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PROPOSED AMENDMENTS TO FRS 102 (LECTURE A528 – 4.27 MINUTES)

The Financial Reporting Council (FRC) have recently issued three Exposure Drafts which outline their intentions to amend FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. The proposed amendments are largely narrow scope amendments and have been issued as follows:

- FRED 62 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Fair value hierarchy disclosures*
- FRED 63 *Draft amendments to FRS 101 Reduced Disclosure Framework – 2015/16 cycle*
- FRED 64 *Draft amendments to FRS 103 Insurance Contracts – Solvency II*

FRED 62

The amendments proposed in FRED 62 are limited and apply only to financial institutions and retirement benefit plans. The overarching objective of the amendments is to simplify the preparation of disclosures relating to financial instruments for those entities affected by the amendments, but at the same time retain consistency with the disclosure requirements of EU-adopted IFRS. Comments on FRED 62 closed on 31 January 2016 and the amendments will apply for accounting periods commencing on or after 1 January 2017, but earlier adoption will be permissible. Where a reporting entity chooses to early-adopt the amendments, disclosure of that fact must be made in the financial statements.

Paragraph 34.22 has been amended to incorporate the fair value hierarchy. The revised paragraph also says that fair value measurement is categorised in its entirety on the basis of the lowest level input which is significant to the fair value measurement in its entirety. There are three levels as follows:

- Level 1: The unadjusted quoted price in an active market for identical assets or liabilities that the entity can access at the measurement date.
- Level 2: Inputs other than quoted prices included within Level 1 that are observable (i.e. developed using market data) for the asset or liability, either directly or indirectly.
- Level 3: Inputs are unobservable (i.e. for which market data is unavailable) for the asset or liability.

Paragraph 34.42 is amended to also bring in the fair value hierarchy noted above.

Amendments have been proposed in this respect because the FRC has received feedback that making these amendments will reduce the costs of complying with FRS 102 for financial institutions and retirement benefit plans. The amendments are also suggested to enable such entities to provide information to users which is more consistent with the requirements of EU-adopted IFRS, on which FRS 102 is primarily based, and will also enable users of the financial statements to make easier comparisons between entities reporting under EU-adopted IFRS and FRS 102.

Under the current framework, the fair value hierarchy is not the same as the hierarchy which is outlined in IFRS 13 *Fair Value Measurement* and therefore the disclosures provided by a financial institution or retirement benefit plan under FRS 102 principles will not be directly comparable to those provided by an entity preparing financial statements under EU-adopted IFRS.

FRED 62 acknowledges that the SORPs for Authorised Funds, Investment Trust Companies and Pension Schemes require, or permit, additional disclosures from entities within their scope in order to improve comparability.

In addition, some financial institutions previously applied FRS 29 *Financial instruments: Disclosures* which required disclosure to be made in accordance with a fair value hierarchy and was consistent with the requirements of IFRS 13. As a result, FRS 102 introduced a departure from the requirements of IFRS.

Disclosures in accordance with the fair value hierarchy are only required for financial institutions and retirement benefits plans and hence the proposed amendments will not affect any other entities applying FRS 102. The Accounting Council does, however, note that this would lead to an inconsistency within FRS 102 because the fair value hierarchy will not be consistent with the hierarchy used for disclosure purposes in Section 34 *Specialised Activities*. Hence, the Accounting Council has advised that as part of the first triennial review of FRS 102 (which is planned to be undertaken in 2019), consideration should be given to revising paragraph 11.27 in relation to the fair value hierarchy.

FRED 63

FRED 63 proposes amendments to FRS 101 *Reduced Disclosure Framework*. The proposals relate to the new revenue recognition standard which was introduced by the International Accounting Standards Board in the form of IFRS 15 *Revenue from Contracts with Customers*.

FRS 101 is planned for amendment so as to allow certain disclosure exemptions to be taken advantage of. In addition, the FRED also proposes to clarify a legal requirement in relation to the order in which the notes to the financial statements are presented. Comments on FRED 63 are to close on 31 March 2016. In terms of the effective date, paragraph 8 of FRS 101 notes that the exemptions contained within FRS 101 are available from the date on which the relevant standard is applied. As a result, there is no need to amend the effect date for the proposed amendments but it is to be noted that the change in company law to permit the equity method in the individual financial statements of a reporting entity is effective from 1 January 2016, or 1 January 2015 if applied early which is the same date as the amendment to IAS 27 *Separate Financial Statements*.

Since the 2014/15 review, the International Accounting Standards Board has completed four projects and one project was brought forward for consideration as part of this review.

IASB project	**Date issued**	**Date effective**	**Date endorsed in the EU**
Equity Method in Separate Financial Statements (Amendments to IAS 27)	August 2014	1 January 2016	Expected Q4 2015
Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (Amendments to IFRS 10 and IAS 28)	September 2014	1 January 2016	Postponed
Annual Improvements to IFRSs (2012-2014 Cycle)	September 2014	1 January 2016	Expected Q4 2015
Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)	December 2014	1 January 2016	Expected Q1 2016
Disclosure Initiative (Amendments to IAS 1)	December 2014	1 January 2016	Expected Q4 2015

Equity method in separate financial statements

The transposition of the EU Accounting Directive into company law now allows the equity method of accounting to be used in the individual financial statements of an investor. Previously only cost-based and fair value methods were permissible. As the revisions have been included within company law, the Financial Reporting Council confirm that no amendments to FRS 101 are necessary with regards to the recent amendment to IAS 27 *Separate Financial Statements*.

Disclosure initiative

The Disclosure Initiative project was intended to clarify existing requirements and give greater guidance on issues such as the application of materiality to disclosures, the levels of aggregation and disaggregation permitted and the order in which the notes to the financial statements are presented. The Initiative itself did not change the disclosure requirements.

One area where additional guidance was included relates to the systematic manner in which the notes to the financial statements are presented. IAS 1 *Presentation of Financial Statements* has been amended and does not require entities to present notes to the financial statements in the order in which they appear in the primary financial statements. UK company law contains a requirement about the order in which the notes to the financial statements should be presented and therefore the amendments to IAS 1 will give rise to a conflict with legislative requirements. The Financial Reporting Council are therefore proposing to include an additional paragraph A2.11A in Appendix II: *Note on legal requirements*. This new paragraph is as follows:

<u>Notes to the financial statements</u>

A2.11A Paragraph 42(2) of the Regulations requires the notes to the financial statements to be presented in the order in which, where relevant, the items to which they relate are presented in the statement of financial position and the income statement. A qualifying entity preparing financial statements in accordance with FRS 101 shall have regard to this requirement when determining a systematic manner for the preparation of its notes to the financial statements in accordance with paragraphs 113 and 114 of IAS 1.

Revenue from contracts with customers

In 2015, the International Accounting Standards Board issued IFRS 15 *Revenue from Contracts with Customers*. The Financial Reporting Council have compared the disclosure requirements in IFRS 15 using the following principles:

(1) Relevance:

Does the disclosure requirement provide information that is capable of making a difference to the decisions made by the users of the financial statements of a qualifying entity?

(2) Cost constraint on useful financial reporting:

Does the disclosure requirement impose costs on the preparers of the financial statements of a qualifying entity that are not justified by the benefits to the users of those financial statements?

(3) Avoid gold plating:

Does the disclosure requirement override an existing exemption provided by company law in the UK?

The Financial Reporting Council (FRC) have also considered how the principle of 'relevance' should be applied in respect of the disclosure requirements by qualifying entities. The FRC concluded that qualifying entities will usually only have a few users of their financial statements which are external the group and any external users are likely to be providers of credit to the qualifying entity.

In light of the fact that the qualifying entity is only likely to have a few external users, the FRC concluded that significant disclosure exemptions from IFRS 15 should be made available to qualifying entities. The Accounting Council also noted that there are company law requirements which relate to the disaggregation of turnover and that IAS 1 contains requirements which relate to judgements that have a significant effect on the amounts that are recognised in the entity's financial statements. Therefore, qualifying entities are exempt from the disclosure requirements of IFRS 15 in the following paragraphs:

- paragraphs 113 to 115;
- paragraphs 118 to 127; and
- paragraph 129.

In addition, an exemption from the second sentence of paragraph 110 should be provided to remove the cross-reference to these later paragraphs.

FRED 64

FRED 64 proposes amendments to FRS 103 *Insurance Contracts* in relation to the implementation of Solvency II. Specifically, FRED 64 proposes updates to the terminology and definitions for changes in the regulatory framework, although established accounting policies can continue to be applied if an entity so wishes.

The Solvency II Directive is an EU Directive which codifies and harmonises the EU insurance regulation and is primarily concerned with the amount of capital that EU insurance companies must hold to minimise the risk of insolvency.

Paragraph 3.1(b) of FRS 103 removes reference to the Prudential Regulatory Authority (PRA) realistic capital regime and refers instead to an entity which has, or had at any time since 31 December 2004, with-profits liabilities greater than £500 million.

Paragraph 3.7 is amended to remove reference to the PRA realistic capital regime and includes reference to 3.1(b) which states that acquisition costs cannot be deferred for with-profits funds within the scope of paragraph 3.1(b).

Paragraph 3.1 is amended to remove reference to the 'modified statutory solvency basis' and refers instead to the 'established long-term insurance business liability basis'. In addition, reference to with-profits funds within the scope of the PRA realistic capital regime is deleted and instead requires the accounting treatment for with-profits funds to use the realistic value of liabilities as the basis for the estimated value of the liabilities to be included in the financial statements.

Paragraph 3.12 is amended to remove reference to the PRA realistic capital regime and paragraphs 3.12(c) (i) and (ii) are deleted.

Finally, paragraph 3.12 removes reference to the modified statutory solvency basis and instead refers to the 'established long-term insurance business liability basis.'

Comments on FRED 64 closed on 28 February 2016 and an entity will be required to apply the amended FRS 103 for accounting periods ending on or after 1 January 2016.

STRATEGIC REPORTS (LECTURE A529 – 19.41 MINUTES)

Certain reporting entities are required to include a strategic report as part of the annual financial statements. These revised requirements became effective for accounting periods ending on or after 30 September 2013.

Strategic reports have to be able to 'tell a story' and auditors have to be satisfied that the contents of the strategic report are consistent with the financial statements as a whole. In addition, the Department for Business Innovation and Skills requested the Financial Reporting Council prepare non-mandatory guidance to support the legal requirements and this guidance is available, free of charge, from the Financial Reporting Council's website. The guidance is titled *Guidance on the Strategic Report* and was issued in June 2014.

Purpose of the annual report

Paragraph 3.2 of the guidance says that the purpose of the annual report is to provide shareholders with relevant information which is useful for making resource allocation decisions and assessing the directors' stewardship. Shareholders should be provided with information within the annual report to enable them to assess the entity's:

- development, performance and position;
- future prospects;
- strategy for achieving its objectives;
- business model;
- governance; and
- directors' remuneration.

The annual report must address issues which are relevant to other users also, such as debt investors and potential investors and it must not be seen as a replacement for other forms of reporting addressed to other stakeholders.

Fair, balanced and understandable

The entity's annual report, as a whole, should be fair, balanced and understandable and should provide the information necessary for shareholders to assess the entity's performance, business model and strategy.

Company directors are required to disclose how they have applied the Corporate Governance Code (the Code) or explain why they have not applied provisions in the Code. In addition, the directors are also required to include a statement that they consider the annual report to be fair, balanced and understandable.

There is a useful table on page 10 of the FRC's guidance which provides an overview of the annual report. The overarching objective of this table is to assist preparers in making judgements regarding where information would be best placed. The table itself is not intended to stifle innovation or experimentation and is reproduced as follows:

Document	**Annual report**				
Document purpose	The purpose of the annual report is to provide shareholders with relevant information that is useful for making resource allocation decisions and assessing the directors' stewardship.				
Component	**Strategic report**	**Corporate governance report**	**Directors' remuneration report**	**Financial Statements**	**Directors' report**
Component objectives	• To provide context for the related financial statements. • To provide insight into the entity's business model and its main objectives and strategy. • To describe the principal risks the entity faces and how they might affects its future prospects. • To provide an analysis of the entity's past performance. • To provide **signposting** to show the location	• To provide information necessary to explain how the composition of the entity's governance structures supports the achievement of the entity's objectives.	• To set out all the elements of the entity's directors' remuneration policy and key factors that were taken into account in setting the policy. • To report on how the directors' remuneration policy has been implemented. • To set out amounts awarded to directors and provide details on the link between the entity's performance and directors' remuneration.	• To present the entity's financial position and development in accordance with Generally Accepted Accounting Practice.	• To provide other statutory/regulatory information about the entity.

	of **complementary information**.				
Main sources of annual report disclosure requirement for an unquoted UK company	• **The Act** s414C	• n/a	• n/a	• Accounting standards • The Act • SI 2008/410	• SI 2008/410 Schedule 7
Main sources of annual report disclosure requirements for a UK company with a premium listing on the London Stock Exchange	• The Act s414C • The Code, Provision C.1.2 • **DTR** 4.1	• The Code Schedule B • **LR** 9.8.6(5)-(6) • DTR 7.1 • DTR 7.2	• SI 2008/410 Schedule B • The Code Section D	• Accounting standards • The Act • SI 2008/410	• SI 2008/410 Schedule 7 • DTR 4.1 • DTR 7.2
	• LR 9.8 requires the inclusion of certain specific disclosures in the ‘annual report and accounts’.				

Placement of information

Information should be placed within the annual report, or elsewhere, in order to facilitate the effective communication of that information.

The guidance recognises that the annual report is a medium of communication between the company's directors and its shareholders. Its structure should, therefore, facilitate that communication and at the same time comply with company law and other regulatory requirements. The annual report should only contain information which is relevant to shareholders; any other information which is primarily provided to meet the needs of other users should be placed elsewhere, such as online or in another report.

Information which is required to meet the requirements of the strategic report should be placed within the strategic report. However, in some instances it might be helpful to group together similar or related disclosure requirements which are needed to comply with other legal or regulatory requirements. This may serve to reduce duplication and enable linkages to be highlighted and explained within one place.

The guidance acknowledges that in some instances, cross-referencing should be used in order to meet disclosure requirements; however cross-referencing should be limited to when a piece of information would tell the company's story more effectively if it were located in another component of the annual report.

The purpose of the strategic report

The guidance acknowledges that the strategic report has three main content-related objectives:

(a) to provide insight into the entity's **business model** and its main **strategy** and **objectives**;

(b) to describe the **principal risks** the entity faces and how they might affect its future prospects; and

(c) to provide an analysis of the entity's past performance.

The strategic report has to provide the shareholders with information that will enable them to assess how the company's directors have performed their duty to promote the success of the business.

The guidance also includes a summary of legal requirements which are as follows:

Summary of legal requirements

The purpose of the strategic report is to inform members of the company and help them to assess how the directors have performed their duty under section 172 of the Act.

The duty of a director, as set out in section 172 of the Act, is to 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

(a) the likely consequences of any decision in the long term;

(b) the interests of the company's employees;

(c) the need to foster the company's business relationships with suppliers, customers and others;

(d) the impact of the company's operations on the community and the environment;

(e) the desirability of the company maintaining a reputation for high standards of business conduct; and

(f) the need to act fairly as between members of the company.'

The disclosure requirements set out in section 414C of the Act, on which the content elements in Section 7 are based, are intended to ensure that the strategic report achieves its statutory purpose.

Materiality

The guidance emphasises that the strategic report and the annual report should only contain information which is material to shareholders. Information is said to be material if its omission or misrepresentation could influence the economic decisions shareholders take on the basis of the annual report as a whole. Only information that is material in the context of the strategic report should be included within it.

Conversely, the inclusion of immaterial information can obscure key messages and impair the understandability of the information provided in the strategic report. Immaterial information should be excluded from the strategic report.

The issue of materiality is an entity-specific matter which is based on the nature or magnitude (or both) of the actual, or potential, effect of the matter to which the information relates in the context of the annual report. As a result, materiality requires the directors to exercise their judgement. Paragraph 5.4 of the guidance confirms that due to the nature of the information contained in the strategic report:

(a) qualitative factors will often have a greater influence on the determination of materiality in the context of the strategic report than might be the case when making materiality judgements in respect of items in the financial statements. Both financial and non-financial information could be material; and

(b) the materiality of an item in the financial statements will often be based on its magnitude relative to other items included in the financial statements in the year under review. The potential magnitude of future effects of a matter on the entity's development, performance, position or future prospects should also be considered when determining the materiality of a matter in the context of the strategic report.

Materiality and the Companies Act

The Companies Act 2006 does not use the term 'material' but materiality is implicit in many of the Act's requirements. Phrases such as '… to the extent necessary for an understanding of the development, performance or position of the company's business' are often used in the Act. It follows that where the Act uses such terminology then it should be included in the strategic report if it is material to the shareholders.

Words such as 'key' and 'principal' are often used, for example 'key performance indicators' and 'principal risks and uncertainties'. These refer to facts and circumstances which may be judged to be material to shareholders' understanding of the development, performance, position or future prospects of the business. The guidance notes that the number of items disclosed as principal risks or key performance indicators will generally be quite small. Entities' should not produce a comprehensive list of all performance measures used within the business, or a list of all risks and uncertainties which may affect the business.

In respect of the annual report of a parent company, the strategic report should be a consolidated report and only include those matters which are material in the context of the consolidated group.

Where law or regulation require disclosures to be made, the concept of materiality cannot be applied unless the law or regulation uses the phrase '… to the extent necessary for an understanding of …' or 'principal'.

The communication principles

Section 6 of the guidance outlines certain principle which must be contained within the strategic report. The principles contained in section 6 are as follows:

- **The strategic report should be fair, balanced and understandable**

In developing the strategic report, the directors should include both the positive and negative aspects of the development, performance, position and future prospects of the entity in an open manner and without any bias. The overarching objective of this principle is that the shareholders are not misled.

Excessive use of jargon should be avoided and the strategic report should be written in plain English. Some entities might use industry-specific terminology and where this is used, it should be clearly defined and used consistently.

Generally the directors must take into consideration the strategic report when ensuring that the annual report (taken as a whole) is fair, balanced and understandable.

- **The strategic report should be comprehensive but concise**

The guidance acknowledges that 'comprehensiveness' reflects the breadth of the information which should be included within the strategic report as opposed to the depth of information. Directors should avoid covering all possible matters in detail and it should instead include information which is necessary for an understanding of the development, performance, position and future prospects of the business.

Information is said to be concise when efficient communication of all material information is enabled.

- **Where appropriate, information in the strategic report should have a forward-looking orientation**

Information contained in the strategic report should explain how a fact or circumstance may affect the entity, when that information is material to an assessment of the development, performance, position or future prospects of the entity. The guidance confirms that providing this information does not mean that the entity has to disclose forecasts of future results.

The principle requires a 'forward-looking' approach and therefore the strategic report should not focus on a single timeframe. Due consideration should be given to short-term, medium-term and long-term implications of the facts and circumstances being described in the strategic report.

- **The strategic report should provide information that is entity-specific**

The guidance acknowledges that generic 'boilerplate' information is of limited use to shareholders. Instead the directors should explain how information relating to a particular fact or circumstances might affect, or has affected, the development, performance, position or future prospects of the entity and how the entity is responding. This will provide information which will be more meaningful to shareholders and enable them to make reasoned assessments of the entity's future prospects.

- **The strategic report should highlight and explain linkages between pieces of information presented within the strategic report and in the annual report more broadly**

The term ‘linkages’ relates to the cause and effect of facts and circumstances which are outlined in the annual report.

Company law outlines a list of discrete disclosure requirements that could be met in a series of independent sections within the strategic report. It is often the case that there may be relationships between the required pieces of information per the Act, that if highlighted and explained, would provide a greater insight into the company’s business, which would be meaningful to shareholders. The guidance provides an example as follows:

Linkage example

Separate sections detailing trends in the entity’s business environment and the entity’s **strategy** may be individually informative. However, highlighting and explaining linkages between these two elements of the strategic report might provide a deeper insight into the reasons for the entity’s strategic choices.

In addition, separate sources of requirements which apply to different components of the annual report may result in the disclosure of related information within the different components of the annual report. The guidance acknowledges that a more valuable insight could be provided where the strategic report highlights and explains linkages between the information disclosed. The guidance provides an example as follows:

Linkage example

Providing independent information on an entity’s business strategy and directors’ remuneration arrangements in the strategic report and directors’ remuneration report components will be informative. However, highlighting and explaining linkages between these two components of the annual report might provide a deeper insight into the entity’s executive incentivisation policies.

The guidance suggests the use of cross-referencing or signposting or using a combination of related disclosures but care should be taken to ensure that the nature of the relationship or interdependency is adequately explained as opposed to merely highlighting its existence.

Duplication of information is also actively discouraged because the guidance recognises that this usually leads to unnecessary volumes of disclosure which, in turn, detracts from the understandability and usefulness of the annual report. This does not preclude the directors from repeating certain pieces of information, but the guidance advises that this repetition should be limited to circumstances when it would tell the company’s story more effectively. It offers an example as follows:

Example

The directors might consider some information on trends and factors to be relevant to an understanding of an entity’s strategy, **principal risks** and current year performance. Directors might choose to highlight relevant linkages either through:

- combining relevant information on trends and factors with the strategy, principal risks and current year performance disclosures;
- highlighting linkages between relevant information on trends and factors and different parts of the strategic report dealing with strategy, principal risks and current year performance; or
- a combination of some or all of the above.

- **The structure and presentation of the strategic report should be reviewed annually to ensure that it continues to meet its objectives in an efficient and effective manner**

The guidance acknowledges that a structure, content and presentation which are all consistent from one year to the next will allow comparisons to be made. However, it is important that such continuity does not override innovation where this might improve the relevant and understandability of the information presented in the report.

- **The content of the annual report should be reviewed annually to ensure that it continues to be relevant in the current period**

Some content might have been brought forward from the prior year and where this is the case, it should be reviewed to ensure that it still remains relevant. The directors must remove any information which no longer meets the objective of the strategic report.

Content elements of the strategic report

The guidance analyses the content elements of the strategic report into three broad category as follows:

Strategic management How the entity intends to generate and preserve value	**Business environment** The internal and external environment in which the entity operates	**Business performance** How the entity has developed and performed and its position at the year end
• Strategy and objectives • Business model	• Trends and factors • Principal risks and uncertainties • Environmental, employee, social, community and human rights matters	• Analysis of performance and position • Key performance indicators (KPIs) • Employee gender diversity

The guidance recognises that despite the above three classifications, the various contents above should not be addressed in isolation. This is because there are several relationships and interdependencies between elements and other disclosures in the annual report which should be highlighted and explained within the strategic report. There is no 'one-size-fits-all' where this is concerned because the relevance and strength of the relationships and dependencies will all vary according to the facts and circumstances surrounding the entity.

- **The strategic report should include a description of the entity's strategy and the objectives it is intended to achieve**

All reporting entities will have some form of aim or mission and these will be outlined in a number of formal objectives aiming to achieve those aims or missions. In addition, the entity will also have developed a strategy which describes the means by which the entity aims to achieve those objectives.

The directors should provide a description of the entity's strategy and objectives it is intended to achieve because this will provide shareholders with insight into the entity's development, performance, position and future prospects. The guidance provides a linkage example as follows:

Linkage example
Relating the development and performance of the entity during the year to the strategy that was in place at the time will allow shareholders to assess the directors' actions in pursuit of the entity's objectives and may be relevant in an assessment of the entity's future prospects.

In terms of the objectives themselves, they can either be financial or non-financial in nature and expressed in either quantitative or qualitative terms. In any event, the description of an entity's strategy and objectives should concentrate on those which are high-level priorities.

The guidance also suggests that, where relevant, linkage to and discussion of key performance indicators should be included in any descriptions so as to allow an assessment to be made of the entity's progress against its overall strategy and objectives.

- **The strategic report should include a description of the entity's business model**

The description of the entity's business model should outline what the entity does and why it does it. It should also describe factors that make the entity different from, or the basis on which it competes with, its peers.

In addition, the description of the business model should also provide shareholders with a high-level understanding of:

- how the entity is structured;
- the markets in which it operates; and
- how the entity engages with those markets.

An example is cited in paragraph 7.14 of the guidance as follows:

Example
An entity operating in the pharmaceuticals sector might have a ready market for an innovative drug; the key to the value creation process is in the development and approval of that drug. In this case, the business model description should give due emphasis to the critical drug development and approval process.

Sufficient description of the entity's business model can provide context for the strategic report and the annual report. There is also a linkage example cited in the guidance in this respect as follows:

Linkage example

Identifying relationships between the business model and other content elements could provide linkage with other relevant information in the strategic report. For instance, it could highlight the principal risks that affect, or strategy that relates to, a specific part of the business model.

- **To the extent necessary for an understanding of the development, performance or position of the entity's business, the strategic report should include the main trends and factors likely to affect the future development, performance or position of the business.**

There are various trends and factors which may affect a business and these can arise internally or externally. The guidance cites an example as follows:

Example

The environment within which an entity operates, particularly that related to consumer sentiment, can change quickly as a result of a specific incident or media interest. A recent incident or media coverage need not be directly related to the entity, and need not have affected the current year performance, to have the potential to give rise to new risks or opportunities that may have a material effect on its future prospects.

In preparing the strategic report, the directors should include a description of the entity's major markets and its competitive position within those markets. Examples of other significant features of its external environment which it should cover include:

- the entity's legal environment;
- its regulatory environment; and
- macro-economic and social environment.

Some entities may discuss internal trends and factors within the strategic report; however this will vary depending on the nature of the business but could include issues such as the development of new products and services or the benefits expected from capital investment. An example cited in the guidance is as follows:

Example

An entity may wish to state in its strategic report that the market in which it operates has grown substantially in the past five years. In this case, the strategic report should, where practicable indicate by how much the market has grown and provide a link to the research or report from which the statistic has been taken.

The guidance acknowledges that trends and factors have important influences on many aspects of an entity's development, performance, position or future prospects. The guidance acknowledges the linkage of this type of information within other areas of the strategic report and the annual report will be important and cites a linkage example as follows:

Linkage example

The strategic report might highlight the principal risks or opportunities that arise from, or the strategy that has been adopted as a result of, significant trends and factors identified. It might also highlight how certain trends or factors have affected the development, performance or position of the entity through reference to information in the financial statements.

- **The strategic report should include a description of the principal risks and uncertainties facing the entity, together with an explanation of how they are managed or mitigated.**

Again it is important to emphasise that the risks and uncertainties which are described in the strategic report should be limited to those which are deemed to be material to the development, performance, position or future prospects of the entity. The risks and uncertainties likely to be included in the strategic report are those which the directors frequently discuss because of their likelihood and/or the magnitude of their potential effect on the entity.

Risks fall to be classed as those which are financial and non-financial. Risks which are deemed to be 'principal' risks should be disclosed and described regardless of how they are classified or whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board have little or no direct control. In addition, the assessment of risks and uncertainties should also include the consideration of threats to solvency and liquidity.

The requirement to include principal risks and uncertainties within the strategic report helps to explain to a shareholder why they are material to the entity. Therefore, directors should provide a description of the likelihood of the risk together with an indication of the circumstances under which the risk might be most relevant to the entity and its possible effects. It would also be helpful for the directors to include an explanation of how the principal risks and uncertainties are managed or mitigated to enable the shareholders to assess the impact on the future prospects of the entity. The guidance provides a linkage example as follows:

Linkage example

The disclosure of risk management or mitigation might be enhanced with the discussion of the reporting and monitoring process, for example, through disclosures that explain the entity's appetite for risk, how often the risk is reviewed, and by whom. Risk management and mitigation could also be linked to an entity's overall approach to risk management and internal control which is often included in the corporate governance report.

Where there have been significant changes in principal risks, for example a change in likelihood, probable timing or possible effect, or new principal risks have emerged, then these should be highlighted and explained within the strategic report.

- **To the extent necessary for an understanding of the development, performance or position of the entity's business, the strategic report should include information about:**

  a) environmental matters (including the impact of the business of the entity on the environment);

  b) the entity's employees; and

  c) social, community and human rights issues.

  The information should include a description of any relevant policies in respect of those matters and the effectiveness of those policies.

> **Where information on any of the matters described above is not included in the strategic report because it is not considered necessary for an understanding of the development, performance or position of the company's business, the strategic report should state the matters that are not covered in the strategic report.**

Information should be included in the strategic report in respect of the above when its influence, or potential influence, on the development, performance, position or future prospects of the entity's business is material to the shareholders. The guidance cites an example as follows:

Example

An entity that sources its products from overseas could face risks (e.g. reputational risks) relating to customer concerns over local labour practices. In this situation, the entity might have put in place a system to validate and monitor adherence to stated labour practice policies across its supply chain. Where the nature or magnitude of the potential effect of the risk on the business is such that it would be material to shareholders, it should be described and discussed in the strategic report.

The guidance requires matters to be described in the strategic report if the influence, or potential influence, is material to shareholders. However, in some situations, information might be better described through other content elements, and in such cases a clear linkage should be provided. The guidance provides a linkage example as follows:

Linkage example

The way an entity conducts its business in relation to the issues in paragraph 7.29 may affect its licence to operate/trade in a particular location or market, or may potentially result in a major event that will directly or indirectly affect the entity (e.g. a material litigation, loss of revenue or reparation of cost). The risk of such an event may constitute a principal risk or uncertainty to the entity and/or the actions taken in response to those matters may constitute a strategy that warrants disclosure. In such circumstances, the information about the issue might be most appropriately disclosed alongside a description of the related risk or strategy rather than in a separate part of the strategic report.

Where information relating to a specific matter is considered necessary so as to obtain an understanding of the development, performance, position or future prospects of the entity's business, the following items could be included within the strategic report if they are considered relevant:

- the entity's policy in respect of the matter, together with a description of any measures taken to embed the commitment within the organisation;
- any process of due diligence through which the entity:
    - assesses the actual or potential impacts arising from its own activities and through its business relationships;
    - integrates the findings from these assessments and takes action to prevent or mitigate adverse impacts;
    - tracks the effectiveness of its efforts; and
    - communicates its efforts externally, in particular to affected stakeholders; and
- the entity's participation in any processes intended to remediate any adverse effects that it has caused or to which it has contributed.

Information which is not considered necessary for an understanding of the development, performance, position or future prospects of the entity's business must not be included within the strategic report. Where directors consider it necessary to release such information in the public domain, it should be done so outside of the strategic report which is more likely to be done online through a corporate social responsibility report.

- **The strategic report should provide an analysis of the development and performance of the business in the financial year and of its position at the end of that year.**

In the broadest terms, the analysis of the business's performance should complement the information provided in the financial statements. The guidance cites an example as follows:

Example

The strategic report might, where relevant, include comments on:

- the existence and timing of commitments for capital expenditures;
- changes in revenue from year to year that result from organic growth, acquisitions, foreign exchange, etc. (a 'revenue bridge'); or
- financing arrangements (e.g. changes in net debt or approach to financing of long-term liabilities).

Where an entity discloses segmental information (for example in line with IFRS 8 *Operating Segments)* any segmentation of the analysis of development, performance or position should be in line with the segmental analysis identified in the financial statements. In addition, the analysis should also make reference to cash flows during the year and factors which may affect future cash flows.

The strategic report should also include information relating to the entity's key strengths and tangible and intangible resources (including those items which are not reflected in the financial statements), and could include:

- corporate reputation and brand strength;
- customer base;
- natural resources;
- employees;
- research and development;
- intellectual capital;
- licences, patents, copyrights and trademarks; and
- market position.

- **The analysis in the strategic report should include financial and non-financial key performance indicators (KPIs).**

Directors should only include those KPIs in the strategic report which they consider to be the most effective in assessing progress against:

- objectives or strategy;
- monitoring principal risks; or
- are otherwise used to measure the development, performance or position of the entity.

Directors can include non-financial KPIs in the strategic report which may relate to the future financial prospects of the business as well as progress in managing risks and opportunities.

Where KPIs are used, they should be included with comparatives and any significant changes from one year to the next should be adequately explained. In addition, the guidance suggests that the following information be identified and explained where relevant in respect of a KPI:

a) its definition and calculation method;
b) its purpose;
c) the source of underlying data;
d) any significant assumptions made; and
e) any changes in the calculation method used compared to previous financial years, including significant changes in the underlying accounting policies adopted in the financial statements which might affect the KPI.

The guidance cites a useful example as follows:

Example

Where an entity uses earnings before interest, tax, depreciation, amortisation (EBITDA) and certain restructuring costs as a KPI, the measure could be referred to as 'EBITDA before restructuring costs' or similar. A reconciliation to an appropriate financial statement line-item and explanation of the adjustment should be provided.

The guidance recognises that a reporting entity will use similar KPIs in its annual report, but requires that similar KPIs should be distinguishable from each other and cites an example as follows:

Example

An entity may use one adjusted earnings per share measure when discussing performance and another when discussing executive remuneration in the directors' remuneration report. The terms adopted to describe each KPI should be unique and used consistently and the differences between the two KPIs clearly identified.

- **The strategic report should provide a breakdown showing, as at the end of the financial year:**

  a) the number of persons of each sex who were directors of the company;

  b) the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph a)); and

  c) the number of persons of each sex who were employees of the company.

The guidance notes that the term 'senior manager' refers to an employee that has responsibility for planning, directing or controlling the activities of the entity, or a strategically significant part of it. In the consolidated annual report of a group, directors of subsidiary companies which are included in the consolidated financial statements are considered senior managers.

The definition of 'senior manager' above is wider than the definition of key management personnel found in IAS 24 *Related Party Disclosures* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. This is because the guidance refers to such senior managers as planning, directing or controlling the activities of an entity or a **strategically significant part of it**.

The guidance acknowledges that there are some instances where entities may not consider that including all the directors of every subsidiary which is included in the consolidated financial statements accurately reflects the executive structure; for example, where a subsidiary may be insignificant in the context of the group as a whole. In such cases, management may find it appropriate to provide an enhanced analysis of the statutory 'senior manager' category and the guidance provides an example as follows:

	Male	**Female**
Directors of the company	X	X
Employees in other senior executive positions	X	X
Directors of subsidiary companies not included in above	X	X
Total senior managers other than directors of the company	X	X
Other employees of the group	X	X

When such an analysis is provided, the directors should also include a description of how employees included in any non-statutory category have been identified.

- **To the extent that matters are considered to be of strategic importance to the entity, the strategic report should include information that would otherwise be disclosed in the directors' report.**

There are several directors' report disclosure requirements which are also closely related to matters which should be considered for inclusion in the strategic report. Where such information is deemed necessary for an understanding of the development, performance, position or future prospects of the entity, it should be provided as part of the strategic report. Conversely, where the directors consider the information not to be necessary for such an understanding, it should be included within the directors' report. Directors should consider the use of 'signposts' so shareholders' can 'drill-down' on this information when it relates to matters contained in the strategic report.

Information which is deemed necessary for an understanding of the development, performance, position or future prospects of the entity should be included in the strategic report. Where this information should also be disclosed in the directors' report, it does not need to be duplicated in the directors' report. The directors should cross-reference information which has been included in the strategic report instead of the directors' report.

Approval of the strategic report, directors' report, directors' remuneration report and financial statements

The Companies Act also requires the board of directors to approve the strategic report, directors' report and directors' remuneration report and the financial statements. The name of the director or company secretary who has signed each report on behalf of the board should be stated on **every** copy of that report to comply with the requirements of section 433 of the Act. However, the Act does not specify where in each report the name should be located.

The strategic report with supplementary material

Section 426 of the Companies Act allows a company (in certain situations) to provide its members with the strategic report with supplementary material rather than the full annual report. The supplementary material that is supplied is outlined in section 426A of the Act and includes information on:

- the audit report on the annual accounts; and
- in the case of a quoted company, limited extracts from the directors' remuneration report.

Care must be taken where this statutory option is taken so entities' comply with the requirements of the Act. The Act requires a complete strategic report, as it appears in the annual report, to be provided to the company's shareholders. If the entity chose to provide a summarised version of the strategic report, the directors would not be complying with the legislation. In addition, extracts of the strategic report cannot be provided; in all cases it must be the full version included in the annual report.

The shareholders must also be provided with those disclosures which are included in the strategic report by way of cross-reference to another part of the annual report, along with the main body of the strategic report. An example is provided in the guidance as follows:

Example

A quoted company has chosen to present the strategic report's quantitative employee gender diversity disclosures alongside the description of the board's policy on diversity, its objectives for implementing this policy and its progress on achieving those objectives, that **the code** recommends is set out in a separate nomination committee report. It has included a cross-reference to these quantitative disclosures in the company's strategic report in order for it to meet the requirements of section 414C(8). If the company wishes to take the option to send its shareholders the strategic report and supplementary material instead of the full annual report, it must ensure that the quantitative employee gender diversity disclosures form part of the supplementary material that is sent with the main body of the strategic report.

Strategic reports will usually 'signpost' to information presented elsewhere in the annual report which shareholders' may be interested in. In such cases, the directors might wish to consider including a statement which clarifies that in the 'strategic report with supplementary material' this information is not included as part of the document which has been issued.

Some shareholders' information needs are different than others; particularly shareholders which are a subset of investors. Such shareholders' might be interested in specific business information, the form and content of which is not prescribed by law or regulation. The guidance cites an example of such as follows:

Example

A company's shareholder base may comprise substantial retail and institutional investor subgroups. The directors may find that he shareholders in the retail investor subgroup wish to receive business information that is less detailed than would be appropriate for inclusion in the strategic report within the full annual report. In these circumstances, the directors might consider it appropriate to send non-statutory summarised business information which focuses on the issues that they believe will be of the greatest relevance to the retail investors, rather than to send this subgroup of shareholders the strategic report with supplementary material as prescribed in paragraphs 8.1 to 8.4.

Publication of non-statutory accounts

Section 435 of the Act sets out the requirements in connection with the publication of non-statutory accounts. A company might choose to send its shareholders non-statutory summarised business information which includes any financial statements. If the company chooses to do this, it must ensure that it complies with the requirements in section 435 of the Act.

Where non-statutory information is provided, the shareholders must also be sent one of the statutory reports (i.e. either the strategic report with supplementary material, or the full annual report).

Electronic publication of statutory reports

Statutory reports can be sent to shareholders electronically as opposed to hard copy form.

Sections 146 and 147 of the Act make provisions where electronic publication of statutory reports is concerned. In order to send shareholders electronic copies of the statutory reports, the company must allow the shareholders' the opportunity to receive their annual report in hard copy form. This is usually done when a member becomes a shareholder, but can also be done later. Where the consent letter is worded appropriately, the member can be assumed to have consented to receiving statutory reports electronically if they do not respond.

A company might also choose to publish the annual report on the company's website and this can be deemed to be considered an acceptable form of delivery to consenting members, but only where the company's articles permit it and the company has notified the members of its availability and where it can be found.

FRS 102 AND LEASING (LECTURE A520 – 19.45 MINUTES)

Leases have always posed a problem for the accountancy profession because of their subjective nature and the ability to manipulate leasing transactions to achieve a desired outcome (commonly referred to as 'off balance sheet finance'). FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* brings about some notable changes to the way in which lease transactions are accounted for; although the concept of 'operating' and 'finance' leases remains.

Leasing is dealt with in Section 20 *Leases*. At the outset this particular section confirms that it does not deal with the following types of leasing transactions:

Type of lease	**Relevant section of FRS 102**
Leases to explore for, or use, minerals, oil, natural gas and similar non-regenerative resources.	Section 34 *Specialised Activities*
Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.	Section 18 *Intangible Assets other than Goodwill*
Measurement of property, plant and equipment held by lessees that is accounted for as investment property and measurement of investment property provided by lessors under operating leases.	Section 16 *Investment Property*
Leases that could lead to a loss to the lessor or the lessee as a result of non-typical contractual terms.	FRS 102 paragraph 12.3(f).

Finance and operating leases

Section 20 still determines the classification of a lease in much the same way as SSAP 21 *Accounting for leases and hire purchase contracts*. The overarching principle in the determination of whether a lease is a financing lease or an operating lease is considered in light of the substance of the arrangement – in other words looking at who bears the risks and rewards of ownership of the asset subjected to the lease.

When, substantially, all the risks and rewards incidental to ownership of the asset are transferred from the lessor to the lessee, this will give rise to a finance lease. The asset will appear on the company's balance sheet together with a corresponding finance lease creditor. Where the risks and rewards of ownership of the asset remain with the lessor, the lease is classified as an operating lease and rentals are charged to profit or loss as they arise. This is the same accounting treatment as we see currently in SSAP 21 and the FRSSE (effective January 2015).

The Guidance Notes to SSAP 21 and the definition of a finance lease in the Glossary to the FRSSE contain a 90% 'bright line test' whereby should the present value of the minimum lease payments that the lessee is required to pay equate to 90% or more of the fair value of the leased asset, this will give rise to a finance lease. However, Section 20 does not contain a 90% bright line test; instead it offers five examples of situations that individually, or in combination, would normally lead to a lease being classified as a finance lease, and a further three indicators of situations that individually, or collectively, would also lead to a lease being classified as a finance lease. The first five are:

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

It is to be noted that d) refers to the term 'substantially all'. This is the term that has essentially replaced the 90% test contained in SSAP 21, hence more judgement is needed on the part of the accountant to determine a level for 'substantially all'.

The three additional indicators of situations which could also lead to classification of a lease as a finance lease are as follows:

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

It is important to understand that the situations above are **not** exhaustive and this is reflected in the wording in paragraph 20.7 which confirms that all of the above situations are not always conclusive. The key to determining the correct lease classification will all depend on whether the risks and rewards of ownership have transferred to the lessee or remain with the lessor at the inception of the lease. Paragraph 20.8 says that lease classification is made at the inception of the lease and the classification is not changed during the term of the lease (i.e. from operating to finance or vice versa) unless the lessee and the lessor agree to a change in the provisions of the lease (other than simply renewing the lease). Where such provisions are changed, the lease classification is then re-evaluated.

Determining amounts in a finance lease

Once a lease has been determined as a finance lease, on initial recognition Section 20 would require a lessee to recognise its rights of use of that asset as an asset at amount equivalent to the fair value of the leased asset or, if lower, the present value of the minimum lease payments which are determined at the start of the lease. Where an entity incurs costs which are **directly attributable** in negotiating and arranging a lease, these costs are added to the amount recognised as an asset.

Example

A company enters into a finance lease with a lessor. The lessee is trying to calculate whether the present value of the minimum lease payments at the commencement of the lease are higher or lower than the fair value of the leased asset, but is unsure which rate to use to discount the minimum lease payments down to present day values.

Paragraph 20.10 of FRS 102 says that the present value of the minimum lease payments shall be calculated using the interest rate implicit in the lease. If this cannot be determined, the lessee's incremental borrowing rate is to be used instead.

Subsequent measurement – finance leases

After initial recognition, paragraph 20.11 to FRS 102 requires a lessee to split the minimum lease payments between the capital element and the interest element. This is currently done in SSAP 21 and the FRSSE and hence should be familiar to accountants. However, the reduction in the outstanding liability is calculated using the **effective interest method**. The effective interest method is a method of calculating the amortised cost of either a financial asset or a financial liability (or a group of financial assets and liabilities) and therefore allocating the interest component of the lease payments over the relevant period. Under the effective interest method:

- the amortised cost of the finance lease liability is the present value of future payments discounted at the effective interest rate; and
- the interest expense in a period is equivalent to the carrying amount of the liability at the beginning of a period multiplied by the effective interest rate for the period.

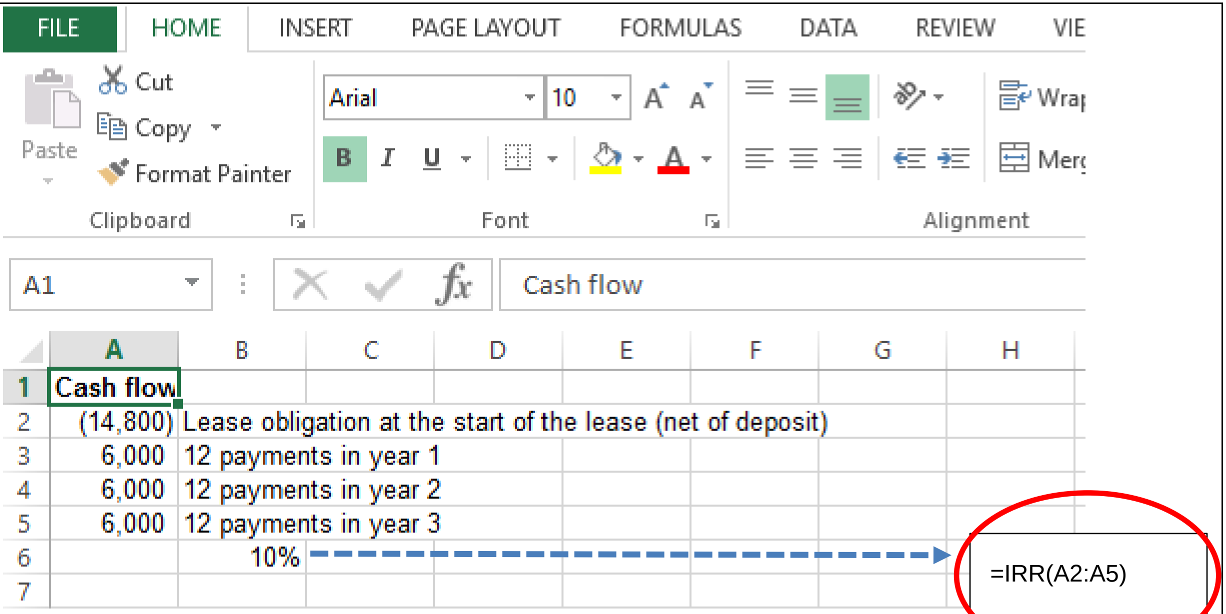
For the purposes of this calculation, the **effective interest rate** is the rate that exactly discounts the future payments through the expected life of the lease.

Example – Calculating the effective interest rate

The effective interest rate can be calculated using the internal rate of return function in Microsoft Excel. Consider the following example:

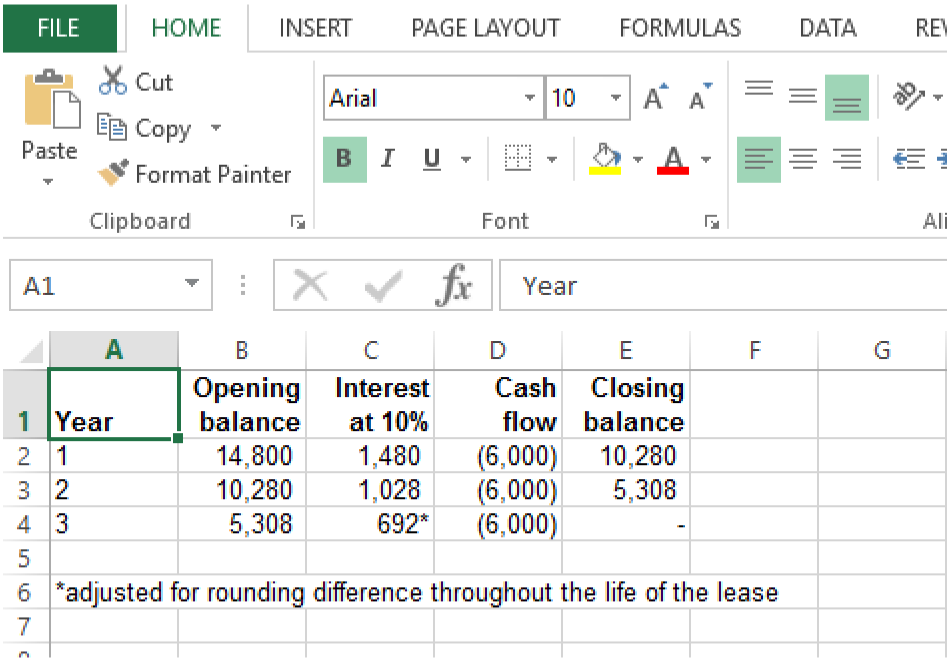
A company enters into a finance lease to lease a machine for three years. The fair value of the machine at the inception of the lease is £15,800. The lessor requires an upfront deposit of £1,000 which the lessee pays by cash. The terms of the requirement monthly payments of £500 for three years (i.e. annual payments of £6,000 per year). VAT has been ignored for the purposes of this example.

The effective rate of interest can be calculated using the internal rate of return function in Microsoft Excel. In order for the internal rate of return function to work, at least one number must be negative (which can be the lease obligation at the start of the lease) as follows:



	A	B
1	Cash flow	
2	(14,800)	Lease obligation at the start of the lease (net of deposit)
3	6,000	12 payments in year 1
4	6,000	12 payments in year 2
5	6,000	12 payments in year 3
6		10%

The above formula gives an effective interest rate of 10% and this is the rate which exactly discounts the future cash flows through the expected life of the lease. The 10% rate of interest is used to charge the profit and loss account with the interest expense and the lease can be profiled as follows:



	A	B	C	D	E
1	Year	Opening balance	Interest at 10%	Cash flow	Closing balance
2	1	14,800	1,480	(6,000)	10,280
3	2	10,280	1,028	(6,000)	5,308
4	3	5,308	692*	(6,000)	-
6	*adjusted for rounding difference throughout the life of the lease				

Depreciation of the leased asset

The lessee must depreciate the leased asset over the *shorter* of the lease term and its useful economic life and at the end of each period assess whether an asset leased under a finance lease is impaired. There is no change to how depreciation of assets under a finance lease works from the provisions in SSAP 21.

Operating leases

Operating leases will essentially follow the same accounting treatment as SSAP 21 and the FRSSE and the lessee will recognise payments under an operating lease (excluding costs for services such as insurance and maintenance) as an expense over the lease term on a straight-line basis, unless:

- another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis; or
- the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. However, if payments to the lessor vary because of factors other than general inflation, then this condition is not met.

If a lessee receives a lease incentive, this is accounted for as a reduction to the expense over the **term of the lease** on a straight-line basis, unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset. This is slightly different than in UITF 28 *Operating lease incentives*. Where a lessee receives a lease incentive, these are usually recognised in profit or loss up to the point at which the rentals revert to market rate (for example after the first periodic rent review) and hence the lease incentive would be written off up to the point of the first review. Under FRS 102 the lease incentive is written off over the lease term, regardless of any break-clauses which might apply. There is also an optional exemption available in paragraph 35.10(p) which allows an entity on transition to either continue accounting for lease incentives under outgoing UK GAAP, or restate to FRS 102. There could be an added tax incentive to restating because the operating lease charge in profit or loss would essentially be higher under FRS 102 principles because the lease incentive is being written off over a longer period.

Lessor accounting – finance leases

Lessors recognise assets which are subject to finance leases in their balance sheet as a debtor at an amount which is equal to the net investment in the lease. The 'net investment in the lease' is the gross investment in the lease, but discounted at the interest rate implicit in the lease. The 'gross investment in the lease' is the total of:

- the minimum lease payments receivable by the lessor under the finance lease; and
- any unguaranteed residual value accruing to the lessor.

Finance income is recognised in profit or loss based on a pattern that reflects a constant periodic rate of return on the lessor's net investment in the finance lease.

Example

A lessor has recognised a finance lease as a debtor, calculated using the gross investment in the lease which is discounted at the interest rate implicit in the lease. A year later it is clear that the unguaranteed residual value which was used to calculate the gross investment in the lease has changed quite significantly due to technological advances.

Where there is an indication that the estimated unguaranteed residual value used in the calculation of the gross investment in the lease has changed significantly, paragraph 20.19 says that the income allocation over the lease term shall be revised, and any reduction in respect of amounts accrued is recognised immediately in profit or loss.

Manufacturer or dealer lessors

Where lessors are manufacturers or dealers, a finance lease can give rise to two types of income:

- a profit or loss resulting from an outright sale of the asset; and
- finance income over the period of the lease.

Revenue recognised at the outset of a lease by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor (calculated using market rates of interest) is lower than the fair value of the asset, this is used as the revenue figure.

The cost of sale recognised at the outset of a lease is the cost (or carrying amount if different) of the leased asset *less* the present value of the unguaranteed residual value.

The difference between the revenue and the cost of sale is the selling profit. However, where a manufacturer or dealer lessor enters into an operating lease, it will not recognise any profit on sale because it is not the equivalent of a sale.

Lessor accounting – operating leases

Assets which are subject to operating leases are recognised in the lessor's balance sheet depending on the nature of the asset and income arising from the lease is recognised in the lessor's profit and loss account on a straight-line basis over the life of the lease. There are two exceptions to the straight-line basis of income recognition, which apply to when:

- another systematic basis is representative of the time pattern of the lessee's benefit from the leased asset, even if the receipt of payments is not on that basis; or
- the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary according to factors other than inflation, then this condition will not be met.

Costs associated with operating leases from the standpoint of the lessor are dealt with as follows:

Cost of lease incentives

These are recognised as a reduction to the income recognised over the lease term on a straight-line basis unless another systematic basis is representative of the time pattern over which the lessor's benefit from the leased asset is diminished.

Costs

Costs incurred with earning the lease income (paragraph 20.26 of FRS 102 cites depreciation as such a cost) are recognised as expenses and the depreciation policy of such assets will be consistent with the lessor's normal depreciation policy for similar assets.

Incidental costs of negotiating and arranging the operating lease

These are added to the cost of the leased asset and recognised as an expense in profit or loss over the life of the lease on the same basis as lease income.

Disclosures – finance leases (lessee's financial statements – full FRS 102)

Paragraph 20.13 says that a lessee shall make the following disclosures for finance leases:

- For each class of asset, the net carrying amount at the end of the reporting period.
- The total of future minimum lease payments at the end of the reporting period, for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years.
- A general description of the lessee's significant leasing arrangements including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases and restrictions imposed by lease arrangements.

Also the requirements for disclosure concerning assets in accordance with Section 17 *Property, Plant and Equipment* and Section 27 *Impairment of Assets* also applies to lessees for assets leased under finance leases.

Disclosures – operating leases (lessee's financial statements – full FRS 102)

Paragraph 20.16 requires the following disclosures for operating leases:

- The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years.
- Lease payments recognised as an expense.

Note – this disclosure is different than the FRSSE because under the FRSSE lessees would have disclosed the payments committed to be made within the next 12 months for leases expiring in:

- one year;
- two to five years inclusive; and
- more than five years.

Under FRS 102, the total lease liability will be split over the timeframes.

Disclosures – finance leases (lessor's financial statements – full FRS 102)

Paragraph 20.23 requires the following disclosures for finance leases in a lessor's financial statements:

- A reconciliation between the gross investment in the lease at the end of the reporting period, and at the present value of minimum lease payments receivable at the end of the reporting period. In addition, a lessor shall disclose the gross investment in the lease and the present value of the minimum lease payments receivable at the end of the reporting period, for each of the following periods:

  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years.
- Unearned finance income.
- The unguaranteed residual values accruing to the benefit of the lessor.
- The accumulated allowance for uncollectible minimum lease payments receivable.
- Contingent rents recognised as income in the period.
- A general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases and restrictions imposed by lease arrangements.

Disclosures – operating leases (lessor's financial statements – full FRS 102)

Paragraph 20.30 requires the following disclosures for operating leases in the lessor's financial statements:

- The future minimum lease payments under non-cancellable operating leases for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years.
- Total contingent rents recognised as income.
- A general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options, escalation clauses and restrictions imposed by lease arrangements.

In addition, paragraph 20.31 requires disclosures about assets in accordance with Section 17 *Property, Plant and Equipment* and Section 27 *Impairment of Assets* for assets provided under operating leases.

Disclosures for small companies under FRS 102 Section 1A

The legally required disclosures for lessees in respect of operating leases under FRS 102 Section 1A are as follows:

- The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
  - not later than one year;
  - later than one year and not later than five years; and
  - later than five years.
- Lease payments recognised as an expense.

Disclosures for micro-entities under FRS 105

A micro-entity shall determine the amount of any financial commitments, guarantees and contingencies not recognised in the balance sheet arising from operating leases and disclose that amount within the total amount of financial commitments, guarantees and contingencies.

New leasing standard (IFRS 16 Leases)

It is worth noting that the International Accounting Standards Board (IASB) issued a new standard on leasing in the form of IFRS 16 *Leases*. This new standard sets out the recognition, measurement, presentation and disclosure of leases for both parties to a contract (the lessee and the lessor).

The new standard applies for accounting periods starting on or after 1 January 2019 but an entity reporting under IFRS can choose to apply the new standard before that date. However, if the entity chooses to early-adopt IFRS 16, it must then also early-adopt the provisions in the new revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers*.

The issuance of IFRS 16 marked the end of several years of work by the IASB in developing a standard which overhauls the way in which leases are accounted for. The new standard will supersede IAS 17 *Leases* and any related Interpretations.

Brief overview

One of the most notable changes brought about in lease accounting by IFRS 16 is that the standard eliminates the concept of 'operating' and 'finance' leases. It introduces a single model which requires a lessee to recognise:

- assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value; and
- depreciation of lease assets separately from interest on lease liabilities in the income statement.

For lessors, there is no change to the accounting requirements and lessors will continue as normal classifying leases as operating leases or finance leases.

Why the need for change?

IAS 17 requirements focused on identifying when a lease is economically similar to an entity purchasing the asset being leased. Indeed, FRS 102 follows similar principles where the economic substance of the leasing transaction is reported and where a finance lease is concerned, the economic substance (i.e. the commercial reality) of the transaction is that the lessee has acquired an asset which has been funded through a leasing transaction, hence the asset is reported as a fixed asset with a corresponding finance lease creditor.

Operating leases are not reported on the balance sheet and these are accounted for similarly to service contracts with the company recognising a rental expense on a straight-line basis over the life of the lease.

The development of a new leasing standard by the IASB has been a long journey; indeed the project was initially started in 2005. Both the IASB and the US Financial Accounting Standards Board (FASB) recognised that most leasing transactions were not reported on the balance sheet and hence assets and liabilities were both conceptually understated. In 2014 companies listed on a recognised stock exchange disclosed almost US$3 trillion worth of off-balance sheet lease commitments in 2014.

The IASB concluded that in the absence of information concerning leases on the balance sheet gave rise to investors and analysts not having a complete picture of the overall financial position of the entity and therefore they were unable to compare companies that borrow to buy assets with those that lease similar assets, without adjustments having to be made.

The IASB undertook a sample of companies entering into off-balance sheet arrangements, and the conclusions reached are quite concerning:

Long-term liabilities of heaviest users of off balance sheet leases[1]	
27%	Africa/Middle East
32%	Asia/Pacific
26%	Europe
45%	Latin America
22%	North America

Changes brought in by IFRS 16

The UK's Financial Reporting Council have not intimated that they intend to change the way in which lease accounting will work in the UK, but some companies in the UK will be affected by the new standard as they report under EU-adopted IFRS. Some of the notable changes are noted below:

Definition of a lease

The definition of an asset has been changed to confirm that a lease is *'… a contract that conveys to the customer ('lessee') the right to use an asset for a period of time in exchange for consideration.'*

A lease will exist when a customer has the right to control the use of an identified asset for a period of time. Whilst the definition of a lease has changed, the IASB acknowledge that this was done on the basis of feedback and that the changes made to the definition are not expected to change the conclusions about whether contracts contain a lease for the vast majority of contracts.

Changes to the balance sheet

In respect of lessees, the notable change comes in the form of the elimination of leases as either operating or finance leases. IFRS 16 regards all leases as finance leases and hence they are capitalised by recognising the present value of the lease payments and showing them as either 'lease assets' (right-of-use assets) or combined with property, plant and equipment. Where lease payments are made over a period of time, a finance lease liability is recognised within creditors representing the lessee's obligation to make future lease payments.

Clearly the most significant change to an entity's balance sheet will be an increase in lease assets and finance lease liabilities.

Exemptions

IFRS 16 does not require a lessee to recognise lease assets and lease liabilities on the balance sheet in two situations:

- the leases are short-term (i.e. 12 months or less); and

[1] Based on a sample of 1,022 listed companies reporting under IFRS or US GAAP. These companies have estimated off-balance sheet leases of more than US$300 million, calculated on a discounted basis. The percentages represent estimated off-balance sheet leases (discounted) compared to long-term liabilities reported on the balance sheet, by region.

- the leases are in respect of low value assets (such as a computer lease).

Changes to profit or loss

For entities that have material off-balance sheet leases, IFRS 16 will bring a change to the nature of expenses which relate to those assets. As mentioned, the concept of operating leases is eliminated and therefore IFRS 16 replaces the straight-line operating lease rental with a depreciation charge for leased assets, which is to be included within operating costs. There will also be an interest expense (recognised in finance costs) in respect of the leasing liabilities.

Depreciation charges will generally be even throughout the life of the lease, but the interest expense will not. This is because the interest expense under IFRS 16 will reduce over the life of the lease as lease payments are made. This results in a reducing total expense as an individual lease matures. The IASB have said that they do not expect the expense profile between IFRS 16 and IAS 17 to be significant for many companies which hold a portfolio of leases which start and end in different accounting periods.

The impact on profit or loss can be seen in the following table:

	IAS 17		IFRS 16
	Finance lease	**Operating lease**	**All leases**
Revenue	X	X	X
Operating costs (excluding depreciation and amortisation)	-	Single Expense	-
EBITDA			↑
Depreciation and amortisation	Depreciation	-	Depreciation
Operating profit			↑
Finance costs	Interest	-	Interest
Profit before tax			↔

Cash flow statement

The actual cash flows involved in leasing transactions will not change. However, the presentation of some cash flows will change.

Operating cash flows are expected to reduce under IFRS 16 principles with a corresponding increase in financing cash flows. This is because under IAS 17 principles, companies presented cash outflows on former off-balance sheet leases as operating activities. Under IFRS 16, capital repayments on all lease liabilities are included in financing activities. Interest payments can also be included within financing activities under IFRS.

NEW COMPANIES HOUSE REQUIREMENTS (LECTURE A531 – 11.41 MINUTES)

Accountants will by now be aware that the Companies Act 2006 has been revised for small and micro-entities as a result of the transposition of the EU Accounting Directive into UK legislation. This will have quite a significant effect on the way that small companies prepare their annual reports and the revised Companies Act 2006 comes into mandatory effect for accounting periods commencing on or after 1 January 2016.

Abbreviated accounts

The vast majority of small companies file abbreviated accounts with Companies House as permitted in section 444 of the Companies Act 2006; specifically section 444(3A) said that a small company preparing Companies Act accounts may deliver to the registrar:

- a copy of a balance sheet drawn up in accordance with the regulations made by the Secretary of State; and
- omit such items from the profit and loss account as may be specified by the regulations.

For companies subject to the small companies' regime, these accounts are currently referred to as 'abbreviated accounts'. Section 444(3A) has been repealed in the revised Companies Act 2006 and the fling requirements for a company subject to the small companies regime are outlined in section 444(1)(a) and (b).

Section 444(1) of the Companies Act 2006 has been amended to say that 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:
    - a copy of the company's profit and loss account for that year; and
    - a copy of the directors' report for that year.

Accountants may have noticed the (extremely) subtle change in wording in the revised Companies Act 2006 from being able to file 'a' copy of the balance sheet to having to file a copy of 'the' balance sheet which is drawn up as at the last day of the accounting period.

The legislation says that the company **may** deliver a copy of the company's profit and loss account and directors' report for the year and where the company chooses to do this (which will be quite rare in practice as most companies will only want to file the bare minimum), section 444(2) says that a copy of the auditor's report should be delivered (except where the company has taken advantage of audit exemption) and any directors' report.

So what does this mean in practice? The concept of abbreviated accounts is abolished for an accounting period commencing on or after 1 January 2016. Section 444(1) offers no choice where the balance sheet is concerned; that must be filed with the registrar together with the associated balance sheet notes. The company can choose to file the profit and loss account as section 444(1)(b) says that the company **may** also deliver the profit and loss account and directors' report for the year to the registrar. In practice, many companies will choose not to file the profit and loss account and simply file the balance sheet, which will be the same balance sheet as that prepared for the shareholders, whether abridged (see later) or not. In addition, the notes which accompany the balance sheet will also be filed.

'Filleted' financial statements

The phrase 'filleted financial statements' or 'filleted accounts' relates to the financial statements which are submitted to Companies House based on the full accounts prepared for the shareholders. The term 'filleted' means that the profit and loss account and related notes (for example, exceptional items) have been stripped out of the financial statements and these filleted financial statements will then be filed with the registrar. Therefore the registrar receives the balance sheet and the balance sheet notes.

In practice there may be more disclosure within the notes submitted to the registrar under the new filing regime than was the case for abbreviated financial statements because of the legally required disclosures for a small company that are needed in the accounts following the transposition of the EU Accounting Directive into company law. For example, the nature and financial effect of material non-adjusting post balance sheet events is a legally required disclosure note. In addition, any additional disclosures which relate to the balance sheet that are needed in the financial statements to give a true and fair view will also be filed.

Where a profit and loss account is not filed, the small company's balance sheet delivered to the registrar must disclose that fact to comply with section 444(5A)(a). If the small company is subjected to an audit, the notes to the balance sheet must:

- state whether the auditor's report was qualified or unqualified;
- if the report was qualified, disclose the basis of the qualification and reproduce any statement under section 498(2)(a), if applicable;
- if the report was unqualified, but contained an emphasis of matter paragraph (for example because of going concern issues), this emphasis of matter paragraph should be included; and
- provide the name of the auditor and (where the auditor is a firm) the name of the person who signed the auditor's report as senior statutory auditor.

In respect of providing the name of the auditor, if the conditions in section 506 of the Companies Act 2006 apply (circumstances in which names may be omitted), the notes to the balance sheet must state that a resolution has been passed and notified to the Secretary of State in accordance with that section.

Abridged financial statements

The concept of 'abridged financial statements' was introduced into the revised Companies Act 2006. Abridged financial statements allow certain items in the statutory formats to be combined. For example, an abridged profit and loss account will start at gross profit (or loss) rather than turnover because turnover, other income and cost of sales will be combined in the abridged profit and loss account. The main impact of an abridged set of financial statements will be to reduce the disclosure notes because abridged financial statements do not use Arabic numerals from the statutory formats. However, this is complicated by the fact that FRS 102 at paragraphs 1AA.2 and 1AB.2 requires directors to refer to paragraph 1A.16 and provide any additional disclosures that are considered necessary to give a true and fair view (e.g. disaggregating the information in the balance sheet and profit and loss account). **Note – there is still a legal requirement for small companies to prepare financial statements which give a true and fair view.**

In terms of preparing abridged financial statements all the shareholders must unanimously agree to the abridgement. There is no majority vote, so if one shareholder does not agree to an abridged set of financial statements being prepared then the company simply cannot prepare abridged accounts. The agreement is an annual process because the shareholders can only agree to abridged financial statements being prepared in respect of the preceding financial year and hence one agreement will not cover all subsequent accounting periods.

In respect of the filing requirements, if the company has prepared an abridged balance sheet or profit and loss account, section 444(2A) of the Companies Act 2006 requires the directors to deliver a statement to the registrar that all members have consented to the abridgement.

Issues relating to the audit of abridged accounts are contained on page 44 of these notes.

Micro-entity filing issues

Where a micro-entity is concerned, such entities should file the balance sheet together with the notes, where applicable, at the foot of the balance sheet as a minimum. There is no requirement to prepare a directors' report for a micro-entity for accounting periods commencing on or after 1 January 2016, so this need not be filed with the registrar. A micro-entity also does not have to file the Format 2 profit and loss account.

THINGS AUDITORS HAVE FORGOTTON TO WORRY ABOUT
(LECTURE A532 – 29.16 MINUTES)

The effects of the changes to UK GAAP are far-reaching and the potential for management and auditors to miss things is huge.

Auditors are going to have to be incredibly vigilant to make sure that management has not produced financial statements with inadvertent errors or even deliberate manipulation of the results. Also, auditors will have to take a look at their own systems to ensure that they have the right tools to be complaint with new legislation and that they work optimally with new UK GAAP.

1. Corporation tax

Tax is often considered to be a separate specialism from audit and accounts. However, with added complexities in accounting aspects for tax under new UK GAAP, and tax treatments also becoming increasingly complex, auditors will need to understand the tax impact of new UK GAAP when they are auditing the corporation tax creditor.

FRS 102 frequently requires assets (and liabilities) to be measured and remeasured at fair value through profit and loss. Some remeasurement differences are taxable (or deductible), and some are not and some allow the exercise of elections.

Here are some common examples:

Asset (or possibly liability in some instances)	**Tax position on remeasurement**
Investment properties	Not taxable or deductible
Investments in shares	Not taxable or deductible
Foreign exchange contracts (without applying hedge accounting)	Taxable or deductible (subject to the disregard regulations)
Interest rate swaps (without applying hedge accounting)	Taxable or deductible (subject to the disregard regulations)
Interest rate swaps (applying cash flow hedge accounting)	Not taxable because of the application of Section 9A for the disregard regulations to amounts in the cash flow hedge reserve
Holiday pay accruals	deductible (subject to the nine-month rule)

Note, this deals with the remeasurement differences and not realised gains or losses, which will be subject to their normal tax treatment.

In reality, auditors might need considerable help getting to grips with some of these tax issues, particularly the disregard regulations or loan relationship rules. Remember if the auditors use a tax expert, whether internal or external, to help them, there are issues in ISA (UK and Ireland) 620 *Using the work of an auditor's expert* that will need to be considered, Such as:

- how has the auditor satisfied themselves of the experts experience, knowledge etc? and
- what evidence is there to support the experts view? E.g. which legislation or legal cases?

2. Deferred tax

A good rule of thumb for auditors is that most profit and loss account entries will either have a real tax effect or a deferred tax effect. When management prepare the accounts it will be easy to forget the new approach to deferred tax in FRS 102, (timing difference plus) where deferred tax liabilities are provided on revaluation differences. This is different from old UK GAAP.

The table in the previous section outlined those remeasurement items in the profit and loss account that were not taxable and so should be subject to deferred tax.

3. Distributable profits

Under old UK GAAP this tended to be relativity straightforward. If a gain or loss passed through the profit and loss account then it tended to affect distributable reserves. As a general rule, to determine what was distributable, you could look at the reserves in the balance sheet and you would know that the profit and loss reserve was distributable.

This is not the case with FRS 102. When auditors are determining the legality of a distribution they will be looking for management to have diligently identified which gains and losses are distributable and those which are not. The table below outlines some of the main areas that auditors will have to be alert to in case any gains and losses are incorrectly identified as distributable or otherwise:

Gain/loss	**Distributable?**
Remeasurement difference on the revaluation of investment properties	Not distributable
Remeasurement difference on investments in listed company shares	Distributable on the basis that the asset is readily convertible into cash
Remeasurement difference on investments in unlisted company shares	Not distributable on the basis that the asset is not readily convertible into cash

Interest rate swaps (without applying hedge accounting)	Distributable on the basis that the asset is readily convertible into cash. If the derivative was 'out of the money' and a liability, it would reduce distributable reserves
Holiday pay accruals	Deduction against distributable reserves on the basis that it is a normal accounting adjustment and the application of the accruals concept

Note, any gain on the ***disposal*** of the unlisted shares would be distributable.

4. Eligibility for group exemptions

There are many detailed points in FRS 102, waiting to catch out the unwary.

A good example of this is the reduced disclosure framework for qualifying subsidiaries and parents in Section 1 of FRS 102. This includes the exemption for the entity not to prepare a cash flow statement, so presumably this will be a very popular exemption, for entities to take advantage of.

If this exemption has been taken advantage of, auditors will need to satisfy themselves that the entity is eligible. To qualify for this exemption a number of conditions have to met, including the following in paragraph 1.11:

- A qualifying entity (for the purposes of this FRS) may take advantage of the disclosure exemptions in paragraph 1.12, in accordance with paragraphs 1.8 to 1.10, provided that:

  a) its shareholders have been notified in writing about, and do not object to, the use of the disclosure exemptions. Objections to the use of the disclosure exemptions may be served on the qualifying entity, in accordance with reasonable specified timeframes and format requirements, by a shareholder that is the immediate parent of the entity, or by a shareholder or shareholders holding in aggregate 5 per cent or more of the total allotted shares in the entity or more than half of the allotted shares in the entity that are not held by the immediate parent.

Just as important as ensuring the entity is eligible for the exemptions, auditors will need to ensure that they document that they considered this and what evidence they obtained to support management's assertions. It is not good enough for management simply to say that they wrote to the members. Auditors will need to document that they saw evidence that this happened.

5. Determining materiality

Because FRS 102 ***recognises*** certain assets and liabilities on balance sheet for the first time, ***measures*** certain assets and liabilities differently and passes amounts through the profit and loss account in a different way, the benchmarks that auditors use to determine materiality will not be the same as old UK GAAP.

Certainly, basing current period materiality on the prior period figures will rarely be appropriate on transition to FRS 102.

When determining materiality, auditors of entities reporting under IFRS sometimes use adjusted or underlying profit figures as the basis for materiality. For example, does it make sense to include a remeasurement difference on the revaluation of shares in the profit for materiality purposes?

Previously, under old UK GAAP, auditors should not have been determining materiality in a mechanical fashion. Under new UK GAAP this would be a doubly dangerous thing to do. Professional judgement will be more important than ever when determining the benchmarks and percentages to use.

6. Using materiality

There have been reports that many entities are resistant to some of the changes in FRS 102. Holiday pay accruals, the recognition of derivatives on balance sheets, remeasurement of investments in shares to fair value and in particular the discounting of intra-group loans, have not been widely popular changes.

When resisting such changes, management often make the argument that the effect on the financial statements is immaterial. Whilst, this might be true, auditors will have to consider the following:

- Is there sufficient audit evidence to support management's assertion that the amounts are immaterial? Management will need determine the magnitude of the adjustments and the auditors will have to obtain audit evidence to support this.

- An individual item might be immaterial but when all errors are aggregated the total might become material.

- Auditors will have to carefully consider their materiality figure and its application in the specific circumstances. Are there certain areas where a lower level of materiality is appropriate?

A practical problem is that management's reluctance to adopt certain aspects of FRS 102 is sometimes motivated by an unwillingness to perform the necessary valuations in the first place. You cannot dismiss something as immaterial if you have not determined its value!

7. Triviality

Auditors should not forget that where management have ignored an element of FRS 102 on the grounds of immateriality, then that the misstatement still counts as an unadjusted error. All non-trivial errors need to be communicated to management and those charged with governance. Auditors should be recommending that errors are adjusted for so it is not for the auditor to agree to an error not being adjusted.

Triviality tends to be set at a low level. About 1 to 5% of materiality or performance materiality is a common benchmark in practice. Therefore, the issue of unadjusted errors is likely to be significant.

8. Audit evidence and multi-employer defined benefit pension schemes

FRS 102 requires liabilities for multi-employer defined benefit pensions schemes to be recognised on the balance sheet. There are some exceptions where the entity's share of the deficit cannot be quantified and equally there are entities who do not have any responsibility for making up deficits on group schemes.

In any event, auditors will need to obtain sufficient appropriate audit evidence to support any representations made by management. There is a risk that because this issue has not previously received as much attention, management might not have made sufficient enquiries into the entity's pension obligations. It is perfectly possible that the paperwork, when reviewed, might contradict management's understanding of the pension arrangements.

9. Audit evidence to support disclosure

Not only are there new disclosure requirements in FRS 102, but Companies Act presentation and disclosure requirements are also changing.

Under old UK GAAP auditors will have been very confident of their mastery of disclosure and presentation requirements. New UK GAAP is a whole new learning curve and auditors will want to ensure that their staff are well trained and good disclosure checklists are used.

It is not uncommon for full disclosure checklists to be used on a rotational basis, by auditors, say, once every three years. When FRS 102 first applies auditors will need to reset the clock. Indeed such is the learning curve, with FRS 102, that auditors might consider using full disclosure checklists for the first two or three years of its application, on the basis that audit staff will be less familiar with the new requirements.

10. Representation letters

Auditors will need to consider updating their bank of example written representations. Particularly, auditors who have little involvement in auditing IFRS accounts will find that their standard letters focus much more on cost and impairment than measurement and remeasurement to fair value.

This is about more than language. Fair values tend to rely on management assumptions and auditors might want to include these in the written representation letter as well.

11. Communications with those charged with governance

Under the ISAs (UK and Ireland), auditors can communicate with those charged with governance either verbally or in writing. In either instance firms will use standard agendas/documentation or proforma letters. These will need to be updated to take into account the different nature of the issues that will need to be communicated when FRS 102 is applied, particularly on transition.

The sorts of issues that might come to the fore in these communications are:

- *Difficulties encountered during the audit* – for example this could arise where it was difficult for the auditor to obtain sufficient appropriate audit evidence to support a fair value.

- *Qualitative accounting issues* – because FRS 102 is fair value based, auditors might have more to communicate on accounting estimates. Also, FRS 102 offers new accounting policy choices which the auditor may wish to comment on.

- *Errors identified during the audit* – particularly at transition, there is a greater chance of error as FRS 102 is being first applied.

- *Deficiencies in internal control* – many entities will have to make changes to their system of internal control and the auditor might have something to report on this.

- *Audit report* – it is possible that auditors might have to modify audit reports for non-compliance with FRS 102 or the Companies Act, or if there is insufficient audit evidence to support remeasured assets or liabilities.

- *Independence* – due to the likelihood that auditors will provide non-audit services in relation to the adoption of FRS 102, auditors might have more to communicate on how they have addressed ethical issues.

12. Engagement letters

There should not be any need to radically change the terms of engagement for the audit when FRS 102 is applied.

However, additional non-audit services might be provided by the auditor to assist the entity with the adoption of the standard. These will need to be included in separate engagement letters or the audit engagement letter will need to be updated to include them.

13. Audit methodologies

There should not be any need to change the core workings of auditors' methodologies. However, it might be worth considering updating the example audit programmes that the audit firm uses. The example tests are often based on auditing accounts that are prepared using the historic cost convention. FRS 102, being fair value based, will require auditors to do different tests against the disclosure and more importantly the valuation assertion.

Another issue that auditors might like to consider is the language that is used in standard working papers. FRS 102 uses IFRS language to describe things. For instance it talks of property, plant and equipment rather than fixed assets; debtors become receivables and stock becomes inventories. This is a relatively minor point but auditors might like to change the language used in their documentation to match that in the financial statements.

14. The audit of abridged accounts

The vast majority of small companies take advantage of small company audit exemption. However, some small companies are not eligible or choose to have a voluntary audit. Auditors of these companies will have to be aware of some important changes to the Companies Act 2006.

From periods commencing on or after 1 January 2016, the option of filing abbreviated accounts is withdrawn (see the earlier section in these notes). Therefore, there is no longer any need for the special auditors' report on abbreviated accountants.

Instead of filing abbreviated accounts, small companies will have the option of filing accounts under S444 of Companies Act 2006. This involves simply removing the profit and loss account when filing the accounts at Companies House.

Where the option to file accounts under s444 is not taken and the profit and loss account is filed, the full audit report is included with the filed accounts. If the s444 option is taken then no audit report is included in the filed accounts and the following disclosures have to be made by the directors in the notes to the balance sheet:

- state whether the auditor’s report was qualified or unqualified;
- where the report was qualified, disclose the basis of the qualification (reproducing any statement under section 498(2)(a) or (b), if applicable);
- where the report was unqualified, include a reference to any matters to which the auditor drew attention by way of emphasis; and
- state:
  - the name of the auditor and (where the auditor is a firm) the name of the person who signed the auditor’s report as senior statutory auditor; or
  - if the conditions in section 506 (circumstances in which names are omitted) are met, that a resolution has been passed and notified to the Secretary of State in accordance with that section.

INTERNATIONAL EDUCATION STANDARD 8 (LECTURE A533 – 6.34 MINUTES)

What is this new standard?

The International Education Standards (IES) are adopted by the International Federation of Accountants (IFAC) of which the ICAEW is a member. The educational standards require member bodies to be responsible for Continuing Professional Development (CPD) and for fostering a commitment to lifelong learning among professionals. IES 7 *Continuing Professional Development (Redrafted)* deals with CPD and requires all member bodies (e.g. the ICAEW) to ensure that their members develop and maintain professional competence which is relevant and appropriate to their work and professional responsibilities. IES 8 *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements (Revised)* applies this concept to the role of an audit engagement partner. This revised guidance takes effect from 1 July 2016.

Table A in IES 8 sets out the learning outcomes for the professional competence of an engagement partner. These outcomes link to the responsibilities under the International Standards on Auditing.

Does it make any difference to what we do in the UK?

The ICAEW, in their response to the consultation on this standard, pointed out that its current requirements on CPD already meet the standards set out in IES 8 for audit engagement partners. The current requirement to plan your individual CPD on the basis of your role within the firm and the 'Reflect', 'Act', 'Impact' assessment means that ICAEW members should already be complying with IES 8 and IES 7. The revised version of IES 8 should not have a significant impact in the UK provided firms are following the current advice on CPD from the ICAEW.

What about the regulators?

The Quality Assurance Department (QAD) of the ICAEW and the Financial Reporting Council already have an interest in reviewing firms CPD to ensure that an appropriate level of CPD has been obtained by relevant individuals within the firm. The issue of the revised version of IES 8 will add emphasis to this review and may cause the regulators to have additional interest in the CPD recorded by audit firms.

It is likely that the application process to hold the position of a Responsible Individual within an audit firm will require some specific examples of how the individual has met the learning outcomes set out in Table A of IES 8.

As an audit firm should we do anything?

ISQC (UK and Ireland) 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements* requires the firm to establish policies and procedures designed to provide reasonable assurance that the firm has sufficient personnel with the competence, capabilities and commitment to ethical principles necessary to deal with the firm's audit engagements.

On a practical front this should include reviewing CPD records part-way through the year to ensure that commitments to CPD are being met. It is one thing to sign up to audit updates at the beginning of the year but the firm should ensure that the courses have been attended as well by the relevant individuals.

Conclusion

At the moment the impact of IES 8 may not be significant unless the regulators find that firms are not following the CPD guidance. If this is the case then further ‘clarification’ may be issued. As far as an audit firm is concern the following steps should ensure that you stay on the right side of this revised standard:

1. Plan your audit CPD using the ‘reflect’, ‘act’ and ‘impact’ approach.
2. Ensure that any specialist audits are covered by specific CPD relevant to the area concerned.
3. Review CPD records part way through the year to ensure that audit staff are meeting the commitments they gave to CPD. This will be particularly relevant for anyone with RI status.

Whilst IES 8 may not change very much it does give the regulators an added reminder to check that all firms are following the CPD guidance.

FRC AUDIT QUALITY THEMATIC REVIEW (LECTURE A534 – 9.56 MINUTES)

Introduction

In January 2016 the Financial Reporting Council issued a thematic review in to the audit firms approach to audit quality monitoring. This review covered nine of the largest audit firms and looked in detail at how they deal with their audit quality reviews.

The FRC has said that this review of quality monitoring is a valuable review for audit firms of all sizes and should help them in developing their own policies on audit quality control monitoring. The review looked at the results of the cold file reviews and quality monitoring carried out by the firm’s own quality control teams and concluded that the internal quality control reviews identified fewer files that needed action than the equivalent reviews carried out by the FRC through the AQR teams. The report recommends that firms own internal quality control reviews should be at least as robust and challenging as the FRC reviews.

SWAT’s own policy on cold file reviews is that our reviews should be more challenging than the QAD or ACCA review teams so that firms can be confident that they would pass a review visit.

Much of the detail within the report is relevant to the larger firms but the following recommendations/points are relevant to a wide range of firms when looking at how they monitor their audit quality.

The firm’s quality review should cover two areas, the operation of the firm’s own internal quality control (i.e. Partner/manager review procedures, dealing with technical issues, use of second partner review and EQCR procedures) and the quality of the audit documentation and audit evidence on individual audit files.

Review programme

The firm should consider the extent and frequency of the quality reviews and be happy that selected file sample sizes are sufficient to ensure reasonable assurance that the firms audit quality procedures are operational.

> Audit regulation 3.20 says 'A Registered Auditor must monitor, at least once a year, how effectively it is complying with the Audit Regulations and take action to deal with any issues found and communicate any changes in procedures to principals and employees on a prompt basis.'
>
> ISQC 1 paragraph 48 says 'Audit firms shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the systems of quality control are operating effectively.'

ISQC 1 requires that 1 file per RI is reviewed on a cyclical basis with all RI's being covered over at least a 3 year period. Annual reviews are required with some RI's being covered each year. The review should also consider risk issues such as newly appointed RI's, qualified audit reports during the year or RI's who have had failed files in the recent past. Firms should also be happy that the number of files selected for review enable them to conclude that their procedures are operational and effective.

The review selection should be unpredictable and the relevant RI should not be notified with no more than 10 days' notice of the audit file that has been selected for review.

The review of individual audit files should be risk focused which the FRC say will lead to more challenging reviews of the audit work carried out.

Who does the quality control review?

The FRC review identified one review that been carried out by the person responsible for the operation of the quality control procedures (i.e. The Audit Compliance Partner) and concluded that this was not an independent review.

The quality control reviews should be carried out by individuals with suitable experience and authority to deal with the review issues. 5 out of the 9 firms reviewed did not provided adequate training for the quality control reviewers – this is of courses avoided if you use external quality control reviewers!

Ongoing themes

Firms should consider if the quality control reviews identify 'ongoing themes' that may represent weaknesses across the firm as a whole. In some situations the firms should consider having their own 'thematic' reviews to cover issues that have been identified on more than one audit file over a period of time so that they are addressed.

Quality Review Report

The report should be a clear summary and justification of the key issues arising on each audit file reviewed. The report should also highlight any cumulative issues that occurred across a number of audit files.

The report should have evidence of the firms/audit partners response to the issues raised.

Feedback and action following the quality review

Failures within individual audit files should be communicated on a timely basis to the individuals concerned with the audit. These areas should be reflected in the performance appraisals for those individuals.

Ongoing themes and recurring issues should be reviewed by the audit compliance partner and the impact of those areas considered against the background of the firm's own quality control procedures.

Example:

Significant disclosure errors have been identified on one audit file.

Quality Control issues to consider:

Why was this not identified through the firm's own quality control review procedures?

Should the firm's software have picked up the disclosure issues?

Does the fact that this was not identified indicate a weakness in the manager or partner review of the work and perhaps call their own CPD in to question?

The follow up to the quality control review should include a 'root cause' analysis. This would look at why a problem as been generated and what the firm can do to prevent or improve this area in the future.

Conclusion

The FRC review of audit quality control procedures has a clear emphasis on feedback and action following the review. This is an important message for all audit firms regardless of their size. For a quality review programme to be effective it must lead to changes in the firm's procedures to tackle the root causes of the issues identified from the review.

For most firms this should include the following:

- Circulating detailed review points to the individuals on the audit reviewed.
- A review of the ongoing themes identified by the team responsible for audit quality control for the firm as a whole – communication of any changes to the firms audit approach or documentation.
- In house training to cover any ongoing issues identified and to update audit teams on the changes that have been made to cover these issues.

SWATs audit review procedures are designed to meet the above criteria.

The FRC review concludes by reminding us that the EU Audit Regulation & Directive will be implemented in the UK on the 17 June 2016 and that some of the quality control issues will be part of the review currently being undertaken by the FRC.

CONSULTATION ON AUDIT REFORM (LECTURE A535 – 19.57 MINUTES)

In September 2015, the Financial Reporting Council (FRC) issued a Consultation Document *Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees*.

In April 2014, the EU issued its Audit Regulation and Directive which is a twofold Directive. The statutory audit of public interest entities (PIEs) outlines specific requirements in the Regulation; whilst the Directive covers the statutory audit of annual accounts and consolidated accounts. Taken together, the Regulation and Directive require revisions to both the Ethical and Auditing Standards as well as to the UK Corporate Governance Code (the Code). The FRC is also taking the opportunity of reviewing the *Guidance on Auditing Committees* (the Guidance) to align it with the new requirements for audit committees and changes to the ethical standards for auditors.

The Directive requires minimum harmonisation of requirements at the European level which are reflected in company law.

Changes to the Ethical Standard

The FRC are proposing to issue a new Ethical Standard (the FRC ES) and this new FRC ES will apply to all audit and other public interest assurance engagements and will replace the existing ESs 1 to 5 which were issued by the (now defunct) Auditing Practices Board. The revised FRC ES will include changes to incorporate the requirements of the Regulation and Directive and compliance with the FRC ES will be required for all audit and assurance engagements performed under the FRC's performance standards.

Overarching principles

The FRC is a principles-based regulator and it follows, therefore, that the FRC ES should also be principles-based. The overarching principles of the FRC ES are more clearly outcomes-based and prominent and have been included at the front of the FRC ES. It is to be emphasised that compliance with the specific requirements may not necessarily mean that the overarching principles and supporting ethical provisions have been complied with.

A key trait which the FRC are keen to avoid is making the FRC ES 'rules based'. Users will find that the FRC ES includes detailed requirements which might lead to the auditor adopting a 'rules-based mind-set' when applying the FRC ES. Adopting this mind-set means that the auditor will focus on issues and actions which are 'specifically prohibited' rather than 'appropriate'. In recognition of this risk, the FRC have clarified in the requirements that safeguards have to reduce threats to *'a level at which it is probable that an objective, reasonable and informed third party would not conclude that independence would be compromised.'* This wording has been incorporated in favour of merely saying that risks should be reduced to 'an acceptable level.'

The FRC have consolidated the five separate existing Ethical Standards into one standard with sub-sections. The objective of doing this is to help to avoid situations where the current ESs 2-5 might be considered in isolation without regard to the overarching principles contained in ES1.

Application to audits of PIEs and listed entities

Where the entity is a PIE or a listed entity, the application of the FRC ES will ensure that auditors of such entities will satisfy the ethical requirements of the Regulation. It is to be noted that these requirements are not being extended to audits of any other type of entity.

In respect of listed entities, the application of the revised FRC ES will ensure such entities comply with more stringent ethical requirements. There will be some reliefs available (principally those relating to non-audit services for smaller listed entities which are not PIEs).

In respect of non-listed entities which are PIEs, the FRC are going to extend the more stringent requirements which are not subject to such relief. Principally these more stringent requirements will affect non-listed entities which are PIEs in respect of reporting to those charged with governance and to circumstances when a firm's fee income from an entity is expected to exceed 5%, 10% or 15% of the firm's total income. The FRC are proposing this action on the basis that they consider this will enable consistency of focus on such matters without additional work by the auditor beyond reporting requirements.

Non-listed PIEs will also be subjected to the more stringent rules relating to rotation of the audit engagement partner, the engagement quality control reviewer and other key audit partners. The EU Regulation requires a maximum tenure for an audit engagement partner of seven years; although Member States can reduce that tenure accordingly and the FRC is planning to reduce it to **five** years for all PIEs and all listed entities. However, the FRC are planning to allow such tenures to be extended in exceptional circumstances (such as to maintain audit quality) and the extension is capped to seven years where the audit committee approve such an extension.

The definition of a listed entity in the FRC ES will be as follows:

'An entity whose shares, stock or debt are quoted or listed on a recognised stock exchange or are marketed under the regulations of a recognised stock exchange or other equivalent body.'

The FRC are removing the previous language difference between the definition contained in the APB's Ethical Standards and International Standards on Auditing (UK and Ireland) of listed entities. This is to avoid any suggestion that the definition for the purposes of the FRC ES is in relation to only UK and Ireland exchanges.

Ethical Standard applicable to smaller entities

The Ethical Standard – *Provisions Available for Smaller Entities* (ES-PASE) will remain. However, the FRC will disapply the standard for audits of (small) PIEs because otherwise there will be a conflict with the requirements of the Regulation.

Requirements for other group component auditors

The FRC are not proposing to make it mandatory for other auditors of group components to have to follow the FRC ES, but this will not preclude such auditors from demonstrating that they are appropriately independent where their work is to be used by the group auditor.

Where the group auditor concludes that the other group component auditors lack the necessary level of independence then the lead group auditor cannot use their work and would therefore have to obtain sufficient appropriate audit evidence through other means (for example by doing the work themselves).

Non-audit services

The FRC are not proposing to make any additions to the prohibited non-audit services in respect of PIEs. The FRC are, however, proposing to make amendments, in accordance with the Regulation to avoid re-setting the three year calculation period where interruption arises from a gap year in providing non-audit services and to apply the cap to firms at the network level.

However, non-audit services which are required by law, or by a rule issued by a regulator in accordance with powers granted by legislation, will be exempt for the purposes of the calculation of the cap. Therefore, where the firm fulfils requirements set out in rules made by, for example, the PRA or FCA, these will be exempt; as will work undertaken to comply with the UK Listing Rules. The exemption will not, however, apply to a report under the Standards for Investment Reporting (SIRs) unless there is a requirement in law or regulation for such a report.

Independence test

Where independence is concerned, the Directive says that *'… an objective, reasonable and informed third party would not conclude that the independence of the auditor is compromised.'* Whilst this wording is consistent with the Audit Directive, it is different from the wording currently contained in ES 1 at paragraph 15 which states *'… it is probable that a reasonable and informed third party would conclude that the auditor's objectivity is either impaired or is likely to be impaired.'*

The FRC ES retains the more stringent reference referring to *'it is probable…'* although it is being aligned with the Directive's wording.

Applying independence requirements

The revisions made to the FRC ES now extend to individuals to include *'any other natural person whose services are placed at the disposal or under the control of the audit firm and who is directly involved in audit.'* To reflect this extension, the FRC have made a series of revisions to the overarching principles and supporting ethical provisions in the FRC ES.

Current ESs require independence to be considered in relation to 'immediate family members'. However, the FRC ES is worded consistently with the requirements of the Directive and will now apply to 'persons closely associated' which follows a broader EU definition.

Extension to other public interest assurance engagements

The FRC are proposing to make the FRC ES applicable to all audit and other public interest assurance engagements (in effect for all such engagements in relation to which the FRC issues performance standards – including SIRs, reporting in connection with investment circulars), engagements where the auditor reports on an interim review of the financial statements and the forthcoming Client Assets Standard.

In addition to the APB Ethical Standards for Auditors, the Ethical Standard for Reporting Accountants (ESRA) will also be withdrawn from issue.

Chain of command

The term 'chain of command' which is found in the ESs is being withdrawn. The FRC will, instead, included a revised definition of a *'person in a position to influence the conduct or outcome of the engagement.'*

Current ESs say that when certain partners leave the firm and join an audit client in a senior position with two years, the firm must resign and cannot accept reappointment until a two-year period from the partner ceasing to have the ability to influence the audit has elapsed.

The FRC are planning to make amendments to the wording in the ESs to say *'a partner in a position to influence the conduct or outcome of the engagement.'*

The Consultation Document acknowledges that the amendment to the definition of a person in a position to influence the conduct or outcome of the engagement is relevant to a number of other requirements in current ESs to which such a person is subject. These are:

- the other requirements in the current Ethical Standard 2 that cover restrictions on financial interests and business relationships with audited entities;
- situations where 'closely associated persons' (including 'immediate family members' and relatives sharing the same household) and 'close family members' are employed by an audited entity in a position in which they could influence the accounting records or financial statements. If it is a 'closely associated person' the partner would need to cease to hold a position in which they could influence the audit or, if a 'close family member', would need to report the situation to the engagement partner to take appropriate action;
- restrictions on holding governance roles with an audited entity – similar to that where closely associated persons and close family members are employed by the audited entity;
- restrictions on the roles a person joining the audit firm from an audited entity can be appointed to; and
- remuneration and performance assessment not to include selling other services to the audited entity.

Partners and other restricted persons joining an audit client

The Directive says that a statutory auditor or key audit partner cannot join the audit client before a period of one year (for a non-PIE) or two years (for a PIE) has elapsed since ceasing to act as statutory auditor. A partner or other person approved as a statutory auditor cannot take up a position with the audit client for which they were involved in the audit until after one year after ceasing to act as statutory auditor for the client.

Accepting an engagement employing a former partner or other restricted person

The FRC are proposing to introduce a new requirement which reflects the existing and new provisions contained in the Directive.

Where an audit partner or other person subject to the requirements in the Directive leaves the audit firm to join a company that is not currently audited by the audit firm, then the firm must not accept appointment as its auditor (or provider of another public interest assurance engagement) for two years. For statutory auditors who are not partners, this timeframe is one year.

Non-audit services provided prior to appointment as auditor

The FRC are going to include more explicit guidance to confirm that the firm does not accept an appointment to carry out an audit (or other public interest assurance engagement) unless an objective, reasonable and informed third party, taking into account safeguards applied, would conclude that the independence of the firm, its partners and staff in performing the audit or other public interest assurance engagement is not compromised.

Acting as an advocate in relation to tax

Current ES 5 prohibits an auditor from acting as an advocate 'before an appeals tribunal or court'. This has caused an element of confusion as to whether an auditor can act as an advocate for an entity in its dealings with HM Revenue and Customs before the matter gets to a tribunal or court. The FRC are proposing to delete the words 'before an appeals tribunal or court'.

Not providing tax services on a contingent fee basis

The FRC are proposing to amend the ES to prohibit the provision of tax services on a contingent fee basis. This has been achieved by deleting the current provision in ES 5 and amending the wording in paragraph 4.13 of the FRC ES which addresses contingent fees. Paragraph 4.13 of FRC ES says:

'The firm shall not undertake an engagement to provide non-audit / additional services, in respect of an entity relevant to an audit or other public interest assurance engagement by the firm, wholly or partly on a contingent fee basis where:

a) the contingent fee is material to the firm, or that part of the firm by reference to which the engagement partner's profit share is calculated; or
b) the non-audit / additional service is a tax service; or
c) in the case of an entity relevant to an audit by the firm, the amount of the fee is dependent on an outcome or result of those non-audit / additional services that is relevant to a future or contemporary audit judgment relating to a material matter in the financial statements; or
d) in the case of an entity relevant to any other public interest assurance engagement by the firm, the amount of the fee is dependent on an outcome of those additional services that is relevant to a future or contemporary assurance judgment relating 68 Annex 1: Revised Ethical Standard - Integrity, Objectivity and Independence (September 2015) to a material matter that is material to the subject of such an engagement.'

Reliefs for smaller listed entities

Smaller listed entities will be able to take advantage of some reliefs from certain requirements set out in the FRC ES where this will not be detrimental to the public interest.

This will apply to listed entities which are not PIEs as follows:

- by clarifying that the definition of listed entity does not include those entities whose securities are technically listed on a recognised market, but where those securities are not in substance open to trading by members of the public; and
- in relation to restrictions on non-audit services, where the market capitalisation value of the entity is below £100 million.

The FRC proposes that the £100 million thresholds is to be assessed using the average of the market capitalisation on the first and last days of the year six months prior to the accounting period under consideration. The idea behind this is to stop an entity from losing the proposed reliefs, in the event that market capitalisation is affected by a temporary spike.

Changes to auditing standards

The Regulation and Directive applies to audits of financial statements commencing on or after 17 June 2016 and the FRC are planning to adopt a single implementation date for all proposed changes to auditing standards, regardless of their originating source. The planned implementation date of the revised auditing standards will be for audits of financial statements commencing on or after 17 June 2016. This effective date is later than the IAASB's and therefore the FRC is planning to allow early adoption of the standards so as to facilitate changes to methodologies of international firms.

Adoption of ISA 700 (Revised) and ISA 701

The FRC propose to adopt the IAASB's ISA 700 (Revised) and ISA 701, but include additional UK 'pluses' so as to retain some requirements which are already contained in the existing standard. The FRC have also proposed to extend the definition of Key Audit Matters, to include:

- a description of the assessed risks of material misstatement which have been identified by the auditor and which have had the greatest effect on the overall audit strategy, the allocation of resources to the audit and the direction of the efforts of the engagement team; and
- in respect of the Regulation for PIEs to include (in support of the audit opinion), a description of the most significant assessed risks of material misstatement which is to include assessed risks of material misstatement due to fraud.

The FRC have confirmed in the Consultation that the reporting of Key Audit Matters in the auditor's report is a matter of professional judgement and will depend on the specific circumstances of the entity and the engagement.

The FRC have also proposed to extend the requirements in ISA 701 (Revised) for listed entities to apply the requirements in ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* to both:

- entities which are mandated, and entities which choose, to report on how they have applied the requirements of the UK Corporate Governance Code in order that they maintain the similar requirements to ISA (UK and Ireland) 700 (Revised September 2014); and
- PIEs, so as to provide auditors of such entities with a framework to assess the risks that are required to be reported in accordance with the Regulation.

The revisions to ISA 720 require the auditor to report on whether they have identified any material misstatements in the other information. The Directive requires the auditor to provide an opinion on certain other information which, for the purposes of the UK and Ireland, would mean the directors' report (where one is required or voluntarily prepared), the strategic report and the separate corporate governance statement. Under existing legislation, the auditor currently provides an opinion as to whether the statutory other information is consistent with the financial statements. The Directive takes this requirement further and requires the auditor to:

- Provide an opinion as to whether the statutory other information complies with the applicable legal requirements.

- State whether the auditor has identified any material misstatement in the statutory other information in light of the knowledge and understanding of the entity the auditor has acquired during the course of the audit.

The FRC have proposed to revise ISA (UK and Ireland) 720 by requiring the auditor to:

- obtain an understanding of the applicable reporting framework used to prepare the statutory other information;
- consider whether there are any material misstatements between the other statutory information and that framework; and
- report on the statutory other information in accordance with legislation.

Further amendments to ISA (UK and Ireland) 720 include:

- incorporation of certain paragraphs of extant ISA (UK and Ireland) 700 (Revised) which relate to reporting on other information;
- a requirement which formalises the reporting on the Listing Rules currently undertaken by premium listed entities; and
- incorporation of requirements and guidance (updated where necessary) from ISA (UK and Ireland) 720B *The auditor's statutory reporting responsibility in relation to the directors' reports.*

As the requirements and guidance from ISA (UK and Ireland) 720B will be included in ISA (UK and Ireland) 720, ISA 720B will be withdrawn and Section A will be dropped from the title.

Reporting on going concern

The FRC have taken the view that reporting on the going concern basis of accounting is important in the public interest and is also valuable to investors. In recognition of this, the FRC propose to include additional UK pluses to ISA (UK and Ireland) 570 *Going Concern* (Revised) for reporting entities where the use of the going concern basis of accounting is appropriate and there is no material uncertainty. The additional requirements will require the auditor to:

- consider whether to communicate a Key Audit Matter regarding going concern where the auditor is required, or chooses, to apply ISA (UK and Ireland) 701; and
- report by exception on management's use of the going concern basis of accounting and whether there are material uncertainties relating to the use of the going concern basis which have been identified but not disclosed.

Reporting to regulators of PIEs

The Regulation requires auditors of PIEs to report the following matters to the competent authorities responsible for oversight of those PIEs:

- certain material breaches in laws, regulations of administrative provisions;
- a material threat or doubt over the continuous functioning of the PIE; and
- a refusal to issue or a modification of the audit opinion.

These requirements have also been incorporated within ISA (UK and Ireland) 250 Section B *The Auditor's Right and Duty to Report to Regulators in the Financial Sector*.

Retention of records

The Regulation requires certain documents and information to be kept for a period of at least five years following the creation of such documents or information. The Regulation also provides Member States with the option of extending this timeframe.

The FRC proposes to include a requirement in ISQC (UK and Ireland) which requires audit working papers (including those documents and information required to be retained by the Regulation) to be retained for a minimum period of six years for all entities from the date of the auditor's report.

Abridged accounts

Where either:

- a balance sheet only; or
- an abridged statement as part of a set of accounts,

is filed, the directors must include a statement on the balance sheet about certain aspects of the audit (i.e. name of the audit firm and senior statutory auditor and whether the opinion was modified or included an emphasis of matter) and a statement that a resolution has been passed to the effect that all members agreed to the preparation of abridged accounts.

There are no responsibilities in law on the auditor regarding the filing of these accounts. It follows, therefore, that there should be no requirement to mandate or recommend procedures which the auditor should follow (for example assessing whether the requirements of the Companies Act with respect to the required statements have been complied with).

As a result, the FRC are planning to withdraw Bulletin 2008/4 with effect for accounting periods commencing on or after 1 January 2016.

True and fair view and abridged accounts

Abridged accounts must be prepared which give a true and fair view and the auditor must be satisfied that the resulting financial statements give such a view. This includes ensuring that any disclosures which the auditor believes should be included to give a true and fair view have been provided adequately.

Additional guidance has been provided in ISA (UK and Ireland) 210 *Agreeing the terms of audit engagements* at paragraph A15-1 in respect of such abridged accounts.

Micro-entities and the deeming provisions

The FRC have confirmed that FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* is not a fair presentation framework as defined in ISA (UK and Ireland) 200 (Revised) *Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK and Ireland)*. This is because the framework does not acknowledge explicitly or implicitly that to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond the required framework, or to depart from a requirement of the framework to achieve a fair presentation.

Notwithstanding this issue, the financial statements of a micro-entity prepared under the micro-entities legislation are presumed in law to give a true and fair view.

Micro-entities are not required to have an audit. However, where the micro-entities does have an audit, then the auditor is required to address the ‘deemed’ true and fair view within the auditor’s report.

Additional application material has been included in paragraph A34-1 of ISA (UK and Ireland) 210 (Revised) to provide such guidance.

CHANGES TO THE AUDIT THRESHOLDS (LECTURE A536 -11.25 MINUTES)

As most accountants will be aware, the small companies' regime has been subject to rather a lot of change over the last few months due, in large part, to the transposition of the EU Accounting Directive into company law.

The main change that has been brought about by the EU Accounting Directive is an increase in the size thresholds which determine whether a company is a micro-entity, small, medium or large (including groups). The revised sized thresholds with effect for accounting periods commencing on or after 1 January 2016 are as follows:

	Turnover	Balance Sheet Total	Average no. of employees
Micro-entity	Not more than £632,000	Not more than £316,000	Not more than 10
Small company	Not more than £10.2 million	Not more than £5.1 million	Not more than 50
Small group	Not more than £10.2 million net OR Not more than £12.2 million gross	Not more than £5.1 million net OR Not more than £6.1 million gross	Not more than 50
Medium-sized company	Not more than £36 million	Not more than £18 million	Not more than 250
Medium-sized group	Not more than £36 million net OR Not more than £43.2 million gross	Not more than £18 million net OR Not more than £21.6 million gross	Not more than 250
Large company	£36 million or more	£18 million or more	250 or more
Large group	£36 million net or more OR £43.2 million gross or more	£18 million net or more OR £21.6 million gross or more	250 or more

The question then arose as to whether audit exemption thresholds would be increased as a result of the above revised size thresholds. The Government confirmed that they did not intend to decouple the links between the audit exemption threshold and the thresholds which determine the size of a small company. However, some stakeholders expressed concern that allowing a company with a turnover of £10.2m to take advantage of audit exemption was too excessive and would allow such larger businesses more scope for unorthodox practices, such as criminal activity. A consultation was undertaken by the Government who sought views as to whether the audit exemption limit should be increased to the maximum permitted by the Audit Regulation and Directive.

Concerns were also raised by the audit profession that increasing audit exemption limits to the maximum allowed under the Audit Regulation and Directive would increase instances of poor financial reporting. Stakeholders suggested that audit exemption limits should remain as they are or raised to some intermediate level lower than the revised thresholds which determine a small company for financial reporting purposes. Conversely, others argued that the thresholds for audit exemption should rise citing the erosion of the value of the audit exemption thresholds due to inflationary effects as well as the increased regulation this would place on small companies.

On 26 January 2016, the Government rejected the concerns raised by the audit profession, preferring to keep the framework as simple as possible. The Government said that having two levels of regulation (one for audit exemption and one for the definition of a small company) would introduce unnecessary complexity into company law and cause confusion for users.

Increased audit limits

The Government has said that all companies should continue to be able to have an audit (i.e. the audit option will remain open for small companies). Companies will not, however, be required to have an audit for financial years which start on or after 1 January 2016 (essentially 31 December 2016 year-ends) if, at the balance sheet date, two out of the following three criteria can be met for (generally) two consecutive financial years:

- Turnover ≤ £10.2 million
- Balance sheet total (fixed assets plus current assets) ≤£5.1 million
- Number of employees ≤ 50

To take advantage of the above, the company must also not be excluded from accessing the audit exemption due to the nature of their business.

Raising the audit exemption thresholds to match those of the small company thresholds is estimated to remove 7,400 companies from the mandatory requirement to have an audit. However, the Government have estimated that some 4,400 companies will choose to continue to have an external audit and the remaining 3,000 companies will seek alternative routes to ensure that their company’s internal systems are robust, such as assurance reviews or oversight of accounts preparation.

The ICAEW Chief Executive, Michael Izza, said:

‘We are disappointed government has decided to go down this route. We have consistently said over the last four years that audit promotes sound financial practice and protects against mismanagement, fraud and tax evasion.

‘There are many reasons why companies have an audit – to give shareholders confidence, satisfy tender requirements, and ensure reliable financial reporting. Even though a number of businesses are now potentially exempt we expect many will continue to choose to have an audit.’

BIS acknowledge that the value of audit and auditors still have an important role to play in supporting small businesses and providing assurance to owners and lenders. Will many small companies continue to have an audit? Will they seek alternatives such as assurance reviews? Only time will tell …

QUARTERLY ROUNDUP

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

FRC and the Charity Commission consult on conventions for electronic tagging of charity accounts

8 October 2015

The FRC and the Charity Commission (CC) have today announced a public consultation on conventions for the electronic tagging of charity accounts to support the CC's objectives of enhancing the quality and accessibility of financial reporting for Charities in the UK and Ireland.

The iXBRL accounts tagging convention (Charity 'taxonomy') has been updated in line with the Charity SORP (FRS 102) and the FRC's financial reporting standard FRS 102. The taxonomy will be used when tagging charity accounts for electronic filing and for other analytical purposes. Electronic tagging helps users of financial information to extract relevant information from corporate reports and analyse it more efficiently.

The consultation closed on 8 December 2015 after which the taxonomy will be finalised.

FRC proposes new guidance to enhance reporting on risks and the going concern basis of accounting

15 October 2015

The Financial Reporting Council (FRC) has issued for consultation draft guidance on the assessment of and reporting on the going concern basis of accounting and solvency and liquidity risks. This should enhance the quality and depth of information investors receive about the business over the longer-term.

In September 2014, the FRC updated the UK Corporate Governance Code (the Code) in response to the recommendations of the Sharman Inquiry on going concern and liquidity risks. The FRC issued related guidance for companies applying the Code, noting that it would issue guidance for non-Code companies in due course. This draft guidance is best practice for those companies.

The guidance is intended to assist directors in applying the relevant requirements in accounting standards and company law, incorporating recent regulatory developments such as the introduction of new UK and Ireland GAAP and the Strategic Report.

Melanie McLaren, Executive Director of Codes and Standards said:

'The Sharman Inquiry highlighted the need for clarity by all companies on the going concern basis of accounting. It identified the need to consider liquidity and solvency when analysing the principal risks a company faces and the need to take a broader longer-term view. This guidance is intended to be practical and aims to assist directors in meeting their legal responsibilities in a proportionate and effective manner, whilst reflecting the de-regulatory nature of developments in corporate reporting for smaller companies.'

Comments and feedback on the FRC's discussion paper closed on 15 January 2016.

FRC publishes Corporate Reporting Review Annual Report

22 October 2015

The annual report of the Financial Reporting Council's (FRC) Corporate Reporting Review (CRR) activities, has found that the overall quality of corporate reporting remains generally good, particularly by large public companies. The report also shows that there has been a good response to the FRC's call for enhanced disclosures about complex supplier arrangements.

The FRC is pleased that an increasing number of companies appear to have conducted 'Clear & Concise' reviews of their reports, but continues to see others that would benefit from a similar initiative. This year's report continues the FRC's 'Clear & Concise' programme by including a case study demonstrating CRR's approach to companies that have undertaken specific projects to make their reports and accounts more clear and concise by removing unnecessary disclosure.

The report acknowledges the challenge to boards of determining what is material information to include in their reports and accounts and notes that materiality should not be used to justify less than transparent reporting about items that are relevant to users such as amendments to prior year accounts.

The FRC's assessment is based on a review of 252 sets of reports and accounts in the year to 31 March 2015, of which 76 (30%) companies were approached for further information and explanation. Nine companies were the subject of a press notice or 'Committee Reference' as a result of more significant concerns about their financial reports.

Geoffrey Green, Chair of FRC's Financial Reporting Review Panel, said:

'We are reassured that the quality of reporting remains high among listed companies as this will continue to attract investment in UK companies. We were also pleased to see some good reporting by some smaller listed and AIM quoted companies although we continued to see evidence of more straightforward errors and lack of focus.

'We were generally pleased with the efforts made by boards to embed the Strategic Report requirements in their reports but there is still room for improvement in ensuring that the disclosures support a fair and balanced understanding of companies' performance and position at the year-end.

'As reported in the FRC's Plan and Budget, we are conducting a review of the effectiveness of our corporate reporting review work and will be consulting on any significant changes to our procedures in due course.'

The FRC's monitoring work is influenced by macro-economic factors that may affect corporate reports. During 2015/16 it is considering:

- the effect on asset valuations of volatility in commodity prices in equity and bond markets; and
- disclosures of tax risks, accounting policies, judgements and estimates following increased uncertainties due to challenges by global and European institutions and governments.

FRC seeks feedback on board succession planning

27 October 2015

The FRC today publishes a discussion paper – 'UK Board Succession Planning' – which seeks views on board succession for both executives and non-executives in order to support a suitably talented, diverse 'pipeline' of directors ready to serve on the boards of UK listed companies.

The FRC has developed its initial thinking through discussions with a wide range of interested parties – both individually and in groups – and now wishes to promote a shared understanding of the key issues and good practice.

Issues explored in the paper include:

- how effective board succession planning is important to business strategy and culture;
- the role of the nomination committee;
- board evaluation and its contribution to board succession;
- identifying the internal and external ‘pipeline’ for executive and non-executive directors;
- ensuring diversity; and
- the role of institutional investors.

Director of Corporate Governance, David Styles commented:

‘Boards which plan effectively for both executive and non-executive positions are more likely to achieve the right mix of diverse skills and experience needed for future prosperity and growth. Feedback on this discussion paper will offer us further valuable insights into issues around board succession.’

Comments closed on 29 January 2016.

FRC to focus on embedding change, opportunities to deregulate and promoting improvements

28 October 2015

Today the Financial Reporting Council (FRC) announces its 2016/19 strategy outlining priority areas for the next three years. The FRC’s mission remains to promote high quality corporate governance and reporting to foster investment.

The FRC will:

- Seek to put the UK indisputably in first place in terms of the quality of corporate reporting, giving investors globally the greatest possible confidence in UK investment. The FRC will do so by working with companies to make the most of the changes to codes, standards and regulations introduced since the financial crisis, and by avoiding the distraction of introducing further changes to codes and standards wherever possible.
- Seek to put the UK indisputably in first place too for the quality of its auditing, making the most of its new role as the Single Competent Authority for audit under the new EU legislation. The aim is that by 2019 at least 90% of FTSE 350 audits will require no more than limited improvements as assessed by the FRC’s monitoring programme. The FRC will work in collaboration with the profession to give assurance and confidence to investors globally.

These pillars of the FRC’s strategy support the UK’s push for economic growth by fostering investment. The FRC will also contribute to growth by looking for opportunities to deregulate and cut business costs where it is safe to do so.

Stephen Haddrill, CEO FRC, said:

‘The FRC’s goal is to ensure reporting and audit in the UK are world leading and provide assurance to global investors to support UK business and growth. The strategy for 2013/16 was informed by lessons from the financial crisis. There was a need to take robust action to restore confidence among the general public and in particular investors.

'In our 2016/19 strategy, there is a change of emphasis. We will work with investors, businesses, professionals and professional bodies to ensure the changes already made are successful in securing the highest quality in reporting and governance.'

FRC proposes limited scope improvements to FRS 102

4 November 2015

The Financial Reporting Council (FRC) has today issued an Exposure Draft (FRED 62) proposing limited scope improvements to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* relating to financial institutions and retirement benefit plans only.

The proposals are intended to simplify the preparation of disclosures about financial instruments for the entities affected, whilst increasing the consistency with disclosures required by EU-adopted IFRS that users of the financial statements will often be familiar with.

Melanie McLaren, Executive Director of Codes and Standards said:

'We are issuing FRED 62 to respond to stakeholders' concerned that certain disclosures required from financial institutions and retirement benefit plans could be made both more cost-effective and more consistent with IFRS. The changes proposed in FRED 62 will not affect the majority of entities applying FRS 102 and therefore should not delay or disrupt their implementation plans.'

The proposed improvements are intended to be effective for accounting periods beginning on or after 1 January 2017, with early application permitted. This means it is possible for entities to apply the changes in financial statements for accounting periods ending on 31 December 2015 provided they have not been approved by the time that these proposals are finalised.

FRC publishes standard on providing assurance on Client Assets

9 November 2015

The Financial Reporting Council (FRC) today publishes its Standard for audit firms on *Providing Assurance on Client Assets to the Financial Conduct Authority*.

The Assurance Standard covers the work auditors do when reporting to the Financial Conduct Authority (FCA) on the compliance by financial services firms, with the FCA's Client Asset (CASS) rules. These provide for 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 assets.

The FCA has recently strengthened its client asset regime. The Assurance Standard will help ensure that he strengthened regime is underpinned by sound assurance.

Melanie McLaren, FRC's Executive Director of Codes and Standards, said:

'The effective safekeeping of client assets is an issue of significant public interest. Our 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.'

The development of the Standard, which will apply to periods starting on or after 1 January 2016, has been supported by the FCA.

Year-end advice to preparers of annual reports

11 November 2015

The Financial Reporting Council (FRC) is writing to around 1,200 smaller listed an AIM quoted companies with advice on ways that improvements could be made to annual reports in areas of particular interest to investors.

In the FRC's report *'Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies'* published earlier this year, investors highlighted their focus on the annual report when making investment decisions in the absence of other sources of information in this sector such as analysts' reports.

In particular investors expect:

- the Strategic Report to be clear, concise, balanced and understandable;
- accounting policies to be clear and specific, particularly in relation to revenue recognition and expenditure capitalisation; and
- a clear explanation of how the company generates cash flow.

Stephen Haddrill, FRC chief executive, said:

'It is imperative that annual reports enable investors to understand exactly how the company is performing to enable them to assess the long term prospects for their investment.

'For smaller quoted companies in particular, investors rely heavily on the annual report because other information is relatively scarce – they look for company specific information, rather than standard templated report, that they can understand and use to make informed decisions.'

The FRC will also write to larger listed companies shortly with specific advice for the preparation of their annual reports.

Audit Committee Chairs believe audit is improving

23 November 2015

Audit Committee Chairs (ACCs) consider that audit quality has improved according to the *Audit Committee Chairs Survey 2015*. This is the second year of the survey and the first to be overseen by the Financial Reporting Council (FRC).

ACCs scored their auditors highly across all questions. There was also evidence of improvement in all categories with the highest being that of independence and objectivity. The lowest overall scores, for a second year, were for questions on professional scepticism and the auditor's response to regulatory oversight suggesting there is still some work for firms to do in this area.

The survey was sent to ACCs at all FTSE 350 and at some smaller listed companies to provide a suitable sized sample for the six largest audit firms. Response rates increased from 2014 with nearly half of ACCS completing the survey.

Making dividends disclosures more relevant for investors

24 November 2015

The FRC's Financial Reporting Lab (the Lab) has today issued a report *'Disclosure of dividends – policy and practice'* exploring how companies can make dividend disclosures more relevant for investors.

Building from the contributions of 19 companies and 31 investors, the report explains, including through the analysis of existing good, proportionate disclosure practice, why investors want information about dividends and what they want to know.

Dividend disclosures need to be clear and provide adequate information so that investors can evaluate the board's stewardship of the company and assess prospective dividends.

Investors want to know:

- Why has the company selected the dividend policy?
- What will the policy mean in practice?
- What are the risks and constraints associated with the policy?
- What was done in practice to deliver under the policy?

Investors said that they also want disclosure of the circumstances in which companies expect to pay special dividends or buy back shares, and whether they are in the best interests of shareholders.

All investors consider that the disclosure of dividend resources, i.e. cash and the amount of the company's reserves legally available for distribution under company law (distributable profits), is helpful in circumstances where the ability of the company to pay dividends is, or might be, insufficient relative to the level of dividends indicated by the policy. Some investors believe that distributable profits are always required to be disclosed. The FRC understands that the Companies Act 2006 does not require companies to identify separately distributable profits on their balance sheet.

Investors find that the dispersal of disclosures across annual reports and other communications results in repetition, and makes it hard for them to find the information they need. They said it would be helpful to group together similar or related disclosures on dividends, or to draw links between the disclosure elements.

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

'Companies, investors and the FRC consider that disclosure of dividend policy and resources, including distributable profits, may be helpful. In addition to demonstrating the board's stewardship of the company, they provide key information used by investors in evaluating the extent to which returns may be provided in the form of dividends in future. In the report, we highlight examples of good and proportionate disclosure practice. Investors said that terms such as 'progressive' and 'payout ratio' in respect of a company's dividend policy or approach need to be clarified. They also told us that they recognise that the unexpected can and does happen and by providing disclosures, companies are not painting themselves into a corner.'

FRC has called on the IASB to reconsider its proposed Conceptual Framework

25 November 2015

The Financial Reporting Council (FRC) has called on the IASB to reconsider its proposed Conceptual Framework so that it properly reflects the importance of stewardship, prudence and reliability, which it describes as cornerstones of the Framework.

The FRC's comments are made in its response to the IASB's Exposure Draft on its Conceptual Framework. This identifies principles for the IASB to use when it develops and revises International Financial Reporting Standards (IFRSs).

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

'We have consistently made clear to the IASB that stewardship, prudence and reliability are fundamental to financial reporting. Although the Exposure Draft goes further than the IASB has previously in recognising their importance, significant further development is essential if we are to be confident that future IFRSs are to be of high quality. We hope that our input will assist the IASB in doing so.

'Investors rely on financial reporting in order to hold management to account; to assess the delivery of the business model and the creation of long-term shareholder value. Providing information for this stewardship must be regarded as a central objective, rather than secondary to information for investment decisions.

'By describing prudence merely as taking a cautious approach to accounting, the IASB has missed the point: prudence requires a greater readiness to recognise losses than profits. It is particularly odd that the IASB acknowledges that this is reflected in current accounting standards, but has omitted it from its draft Framework.'

The FRC's response also suggests that a more fundamental analysis than that provided in the Exposure Draft is required of the reporting of financial performance and the measurement of assets and liabilities.

FRC calls for transparent disclosure of tax risks in corporate reports

1 December 2015

The Financial Reporting Council (FRC) will conduct a thematic review of companies' tax reporting to encourage more transparent recording of the relationship between the tax charges and accounting profit. The required disclosures are key to helping users understand the significant factors that could affect that relationship in the future.

The FRC will write to a number of FTSE 350 companies prior to their year-end, informing them that the Corporate Reporting Review Team will review the tax disclosures in their next published reports. The aim of this monitoring activity is to drive continuous improvements in the quality of corporate reporting.

The FRC plans to take a particular interest in:

- the transparency of tax reconciliation disclosures and how well the sustainability of the effective tax rate is conveyed; and
- uncertainties relating to tax liabilities (and assets) where the value at risk in the short term is not identified.

Companies are required to disclose the principal risks and uncertainties they face and are expected to explain the actions they propose to mitigate the impact of those risks. The FRC's targeted review will consider the totality of the companies' reporting including relevant disclosures in their strategic and other narrative reports as well as in the detailed accounting disclosures.

Geoffrey Green, Chairman of the FRC's Financial Reporting Revenue panel and member of the Conduct Committee, said:

'There is considerable public interest currently in international tax arrangements, prompted by developments both in the UK and on a global basis. Investors have a heightened interest in wanting to understand the policy decisions made by companies and the impact these have on their current and future accounts. Through the FRC's Clear & Concise initiative, the FRC aims to stimulate boards to review their tax disclosures to ensure their annual reports provide high quality information for investors. Companies which are clear about their tax risks will be looked to as examples of good practice while in other cases, there will be an identification of where improvements may be made. Consistent with its overall objective, the

FRC will consider how to publicly share the best of what is seen to help others raise the quality bar on this aspect of their reporting.'

Audit quality and transparency key to Audit Firm Governance Code's provisions

7 December 2015

The Financial Reporting Council (FRC) today issues a consultation on the provisions of the Audit Firm Governance Code, in light of its review earlier this year.

The proposed changes reflect the following key messages from investors and other respondents to the earlier consultation:

- The purpose of the Code should be clarified. Its primary role should lie in audit quality, but good governance should also be promoted across the firms as a whole.
- The role of independent non-executives was important and could be strengthened in some areas. In particular investors wished to hear more from independent non-executives directly about their work and views on the firms' performance on audit.
- The firms should consider over time adopting provisions of the Corporate Governance Code not currently in the Audit Firm Governance Code.
- The firms should maintain and grow the efforts they have built to engage investors.

FRC's CEO, Stephen Haddrill, said:

'The Audit Firm Governance Code has led to an enhancement in governance of the major firms who have put significant effort into adopting its key provisions. Above all it creates, through the independent non-executives, an independent voice and challenge at the heart of the firms, which is of particular importance in view of their public interest responsibilities. The proposed new provisions will strengthen this voice further, provide clarity about the Code's purpose particularly in relation to audit quality and encourage further transparency to investors.'

FRC proposes limited amendments to FRS 101 and FRS 103

11 December 2015

The Financial Reporting Council (FRC) has today issued two Exposure Drafts (FRED 63 and FRED 64) proposing limited amendments to two UK and Ireland accounting standards.

FRED 63 arises as a result of the annual review of FRS 101 *Reduced Disclosure Framework*. The annual review aims to ensure that FRS 101 continues to be cost-effective as IFRS, on which it is based, changes. FRED 63 principally proposes disclosure exemptions in relation to IFRS 15 *Revenue from Contracts with Customers*.

FRED 64 proposes amendments to FRS 103 *Insurance Contracts* to reflect changes in the regulatory framework, with the introduction of Solvency II, including updating some of the terminology used. However, established accounting policies can continue to be applied if an entity so chooses.

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

'FRED 63 proposes additional disclosure exemptions for entities applying FRS 101, and should reduce the cost of compliance for entities choosing to use this standard. We are also asking stakeholders to reflect, with us, on the principles for determining disclosure exemptions and whether there are opportunities to further increase the cost-effectiveness of FRS 101.

'The changes proposed in FRED 64 are necessary given the changes in the regulatory framework for insurance business, but do not require entities to change their accounting policies and therefore should not result in additional costs for entities.'

The proposals in FRED 64 are intended to be effective for accounting periods ending on or after 1 January 2016. The key proposals in FRED 63 are expected to be available from when an entity applying FRS 101 first applies IFRS 15.

FRC promotes improved reporting by signatories to the Stewardship Code

14 December 2015

The Financial Reporting Council will introduce public tiering of signatories to the Stewardship Code in July 2016 to improve reporting against the principles of the Code and assist investors. Improved reporting will help asset owners judge how well their fund manager is delivering on their commitments under the Stewardship Code; help those who value engagement to choose the right manager; and in consequence should provide a market incentive in support of engagement.

The Stewardship Code, introduced by the FRC in 2010, sets out a number of areas of good practice to which investors should aspire and operates on a comply or explain basis. Over the past five years the quality and quantity of stewardship has improved, but not consistently and transparently.

To promote commitment to stewardship, the FRC will assess signatories' reporting against the Code and make public its assessment. Signatories will be assessed as being:

- Tier 1 – meeting reporting expectations in relation to stewardship activities. Additionally, asset managers will be asked to provide evidence of the implementation of their approach to stewardship. The FRC will look particularly at conflicts of interest disclosures, evidence of engagement and approach to resourcing and integration of stewardship; or
- Tier 2 – not meeting those reporting expectations.

Before making a public assessment, the FRC will contact firms with feedback to allow time for improvements. The FRC encourages signatories to engage with this process positively and be proactive in improving their reporting of stewardship activities.

Sir Winfried Bischoff, Chairman of the FRC, said:

'The Stewardship Code has helped to raise the profile of stewardship, normalised discussions about stewardship in the investment chain and led to improvements in the quality and quantity of engagement between investors and companies. We wish to maintain momentum by ensuring that signing up to the Stewardship Code is a true marker of commitment.'

FRC highlights key considerations for 2015 annual reports

15 December 2015

To assist companies ahead of the reporting season the Financial Reporting Council (FRC) is writing to audit committee chairs in larger listed companies summarising key developments for 2015 annual reports.

The FRC encourages companies towards Clear & Concise reporting to ensure that their annual reports contain information that is relevant to investors. The letter identifies some of the key themes in corporate governance and reporting including considering the risks a company is exposed to and the importance of materiality assessments to underpin effective, tailored disclosure.

Stephen Haddrill, FRC chief executive, said:

‘The quality of corporate reporting in the UK is generally of a high standard with companies taking steps to improve their annual reports. Being clear and concise in reporting is essential to such improvements, with companies focussing as far as possible on whether they are reporting matters that are genuinely material to investors.’

The FRC wrote to smaller listed and AIM quoted companies recently with year-end advice that is proportionate for those companies.

FRC promotes clear and concise reporting through strategic report

17 December 2015

The Financial Reporting Council (FRC) has identified that the introduction of the Strategic Report and the FRC’s *Guidance on the Strategic Report* has had a positive effect on the quality of corporate reporting. Many companies have embraced this as an opportunity to rethink how they communicate with investors.

The FRC has today issued a report, *Clear & Concise: Developments in Narrative Reporting*, which includes practical tools to help companies achieve Clear & Concise reporting and provides an overview of developments in narrative reporting. It also includes a study reviewing the influence of the FRC’s *Guidance on the Strategic Report* since its publication in 2014, which found that annual reports have become more cohesive, with better linkage between related information and more focus on Clear & Concise reporting.

The study notes that business model and strategy reporting provides useful insight into how a company is managed and that best practice in this area is evolving. It also highlights focus areas for the next reporting period such as the application of materiality and improving reporting of key performance indicators; principal risks; and forward-looking information.

The overriding objective of the strategic report is to provide information for shareholders that will enable them to assess how the directors have performed their duty to promote the success of the company. It should reflect the directors’ view of the company and provide context for the related financial statements. In meeting the needs of shareholders, the information in the annual report may also be of interest to other stakeholders. The annual report should not, however, be seen as a replacement for other forms of reporting addressed to other stakeholders.

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

‘Two years on from the introduction of the strategic report, investors tell us that companies are providing more relevant, entity-specific and useful information in their annual reports. Our study found that many companies are improving how they communicate and making important information more accessible; but good practice is far from universal.

‘We believe there is room to go further on the application of materiality so that irrelevant information does not get in the way of the relevant; continuing to improve the linkage of related information to communicate cohesively; and including more forward-looking analysis to promote longer-term sustainability. Making change requires leadership from boards and investors with support from auditors, advisors and regulators.’

The FRC will use the study results to inform the update of its strategic report guidance. It expects to update the guidance to take account of the UK's implementation of the EU's Non-Financial Reporting Directive that BIS (Department for Business, Innovation and Skills) will be consulting on.

FRC issues draft Plan and Budget for 2016/17

21 December 2015

The Financial Reporting Council (FRC) today publishes its Draft Plan, Budget and Levy Proposals for 2016/17. This will be the first year of its new 2016/19 three year strategic programme. This consultation which seeks stakeholder views on the FRC's priorities and resources will close on 12 February 2016.

FRC CEO, Stephen Haddrill, said:

'Our work continues to be guided by our mission, which is to promote high quality corporate governance and reporting to foster investment. We will aim to do so in a way that avoids adding to regulatory burdens wherever possible and do not expect, over the next three years, to amend codes and standards beyond those changes already announced. We are seeking views on our priorities and resources for 2016/17.

'A key focus for the coming year will be to implement the responsibilities we are being given as the competent authority for audit regulation under the EU Audit Regulation and Directive. We will make the most effective use of our new role to promote the investor and wider public interest in the quality of audit.

'On corporate governance, we will focus on our work with stakeholders on corporate culture and publish a report on observations of good practice. We will also take action to enhance effective investor stewardship.

'On actuarial matters, we will complete our updated framework of actuarial standards and review our oversight of the actuarial profession.

'Our record on monitoring of corporate reporting and auditing is strong as shown by an external review this year of our effectiveness, but we are determined not to stand still and will be taking further action to enhance this area, including through greater transparency of our findings.'

The FRC's budget for 2016/17 is proposed at the same level as agreed for 2015/16. However, with that overall level, the FRC proposes to seek increased resources from the audit profession to fund additional work arising from the new EU audit legislation.

FRC announces updates to conventions for electronic tagging of accounts

23 December 2015

The Financial Reporting Council (FRC) has published additional tags to the XBRL electronic tagging conventions (taxonomies) last published in September 2014 to enable up-to-date electronic reporting to be in place in 2016.

Taxonomies enable accounts to be filed electronically and for users of information in corporate reports to extract data and analyse it more effectively.

The latest updates reflect 2015 changes in UK GAAP and company law and include electronic tags to indicate the nature of the entity and the accounting standards applied. HMRC and Companies House will be updating their guidance to incorporate the amended taxonomies.

Guidance for amendments to the FRC 2014 Taxonomies

The FRC has made amendments to the suite of taxonomies issued in September 2014 by implementing additional tags to enable:

- Micro preparers to tag using only those parts of the FRS 102 taxonomy which are relevant
- Small preparers using FRS 102 to do likewise
- FRS 101 preparers using the IFRS formats to tag using the extant IFRS taxonomy
- The introduction of an Abridged Accounts indicator
- To insert 150 new tags over and above the 50 tags which already exist in the taxonomies for the reporting of subsidiaries. Further, to introduce a tag to indicate companies which have more than 200 subsidiaries.

The amended taxonomies are at: https://xbrl.frc.org.uk/FRC-Documents/Accounting-and-Reporting/FRC-Taxonomy.aspx.

A mapping for software companies of the amended taxonomies to those issued in September 2014 can be found at: https://xbrl.frc.org.uk/FRC-Documents/Accounting-and-Reporting/Mapping.aspx.