting Policies, Estimates and Errors* should be applied where this is the case.

Example – Accounting incomplete at the year-end

On 1 June 2015, Topco Ltd acquired 100% of the net assets of Subco Ltd (this was also the date of acquisition). At the date the financial statements of Topco Ltd for the year-ended 31 August 2015 were authorised for issue the accounting for a portion of capitalised development expenditure was incomplete and a provisional amount of £18,000 was used and this was amortised in line with Subco's accounting policy for amortisation which is five-years using the straight-line method on a pro-rata basis. On 31 December 2015 the fair value of the development expenditure was assessed as being £20,000.

Retrospective adjustments will be applied in the financial statements for the year-ended 31 August 2016 as follows:

1. The carrying amount of the capitalised development costs as at 31 August 2015 will be increased by £1,900 which represents the uplift in cost of £2,000 less the additional amortisation of £100 (£2,000 x 3 months/60 months).
2. The amortisation charge in the profit and loss account is increased by £100 to reflect the fair value of the development costs since the date of acquisition.
3. Goodwill is decreased by £2,000.

In journal terms, these will be:

DR development costs	£2,000
CR goodwill	£2,000

Being adjustment to fair value of development costs

DR amortisation expense (P&L)	£100
CR accumulated amortisation	£100

Being adjustment to amortisation of development costs re adjustment to fair value

The value of goodwill will also have been amortised and this will need retrospective adjustment to reflect the reduction of £2,000.

Contingent liabilities

Paragraph 19.15(c) says that the acquirer must recognise a separate provision for contingent liabilities of the acquiree, but only if the fair value of contingent liabilities can be measured reliably. Where fair value cannot be reliably measured:

(a) there is a resulting effect on the amount recognised as goodwill (or, where applicable, negative goodwill); and

(b) the acquirer should instead disclose the information concerning that contingent liability as required by Section 21 *Provisions and Contingencies*.

Where contingent liabilities meet the recognition criteria, the acquirer measures them separately at the *higher* of:

(a) the amount that would be recognised in accordance with Section 21; and

(b) the amount initially recognised less any amounts previously recognised as revenue in accordance with Section 23 *Revenue*.

Example – Contingent liability assumed

On 1 June 2015, Topco Ltd acquired 100% of the net assets of Subco Ltd. At the date of acquisition there was an ongoing legal case brought against Subco by one of its customers for damage to their property and rectification costs. The total amount of the claim is £45,000 and whilst the management of Subco have admitted the damage to the property was caused by them, they do not agree with the level of the claim as their independent surveyor has suggested the value of the repairs plus costs are usually settled in the region of £20,000 to £25,000. Subco's lawyers have dealt with such claims before and have said that in their experience it is probable that there is a 80% chance of settling at the lower end of the estimate (i.e. £20,000) and a 20% chance of settling at the higher end of the estimate (i.e. £25,000).

This is an example of a present obligation and is recognised as a contingent liability at the date of acquisition. It should be recognised using an estimate of fair value which can be calculated as:

Chance of settlement at the higher end of the scale (£25,000 x 20%)	£5,000
Chance of settlement at the lower end of the scale (£20,000 x 80%)	£16,000
Total provision for contingent liabilities at the date of acquisition	£21,000

Goodwill

Goodwill is basically the difference between the net assets acquired and the consideration paid for those net assets.

Example – Positive goodwill

On 1 June 2015, Topco Ltd acquired 80% of the net assets of Subco Ltd. The net assets of Subco at the date of acquisition were as follows:

	£
Ordinary share capital	20,000
Revaluation reserve	15,000
Accumulated profit and loss	92,000
	127,000

Topco paid £120,000 for an 80% ownership interest in Subco and this was paid in cash at the date of acquisition. There was no provision in the sale and purchase agreement for any contingent consideration to be paid to the outgoing shareholders of Subco.

Goodwill is calculated as follows:

		£	£
Cost of investment			120,000
Less net assets acquired:			
80%:	Ordinary share capital	16,000	
	Revaluation reserve	12,000	
	Profit and loss reserves	73,600	
			(101,600)
Goodwill on acquisition			18,400

Positive goodwill is amortised on a systematic basis over its useful economic life. (Note: goodwill always has a finite useful life under FRS 102). Where management of an entity are unable to make a reliable estimate of the useful life of goodwill, the life must not exceed five years.

In addition, management must also review the value of goodwill to assess if there are any indicators of impairment. If this is the case, the provisions in Section 27 *Impairment of Assets* are triggered.

Negative goodwill

Negative goodwill arises in a bargain purchase (i.e. where the consideration is less than the net assets acquired). This can usually arise in a distressed sale where the shareholders want a quick way out of the business.

There are three steps to follow where negative goodwill arises:

a) Reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination. This is to ensure that everything has been captured for the purpose of the goodwill calculation (i.e. assets, liabilities and contingent liabilities are complete and the cost is complete).
b) Following this reassessment, if negative goodwill is still arising, recognise and separately disclose the resulting excess on the face of the balance sheet as at the date of acquisition, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.
c) Recognise subsequently the excess up to the fair value of non-monetary assets acquired in profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired is recognised in profit or loss in the periods expected to be benefited.

Group reconstructions

When a group reconstruction takes place, it is accounted for using the merger accounting method. There are strict criteria for merger accounting and it can only be used provided:

- it is not prohibited by company law or other relevant legislation;
- the ultimate equity holders remain the same, and the rights of each equity holder, relative to the others, remain unchanged; and
- no non-controlling interest in the net assets of the group are altered by the transfer.

In a merger, no one party obtains control because if they do, this means merger accounting cannot be used and the purchase method is applied instead. This is because of what a merger, in substance, actually is.

In a merger, two (or more) entities join together to create a new entity. The carrying values of the assets and liabilities of all parties to the merger are not adjusted to fair values. The only adjustments that are made to the carrying values of assets and liabilities are those which achieve uniformity of accounting policies for all of the combining entities.

The results and cash flows of all parties to the merger are included in the financial statements of the combined entity from the start of the financial year in which the combination occurred and these amounts will reflect the adjustments made to achieve uniformity of accounting policies.

Comparative financial information will also be restated by including the total comprehensive income for all of the combining entities for the previous accounting period and their balance sheets as at the previous reporting date. Again, these will be restated to achieve uniformity of accounting policies only.

If any differences arise between the nominal value of the shares issued plus the fair value of any additional consideration given, and the nominal value of the shares received in exchange, such differences are recognised as a movement on other reserves in the consolidated financial statements. For any existing balances on the share premium or capital redemption reserve account of the new subsidiary, these are brought in as a movement on reserves and are shown in the statement of changes in equity.

Any expenses attributable to the merger are not recognised as part of the movement on reserves, but are instead charged to profit or loss of the combined entity at the effective date of the group reconstruction.

Disclosure requirements: business combinations and goodwill

The disclosure requirements for business combinations and goodwill are split into two components in Section 19:

- those that have taken place during the period; and
- all business combinations.

Business combinations that have taken place during the period

For each business combination, excluding any group reconstructions that have taken place during the period, the acquiring party (i.e. the parent) shall disclose:

a) the names and descriptions of the combining entities or businesses;
b) the acquisition date;
c) the percentage of voting equity instruments acquired;
d) the cost of the combination and a description of the components of that cost (such as cash, equity instruments and debt instruments);
e) the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, including goodwill;
f) the useful life of goodwill, and if this exceeds five years, supporting reasons for this; and
g) the periods in which the excess recognised in respect of negative goodwill will be recognised in profit or loss.

The acquirer must also disclose, separately for each material business combination that occurred during the reporting period, the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period.

The disclosure may be provided in aggregate for business combinations that occurred during the reporting period which, individually, are not material.

For all business combinations

An acquirer must disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period, showing separately:

a) changes arising from new business combinations;
b) amortisation;
c) impairment losses;
d) disposals of previously acquired businesses; and
e) other changes.

This reconciliation does not need to be presented for prior periods.

In addition, paragraph 19.26A requires an acquirer to disclose a reconciliation of the carrying amount of the excess of negative goodwill recognised in accordance with paragraph 19.24 at the beginning and end of the reporting period, showing separately:

a) changes arising from new business combinations;
b) amounts recognised in profit or loss in accordance with paragraph 19.24(c) [amounts recognised in profit or loss arising from negative goodwill]
c) disposals of previously acquired businesses; and
d) other changes.

This reconciliation does not need to be presented for prior periods.

Disclosure requirements: group reconstructions

In respect of group reconstructions that have taken place during the period, the combined entity must disclose:

- the names of the combining entities (other than the reporting entity);
- whether the combination has been accounted for as an acquisition or a merger; and
- the date of the combination.
-

DISTRIBUTABLE PROFIT (LECTURE A514 – 15.15 MINTUES)

With the new UK GAAP beginning to bite, many companies are turning their attention to the impact that the transition across to FRS 102/FRS 102 with reduced disclosure/FRS 105 will have on previously reported financial information. Recognition and derecognition of assets and liabilities will clearly impact a company's balance sheet and net assets position, including profits available for distribution to shareholders.

Tech 02/10 *Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006* does give guidance on distributable profit. In addition, the ICAEW Financial Reporting Faculty has issued a Factsheet *UK Distributable Profits* which offers a summary of the law and related guidance on the payment of dividends by UK companies. It is not considered to be a substitute for Tech 02/10, but instead aims to provide a simplified overview.

Meaning of 'distribution'

The meaning of the term 'distribution' is wider in scope than simply a dividend to a shareholder. It is defined in law as every description of distribution of a company's assets to its members (shareholders), whether in cash or otherwise. This means that a distribution can also apply to transfers of assets to shareholders at below market rates.

The most common type of distribution is a dividend paid to shareholders, but a dividend can also be a 'dividend in specie' which involves the transfer of an asset, such as a property or investment.

A company is prohibited in law from making a distribution to a shareholder (or a company owned by a shareholder) for less than its fair value, or to assume a liability from them for receipt of consideration (cash or otherwise) at below fair value. The exception to this would be where the value of distributable reserves is still positive after the transfer has been made and taking account of any profit or loss on the transfer.

In the *Aveling Barford v Perion Ltd [1989]*, the defendant owned and controlled Aveling Barford which was sold to Perion Ltd, a company which was also controlled by the defendant. The property consisted of a country house and 18 acres of land in Grantham, which was sold for £350,000 as opposed to £1,150,000 for which it had been valued at for mortgage purposes. The court looked at the substance of this transaction and concluded that it was an unlawful distribution because it was known, and intended, to be a sale at below market value.

When a distribution becomes unlawful, the consequences are serious because it cannot be ratified by the shareholders. The recipient of the unlawful distribution can be forced to repay it; or if it involves the distribution of non-cash assets, the recipient can be forced to repay an amount equivalent to the fair value of the non-cash asset transferred in the distribution.

Whilst the courts ruled in the *Aveling Barford* case that the distribution was unlawful, it did raise an element of confusion for companies that were considering distributing company assets to shareholders because it was not clear as to whether sufficient distributable reserves would be needed to cover the difference between the transfer price and the fair value if the fair value was higher than book value, or whether the book value of the asset in question was the relevant amount.

The issue about fair value versus book value in relation to the transfer price has been codified in the Companies Act 2006. Section 845 effectively says that where a company has distributable reserves, any transfer of an asset for at least its book value will not be an unlawful distribution. Where the asset is transferred to a shareholder for less than book value, the difference between the transfer price and the book value has to be covered by distributable reserves. If the company does not have distributable reserves then it will not be able to transfer any assets to members at less than market value.

The effect of the rules concerning distributions are more likely to affect group companies because often group companies will transfer assets at book values rather than fair values because, in reality, this will avoid the need to obtain a valuation of the asset and undertake consolidation adjustments.

Profits available for distribution

A company can only make distributions out of distributable profit. The term 'distributable profit' means accumulated realised profits (so far as not previously distributed or capitalised) less accumulated realised losses (so far as not previously written off in a reduction or reorganisation of share capital).

Section 853(4) of the Companies Act 2006 says that references to realised profits and realised losses are to such profits or losses which are treated as realised in accordance with principles which are generally accepted at the time the financial statements are prepared (i.e. GAAP), with respect to the determination for accounting purposes of realised profits or losses.

When a company makes a distribution (say, a dividend to shareholders) out of distributable profits it must consider whether this distribution is lawful with reference to 'relevant accounts'. Section 836(2) says that relevant accounts are the company's last annual accounts, but if the distribution might contravene s836(2) by reference to the company's last annual accounts, it may be justified by having reference to interim accounts. Group accounts are not relevant for the purposes of determining a company's profit available for distribution.

When it is proposed to make a distribution in the company's first accounting period, or before any accounts have been circulated, 'initial' accounts must be prepared.

Companies must maintain sufficient records to enable them to distinguish between profits available for distribution and profits which are not available for distribution and this becomes more relevant under new UK GAAP because of changes to various methods of accounting for certain transactions (e.g. investment property).

Impact of new UK GAAP on distributable profit

The section above referred to 'relevant accounts' and for the purposes of determining distributable profit will be those prepared under EU-adopted IFRS or UK GAAP, depending on the choice made by the company. The switch to new UK GAAP, whether it be full FRS 102, FRS 102 with reduced disclosures or FRS 105 will change the way in which certain transactions are accounted for. For example, fair value gains and losses on investment property are no longer taken to a revaluation reserve account in equity, but are instead taken to profit or loss under full FRS 102 and FRS 102 with reduced disclosures. Such gains will not be distributable to shareholders, nor will any previous revaluation surpluses taken to profit and loss reserves as transitional and prior year adjustments.

In addition, many companies will see a change in accounting policy in respect of financial instruments as more financial instruments must be brought onto the balance sheet under FRS 102. This will have a particular effect where derivative instruments are recognised on the balance sheet as it will affect distributable reserves (adversely in the case of derivative instruments which are liabilities).

Tech 02/10 does address the effect of a change in accounting policies due to the adoption of a new financial reporting framework (specifically the adoption of EU-adopted IFRS). The same principles, will, however, apply on transition to FRS 101 *Reduced Disclosure Framework* and FRS 102 from outgoing UK GAAP.

Where adoption of new UK GAAP results in a deficit on distributable reserves, it does not necessarily mean that past distributions have automatically become unlawful.

Example – Payment of dividends

Smallco Ltd currently reports under the FRSSE (effective January 2015) and is a husband and wife run company. Financial statements are prepared to 31 December each year and the company would not meet the eligibility criteria for a micro-entity and will therefore adopt FRS 102 with reduced disclosures for its financial year-ended 31 December 2016.

The husband and wife are both equal shareholders in the business and the company has a very low level of distributable profit because most of the profits generated by the business are paid out to the shareholders in the form of a dividend.

The financial statements for the year-ended 31 December 2015 are in the process of being completed and the shareholders have enquired as to whether the move across to the new UK GAAP will affect their dividend for the year-ended 31 December 2015.

Provided the accounts for the year-ended 31 December 2015 are ‘relevant accounts’ for the purposes of distributions then the company can still pay dividends to the shareholders without considering any effects that changes in accounting policies as a result of FRS 102 will have on the 2016 financial statements.

However, the company should be advised not pay a dividend which is not provided for in the 31 December 2015 financial statements or pay a 2016 interim dividend without having considered the impact that accounting policy changes will have as a result of adopting FRS 102.

The impact on a company’s distributable reserves must be carefully considered, not only in the context of a transition, but also going forward. This is because certain items will be recognised in profit or loss which are not distributable (such as gains on investment properties). It might be advisable, therefore, to have two sets of reserves in the balance sheet; one which is distributable and one which is not distributable.

DATA PROTECTION – THE NEXT BIG THING FOR PRACTICE ASSURANCE (LECTURE A515 – 7.19 MINUTES)

The Data Protection Act (DPA)

The ICAEW Quality Assurance Directive (QAD) has highlighted the need for firms to have proper procedures to comply with the Data Protection Act and of course to ensure generally has sufficient back-ups and fail safes to mitigate the risk of downtime in their system

The ICAEW's view is that practically all firms of accountants will need to be registered with the Information Commissioners as Data Controllers, and the QAD will check to ensure this is the case.

There is a self-assessment checklist on the ICO website firms can use to confirm their registration requirement and the registration process itself is completed on that website:

https://ico.org.uk/for-organisations/register/

While it might come as a surprise to many that this area is so high up the list of topics, it is clear that most firms are heavily reliant on IT for all aspects of their practice, and yet many lack the skills to fully understand this area and so are often reliant on external consultants and suppliers.

The QAD highlight four key areas of best practice in their document:

1. Review policies and procedures regularly

The first point is to make sure you have policies and procedures! The bullet points below show the key points to include but these should be expanded to fit a firm's actual attitude to items such as USB storage, internet use and staff's own devices connecting to the office network. If the firm does not have suitable procedures in place, then where there is a loss of data, it can be very hard for a firm to discipline staff appropriately:

- data storage – use of external media such as USB drives and external hard drives;
- passwords and encryption of laptops and other devices such as USB drives and external hard drives;
- use of internet and social media (e.g. when, sites excluded, purpose and monitoring);
- email use (e.g. when, recipients excluded, purpose, content and monitoring);
- use of own devices (bring your own device – BYOD) such as tablets (are they secure, password protected and able to be remotely wiped); and
- data loss.

2. Make sure data is secure

While often the focus is on passwords, this is only part of the story. Few data breaches are from passwords being remotely hacked and other issues (as noted below) are equally as important:

- make sure client data is physically secure;
- make data transfers as secure as possible (this can be done with encryption, passwords or client portals);
- don't put more than one set of data on a USB; and
- protect data with up-to-date security, back it up and then test back-ups regularly.

3. Use of third parties and cloud computing

The risks in this section could simply be from subcontractors accessing your network to work on client data, to third parties processing payroll for the firm, through to experts consulting on your audit work. In all these cases, make sure the other party understands your data security policies. If you transfer data to them, check they comply with the provisions of the DPA.

So, do these third parties have backups? Do they use passwords and encryptions? Do they copy data to unsecure locations like DropBox, USB memory sticks or smart phones?

If the firm uses the cloud for storing client data or is considering it:

- make sure your clients understand and agree to the arrangement;
- check the third party has appropriate security in place to comply with the DPA; and
- check if the data is going to be stored outside the EEA. If so you may need additional contractual confirmation that their security is adequate.

4. Make sure your staff understand the firm's policies and procedures

As this is such a key area of most business, the ICAEW recommend that staff (and principals!) are trained in, and confirm their understanding of, the firm's procedures. The firm could also carry out regular monitoring reviews and the ICAEW helpsheet and checklist:

http://www.icaew.com/en/members/advisory-helplines-and-services/practice-helpsheets/it-systems-compliance-review-pas4-hs10

Note that for sole practitioners with no staff, QAD do mention the need for an alternate who can access client data in case you are incapacitated. This is a valid point as it would be impossible for an alternate to run a practice if they could not access key information regarding the firm's clients.

The ICAEW website contains more information here:

http://www.icaew.com/en/technical/legal-and-regulatory/information-law-and-guidance/data-protection

Cyber Essentials

In conjunction with the government, the ICAEW has launched a guide and industry mark called Cyber Essentials to help UK businesses protect themselves.

Cyber Essentials aims at the most basic technical controls (five in total) and is really a starting point for cyber security. It doesn't supersede other standards, such as ISO27001, but is a base level of cyber hygiene which all businesses should have in place. It won't prevent all security breaches, but it will raise the bar significantly for many firms who are currently very vulnerable.

It incorporates a 'badge' system to demonstrate compliance with the controls. To get a Cyber Essentials badge, a business fills in a questionnaire on the controls, which is then validated by a qualified professional. This badge can provide differentiation and competitive advantage to businesses, and help build trust and confidence in the digital economy.

The government has no intention to make it a legal requirement - instead, they are focusing on market incentives to drive adoption. In particular, they are looking for the standard to be driven down supply chains and, to this end, they will make it mandatory for companies bidding for government contracts, where it is 'proportionate and relevant'. So, while it is not a legal requirement, it could become a pre-requisite for doing business in many supply chains.

The guide can be found here:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/317480/Cyber_Essentials_Summary.pdf

The launch article and links to consultants who assess compliance in this area can be found here:

http://www.ion.icaew.com/itcounts/post/Cyber-Essentials-launched-at-Chartered-Accountants-Hall

Use of cloud accounting packages

Many firms uses cloud based accounting packages such as QuickBooks or ZERO for client bookkeeping. However before starting to work with QuickBooks or ZERO the firm should confirm where it holds data.

If the data is held outside the EEA then the firm should change its registration with the Data Commissioner to include worldwide transfers or check that it has a worldwide registration. Many firms have a DP licence that only permits data to be transferred within the EEA.

The firm should also then confirm with QuickBooks/ZERO/anyone else they use that it complies with the UK Data Protection Regulations and obtain a Safe Harbour agreement. (QuickBooks should be able to supply this easily when asked as other firms have obtained it).

The firm should then amend its engagement information so that clients are aware where the data is held. The IT Faculty of the ICAEW are working on a help sheet in this area but this will not be out until at least September 2015 and even then might not include engagement letter wording.

HMRC IT Advice

When considering the firms IT policies generally the firm should take note of the latest advice from HMRC. It is firstly saying that firms should ensure they use their own login to access HMRC online service and not the client's.

Then it is advising firms to keep their HMRC agent login details secure and update them periodically. A particular risk in this area are the firm's procedures when a member of staff leaves, if that member of staff would have had access to the firm's agent login details.

BARCLAYS BANK PLC V GRANT THORNTON UK LLP (GT) – BANNERMAN WORKS! (LECTURE A516 – 7.54 MINUTES)

The recent ruling of the English Commercial Court in *Barclays Bank Plc v Grant Thornton UK LLP* (GT), is great news for auditors. It confirmed that the 'Bannerman' paragraph works and that it does what it was intended to do; limit liability to third parties for the content of the audit report.

Details of the case

GT performed non-statutory audits of the Von Essen Hotels Limited Group (VEH). GT gave clean audit reports for 2006 and 2007. Barclays claimed that the accounts had been manipulated to show that VEH was able to meet bank covenants on the loan facility, when in fact it could not. It is claimed that GT was provided with false information by two of VEH's key employees.

Barclays suffered losses of approximately £45 million when VEH went into administration in April 2011. Barclays said that it relied upon the clean audit reports in advancing loans to VEH.

Particulars of the claim

Barclays claimed that GT owed it a duty of care and that the duty of care was breached because of the auditors' failure to uncover the alleged fraud. Barclays also claimed that GT would have known that Barclays would place reliance on the audit reports.

Bannerman was included in both audit reports. The wording was based upon ICAEW guidance (www.icaew.com/en/technical/audit-and-assurance/working-in-the-regulated-area-of-audit/audit-reports) and amended taking into account the fact that the audits were non-statutory. Basically, the Bannerman paragraph says that the auditor did not accept or assume responsibility in respect of the reports to anyone other than the company and its directors.

GT applied for summary judgment on the basis that Barclays' claim had no reasonable prospect of success. The judge agreed, and proceeded assuming that the factual assertions made by Barclays were true, namely that GT knew Barclays would rely upon the audit reports.

Bannerman and the decision

The court paid particular attention to the Bannerman paragraph, from the following perspectives:

Was Barclays aware of the Bannerman clause?

The judge said that Barclays should have been aware of Bannerman. It was included in the first two paragraphs of the report so even if the relevant person at Barclays had not read it, then they should have.

Was the Bannerman clause reasonable?

The judge considered whether the Bannerman clause was reasonable by reference to the 1977 Unfair Contract Terms Act.

For a very wide range of reasons, the Court found that the Bannerman clause was reasonable.

Would the decision have been different if GT had not used Bannerman?

Mr Justice Cooke commented that in the circumstances, had there not been any disclaimer, it would be "clearly arguable" that GT would have owed a duty of care to Barclays.

The existence of the Bannerman clause was therefore critical.

'Disclaimer'

It is interesting to note that during the case the judge and lawyers routinely referred to the Bannerman paragraph as a 'disclaimer'. ICAEW goes to some lengths to avoid this word, calling Bannerman, 'clarification language'. Nonetheless, it appears that when it comes to the crunch, it is a disclaimer and without it, auditors are at much greater risk of successful legal action.

SRA ACCOUNTANTS' REPORT REQUIREMENTS RELAXED
(LECTURE A517 – 5.04 MINUTES)

Reporting accountants who work with solicitor clients will know all too well that the SRA Accounts Rules 2011 are complex. However, the Solicitors Regulation Authority (SRA) is going through a programme of deregulation and the accountants' report has been the subject of a lot of attention by the SRA.

The idea behind the deregulation phases by the SRA is to reduce what they deem to be 'unnecessary regulatory burdens' whilst at the same time maintaining an appropriate level of consumer protection.

Purpose of the accounts rules

The primary purpose of the SRA Accounts Rules is to keep client monies safe, but the SRA acknowledge that whilst this is the primary purpose of the Accounts Rules, there has to be a balance between this and the regulatory burdens they impose, which have to be necessary and proportionate.

The Accounts Rules make it mandatory for solicitors who hold client money to obtain an annual accountant's report and the SRA has been considering whether this obligation is necessary in every situation based on the specific risks posed.

The SRA have embarked on a programme of simplification where the rules are concerned and this is likely to be welcomed by many accountants, especially as the SRA intimated in their proposals that they want to reduce the length and complexity of the rules.

First round of proposals

The first consultation by the SRA where the accountant's report was concerned generated a significant amount of debate. This was because the SRA proposed to remove the annual requirement to obtain and deliver an accountant's report and place the responsibility for ensuring client money is safe on the Compliance Officer for Finance and Administration (the COFA).

Respondents to the first round of proposals expressed support for the SRA to move towards a more proportionate and targeted regulation of the risks, but generally did not support the removal of the requirement to obtain an accountant's report; it was felt that retaining a degree of independent scrutiny of the way that firms safeguard client money was important. As a result, the SRA decided to implement a phased approach to the changes in the Accounts Rules.

Recent changes to reporting requirements: phase one

The first phase of the deregulatory exercise was implemented through changes to the SRA Accounts Rules which came into effect on 31 October 2014. These changes:

- introduced an exemption from the requirement to obtain an accountant's report for the small number of firms which receive 100% of their client money from Legal Aid Agency work. This change was on the basis that the blanket requirement was no longer justified by the limited risks posed to client money;
- retained the existing requirement on all other firms to obtain an accountant's report within six months of the end of the accounting period to which the report relates. Only qualified accountants' reports are required to be submitted to the SRA; and

- update the format of the accountant's report to remove unnecessary information fields.

The latest version of the SRA Accountant's Report form is on the SRA's website at www.sra.org.uk and reflects the following changes:

- less wording on page 1 of the form;
- requirement to disclose the name of the firm's COFA in section 1;
- additional confirmation as to whether consultants or employees held, or received, client money, or operated a client's own account as signatory during the reporting period;
- comparison date information brought forward into section 2;
- removal of section 3A *Sole practice*, 3B *Recognised body/licensed body (partnership)*, 3C *Recognised body/licensed body (LLP or company)* and 3D *In-house practice*; and
- removal of the statements relating to independence.

During the comment period on the first consultation, some reporting accountants suggested to the SRA that they should be allowed to rely more on their professional judgement. The SRA responded that this approach is already reflected in the Accounts Rules which make provision that the accountant *'should exercise his or her professional judgment in adopting a suitable "audit" programme'*.

Recent changes to reporting requirements: phase two

On 15 July 2015, the SRA announced that the reporting requirements for reporting accountants are to be relaxed. The objective here is to further reduce the complexity of the SRA Accounts Rules.

The SRA Board agreed that existing, rigid requirements on the submission of accountants' reports are to be relaxed. To that end, reporting accountants will be able to use their professional judgment in the future to assess if the reports they prepare for solicitors' practices comply with the SRA Accounts Rules.

The most notable change being brought about by this relaxation is the fact that accountants will no longer be required to qualify reports for trivial breaches of the rules, but can, instead, focus on risks to client money.

Crispin Passmore, Executive Director, Policy, said:

'These changes give accountants more scope to use their expertise and advise firms on potential risks. Some firms may find that obtaining reports is very expensive because of their size and structure, so it makes sense to use accountants' expert views in this way to ensure value for money.

'At the other end of the scale, where firms hold small amounts of client money and are relatively low-risk, relaxing the current arrangement is sensible. This second phase of changes is part of our drive to reduce bureaucracy and be proportionate.'

Guidance on how this new approach will work should be available shortly on the SRA's website (SRA have said that it will be made available 'well in advance of implementation').

The exemption from the requirement for lower-risk firms to obtain an accountant's report will be extended to include firms with an average client balance of less than £10,000 a year and a maximum account balance of £250,000.

Implementation date: phase two

The changes implemented in phase two by the SRA are subject to approval by the Legal Services Board. If these changes are approved, the amendments will form part of Version 15 of the SRA Handbook which goes live on 1 November 2015. Reporting accountants should note that a further revised version of the accountants' report form will be available for use after 1 November 2015 and will apply to all firms whose accounting period ends on or after that date.

Phase three

The next phase of simplifications will commence in the autumn and will be focused on simplifying the Accounts Rules themselves.

ISA (UK AND IRELAND) 210 *AGREEING THE TERMS OF AUDIT ENGAGEMENTS* *(LECTURE A518 – 8.15 MINUTES)*

One of the most frequently cited problems by file reviewers of audit assignments is the content of the letter of engagement. The problems generally stem from a failure to comply with the requirements of ISA (UK and Ireland) 210 *Agreeing the terms of audit engagements*. In some, more worrying, cases letters of engagement are not on file and this demonstrates a failure by firms to comply with ISA (UK and Ireland 210).

Objective of ISA (UK and Ireland) 210

Before an auditor can accept, or continue, an audit engagement the basis upon which the audit is performed has to be agreed. This agreement is obtained by way of:

- establishing whether the preconditions for an audit are present; and
- confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Preconditions for an audit

Some file reviewers have criticised firms for failing to ensure that the preconditions for an audit are present in their engagement letter. This is usually because the engagement letter on file is out of date.

Preconditions for an audit were introduced as part of the Clarity project and so have been a core requirement of ISA (UK and Ireland) 210 for a number of years. Paragraph 6 of ISA (UK and Ireland) 210 says that the auditor shall:

(a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

  (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

  (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

  (ii) To provide the auditor with:

    (a) Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

    (b) Additional information that the auditor may request from management for the purpose of the audit; and

    (c) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Audit firms are advised to review their engagement letter to ensure that the preconditions are present.

Where the preconditions for an audit are not present, the first thing the auditor must do is to discuss the issue with management. If, after discussion with management, the preconditions for the audit are still not present the auditor must resign. The only time the auditor should not resign is if the auditor is compelled by law or regulation to accept the engagement.

Agreeing the terms of the audit engagement

Before acceptance, or continuance, of an audit engagement, the terms of the audit engagement must be agreed between the auditor, management and those charged with governance (as appropriate).

The agreed terms of the audit engagement should be recorded in a letter (or another acceptable form of written agreement) and must include the following:

(a) the objective and scope of the audit of the financial statements;

(b) the responsibilities of the auditor;

(c) the responsibilities of management;

(d) identification of the applicable financial reporting framework for the preparation of the financial statements; and

(e) reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Agreeing the terms of the audit engagement for recurring audits

For many audits, these will be recurring engagements. In such instances, paragraph 13 of ISA (UK and Ireland) 210 require the auditor to assess whether the circumstances indicate a need for the terms of the audit engagement to be revised and also whether there is a need to remind the entity of the existing terms of the engagement.

It is not usually necessary to send a new engagement letter each year for recurring audits. The *Application and other explanatory material* of ISA (UK and Ireland) 210 at paragraph A28 outlines some factors that the auditor should consider when assessing whether to revise the terms of the audit engagement or remind the client of the existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity’s business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Accepting a change in the terms of an audit engagement

The auditor must not accept a change in the terms of an audit engagement where there is no reasonable justification for doing so. The *Application and other explanatory material* at paragraph A31 says that a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. It then goes on to cite an example where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables (debtors) and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified, or disclaimer of, opinion.

Whilst fairly uncommon, paragraph 15 of ISA (UK and Ireland) 210 says that where the auditor is requested to change the audit engagement to an engagement which provides a lower level of assurance, prior to completing the audit assignment, then they must consider whether there is reasonable justification for doing so.

Where the terms of an audit engagement are changed and both management and the auditor agree to the change, a revised letter of engagement (or other suitable form of written agreement) should be sent to the client.

In situations where the auditor cannot agree to a change in the terms of an audit engagement, and management will not allow the auditor to continue without agreeing to the change, the auditor must take the following courses of action:

- withdraw from the audit engagement where possible under applicable law or regulation; and
- determine whether there is any obligation (contractual or otherwise) to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Other engagement acceptance considerations

Financial reporting standards supplemented by law or regulation

If there are any laws or regulations which supplement financial reporting standards (FRSs) to which the audited entity reports under, the auditor must establish whether there are any conflicts between the FRSs and the additional requirements by law or regulation. Where such conflicts do exist, the auditor must discuss the nature of the additional requirements with management and agree whether:

(a) the additional requirements can be met through additional disclosures in the financial statements; or

(b) the description of the applicable financial reporting framework in the financial statements can be amended accordingly.

Where neither of these courses of action is possible, the auditor then determines whether it will be necessary to modify the auditor's report as per ISA (UK and Ireland) 705 *Modifications to the opinion in the independent auditor's report*.

Financial reporting framework prescribed by law or regulation – other matters affecting acceptance

Where the auditor concludes that the financial reporting framework prescribed by law or regulation would be unacceptable, but for the fact that it is prescribed by law or regulation, the auditor can accept the audit engagement, but only where the following conditions are present:

(a) management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and

(b) it is recognised in the terms of the audit engagement that:

    (i) the auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures in accordance with ISA (UK and Ireland) 706; and

(ii) unless the auditor is required by law or regulation to express the auditor's opinion on the financial statements by using the phrases 'present fairly, in all material respects', or 'give a true and fair view' in accordance with the applicable financial reporting framework, the auditor's opinion on the financial statements will not include such phrases.

Where these conditions are not present, but the auditor is compelled by law or regulation to undertake the audit, the auditor must:

(a) evaluate the effect of the misleading nature of the financial statements on the auditor's report; and

(b) include appropriate reference to this matter in the terms of the audit engagement.

Auditor's report prescribed by law or regulation

There are cases where law or regulation of the relevant jurisdiction will prescribe the layout, or wording, of the auditor's report and this form may be significantly different from the requirements of the UK and Ireland ISAs in the 700 series. Where this is the case, the auditor must evaluate:

(a) whether users might understand the assurance obtained from the audit of the financial statements and, if so,

(b) whether additional explanation in the auditor's report can mitigate possible misunderstanding.

The auditor must not accept the audit engagement if it is concluded that additional explanations in the auditor's report cannot mitigate possible misunderstanding. The only exception to this is where the auditor is compelled by law or regulation to undertake the audit, but where this is the case the audit will not be compliant with UK and Ireland ISAs and hence the auditor must not make any reference within the auditor's report to the audit having been conducted in accordance with ISAs (UK and Ireland).

ISA (UK AND IRELAND) 220 *QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS* *(LECTURE A519 – 7.32 MINUTES)*

Over the years firms have been heavily criticised for failings in the way that they manage quality control at all stages of an audit. ISA (UK and Ireland) 220 *Quality control for an audit of financial statements* outlines the specific responsibilities of the auditor where quality control issues are concerned. In addition, ISA (UK and Ireland) also outlines the responsibilities of the engagement quality control reviewer.

There is a close interaction of ISA (UK and Ireland) 220 with ISQC (UK and Ireland) 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements*. This is because under ISQC (UK and Ireland) 1, the audit firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) the firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) the reports issued by the firm or engagement partners are appropriate in the circumstances.

An important point to emphasise where ISQC (UK and Ireland) 1 matters are concerned is that professional bodies (such as QAD and ACCA monitoring officers) are very interested in ensuring member firms have an up-to-date and technically compliant ISQC (UK and Ireland) 1 process in place. The system of quality control includes policies and procedures which address each of the following:

- leadership responsibilities for quality within the firm;
- relevant ethical requirements;
- acceptance and continuance of client relationships and specific engagements;
- human resources;
- engagement performance; and
- monitoring.

Objective of the auditor for quality control

ISA (UK and Ireland) 220 states at paragraph 6 that the objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and applicable legal and regulatory requirements; and

(b) The auditor's report issued is appropriate in the circumstances.

Quality control aspects go beyond making sure that staff are technically competent or that the team consists of an appropriate number of members (although these are, of course, important points). ISA (UK and Ireland) 220 is very comprehensive and also requires the auditor to consider relevant ethical requirements throughout the audit assignment.

Quality control for an audit of financial statements

The individual who takes overall responsibility for quality control issues on each audit engagement is the relevant audit engagement partner.

Ethical requirements

Paragraph 9 of ISA (UK and Ireland) 220 also requires the auditor to remain alert (by way of observation and making enquiries), for evidence of non-compliance with relevant ethical requirements by members of the engagement team.

This is an important part of quality control because recently regulators have criticised some firms for failing to ensure compliance with the Ethical Standards. Ethical Standards are at the heart of audits and must be complied with and rank as equally important as the UK and Ireland ISAs.

Where matters come to the attention of the audit engagement partner which might indicate that members of the audit engagement team have not complied with relevant ethical requirements, the engagement partner, in conjunction with the others in the firm, must determine the appropriate action. An example would be the acceptance by one, or more, audit team members of hospitality that is not considered to be insignificant – this would give rise to self-interest and familiarity threats to independence and objectivity.

Independence

The audit engagement partner is responsible for forming a conclusion as to whether independence has been maintained throughout the course of the audit engagement. This is a requirement of paragraph 11 of ISA (UK and Ireland) 220 and in this respect the audit engagement partner must:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships which create threats to independence (e.g. familiarity threats or long association with the audit client).

(b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement.

(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Acceptance and continuance of client relationships and audit engagements

The engagement partner has an obligation to ensure that appropriate procedures concerning acceptance and continuance of client relationships and audit engagements have been followed. In addition, any conclusions drawn in this regard must also be considered as to their appropriateness by the audit engagement partner.

Where the audit engagement partner obtains information which would have caused the audit firm to decline the audit engagement had that information been made available earlier, the engagement partner must inform the audit firm promptly so that the firm and the audit engagement partner can take the required action. An example of receiving such information would be where the integrity of the owners has been brought into question.

Assignment and review of the engagement team

The engagement team assigned to an audit (together with any experts which the auditor might commission) must, collectively, have the appropriate experience and technical competence in order to:

- perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and
- enable an auditor's report that is appropriate in the circumstances to be issued.

Review of engagement performance

Firms are frequently criticised during file reviews for a lack of partner involvement during the audit, or a lack of supervision and review procedures. Criticisms arise because it demonstrates a failure to apply the provisions in ISA (UK and Ireland) 220 properly.

It is the overall responsibility of the audit engagement partner to ensure that reviews of audit team members' work are undertaken in accordance with the firm's review policies and procedures. This is important because the team will be responsible for gathering sufficient and appropriate audit evidence on which the engagement partner will base their conclusion.

The *Application and other explanatory material* at paragraph A17 gives a useful list of considerations when it comes to reviewing engagement team performance, such as whether, for example:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

Reviews by the engagement partner should not merely be confined to whether the audit fieldwork has been completed. Reviews must take place at appropriate stages during the engagement so as to allow any significant matters to be resolved on a timely basis. Factors which paragraph A18 say should be focussed on at appropriate stages of the engagement are:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

It is not absolutely necessary for the audit engagement partner to review all audit documentation, but s/he may choose to do so. What is more important is that the audit engagement partner adequately documents the extent and timing of the review so as to comply with ISA (UK and Ireland) 230 *Audit documentation*.

Consultation during the audit

The evidence which is gathered must be sufficient and appropriate so as to enable the audit engagement partner to reach a conclusion and issue the audit report. To that end, the engagement partner must:

(a) take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;

(b) be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

(c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and

(d) determine that conclusions resulting from such consultations have been implemented.

Members of the audit engagement team may wish to consult on significant technical, ethical and other matters. Effective consultation is achieved when those consulted:

1. are given all the relevant facts which will enable them to provide informed advice; and

2. have appropriate knowledge, seniority and experience.

Quite often during the course of an audit engagement, certain team members may wish to consult outside of the firm, such as on a difficult tax issue or financial reporting matter. It may be that the firm itself does not have appropriate internal technical resources available and hence the team member may wish to consult with, say, a professional body's technical advisory department. This should be encouraged where effective consultation will be achieved.

Engagement quality control review

For audits of financial statements of listed companies and for those other audit engagements (i.e. private entity audits) for which the firm has concluded an engagement quality control review is required, the engagement partner must:

(a) determine that an engagement quality control reviewer has been appointed;

(b) discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and

(c) not date the auditor's report until the completion of the engagement quality control review.

Responsibility of the engagement quality control reviewer

The engagement quality control reviewer must undertake an objective evaluation of the significant judgments which have been made by the audit engagement team and the conclusions which have been drawn in arriving at the opinion stated in the auditor's report. In undertaking this evaluation, the engagement quality control reviewer must:

(a) Discuss significant matters with the audit engagement partner.

(b) Review the financial statements and the proposed audit report.

(c) Review selected audit documentation relating to significant judgments of the engagement team together with the conclusions they have reached.

(d) Evaluate the conclusions reached in compiling the auditor's report and then consider whether the proposed auditor's report is appropriate.

For listed company audits, there are three additional considerations for the engagement quality control reviewer:

(a) Evaluating the audit team's and audit firm's independence in relation to the audit engagement.

(b) Considering whether appropriate consultation has been made on difficult and contentious matters and the conclusions which have arisen from those consultations.

(c) Assessing whether the audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.

If any differences of opinion arise between the audit engagement partner and the engagement quality control reviewer, the engagement team must follow the firm's policies and procedures for dealing with, and resolving, such differences of opinion.

Monitoring

The firm's policies and procedures should be monitored and updated on a regular basis. Policies are procedures cannot simply be adopted and then forgotten about, or not updated, because circumstances may change or deficiencies might be noted in the firm's policies and procedures which would mean they have to be updated.

At all times it needs to be demonstrated that the firm's policies and procedures in relation to the system of quality control are:

- relevant;
- adequate; and
- operating effectively.

Documentation

This area of ISA (UK and Ireland) 220 is probably where a lot of firms fall down because certain issues are not adequately documented on file. ISA (UK and Ireland) 220 at paragraph 24 outlines four issues which must be documented as part of the quality control process. Paragraph 25 then goes on to outline what the engagement quality control reviewer must document as part of the audit engagement which they have reviewed.

Auditor's documentation

The auditor must include in the audit documentation:

(a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

Engagement quality control reviewer's documentation

The engagement quality control reviewer must document:

(a) The procedures required by the firm's policies on engagement quality control review have been performed.

(b) The engagement quality control review has been completed on or before the date of the auditor's report.

(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

SUMMARY OF DEVELOPMENTS

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

FRC consults on limited amendments to FRS 102

20 April 2015

The Financial Reporting Council (FRC) has today issued an Exposure Draft, FRED 61 'Draft Amendments to FRS 102 – Share-based payment transactions with cash alternatives' which proposes clarifying and simplifying the accounting for share and share option awards where a cash-settlement alternative exists. Entities would generally be able to continue with their existing accounting practices applied under previous UK and Irish GAAP which should reduce transition and application costs of FRS 102.

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

'Stakeholders recently informed us of unintended consequences when entities apply FRS 102 to certain types of share option arrangements. This proposal addresses these issues and aligns FRS 102 more closely with IFRS.'

The amendments are proposed to be effective for accounting periods beginning on or after 1 January 2016. The comment period on this proposal closes on 1 June 2015.

FRC publishes exposure draft to provide assurance on Client Assets

14 May 2015

The Financial Reporting Council (FRC) has today issued an exposure draft, *Providing Assurance on Client Assets to the Financial Conduct Authority*, for consultation. The Assurance Standard has been developed to support and challenge auditors when reporting on compliance, by regulated firms, with the Financial Conduct Authority's (FCA's) Client Asset (CASS) rules designed to ensure the effective safekeeping of client assets and client monies. More than 1,500 firms hold more than £100 billion of client assets and £11 trillion of other custody asses.

The FCA has identified issues with the compliance of some firms and has strengthened its client asset regime. The proposed Assurance Standard will help ensure that the strengthened regime is underpinned by sound assurance and where regulated firms fail to maintain the control regime required by the FCA's rules, auditors will report these failing to the FCA.

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

'The effective safekeeping of client assets is an issue of significant public interest. Our proposed Assurance Standard will support auditors in providing high quality assurance over the control systems operated by regulated firms and will support auditor reporting to the FCA where regulated firms fail to fulfil their obligations.

The development of the Standard for consultation has been supported by the FCA. I encourage audit practitioners, regulated firms, investors and other interested stakeholders to read the draft, and to provide us with their views.'

The comment period on this proposal ends on 31 July 2015. Subject to consultation, the Standard would apply to periods commencing on or after 1 January 2016.

FRC publishes feedback statement on the Regulation of Auditors of Local Bodies

18 May 2015

The Financial Reporting Council (FRC) has today published Regulations and Guidance pursuant to its responsibilities under the Local Audit and Accountability Act 2014 and a feedback statement to Recognised Supervisory Bodies (RSBs) on the approval of key audit partners for local audit. Under the Act the Secretary of State has delegated most of this responsibilities for the oversight of the regulation of auditors of local bodies to the FRC.

These include:

- inspecting the quality of audits of the largest local public bodies and health bodies other than Foundation Trusts;
- recognising professional bodies responsible for overseeing auditor activities; and
- setting specific statutory requirements for local auditors.

In July 2014, the FRC issued a consultation document seeking views on the way in which it should give effect to three specific responsibilities delegated to it under the Local Audit and Accountability Act 2014, i.e.:

- guidance on the recognition of individuals as key audit partners;
- regulations for the keeping of the Register of Local Auditors; and
- regulations for local audit firms on the requirement to publish transparency reports.

The FRC has now published a feedback statement to this consultation together with Guidance and Regulations.

FRC seeks strengthening on review of Audit Firm Governance

21 May 2015

The Financial Reporting Council (FRC) today issues its Review of the implementation and operation of the Audit Firm Governance Code. It considers the progress made in terms of governance of UK audit firms following the Code's implementation, and seeks feedback on strengthening the Code to put more focus on the public interest in, and governance of, audit work within the firm's total business. The FRC also calls for the adoption of an independent voice at international level in the firms' global networks.

The Audit Firm Governance Code was issued in 2010 and provides a formal benchmark of good governance practice against which firms which audit listed companies can report for the benefit of investors.

Chief Executive, Stephen Haddrill, said:

'The major accountancy firms are of great importance to the UK economy, both as major businesses in their own right and through the impact they have on the broader health of the financial system.

Adoption of the Audit Firm Governance Code is not a regulatory requirement, but the firms to which it applies have used it as a catalyst for improved governance of their businesses.

However, there is scope for the action already taken to be built upon. The report suggests that the principle of external challenge be adopted in the international network organisations as well as at national level. As the firms grow their consultancy businesses this challenge should remain focused on the audit practice as well as across the firm as a whole.

The Code itself should more sharply define the public interest, particularly by explicitly recognising the importance of audit quality. It should continue to be sufficiently flexible to allow firms to apply it in ways which best suit their governance structure.'

FRC welcomes IASB Exposure Draft on the Conceptual Framework for Financial Reporting

28 May 2015

The Financial Reporting Council (FRC) welcomes development of the International Accounting Standards Board's Conceptual Framework, on which an exposure draft has been issued today. The Framework will have a central role in the development of IFRS and so have a profound influence on financial reporting in the UK, Europe and globally.

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

'The updated Conceptual Framework should lead to a marked improvement in the quality of thinking on key aspects of financial reporting. The FRC is pleased that the Framework recognises the importance of stewardship and prudence, consistent with the views we and other UK stakeholders expressed on the IASB's earlier Discussion Paper. We shall review the Exposure Draft carefully to provide constructive criticism to assist the IASB in finalising the Framework.'

The FRC and ICAEW will host an event on 3 September at Chartered Accountants Hall to discuss views on the IASBs conceptual framework. The event will be chaired by FRC Board member and chair of the Accounting Council Roger Marshall. Speakers will include Ian Mackintosh, Vice Chairman of the IASB. To register, visit http://www.icaew.com/en/events/2015/September/tfrfsem150903-conceptual-framework-for-financial-reporting.

Investors welcome relevant use of digital reporting

28 May 2015

The Financial Reporting Council's (FRC) Financial Reporting Lab (Lab) has today published 'Digital Present', its report on investors' views on digital communication used by companies in their corporate reporting. The report shows that investors welcome digital reporting where it is helpful in meeting their needs for corporate information.

The Lab found:

- The annual report and its contents are of paramount importance to investors. PDF, with its 'search' capabilities, is investors' preferred format for digital annual reports;
- PDF offers a range of ways to blend the best of paper and digital formats;
- Companies could make better use of PDFs by thinking about their presentation on screen, keeping them simple, and optimising them for searching; and
- Investors need to absorb information on many companies in an efficient manner. Digital communications are of most interest to investors when they bring new information to investors' attention while avoiding duplication, and provide clarity on the purpose of each digital channel or tool and the scope of information it contains.

The report shares practical suggestions on how companies can improve their digital corporate reporting across a range of communication channels, tools and PDF annual reports.

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

'Investors have shown they are open to innovation when it meets their needs to access information relevant to their analysis, across companies and time. To enhance current digital reporting methods and innovate further, it will be important to build on the attributes identified as being most helpful. We will do this in our next phase of work on the Digital Future.'

The Lab will build on the findings from this 'Digital Present' report, to inform its next phase of work on the 'Digital Future'. It will work with companies and investors to develop ideas for optimising the opportunities digital reporting offers to companies and investors.

The Lab has released a survey alongside the 'Digital Present' report seeking views on digital reporting from those involved in the production and use of corporate reporting. The survey will be open until the end of June.

FRC provides aid to Audit Committees in evaluating audit quality

29 May 2015

The Financial Reporting Council (FRC) has issued a Practice Aid to assist audit committees in evaluating audit quality in their assessment of the effectiveness of the external audit process. The FRC is responding to requests for guidance in this area, in light of the UK Corporate Governance Code provision, introduced in 2012, that the audit committee report should include an explanation as to how it has assessed the effectiveness of the external audit process.

The aid focusses on assessing audit quality and has been developed based on feedback from audit committee members, investors, financial management and auditors. As well as setting a framework for the committee's evaluation, the aid sets out practical suggestions on how audit committees might tailor their evaluation in the context of the company's business model and strategy; the business risks it faces; and the perception of the reasonable expectations of the company's investors and other stakeholders.

The framework set out in the Practice Aid focuses on understanding and challenging how the auditor demonstrates the effectiveness of key professional judgments made throughout the audit and how these might be supported by evidence of the following critical auditor competencies:

- A mindset and culture that exhibits integrity and objectivity, and is aligned with the expectations and interests of users of their reports.
- The skills and knowledge to develop a thorough understanding of the company's business and industry, the environment in which it operates and of the applicable legal and regulatory framework, and the strength of character to provide effective challenge in performing the audit.
- The ability to establish effective quality control by putting in place the processes necessary to deliver a consistently high quality audit.

Audit committees are encouraged to see their evaluation as integrated with other aspects of their role related to ensuring the quality of the financial statements – obtaining of the quality of the auditor's judgments made throughout the audit, in identifying audit risks, determining materiality and planning their work accordingly, as well as in assessing issues.

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

'The FRC encourages audit committees to develop their own approach to their evaluation of audit quality, tailored to the circumstances of their company. Audit committees need evidence that the auditor has the competence to and has:

- *made appropriate judgments about materiality;*

- *identified and focused on the areas of greatest risk;*
- *designed and carried out an effective investigation;*
- *understood and interpreted the evidence they obtain;*
- *made reliable evaluations of that evidence; and*
- *reported with clarity and candour.*

The Practice Aid gives practical suggestions, based on what audit committees have told us they do, on how to obtain such evidence. We hope the Practice Aid will also enable audit committees to provide colour and insight and to avoid "boilerplate" in reporting on their evaluation.'

FRC publishes Audit Quality Inspections Annual Report 2014/15

29 May 2015

Audit quality improves but further action required to address recurring issues

The Financial Reporting Council (FRC) today publishes its 11th annual report on its inspections of audit quality in the UK and individual reports on five of the largest firms. The FRC inspected 109 private sector audits and believes that overall the quality of auditing in the UK is improving.

Nevertheless, there is room for further improvements in the quality of auditing and at the FRC's request a number of initiatives are being undertaken by firms to address recurring issues including undertaking root cause analysis; developing action plans to address weaknesses; and, in some instances, performing additional work to remedy significant deficiencies.

Entities outside the FTSE 350 are most likely to show a need for significant improvement in their audits. The FRC recognises that smaller companies have less resources to put into the preparation of their financial statements and this can make the audit more difficult. However, investors consistently say they rely particularly heavily on the quality of reporting in smaller listed companies given the absence of other analysis. Therefore it is particularly important that a good audit is done. The FRC is working to help companies improve the quality of reporting in this sector and will publish a report shortly. We look to the audit firm to play their part fully in this area too.

In 2015/16 the FRC will include a focus on the audits of businesses where complex supplier arrangements are prevalent; predominantly food, drinks and consumer goods manufacturers and retailers. We will pay particular attention to the extent to which the audit team has challenged and checked the appropriateness of how these arrangements are accounted for[1]. The FRC also plans to inspect a number of first year audits to assess the extent to which changes in auditors have an impact on audit quality.

Executive Director, Paul George, said:

'Audit is an integral part of the reporting process that ensures investors have confidence in the information they receive on the performance of the companies they invest in.

We were pleased firms responded positively to the new extended auditor reporting requirements. We hope to see further improvements in the clarity of reporting by auditors to discuss findings from our inspections to Audit Committees ('ACs') and will monitor closely how companies report our findings to their shareholders.'

[1] The FRC's Corporate Reporting Review team will also give priority to the reporting of these arrangements.

The FRC's Audit Quality Practice Aid for Audit Committees, also published today, seeks to assist Audit Committees by providing an overview of how to assess audit quality and highlights factors and questions that Audit Committees could consider in doing so.

FRC launches a programme of measures to improve the quality of reporting by smaller quoted companies

2 June 2015

The Financial Reporting Council (FRC) has today launched a programme of measures to help smaller quoted companies improve the quality of their corporate reports.

A discussion paper, 'Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies' published by the FRC, details its findings following a review of the quality of reporting by these companies and invites feedback on the findings and conclusions.

Stephen Haddrill, CEO of the FRC, said:

'Smaller quoted companies are critical to generating future jobs and growth in the economy and need access to capital to invest and grow. We recognise that these businesses have limited resources and face challenges in reporting. Our evidence though is that the annual report is important to investors and the quality of reporting can affect investment, rating and lending decisions. Companies, investors, auditors and the FRC all have a role to play in enabling improvements in the quality.'

The FRC will address the issues identified in a number of ways:

- Develop with Professional Accounting Bodies and others, ways of providing more focussed training to finance staff;
- Provide practical guidance to Audit Committees and Boards on evaluating the adequacy of a company's financial reporting function and process;
- Promote options for reduced disclosures against IFRS against such companies;
- Provide annual guidance to boards of smaller quoted companies on the current issues, areas of focus for investors and common errors; and
- Enable participation by smaller quoted companies and their investors/analysts in the work of the FRC's Financial Reporting Lab to identify ways to improve the quality of corporate reporting.

In addition, the FRC will be discussing with the London Stock Exchange and UK Listing Authority ways to ensure that companies have appropriate financial reporting resources.

The FRC's evidence suggests smaller quoted companies believe that investors pay little attention to their annual report and hence do not prioritise its preparation to a higher standard. In fact, investors have told the FRC that such reports are important to them, partly because there are fewer analysts' reports. In addition, companies can lack sufficient skilled resources and are not always up to date with reporting requirements.

Comments and feedback on the FRC's discussion paper are invited by 31 July 2015.

FRC issues Key Facts and Trends in the Accountancy Profession

18 June 2015

The Financial Reporting Council (FRC) has today published the thirteenth edition of 'Key Facts and Trends in the Accountancy Profession', the annual report which provides key data on the accountancy profession, its member bodies and firms.

Information in the report illustrates the size and current state of the accountancy profession, and how it has evolved over recent years. It brings together data on the major audit firms and seven accountancy bodies including those who offer audit qualifications and those who register and supervise audit firms.

Paul George, Executive Director, Conduct, said:

'Accountancy expertise and trust in the work of the profession are critical to UK economic growth and this report provides context for the work of the FRC in monitoring the profession's health. It is encouraging that accountancy remains an attractive profession and membership continues to grow. However, student numbers have grown at a larger rate globally compared to last year and have declined slightly in the UK and the Republic of Ireland. The long-term health of the profession relies on sufficient bright, young accountants coming into it to replace those who leave at the end of their careers.'

Key points:

- Total membership of the accountancy bodies continues to grow steadily. The seven bodies included in the report have over 335,000 members in the UK and ROI and over 485,000 members worldwide.
- There has been a decline in the number of students in the UK and Republic of Ireland, falling by 0.8% between 2010-2014. However, worldwide, the number of students qualifying with UK Bodies increased by 3% in 2014.
- The number of registered audit firms continues to decline gradually, reducing by 4.9% between 31 December 2013 and 2014.
- Audit fee income for the Big Four firms increased by 0.1% in 2013-14 compared with an increase of 9.5% for the larger registered firms outside of the Big Four.
- The larger registered firms outside of the Big Four had significant growth in all areas of fee income in 2014. This can be largely attributed to mergers and acquisitions in 2013 and the transfer of Local Authority audits from the Audit Commission to the private sector.

FRC welcomes European Commission's Report on the evaluation of the IAS Regulation

19 June 2015

The European Commission has today adopted a report on the evaluation of its regulation on the application of International Financial Reporting Standards (the IAS Regulation).

Melanie McLaren, Executive Director, Codes and Standards at the FRC, welcomed this report:

'The Commission concludes that adoption of IFRS has been largely beneficial and contributed to greater transparency, quality and consistency of corporate reporting by companies in Europe, and enabled meaningful comparisons to be made by investors. We agree that the existing scope of the Regulation and the options given to Member States are appropriate and support consideration of developing more simplified reporting standards for SMEs, as part of building the Capital Markets Union. Improvements to the endorsement process for accounting standards are in train through the reform programme currently being undertaken by EFRAG. The FRC will continue to input to the IASB's deliberations on its governance and conceptual framework which the Commission has identified as being important to underpinning the quality of standards.'

The Commission's conclusions were reached after extensive stakeholder research and outreach, and following the views of a panel of experts that included representatives of the FRC.