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DIRECTORS LOAN ACCOUNTS (LECTURE A546 – 16.28 MINUTES)

The issue surrounding directors' loan accounts under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* is beginning to become a controversial issue with many practitioners questioning the appropriate accounting treatment under the new regime.

The update in Quarter 4 of 2015 looked in detail at the impact of FRS 102 on directors' loans both to and from a company. However, in practice it is not uncommon for a director to introduce funds into a business without formal loan terms being put in place; indeed, for companies in the SME sector, this is extremely common. Directors which do this might also not require the loan to be repaid within 12 months from the balance sheet date. Under outgoing UK GAAP, the loan would ordinarily be treated as a long-term liability but since the issuance of FRS 102, questions have begun to emerge as to the treatment of loans which may not necessarily be at market rates of interest (in practice a significant majority of loans introduced by the directors are not at market rates of interest).

Generally, when a loan does not contain any formal loan terms then FRS 102 would treat this loan as repayable on demand. This means that the loan would be classed as current, in much the same way as a bank overdraft. Some practitioners are understandably concerned about the impact that this will have on the reporting entity's balance sheet because it could reduce net current assets, or increase net current liabilities or turn net current assets into net current liabilities, something which directors are keen to avoid wherever possible.

Where formal loan terms do exist and a loan is repayable more than 12 months after the balance sheet date, it may need to be discounted to present values if the loan is not at market rates and the measurement difference which arises on the difference between present value and transaction price is brought into the entity's financial statements, with the profit and loss account reflecting a market rate of interest to comply with the requirements of Section 11 *Basic Financial Instruments*.

Loan from a director not repayable within 12 months

As mentioned in the introductory section, practitioners are becoming concerned about the accounting treatment of loans to the company by directors under the principles in FRS 102. Commentators are suggesting the use of 'rolling loan agreements' whereby the loan will fall to be classed as repayable in, say, 370 days from the balance sheet date (i.e. one year and one week). Technically the week which takes the loan into long-term (i.e. the 53rd week) should be discounted, but there are more issues to consider than just avoiding measurement differences. Certainly, from an auditor's perspective the issue of any deliberate attempt by the client not to recognise the benefit the company has received from an interest free loan may not sit comfortably with the auditors. This may arise when, for example, the client keeps changing the likely repayment date of the loan in an attempt to manipulate the financial statements through the desire to keep a loan in long-term as opposed to current liabilities.

In addition, there are also issues relating to distributable or undistributable reserves to consider as well as the likely repayment date. There may, however, be instances where a company draws up formal loan terms subsequent to the director providing the loan to the company which might say that an interest free loan may not be repayable for, say, 370 days after the balance sheet date as can be highlighted in the following example:

Example – Loan from a director to Company A and presentation in the accounts

Peter is a director and shareholder of Cahill Enterprises Ltd and has made a loan of £100,000 to the company to provide additional working capital. There are no formal loan terms in existence, but Peter has said that he does not require the loan to be repaid within the next 12 months.

On 31 December 2015 (the company's year-end date), the company entered in to a formal loan agreement with Peter which confirms that the loan is interest free and is not repayable for 370 days after date of the agreement. The terms of the agreement confirm that it is a rolling loan agreement and can be terminated by notification from either party; the notification must be in writing and must be made on or before the 31 December each year. If notification is given the agreement ceases on 31 December and the loan becomes repayable on demand.

Likely repayment date

UK GAAP says that in order for the loan to be recognised as a liability on the balance sheet, it must be probable (i.e. more likely than not) that the company will incur a cash outflow to settle the obligation. Where this is the case the auditor/directors should make a best estimate of the likely repayment date. If the actual repayment date is unable to be established, then the recognition criteria may not be met and the loan would be accounted for as a gift from Peter to the company.

However, for the purposes of this example, assume that it seems likely that the best estimate of a repayment date is at the end of the 370 days and the directors (at this stage) believe that it is likely that notification under the agreement will be given on 1 December 2016 to end the agreement.

Accounting treatment in the books of Cahill Enterprises Ltd

The loan is discounted to present day value for the one year as this is the best estimate of the likely repayment date. If the company were to borrow the same amount from its bank, the bank have confirmed an interest rate of 5.5% would be payable and therefore the present value of the loan would be £95,300. In the year to 31 December 2016 the interest to be shown would be £4,700 representing the unwinding of the discount provided in the 31 December 2015 accounts.

The accounting treatment as at 31 December 2015 should be as follows:

	£	
Dr bank account	100,000	
Cr director's loan account	95,300	(creditors falling due within one year)
Cr capital contribution	4,700	(equity section of the balance sheet)

Audit considerations

Cahill Enterprises Ltd is an audit client and the financial statement materiality level on the audit is £75,000, with the level of trivial error being calculated as £1,000. The client does not want to adjust for amount to be recognised as capital contribution, so this is listed as an unadjusted error of £4,700 for the 31 December 15 year-end. The loan is shown at £100,000 falling due after more than one year.

The unadjusted error schedule would show that the profit and loss account reserve is understated by £4,700 (because of the lack of capital contribution being recognised). In addition, the director's loan account is over stated by £4,700 because the capital contribution has not been recognised in accordance with the requirements of Section 11 *Basic Financial Instruments* in FRS 102 for non-market rate loans. These adjustments are considered to be

immaterial in isolation, but are above the level of trivial error so should be reported to the client.

Notification to end the rolling agreement is received

Notification to end the rolling agreement was received by the company on 1 December 2016 and the loan was repaid on 5 January 2017.

If the loan had been accounted for correctly and the capital contribution amount recognised, then the journal entries for the 31 December 2016 year-end financial statements would have been:

	£
Dr interest payable (profit and loss)	4,700
Cr director's loan account	4,700

The loan of £100,000 would then be shown as a current liability in the 31 December 2016 financial statements as subsequent repayment was made on 5 January 2017.

The unadjusted audit error schedule would still confirm that the capital contribution is understated by £4,700 because the adjustment was not made in the prior year and hence is carried over into the current year's audit error schedule. In addition, the interest cost is also understated by the same amount. However, the unadjusted errors are immaterial in isolation, but are above the level of trivial error hence should be reported to the client.

No notification has been received, and the loan term is further extended

At 31 December 2016 no notification to end the rolling agreement has been received. There needs to be consideration as to the likely repayment date. Upon discussion with the client, they have confirmed that the current best estimate of the likely repayment date is 5 January 2018.

The accounting treatment (assuming the loan had been discounted at the market rate) to revise the current loan would be:

Nominal Ledger	Dr	Cr
Profit and loss: interest payable	£4,700	
Director's loan account		£4,700
Being the discount restating the loan to £100k.		
Director's loan account	£4,700	
Capital contribution		£4,700
Being restatement of the loan within long-term liabilities.		

The directors have confirmed that they do not want to put any of these adjustments through and hence the unadjusted audit error schedule for the 31 December 2016 audit would show the following:

Profit and loss account interest = understated by £4,700

Loan account in the balance sheet = overstated by £4,700

Capital contribution reserve = understated by £4,700 (there is no 'rolling-up' of the capital contribution error as the reserves would have been reduced by the interest charge going through retained earnings).

The unadjusted errors would be reported to the client and the loan would be shown as £100K due after more than one year.

Auditor's additional considerations

The unadjusted errors are unlikely to be material at today's current interest rate expectations, however the auditor must consider the underlying intentions of management and ask 'is this "arrangement" a deliberate attempt to manipulate the financial statements by not recognising the benefit the company has received by Peter providing the company with an interest-free loan?' In addition, the auditor should also consider the likelihood of the rolling agreement keeping on rolling forward until the loan actually gets paid.

The auditors may accept that the error is immaterial, but could conclude that this is evidence of systematic manipulation of the figures by the client, which may not sit comfortably with the auditors.

In the event of constant deferral, the auditor should challenge the client's overall ability to make a realistic estimate. In this example, it is unlikely that the reported error would become material, and hence would simply increase in the unadjusted audit error schedule, but the auditor should at least question the client's intentions.

Measurement differences: are they distributable or not?

The ICAEW will shortly issue further guidance on distributable profits. The draft guidance suggests that a debit entry for interest would be treated as an adjustment against realised profit but the credit entry in respect of the capital contribution would be unrealised and therefore would not form part of distributable profit.

This additional complexity means that any disclosure of distributable and non-distributable profits may be affected by the unadjusted error to the extent that the disclosure of distributable and non-distributable profit does not give a true and fair view. If the company chooses to disclose the split of distributable and undistributable profits, then the unadjusted capital contribution part of the above example would not net off through the reserves and would then have an impact on the disclosure in the financial statements. As the disclosure is specific, the impact on the view given by the disclosure may have an effect on the true and fair view that is greater than the auditor's level of materiality may suggest.

Conclusion

The above example may be technically feasible in practice, but the question of the auditor's independence in accepting or even encouraging such an exercise may cause more problems for the auditor in the long term.

Auditors should therefore consider the truth and fairness of the financial statements, in light of any unadjusted errors in respect of distributable and undistributable profit, moreso where the impact on distributable profit is relevant to the disclosures made in the accounts and the ability of the entity to pay a lawful dividend.

Auditors should consider advising the client to charge a market rate of interest or have the loan as repayable on demand. At the very least, in such situations the auditor must be seen to be challenging the client's intentions.

MICRO-ENTITIES: REVALUE OR NOT? (LECTURE A 547 – 16.33 MINUTES)

FRS 105 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* becomes mandatory for micro-entities choosing to report under FRS 105 for accounting periods starting on or after 1 January 2016. It is to be emphasised that FRS 105 is **optional** and a micro-entity that would be eligible to apply FRS 105 can choose to apply a more comprehensive framework if they so choose (such as FRS 102, Section 1A *Small Entities*).

The Financial Reporting Council are keen to emphasise that while FRS 105 may be appropriate for some micro-entities, it may not necessarily be appropriate for others and hence the suitability of the framework should be judged on a case-by-case basis. Examples of factors to consider where FRS 105 are:

- eligibility criteria: the eligibility criteria outlined in the micro-entities' legislation is very restrictive and therefore the advisor should consider whether the entity is a business which is ineligible to apply the framework;
- production of non-statutory information: the scope for producing non-statutory information should be considered because the financial statements are significantly reduced in terms of detail than they would have been under, say, the Financial Reporting Standard for Smaller Entities (the FRSSE) and hence banks and other interested third parties may require additional information over and above that required by law;
- pace of growth: the entity may be a new start-up, but is expecting to grow at a rapid rate and hence it may be more beneficial to choose a more comprehensive financial reporting framework; and
- prohibition of fair value accounting and revaluation amounts: the standard does not allow fair values or revaluation amounts to be recognised in the financial statements.

Removal of fair values and revaluations in FRS 105

One of the most significant changes that FRS 105 brings about in terms of changes to accounting methodologies is the removal of the fair value and alternative accounting rules found in the UK's Companies Act 2006. This is not something which the Financial Reporting Council have chosen to do; it has been done because the EU Accounting Directive prohibits the application of the fair value accounting rules or the alternative accounting rules. The consequence of this is that any assets that have previously been carried at fair value or at a revalued amount will have to be restated to historic cost principles on transition to FRS 105. In addition, the prior year comparatives will also have to be adjusted to reflect historic cost principles and a depreciation policy will have to be introduced for a micro-entity that has investment property on its balance sheet (this is because under previous UK GAAP, the micro-entity would have taken fair value fluctuations to a revaluation reserve within equity).

Example – Use of a previous GAAP revaluation as deemed cost

A company qualifies as a micro-entity and has decided to use FRS 105 as its financial reporting framework in its first FRS 105 financial statements for the year-ended 31 December 2016. The micro-entity has an investment property on its balance sheet which was previously accounted for under the FRSSE (effective January 2015) at open market value in accordance with paragraph 6.51.

The accountant is proposing to use the previous year's valuation that was undertaken as at 31 December 2015 as deemed cost and apply the historic cost principles going forward as he feels this is a more sensible approach.

The accountant's proposed treatment is not acceptable under FRS 105. This is because it is not possible to use a previous valuation for investment property as deemed cost on the grounds that this would be inconsistent with the requirements of the law. While the 'deeming provisions' provide that accounts prepared in accordance with the minimum legal requirements are presumed to give a true and fair view, the accountant's proposed treatment would not comply with the law and hence the financial statements would not be presumed to be true and fair. The accountant should, as a minimum, exercise the transitional option contained in paragraph 28.10(c) of FRS 105.

Removing revaluation amounts on transition for an investment property

The rules in FRS 105 are retrospective (as is the case with FRS 102) in that they have to be applied as far back as the date of transition. The date of transition is the start date of the comparative period reported in the financial statements. Therefore, assuming a 31 December 2016 year-end, the date of transition will be 1 January 2015 as this is the start date of the comparative year and hence the opening balances as at 1 January 2015 must be restated so the financial statements are both comparable and consistent (i.e. restated as if FRS 105 has always been the financial reporting framework applied by the micro-entity).

It is likely that micro-entities with investment properties on their balance sheet are going to be affected by the prohibition of the alternative accounting rules (i.e. using revaluation amounts). Therefore, after all issues have been considered, if the micro-entity still wishes to report under FRS 105, the investment property must be restated to the value that it would have been carried at in the financial statements had the investment property been carried under historic cost principles (in other words, at cost less depreciation and less any amounts in respect of impairment).

Many accountants are surprised at this accounting treatment because the value of investment property can (and often does) increase. The Accounting Council have also expressed their disapproval at the prohibition of micro-entities from adopting the revaluation model for investment property saying in *The Accounting Council's Advice to the FRC to issue FRS 105* at paragraph 16 that:

'… the Accounting Council continues to believe that investment property should always, where practicable, be measured at fair value as this provides more relevant information to users of the financial statements on an investment property company's financial position and performance. However, company law prohibits the revaluation of any asset by micro-entities and instead requires that fixed assets are measured at cost less depreciation and impairment.' [1]

In recognition of this issue, the Financial Reporting Council (FRC) have included a transitional provision in FRS 105 at paragraph 28.10(c), which says:

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

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

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

[1] FRS 105 Accounting Council's Advice to the FRC to issue FRS 105 paragraph 16

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

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

(v) *Any amount of the total depreciated cost not allocated under paragraph (iv) shall be allocated to the most significant component of the investment property.'* [2]

Step 1: Determine the total cost of the investment property

The first step is to determine the total cost of the investment property, including all of its components (the term 'components' mean items in addition to the main structural element of the property). Assuming the micro-entity previously carried the investment property at open market value, this is simply a case of reversing the revaluation reserve against cost.

Example – Determining the total cost of the investment property

A micro-entity has an investment property on its balance sheet as at 1 January 2015 (the date of transition) with a carrying amount of £150,000 and an associated revaluation surplus of £25,000. The micro-entity previously applied the provisions in the FRSSE (effective January 2015) and carried the investment property at open market value with fair value fluctuations going through the revaluation reserve account in equity and reported through the entity's statement of total recognised gains and losses. The investment property was purchased on 1 January 2011 and the accountant is unsure as to how to get the investment property back to historical cost for the purposes of transitioning to FRS 105. The value of the land according to the Chartered Surveyor's report is £30,000.

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

Dr revaluation reserve	£25,000
Cr investment property cost	£25,000

Being reallocation of revaluation reserve to restate the investment property to cost.

The FRC has included this transitional option in recognition of the fact that all revaluation gains and losses would have been recognised within equity and therefore by offsetting the revaluation reserve against the carrying amount of the investment property at the date of transition, the investment property is then reduced to historic cost.

Step 2: Remove the land element from the cost of the investment property

Once the cost in Step 1 has been derived, the value of the land is deducted. This is in recognition of the fact that land does not depreciate.

[2] FRS 105 paragraph 28.10(c)

Example – Removal of the land element

Continuing with the example of the micro-entity above, the Chartered Surveyor's report in Step 1 said that the value of the land was £30,000. This is removed from the cost calculated in Step 1 as follows:

Cost of property (post reallocation of revaluation reserve)	£125,000
Less land element	(£30,000)
	£95,000

Step 3: Estimate the total depreciated cost of the property

For micro-entities which previously accounted for investment property at open market value at each balance sheet date, a depreciation policy will have to be derived by management in respect of the investment property. Many reporting entities choose a depreciation policy of 2% on a straight-line basis (i.e. 50 years) and it may be the case that this policy is also assigned to investment property.

Practical point

The majority of entities tended to assign 50-year useful economic life to buildings on the grounds that FRS 15 *Tangible fixed assets* required impairment tests to be carried out each year if the asset was being depreciated longer than 50 years. FRS 105 requires impairment tests to be carried out each year regardless of the depreciation policy as per paragraph 22.6, so the policy for depreciation need not, necessarily, be 2% on a straight-line basis; it could, instead, be 1% if the entity so wishes and the entity would still need to consider whether the asset was showing signs of impairment each year.

Paragraph 28.10(c)(iii) says that the accumulated depreciation must be calculated since the **date of initial acquisition** to the date of transition on the basis of the property's useful economic life. This is where it is vital that an impact assessment is carried out before advising the client to use FRS 105 where an investment property is concerned, because this may have a significantly detrimental impact on the micro-entity's balance sheet position. The reason depreciation is being charged from the date of initial acquisition is because the property has to be accounted for under the historical cost principles.

In addition, it is also worth noting that many practitioners have suggested that depreciation could be immaterial. Remember, depreciation reflects the **consumption** of an asset and hence is not necessarily based on the overall valuation of the asset therefore it is important that the definition of depreciation is carefully borne in mind. Also, the materiality of depreciation should be judged not only in respect of the amount of the charge for the year in question, but as an accumulated value where previous years' depreciation charges have been judged as immaterial. The reason is, that over time the depreciation charge could become a material amount if it is not brought into account within the financial statements.

Example – Total depreciated cost of the investment property

The total depreciable amount of the investment property so far is £95,000 (see Step 2). Assuming the micro-entity depreciates the investment property at 2% on a straight-line basis, the depreciation to the date of transition is calculated as:

£95,000 x 2% x 4 years* = £7,600

*the micro-entity purchased the investment property on 1 January 2011 and therefore this would mean four years' depreciation being charged up to the date of transition (1 January 2015).

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

Dr accumulated profit and loss (retained earnings) £7,600
Cr accumulated depreciation (investment property) £7,600

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

Step 4: Apply component depreciation to each of the major components

FRS 105 (as does FRS 102) places more emphasis on component accounting. Component accounting works by breaking down an asset into its major components and where those major components have a significantly shorter useful economic life than the main asset itself, these are depreciated separately over their useful economic lives. This concept applies in respect of investment property for a micro-entity.

At the date of transition, the investment property in the example so far has a total depreciated cost of £87,400 (£95,000 less £7,600). Paragraph 28.10(c)(iv) then requires the entity to allocate this depreciated cost to the property's major components.

Example – Component depreciation

Continuing with the example above, the central heating system in the investment property needs to be replaced in three years' time (being three years' from the date of transition). The current cost to replace the central heating system is £12,000.

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

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

Step 5: Remaining amounts

Finally, paragraph 28.10(c)(v) says that any amount of the total depreciated cost which is not allocated under component accounting (see Step 4) is to be allocated to the most significant component of the investment property (namely the structural element).

Micro-entity wishes to continue carrying investment property at fair value

The importance of an impact assessment is critical where a micro-entity might have an investment property stated at revaluation (or, in fact, any item of fixed asset carried under either the fair value or alternative accounting rules). This is because restating such properties to historic cost values will, in almost all cases, result in a detrimental impact on the balance sheet, because historic cost prices tend to be far less than current prices and therefore if the micro-entity has owned the investment property for several years, the impact of offsetting the revaluation reserve against cost and then charging depreciation from the date of acquisition up to the date of transition, then in the prior year and also going forward will reduce the balance sheet position of the company quite considerably; something which the client may not thank the practitioner for if discussions have not been entered into with the client beforehand.

If the micro-entity does not want to restate any asset to historic cost principles and hence wishes to continue revaluing, then it must report under FRS 102, Section 1A *Small Entities* as a minimum because this standard would allow a micro-entity to carry investment property at fair value through profit or loss under Section 16 *Investment Property* although additional considerations need to be borne in mind where that is concerned (such as an increase in undistributable reserves and the need to bring deferred tax into consideration as per paragraph 29.16 of the standard).

RELATED PARTIES (LECTURE A548 – 17.26 MINUTES)

Related parties have often posed difficulties for accountants, largely because of their subjective nature and further issues are brought about by new UK GAAP in the form of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

The objective of related party disclosures is to enable the users of the reporting entity's financial statements to be made aware that the financial statements may have been influenced by transactions with related parties and also enable the users to evaluate the impact on the financial statements as a result of the entity entering into transactions with such related parties.

Over the years, standard-setters have tried to widen the definition of related parties and related party transactions in an attempt for the standards to be a 'catch all' where such parties and transactions were concerned. The transposition of the EU Accounting Directive into company law has meant that small companies are only legally obliged to make limited related party disclosures and micro-entities need not make any related party disclosures at all (the Glossary to FRS 105 does not define a 'related party' or a 'related party transaction' because such concepts do not apply to micro-entities). However, a micro-entity may choose to voluntarily provide related party disclosures if the directors so wish.

It should also be noted that FRS 105 does require the disclosure of advances, credit and guarantees granted to directors as required by Section 413 CA 2006.

Definition of a related party

FRS 102 splits the definition of a related party into two components:

- related parties which are natural persons; and
- related parties which are entities.

The Glossary to FRS 102 says that:

*'A related party is a person or entity that is related to the entity that is preparing its **financial statements** (the reporting entity).*

a) A person or a close member of that person's family is related to a reporting entity if that person:

  *i. has **control** or **joint control** over the reporting entity;*

  *ii. has **significant influence** over the reporting entity; or*

  *iii. is a member of the **key management personnel** of the reporting entity or of a **parent** of the reporting entity.*

b) An entity is related to a reporting entity if any of the following conditions apply:

  *i. the entity and the reporting entity are members of the same **group** (which means that each parent, **subsidiary** and fellow subsidiary is related to the others).*

  *ii. one entity is an **associate** or **joint venture** of the other entity (or of a member of a group of which the other entity is a member).*

  iii. both entities are joint ventures of the same third entity.

  iv. one entity is a joint venture of a third entity and the other entity is an associate of the third entity.

  *v. the entity is a **post-employment benefit plan** for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the*

reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

vi. *the entity is controlled or jointly controlled by a person identified in (a).*

vii. *a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).*

viii. *the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.'* [3]

In addition to defining a related party, the Glossary also defines a 'related party transaction' as:

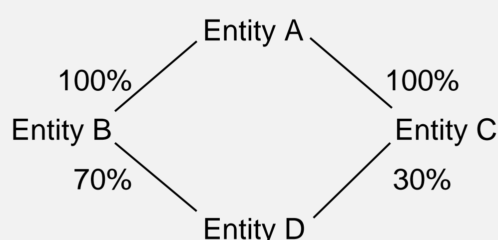
'A transfer of resources, services or obligations between a reporting entity and a ***related party****, regardless of whether a price is charged.'* [4]

Transactions among group members

FRS 102 does not require disclosures of transactions which have been entered into between two, or more, members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member. It can be taken that 'wholly owned by such a member' extends to those members where 100% ownership is achieved indirectly.

Example – Transacting group members

A group is structured as follows:



All members of the group trade with each other during the year to 31 December 2016.

FRS 102 would not require disclosure of transactions between entities A and B, A and C or B and C because B and C are wholly-owned within Entity A's group. Entity D is also 100% owned within Entity A's group and this is achieved indirectly through Entity B and Entity C's ownership of Entity D. As a result, the disclosure exemption contained in paragraph 33.1A of FRS 102 can be extended to trading transactions between Entity D and entities A, B and C.

Parties not deemed to be related

Paragraph 33.4 confirms that the following are not related parties:

(a) Two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

[3] FRS 102 Glossary **related party**
[4] FRS 102 Glossary **related party transaction**

(b) Two **venturers** simply because they share joint control over a joint venture.

(c) Any of the following simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process):

  (i) providers of finance;

  (ii) trade unions;

  (iii) public utilities; and

  (iv) government departments and agencies.

(d) A customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, merely by virtue of the resulting economic dependence. [5]

Paragraph 33.4A also confirms that in the definition of a related party, an 'associate' includes subsidiaries of the associate and a joint venture will also include subsidiaries of the joint venture.

Parent-subsidiary relationships

Paragraph 33.5 of FRS 102 requires a relationship between a parent and its subsidiaries to be disclosed, regardless of whether there have been any related party transactions. The reporting entity must also disclose the name of its parent and (where different), the ultimate controlling party. Where neither the entity's parent or the ultimate parent company produces financial statements which are available for public use, the name of the next most senior parent that does so should also be disclosed.

Example disclosure – Related party transaction not conducted on an arm's length basis

22. Parent undertaking and related parties

The ultimate parent undertaking is Topco Holdings Limited who prepare the group's consolidated financial statements. Copies of the consolidated financial statements can be obtained from 123 High Streeet, Anytown, Country, AB1 2CD.

During the year the company provided services to Related Co Ltd, a company which is owned by the wife of the managing director. These services were undertaken at favourable discount rates and at the year-end 31 December 2016, there was an amount of £140,000 (2015: £nil) owed to the company.

Key management personnel compensation

FRS 102 confirms that 'key management personnel' are those persons that have authority and responsibility for planning, directing and controlling the activities of the company and this can either be directly or indirectly. The term itself is not confined to the directors of the company, but can also include non-executive directors and managers.

The term 'compensation' relates to all employee benefits (as defined in Section 28 *Employee Benefits*) as well as share-based payment transactions which are dealt with in Section 26 *Share-based Payment.* For clarity, employee benefits include all forms of consideration paid, payable or provided by the entity (or on behalf of the entity) in exchange for services rendered. It also includes consideration paid on behalf of a parent of the entity in respect of goods or services provided to the entity.

[5] FRS 102 paragraph 33.4

Paragraph 33.7 of FRS 102 requires key management personnel compensation to be disclosed in totality.

Example – Disclosure of key management personnel compensation

34. Key management personnel compensation

The remuneration of directors and members of the entity's key management personnel during the year were as follows:

	2016	2015
	£'000	£'000
Short-term benefits	315	304
Post-employment benefits	185	92
	500	396

Disclosure of related party transactions

Related party transactions can be fairly wide in their scope and paragraph 33.12 provides a useful list of examples of the types of related party transactions that would require disclosure under the standard. The list is not exhaustive but aims to highlight typical examples of transactions that should be disclosed if they are with a related party as follows:

(a) purchases or sales of goods (finished or unfinished);

(b) purchases or sales of property and other **assets**;

(c) rendering or receiving of services;

(d) leases;

(e) transfers of **research** and **development**;

(f) transfers under licence agreements;

(g) transfers under finance arrangements (including loans and equity contributions in **cash** or in kind);

(h) provision of guarantees or collateral;

(i) settlement of **liabilities** on behalf of the entity or by the entity on behalf of another party; and

(j) participation by a parent or subsidiary in a **defined benefit plan** that shares risks between group entities.

When a reporting entity has undertaken transactions with related parties, it must disclose the nature of the related party relationship as well as information relating to transactions, outstanding balances and commitments so that the user can obtain an understanding of the potential effect of the related party relationship (and transactions) on the financial statements. Paragraph 33.9 requires the following information to be disclosed **as a minimum**:

(a) The amount of the transactions.

(b) The amount of outstanding balances and:

  (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and

  (ii) details of any guarantees given or received.

(c) Provisions for uncollectible receivables related to the amount of outstanding balances.

(d) The expense recognised during the period in respect of bad or doubtful debts due from related parties.

A notable feature about the disclosure requirements outlined in paragraph 33.9 is that the section does not require the names of the transacting related parties to be disclosed, which is required under the FRSSE (effective January 2015) paragraph 15.1(c) (i) and FRS 8 *Related party disclosures* paragraph 6 (a). However, reporting entities may choose to provide the names of the transacting related parties if this aids an understanding of the related party relationships and transactions.

Other points to note relating to related party disclosures

There are a couple of other points to note concerning related party disclosures.

Disclosure per category of related party

The disclosure requirements of Section 33 need to be made separately for each of the following categories:

(a) entities with control, joint control or significant influence over the entity;

(b) entities over which the entity has control, joint control or significant influence;

(c) key management personnel of the entity or its parent (in the aggregate);

(d) entities that provide key management personnel services to the entity; and

(e) other related parties.

For clarity, the term ‘control’ means that the parent governs the financial and operating policies of the subsidiary and this is usually (but not always) achieved with an ownership interest in the subsidiary of more than 50% of the net assets.

The term ‘significant influence’ is the power to participate in the financial and operating policy decisions of an associate. This is **not** control or joint control and is usually (but not always) achieved with an ownership interest in the associate of between 20% and 50% of the net assets.

Transactions on an arm’s length basis

FRS 102 prohibits a reporting entity from stating in the financial statements that related party transactions have been made on terms which are equivalent to those that would arise in an arm’s length transactions. However, making such a disclosure in the financial statements is acceptable if, and only if, such terms can be substantiated. This is to prevent reporting entities from making misleading statements in the accounts for related party transactions.

Aggregation of similar items

It may be the case that the reporting entity enters into several transactions with related parties. Paragraph 33.14 allows items of a similar nature to be disclosed in aggregate. However, the paragraph also says that the exception to this concession is where separate disclosure would be deemed necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

Small entities reporting under Section 1A of FRS 102

Section 1A *Small Entities* in FRS 102 is a new section introduced in the September 2015 edition of the standard. It was also borne out of the requirements of the EU Accounting Directive and will apply to all small companies that apply Section 1A in the preparation of their financial statements mandatorily for accounting periods starting on or after 1 January 2016, although early adoption is permitted.

The FRSSE required far more comprehensive disclosures than Section 1A legally requires. This is because the EU Accounting Directive restricts the legally required related party disclosures to 'limited' related party disclosures and therefore the FRC had to reflect the provisions of the EU Accounting Directive in Section 1A.

The disclosures required by law are outlined in Section 1A Appendix C *Disclosure requirements for small entities.* Related party disclosures are contained in paragraph 1AC.34 to 1AC.36 of the section and the section breaks down the disclosure requirements into three components:

- disclosure requirements for subsidiaries;
- disclosure requirements for transactions not concluded under normal market conditions; and
- directors' transactions.

Disclosure requirements for subsidiaries

When the small entity is a subsidiary of a parent company, it must provide the following information in respect of the parent of the smallest group for which consolidated accounts are drawn up of which the small entity is a member:

a) the name of the parent which draws up the consolidated financial statements;
b) the address of the parent's registered office (whether in the UK or outside of the UK); and
c) if it is unincorporated, the address of its principal place of business.

Disclosure requirements for transactions not concluded under normal market conditions

Where the small company has entered into related party transactions with:

a) owners holding a participating interest in the small entity;
b) companies in which the small entity itself has a participating interest; and
c) the small entity's directors (or equivalent governing body),

and those transactions have not been conducted under normal market conditions (i.e. on an arm's length basis), then the small entity must disclose:

- the amount of the transactions;
- the nature of the related party relationship; and
- other information concerning the transactions which will aid an understanding of the financial position of the small company.

Accountants will note there is no requirement to provide the names of the transacting related parties (although in practice some entities may choose to do so to aid an understanding). This follows the same principles as that required if an entity was reporting under the full provisions of Section 33 *Related Party Disclosures*.

The section allows individual transactions to be combined according to their nature. However, where separate information is necessary for an understanding of the effects of the related party transactions, combining the transactions would not be permitted.

It is also worth noting that, as is the case with mainstream Section 33, Section 1A does not require particulars of transactions which have been entered into between two or more members of a group. The proviso here is that any subsidiary which is a party to the transaction must be wholly-owned by such a member.

Paragraph 1AC.35 also acknowledges that transactions with directors, or members of an entity's governing body, will include items such as directors' remuneration and dividends paid to directors in their capacity as shareholders.

The FRC are keen to emphasise that directors of small companies still have a legal obligation to prepare financial statements that give a true and fair view. Unlike the micro-entities' legislation, there is no presumption in law that a small company preparing financial statements in accordance with the legally required minimum will give a true and fair view. Hence, the directors must make additional disclosures, over and above those required by Appendix C of Section 1A where so doing will result in a true and fair view being given.

Paragraph 1AC.35 of FRS 102 also acknowledges that if a small entity chooses to disclose all transactions with related parties (i.e. those concluded under normal conditions and those not concluded under normal market conditions) then the entity will still be compliant with company law.

Directors' transactions

Where transactions with directors are entered into during the reporting period, paragraph 1AC.36 requires certain disclosures to be made to comply with the Companies Act 2006. The disclosures specifically relate to:

- advances and credit by the small entity to its directors; and
- guarantees of any kind entered into by the small entity on behalf of its directors.

Advances and credit

The details required to be disclosed in respect of an advance or credit are:

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

Totals are required to be disclosed in respect of items a), d), e) and f). There is no change here in the reporting requirements because these are derived from company law.

Guarantees

The details requiring disclosure in respect of a guarantee are:

a) its main terms;
b) the amount of the maximum liability that may be incurred by the small entity; and
c) any amount paid and any liability incurred by the small entity for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

Totals are required to be disclosed in respect of items b) and c). Again, there is no change here in the reporting requirements because these, too, are derived from company law.

INTANGIBLE ASSETS (OTHER THAN GOODWILL) (LECTURE A549 (9.02 MINUTES)

Intangible assets (other than goodwill) are dealt with in Section 18 *Intangible Assets other than Goodwill* in FRS 102. Section 18 applies to all intangible assets, excluding goodwill which is dealt with in Section 19 *Business Combinations and Goodwill*. Goodwill has been included in a separate section of FRS 102 in recognition of the fact that goodwill should only ever arise in a business combination as internally generated goodwill can never be recognised on the balance sheet (as was the case under outgoing UK GAAP).

Section 18 recognises that an intangible asset is an identifiable non-monetary asset that does not possess a physical substance. The term 'identifiable' is critical in this definition because such an asset is identifiable when:

(a) it is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or **liability**; or

(b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. [6]

There are certain intangible assets to which Section 18 does not apply:

Intangible asset	Relevant section of FRS 102 or relevant FRS
Intangible assets held for sale in the ordinary course of business	Section 13 *Inventories* and Section 23 *Revenue*
Intangible assets arising from contracts in the scope of FRS 103	FRS 103 *Insurance Contracts*
Financial assets	Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues*
Heritage assets	Section 34 *Specialised Activities*
Mineral rights and mineral reserves, such as oil, natural gas and similar non-regenerative resources	Section 34 *Specialised Activities*

Recognising an intangible asset on the balance sheet

The recognition criteria for an intangible asset is outlined in paragraph 18.4 of FRS 102 and is based on the principles found in Section 2 *Concepts and Pervasive Principles*. An intangible asset can only be recognised on the balance sheet if, and only if:

(a) it is probable that the expected future economic benefits attributable to the asset will flow to the entity; and

(b) the cost or value of the asset can be measured reliably.

The criterion above will always be considered satisfied where an entity acquires an intangible asset separately.

[6] FRS 102 paragraph 18.2 (a) and (b)

In addition, if an entity acquires an intangible asset as part of a business combination this can usually be recognised as an asset because fair value can be measured with sufficient reliability. The exception to this is when an intangible asset arises from legal or other contractual rights and there is no history or evidence of exchange transactions for the same or similar assets. This is because estimating fair values would be dependent on immeasurable variables.

In all cases, an intangible asset is measured initially at cost. The cost of a **separately acquired** intangible asset will comprise:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

(b) any directly attributable costs of preparing the asset for its intended use.

A point worthy of note is that Section 18 does not allow an expenditure on an intangible asset that was initially recognised in profit or loss as an expense to be subsequently recognised as part of the cost of the asset.

Measurement after initial recognition

There are two methods which can be used to measure the intangible asset after initial recognition at cost:

- the cost model; and
- the revaluation model.

Cost model

In practice this is the most common model applied to intangible assets. The entity measures the intangible asset at cost less accumulated amortisation and any accumulated impairment losses.

Revaluation model

For the vast majority of intangible assets, the revaluation model will not be appropriate because under this model, the intangible asset is carried at a revalued amount, being fair value at the date of revaluation less subsequent accumulated amortisation and subsequent impairment losses. The reason that it will be inappropriate for many intangible assets is that in order to use the revaluation model, fair value must be determined by reference to an **active market**. The Glossary to FRS 102 defines an 'active market' as:

'A market in which all of the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.' [7]

Active markets can generally exist for intangible assets such as taxi licences or fishing quotas; but ordinarily intangible assets are carried under the cost model.

Where, however, an intangible asset is carried under the revaluation model, the principles in Section 18 follow the same as those for a tangible fixed asset carried at revaluation under Section 17 *Property, Plant and Equipment*. Where the revaluation model applies, revaluations must be carried out with sufficient regularity to ensure that the carrying amount of the intangible asset does not differ materially from that which would be determined using

[7] FRS 102 Glossary **active market**

fair value at the end of the reporting period. The standard requires professional judgement to be applied in this area because there are no prescriptive time limits in which to carry out revaluations.

Example – Fair value no longer available

A company has been carrying an intangible asset under the revaluation model for a number of years. However, the market in which fair value has been derived no longer exists and for the year-ended 31 December 2016 the entity cannot obtain a fair value for the intangible asset.

In this situation, paragraph 18.18E says that where fair value of a revalued intangible asset can no longer be determined by reference to an active market, then the carrying amount of the asset is to be its revalued amount at the date of the last revaluation by reference to the active market, less subsequent accumulated amortisation and subsequent accumulated impairment losses. In other words, the previous fair value becomes 'deemed cost' at the date of the last revaluation.

Any increases in an intangible asset's carrying amount as a result of a revaluation (i.e. revaluation gains) are taken to other comprehensive income and accumulated within equity. The only exception to this rule would be where the increase reverses a previously recognised loss that was taken to profit or loss. The amount taken to profit or loss must not exceed the amount originally debited to profit or loss and any excess is then taken to equity.

Conversely, where an intangible asset's carrying amount reduces as a result of a revaluation (i.e. a revaluation loss) then this loss is recognised in equity to the extent of a credit balance on the revaluation reserve in equity. Any excess of the revaluation reserve over the loss is then taken to profit or loss.

Point to note

Please note that, as is also the case for tangible assets subjected to revaluation under Section 17 *Property, Plant and Equipment*, any revaluation gains are taken to a revaluation reserve within equity (as is the case under outgoing GAAP). Some accountants are under the impression that new UK GAAP removes the concept of the revaluation reserve account in its entirety; but this is only for investment property carried at fair value through profit or loss and accounted for under Section 16 *Investment Property*. Therefore, care must be taken to ensure correct accounting treatment in respect of revalued assets under the new regime.

Amortisation

The first thing to emphasise where FRS 102 is concerned is that no intangible assets can have indefinite useful lives, as was the case under outgoing UK GAAP. Paragraph 18.21 requires a reporting entity to allocate the depreciable amount of an intangible asset on a systematic basis over its useful life.

Amortisation is to begin when the intangible asset is available for use. The term 'available for use' means that the intangible asset is in the location and condition necessary for it to be usable in the manner intended by management. Conversely, amortisation must cease when the intangible asset is derecognised.

Paragraph 18.21 of FRS 102 refers to 'depreciable amount'. The depreciable amount of an asset is calculated as its cost less residual value and this balance is then depreciated/amortised over its useful economic life.

Residual values for intangible assets are presumed to be zero.

However, there are two instances where an intangible can have a residual value:

(a) Where there is a commitment by a third party to purchase the asset at the end of its useful life.

(b) There is an active market for the intangible asset, and:

 (i) residual value can be determined by reference to that market; and

 (ii) it is probable that such a market will exist at the end of the asset's useful life.

Review of amortisation method

Amortisation policies for intangible assets should be reviewed regularly to ensure they are appropriate. Paragraph 18.24 recognises changes in how an intangible asset is used, technological advancement and changes in market prices may indicate that the residual value (where appropriate) or useful economic life of an intangible asset may have changed since the last reporting period. Where this is the case, the entity must review previous estimates and, where current expectations are different, change the residual value, amortisation method or useful economic life of the intangible asset accordingly.

Changes to residual values, amortisation methods or useful lives are treated as a change in accounting estimate (as per Section 10 *Accounting Policies, Estimates and Errors*) and hence should be applied prospectively; in other words, there is no need to apply the change retrospectively via a prior year/period adjustment.

Research and development (internally generated intangible assets)

An entity is not permitted to recognise internally generated goodwill on the balance sheet and this was the case under previous UK GAAP (despite the fact that some entities did so in the belief that it was appropriate, even though FRS 10 *Intangible assets and goodwill* specifically prohibited the recognition of internally generated goodwill).

An entity can, however, internally generate an intangible asset and provided it meets the recognition criteria, may even report the internally generated intangible asset on the balance sheet.

In order to decipher whether an internally generated intangible asset meets the recognition criteria, the generation of the asset is classified into:

(a) the research phase; and

(b) the development phase.

Expenditure in the research phase

All expenditure in the research phase of a project is to be recognised in profit or loss. There is no option to capitalise any research expenditure because the standard recognises that at the research phase of an internal project, an entity will be unable to demonstrate that an intangible asset exists which will generate probable future economic benefits.

It may be the case that the entity cannot distinguish expenditure from that which relates to the research phase of a project and that which relates to the development phase.

Example – Distinction not possible

An entity is undertaking a project to develop a new vaccine against a strain of virus in dogs that can cause serious illness to the animal.

The project director has been unable to distinguish the project into the research phase or the development phase despite the project team suggesting to the board of directors that the project *'is in the advanced stages'*.

The finance director is proposing to capitalise the last two months' worth of expenditure on the project as an intangible asset in the belief that if the project is in the advanced stages, then surely the last two months' worth of expenditure can be classed as development costs and hence capitalised.

The finance director must not capitalise any of the expenditure as an intangible asset. This is because paragraph 18.8B says that where an entity is unable to distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only. Therefore, the entity must recognise all the expenditure in profit or loss until the development phase can be clearly distinguished.

Expenditure in the development phase

Strict criteria exists in FRS 102 which must be met before an entity can recognise any expenditure in the development phase as an intangible asset on the balance sheet. If, and only if, the entity can demonstrate all of the following criteria may an entity recognise development expenditure as an intangible asset:

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) Its intention to complete the intangible asset and use or sell it.

(c) Its ability to use or sell the intangible asset.

(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development. [8]

Where the reporting entity adopts a policy of capitalising development expenditure, that policy must be applied consistently to all expenditure which meets the above criteria. Where any expenditure does not meet the above criteria, it is to be expensed to profit or loss as it is incurred.

Items which must never be capitalised as an intangible asset

Section 18 has identified certain types of expenditure which must always be expensed to profit or loss and never recognised as an intangible asset on the balance sheet.

These are as follows:

(a) Internally generated brands, logos, publishing titles, customer lists and items similar in substance.

(b) Start-up activities (ie start-up costs), which include establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a

[8] FRS 102 paragraph 18.8H (a) to (f)

new facility or business (ie pre-opening costs) and expenditure for starting new operations or launching new products or processes (ie pre-operating costs).

(c) Training activities.

(d) Advertising and promotional activities (unless it meets the definition of **inventories held for distribution at no or nominal consideration**) (see paragraph 13.4A)).

(e) Relocating or reorganising part or all of an entity.

(f) Internally generated goodwill. [9]

Example – Advertising expenditure as an asset

A company has a year-end of 31 March 2017 and is in the process of launching a new product into the market which it has internally developed. On 1 February 2017 they paid for a series of radio adverts at a cost of £15,000 (excluding VAT) for six months from 1 February 2017. The finance director has read paragraph 18.8C(c) which says that advertising expenditure must be expensed to profit or loss and has therefore recognised the entire £15,000 in advertising expense.

Paragraph 18.8D says that the requirements in paragraph 18.8C do not prohibit an entity from recognising a prepayment in respect of expenditure paid for upfront. Therefore, the finance director can recognise four-sixths of the cost in prepayments, hence £10,000 (£15,000 x 4/6).

Initial cost of internally generated intangible assets

Where the reporting entity has a policy of capitalising development costs as internally generated intangible assets, the cost of such is the sum of the expenditure incurred from the date on which the intangible asset first meets the recognition criteria. This will also include all directly attributable costs, such as:

- the cost of materials and services used, or consumed, in creating the intangible asset;
- cost of employees (as defined in Section 28 *Employee Benefits*) which have been incurred to create the intangible asset;
- fees the entity has incurred to register a legal right; and
- amortisation of patents and licences which are used to generate the intangible asset.

Other issues relating to intangible assets

Some other notable points relating to intangible assets that should be borne in mind are as follows:

- When an intangible asset is acquired in a business combination, the cost of that intangible is the asset's fair value at the date of acquisition.
- If an entity acquires an intangible asset by way of a government grant (see Section 24 *Government Grants*), the cost of the intangible asset is the fair value of the asset at the date the grant is received or becomes receivable.
- If the entity acquires an intangible asset through an exchange transaction, the entity measures the cost of the intangible asset at fair value. Two exceptions to this rule are where:
  - the exchange transaction lacks commercial substance; or

[9] FRS 102 paragraph 18.8C (a) to (f)

- the fair value of neither the asset received, nor the asset given up, is reliably measurable. In such cases, the asset's cost is measured at the carrying amount of the asset given up.

Disclosure requirements

The disclosure requirements in respect of intangible assets (other than goodwill) are outlined in paragraphs 18.27 to 18.29A. Practitioners may note that some of these disclosure requirements contain asterisks (*) at the start. This means that these paragraphs are cross-referenced for small companies reporting under Section 1A, Appendix C.

The disclosure requirements are as follows:

(a) The useful lives or the amortisation rates used and the reasons for choosing those periods.

(b) The amortisation methods used.

(c) The gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the reporting period.

(d) The line items in the statement of comprehensive income or income statement (if presented) (i.e. profit and loss) in which any amortisation of intangible assets is included.

(e) A reconciliation of the carrying amount at the start and end of the accounting period showing separately:

   (i) additions, indicating separately those from internal development and those separately acquired;

   (ii) disposals;

   (iii) acquisitions through business combinations;

   (iv) revaluations;

   (v) amortisation;

   (vi) impairment losses; and

   (vii) other changes.

   The reconciliation above does not need to be presented for prior periods.

The standard requires additional disclosures as follows:

(a) A description, the carrying value and remaining amortisation period of any individual intangible asset which is material to the financial statements.

(b) For intangible assets acquired by way of a grant and initially recognised at fair value, disclose:

   (i) the fair value initially recognised for these assets; and

   (ii) their carrying amounts.

(c) The existence and carrying value of intangible assets to which the entity has restricted title or which have been pledged as security for liabilities.

(d) The amount of contractual commitments for the acquisition of intangible assets.

Disclosures for research and development

The entity must disclose the total amount of research and development expenditure that it has recognised as an expense during the period; that is the total amount of expenditure incurred internally on research and development which has not been capitalised as an intangible asset or as part of the cost of another asset which meets the recognition criteria in FRS 102.

Disclosures for revalued intangible assets

Where an entity carries intangible assets at revalued amounts, disclosure should be made as follows:

(a) The effective date of the revaluation.

(b) Whether an independent valuer was used.

(c) The methods and significant assumptions applied in estimating the assets' fair values.

(d) For each revalued class of intangible asset, the carrying amount which would have been recognised in the financial statements had the assets been carried under the cost model.

FAQS ON UK GAAP AND THE REVISED COMPANIES ACT 2006 (LECTURE A550 – 8.23 MINUTES)

As the new reporting regime starts to gather faster pace, SWAT (UK) has put together some FAQs which are beginning to emerge:

If my client becomes small under the new size thresholds and early-adopts the revised Companies Act 2006, does this mean I can claim audit exemption for my December 2015 year-end?

No. You must be extremely careful not to early-adopt the audit exemption thresholds. This is because while the audit exemption limits have been increased to match the new small company size thresholds, the audit exemption limits cannot be early-adopted. Therefore, your client will need an audit if it would have needed an audit under the old regime.

My client would like to adapt their financial statements because this will help with the group consolidation. Is this permissible?

Yes, this is possible but your client would have to early-adopt the legislation because if the client does not early-adopt SI 2015/980, then it will report under the old legislation which did not allow the statutory formats to be adapted and this will also mean early-adopting the provisions of the new FRSs in new UK GAAP.

I note FRS 102 refers to 'statements of financial position' and 'income statements'. Can I still use the old terminology, i.e. a 'balance sheet'?

Yes, this is permissible as paragraph 3.22 of FRS 102 allows alternative titles to be used for the financial statements, provided they are not misleading. In addition, if you have clients that are charitable companies limited by guarantee, it would be equally permissible for them to continue with 'Income and expenditure' statements rather than 'Profit and loss accounts'.

Why is an LLP prohibited from using FRS 105?

The Department for Business Innovation and Skills (BIS) have only just updated the LLP Regulations which followed a short consultation by BIS in November 2015. The final draft LLP Regulations have been laid before Parliament and are expected to be issued in the summer of 2016. These revised Regulations will allow LLPs the ability to use FRS 105 in the preparation of their financial statements.

FRS 105 will, therefore, be reissued by the FRC at the same time the final LLP Regulations are issued. There will not be a consultation carried out by the FRC in this respect because the amendments to FRS 105 will only reflect a change in legislation (i.e. by extending the scope of FRS 105 so it covers micro-entity LLPs) and therefore a formal consultation will not be required.

LLPs can use FRS 105 for accounting periods starting on or after 1 January 2016, with early adoption permissible.

I have heard that the names of the financial statements are derived from Companies Act 2006. Surely an entity cannot call the balance sheet a 'statement of financial position' if the Act does not recognise this term?

SI 2015/980 amends The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 for accounting periods starting on or after 1 January 2016 with early adoption permissible. The revised Companies Act 2006 also allows the new terminology to be used. Early-adopters of the new legislation need to ensure that they also early-adopt the new suite of FRSs (i.e. it is prohibited to apply the revised Companies Act 2006 early, but then to apply old UK GAAP in the preparation of the financial statements for the same year-/period-end).

NEW AUDITING AND ETHICAL STANDARDS ISSUED (A551 – 12.51 MINUTES)

On 27 April 2016, the Financial Reporting Council (FRC) issued the revised UK Corporate Governance Code, Guidance on Audit Committees, and Auditing and Ethical Standards. It is to be noted that the FRC has also said that it will avoid further updates to the Corporate Governance Code until at least 2019.

At the time of writing these notes, the revised Auditing and Ethical Standards were at final draft stage. This is because they are subject to legislative changes and Parliamentary Scrutiny. They are scheduled to take effect on 17 June 2016.

The overarching objective of the changes to the standards is to strengthen auditor independence by applying prohibitions to a range of engagements that may give rise to a conflict of interest, although there are some reliefs which will permit, in certain circumstances, an auditor to provide additional assistance to small and medium-sized entities.

The changes to the UK Corporate Governance Code, Guidance on Audit Committees and the Ethical and Auditing Standards were necessary so as to implement the requirements of the EU Audit Regulation and Directive (ARD).

Changes to the Corporate Governance Code (the Code)

The changes to the Code were minimal and reflect only those changes required by the ARD as well as recent reviews into best practice and information gathered from the FRC's own work.

The revised Code retains the requirement for at least one member of the audit committee to have *'recent and relevant financial experience'* because under the ARD there is a need to have at least one member of the audit committee with *'competence in accounting and/or auditing'*. The Code also requires the audit committee, as a whole, to have competence relevant to the sector in which the company operates. The Code also requires that the board ensures a range of skills, experience, knowledge and professional qualifications when addressing the composition requirements.

In respect of audit retendering plans, the Code requires that committees inform investors in advance of such plans.

The reason this guidance was amended was to clarify the committee's role in respect of risk and internal audit. It is now expected that the audit committee will report on the significant findings of reviews which are undertaken by the FRC's Corporate Reporting Review and Audit Quality Review teams.

At the consultation phase, it was asked whether an advisory vote on the audit committee report should be required as this was recommended by the Competition and Markets Authority. Respondents did not agree that this was necessary on the basis that there are other avenues through which they may register concern.

Changes to the Ethical Standards

Changes have been made to the Ethical Standards to enhance the independence of the auditor and also to include policy decisions which are to be reflected in UK legislation, such as the retendering and rotation of the audit. For Public Interest Entities (PIEs), the Ethical Standards prohibit the auditor from providing certain types of non-audit services. Other entities will be subject to fee cap of no more than 70% of the audit fee which is calculated on a rolling three-year basis.

The FRC have acknowledged that in some areas, the UK Ethical Standard retains some of the previous existing ethical requirements and goes beyond the ARD, which is in line with feedback received from earlier consultations. For a PIE, the standard requires that those auditors from a network firm auditing a component of a PIE should be held to the more stringent UK ethical requirements. In other situations, the recognised international code will apply (as is the case now).

The structure of the revised Ethical Standard is as follows:

Introduction

- Scope of this Ethical Standard
- Investment Circular Reporting Engagements
- Meeting the Ethical Outcomes Established by the Overarching Principles, Supporting Ethical Provisions and Specific Requirements
    - The 'Third Party Test'
    - Threats to Integrity, Objectivity and Independence
- The EU Audit Directive and Regulation
- Definitions

Part A: Overarching Principles and Supporting Ethical Provisions

- Integrity and Objectivity
    - Overarching Principle
    - Supporting Ethical Provisions
- Independence
    - Overarching Principle
    - Supporting Ethical Provisions

Part B

Section 1 – General Requirements and Guidance

- Compliance
    - Ethics Partner
    - Breaches
    - Non-involvement in Management Decision-taking
- Identification and Assessment of Threats
    - Threats to Integrity, Objectivity and Independence
    - Investment Circular Reporting Engagements
- Identification and Assessment of Safeguards
- Other Firms Involved in Engagements
- Engagement Quality Control Review
- Overall Conclusion
- Communication with Those Charged With Governance
- Documentation
- Effective Date

Section 2 – Financial, Business, Employment and Personal Relationships

- Financial Relationships
  - General Considerations
  - Financial Interests Held as Trustee
  - Financial Interests Held by Firm Pension Schemes
  - Loans and Guarantees
- Business Relationships
- Employment Relationships
  - Management Role with an Entity Relevant to an Engagement
  - Loan Staff Assignments
  - Partners and Engagement Team Members Joining an Entity Relevant to an Engagement
  - Family Members Employed by an Entity Relevant to an Engagement
  - Governance Role with an Entity Relevant to an Engagement
  - Employment with the Firm
- Family and Other Personal Relationships
- External Consultants Involved in an Engagement

Section 3 – Long Association with Engagements and with Entities Relevant to Engagements

- General Requirements
- Public Interest Entities and Other Listed Entities
  - Audit Firm Rotation
  - Key Audit Partners and Engagement Partners
  - Engagement Quality Control Reviewers and Other Key Partners Involved in the Engagement
  - Other Partners and Staff Involved in the Engagement in Senior Positions

Section 4 – Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation

- Fees
- Remuneration and Evaluation Policies
- Gifts and Hospitality
- Threatened and Actual Litigation

Section 5 – Non audit / Additional Services

- General Approach to Non-Audit / Additional Services
  - Investment Circular Reporting Engagements
  - Identification and Assessment of Threats and Safeguards
    - Threats to Objectivity and Independence
    - Safeguards
  - Communication with Those Charged With Governance
  - Documentation
- Audit Related Services
- Evaluation of Specific Non-audit Services and Additional Services
  - Internal Audit Services
  - Information Technology Services

    - Valuation Services
    - Actuarial Valuation Services
    - Tax Services
    - Litigation Support Services
    - Legal Services
    - Recruitment and Remuneration Services
    - Corporate Finance Services
    - Transaction Related Services
    - Restructuring Services
    - Accounting Services
- Prohibited Non-audit Services for Public Interest Entities

Section 6 – Provisions Available for Audits of Small Entities

- Introduction
- Alternative Provisions
    - Economic Dependence
    - Self-review Threat – Non-audit Services
- Exemptions
    - Management Threat – Non-audit Services
    - Advocacy Threat – Non-audit Services
    - Partners and Other Persons Approved as a Statutory Auditor Joining an Audited Entity
- Disclosure Requirements

Appendix: Illustrative template for communicating information on audit and non-audit services provided to the group

Considering independence

The revised Ethical Standard requires the auditor to consider their independence from the perspective of an objective, reasonable and informed third party. Where such a party may come to the conclusion that an action would compromise the independence of the auditor, the auditor must ensure they do not take that course of action because otherwise they will not be able to undertake the audit engagement.

The risks in the revised Ethical Standard are made clearer where the auditor acts as an advocate for the client. Only in immaterial situations can the auditor act as an advocate as the revised Ethical Standard emphasises the prohibition which applies. For example, paragraph 5.97 of the revised Ethical Standard says:

'The firm shall not provide tax services to an entity relevant to an engagement where this would involve acting as an advocate for the entity in the resolution of an issue:

(a) that is material to the entity's present or future financial statements, or the subject matter information or subject matter of the engagement; or

(b) where the outcome of the tax issue is dependent on a future or contemporary judgment by the firm in relation to the financial statements, or other matter information or subject matter of the engagement.' [10]

[10] Revised Ethical Standard paragraph 5.97

The meaning of an advocacy threat is outlined in paragraph 1.29 of Section 1 of Part B of the revised Ethical Standard and includes supporting a position taken by management in an adversarial context where the first has to adopt a position closely aligned to that of management. Paragraph 1.29 says:

'An advocacy threat arises when the firm undertakes work that involves acting as an advocate for an entity relevant to an engagement, and supporting a position taken by management in an adversarial or promotional context (for example, by acting as a legal advocate for the entity in litigation or a regulatory investigation, or undertaking an active responsibility for the marketing of an entity's shares). In order to act in an advocacy role, the firm has to adopt a position closely aligned to that of management. This creates both actual and perceived threats to the integrity, objectivity and independence of the firm and covered persons. For example, where the firm, acting as an advocate, has supported a particular contention of management, it may be difficult for the persons conducting the engagement to take an impartial view of this in the context of an audit of the financial statements.

Where the provision of a non-audit / additional service would require the firm, its partners or staff to act as an advocate for the entity in relation to matters that are material to the financial statements or other subject matter information, or to the subject matter of an engagement, it is unlikely that any safeguards can eliminate or reduce the advocacy threat to a level where independence would not be compromised.' [11]

Contingent fee arrangements

Unsurprisingly, the revised Ethical Standard prohibits contingent fees for tax services provided to larger listed entities with a market capitalisation of more than €200 million on the basis that the FRC considers the risk that contingent fees can grow to a level whereby they pose a threat to auditor independence.

Revisions to the UK and Ireland Auditing Standards

The UK and Ireland Auditing Standards have been amended to reflect the provisions of the ARD as well as changes that have been made at international level by the International Auditing and Assurance Standards Board (IAASB). The IAASB have completed three projects which have given rise to changes having to be made to the UK and Ireland International Standards on Auditing as follows:

- Revisions to reporting standards have incorporated existing UK Extended Auditor's Reporting requirements.
- A requirement for auditors to provide within their report a separate opinion, covering the statutory other information published alongside the financial statements stating whether that information is:
  - consistent with the financial statements;
  - prepared in accordance with legal requirements; and
  - does not contain material inconsistencies.
- Enhanced reporting to audit committees covering key audit matters.
- By-exception reporting on going concern.

The International Standards on Auditing (UK and Ireland) which have been revised are as follows:

[11] Revised Ethical Standard paragraph 1.29

ISQC (UK and Ireland) 1	Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements
ISA (UK and Ireland) 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK and Ireland)
ISA (UK and Ireland) 210	Agreeing the Terms of Audit Engagements
ISA (UK and Ireland) 220	Quality Control for an Audit of Financial Statements
ISA (UK and Ireland) 230	Audit Documentation
ISA (UK and Ireland) 240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
ISA (UK and Ireland) 250A	Consideration of Laws and Regulations in an Audit of Financial Statements
ISA (UK and Ireland) 250B	Section B – The Auditor's Statutory Right and Duty to Report to Regulators of Public Interest Entities and Regulators of Other Entities in the Financial Sector
ISA (UK and Ireland) 260	Communication With Those Charged With Governance
ISA (UK and Ireland) 300	Planning an Audit of Financial Statements
ISA (UK and Ireland) 315	Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment
ISA (UK and Ireland) 320	Materiality in Planning and Performing an Audit
ISA (UK and Ireland) 330	The Auditor's Responses to Assessed Risks
ISA (UK and Ireland) 450	Evaluation of Misstatements Identified During the Audit
ISA (UK and Ireland) 510	Initial Audit Engagements – Opening Balances
ISA (UK and Ireland) 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
ISA (UK and Ireland) 570	Going Concern
ISA (UK and Ireland) 600	Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)
ISA (UK and Ireland) 610	Using the Work of Internal Auditors
ISA (UK and Ireland) 620	Using the Work of an Auditor's Expert
ISA (UK and Ireland) 700	Forming an Opinion and Reporting on Financial Statements
ISA (UK and Ireland) 705	Modifications to the Opinion in the Independent Auditor's Report
ISA (UK and Ireland) 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
ISA (UK and Ireland) 720	The Auditor's Responsibilities Relating to Other Information

ISA (UK AND IRELAND) 701 *COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT* *(LECTURE A552 – 14.40 MINUTES)*

As part of the implementation of the Audit Regulation Directive, the Financial Reporting Council (FRC) have introduced a new International Standard on Auditing UK and Ireland (ISA (UK and Ireland)) which outlines key audit matters that have to be communicated in the independent auditor's report. ISA (UK and Ireland) 701 *Communicating Key Audit Matters in the Independent Auditor's Report* should be read in conjunction with ISA (UK and Ireland) 200 (Revised June 2016) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standard on Auditing (UK and Ireland)*.

ISA (UK and Ireland) 701 is effective for audits of financial statements for periods commencing on or after 17 June 2016 and early adoption of the ISA (UK and Ireland) is permitted.

Scope of ISA (UK and Ireland) 701

The scope of ISA (UK and Ireland) 701 is to outline the auditor's responsibilities to communicate key audit matters within the auditor's report. The intention of the standard is twofold:

- it addresses the auditor's judgement as to what information to communicate in the auditor's report; and
- addresses the form and content of such communication.

ISA (UK and Ireland) 701 was introduced to enhance the value of the auditor's report. The auditor's report has been heavily criticised over the years because of its complex jargon and users' difficulty in understanding what exactly the report is trying to say. The idea of ISA (UK and Ireland) 701 is to offer greater transparency about the audit and how it was performed. Disclosing key audit matters in the auditor's report is intended to enable the users of the financial statements to understand those matters which, in the auditor's professional judgement, were of most significance in the audit.

Care should be taken where key audit matters disclosed in the auditor's report are concerned because the ISA (UK and Ireland) is quite clear; the communication of key audit matters in the audit report is **NOT**:

(a) A substitute for disclosures in the financial statements that need to be made under the financial reporting framework, or which would be necessary to achieve a fair presentation.

(b) A substitute for the auditor expressing a qualified opinion when this would be required in the circumstances.

(c) A substitute for reporting in accordance with ISA (UK and Ireland) 570 *Going Concern* where there are material uncertainties relating to the entity's ability to continue as a going concern.

(d) A separate opinion on individual matters.

ISA (UK and Ireland) 701 only applies to the audits of listed entities or when the auditor is required by law or regulation to communicate key audit matters in the auditor's report.

If the auditor disclaims an opinion on the financial statements, ISA (UK and Ireland) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report* does not allow the auditor to communicate key audit matters, unless reporting such matters is required by law or regulation.

Determining key audit matters

The term 'key audit matters' is defined in paragraph 8 of ISA (UK and Ireland) 701 which says that key audit matters are:

'Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters were selected from matters communicated with those charged with governance.'

In deciding what key audit matters should be communicated in the auditor's report, the auditor must take account of the following factors:

(a) Areas of higher assessed risk of material misstatement as well as significant risks that have been identified in accordance with ISA (UK and Ireland) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment*.

(b) Significant auditor judgements that relate to areas in the financial statements which involve significant management judgements. These include accounting estimates which have been identified as having high estimation uncertainty.

(c) The effect of significant events or transactions on the audit that have taken place during the period.

Communicating key audit matters

The auditor's report should include a separate section headed up 'Key Audit Maters'. The introductory paragraphs of this section of the report must state that:

(a) Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period] and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditor, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team; and [12]

(b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters. [13]

Describing individual key audit matters

Items considered to be key audit matters and described as such in the auditor's report must include a cross-reference to any related disclosure(s) in the financial statements. In addition, the auditor must describe:

(a) the reasons why the matter was considered to be one of most significance in the audit and hence classed as a key audit matter; and

(b) how the auditor addressed the matter in the audit.

ISA (UK and Ireland) 701 requires additional information to support the audit opinion in respect of key audit matters as follows:

(a) Provide a description of the most significant assessed risks of material misstatement (whether or not due to fraud).

[12] ISA (UK and Ireland) 701 paragraph 11(a)
[13] ISA (UK and Ireland) 701 paragraph 11(b)

(b) Provide a summary of the auditor's responses to those risks.

(c) Where relevant, provide a description of the key observations arising with respect to those risks.

Where relevant, the auditor's report must include a clear reference to the relevant disclosures in the financial statements.

The auditor must also indicate that the matter was one of the most significant assessed risks of material misstatement (whether, or not, due to fraud) identified by the auditor.

Key audit matter(s) not communicated in the auditor's report

There may be certain circumstances where matters which are determined to be key audit matters are not communicated in the auditor's report. This is because:

(a) Law or regulation precludes public disclosure concerning the matter.

(b) In extremely rare circumstances, the auditor determines that the matter should not be communicated because of adverse consequences.

The circumstances in (b) above relate to where the adverse consequences of reporting as key audit matters would reasonably be expected to outweigh the public interest benefits of such communication. However, where the audited entity has publicly disclosed information about the matter, the auditor must communicate it as a key audit matter in the auditor's report.

Key audit matters which would otherwise be required in the audit report

It can quite often be the case that the audit opinion is modified (i.e. qualified) in accordance with ISA (UK and Ireland) (Revised June 2016) 705 (the provisions in the revised ISA (UK and Ireland) 705 are examined in the next section of these notes. In addition, there may also be a material uncertainty related to events or conditions that may cast significant doubt over the entity's ability to continue as a going concern and hence the provisions of ISA (UK and Ireland) 570 *Going Concern* (Revised June 2016) may come into play.

Under the previous UK and Ireland ISAs, if there was a material uncertainty relating to going concern, the auditor would include an Emphasis of Matter paragraph directly underneath the opinion paragraph and cross-reference this to the relevant disclosure outlining the material uncertainties relating to going concern. In relation to a material uncertainty relating to going concern, the auditor must include a reference to the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters of the audit report.

In respect of other matters which are dealt with in a separate UK and Ireland ISA, the auditor must report on these matter(s) in accordance with the applicable ISAs (UK and Ireland).

Form and content of key audit matters in other circumstances

If the auditor concludes that there are no key audit matters that require communicating in the audit report, or the only key audit matters are those which give rise to a modified opinion, or a material uncertainty related to events or conditions casting significant doubt on the ability to continue as a going concern (i.e. key audit matters by nature), then the auditor must include a statement to this effect in a separate section of the audit report under the heading 'Key Audit Matters'.

Other audit planning and scoping matters

The auditor's report must provide the following information:

(a) An explanation of how the auditor applied the concept of materiality in planning and performing the audit. This should include the threshold used by the auditor for materiality for the financial statements as a whole.

(b) An overview of the scope of the audit, including an explanation of how such scope:

(i) addressed each key audit matter relating to one of the most significant risks of material misstatement disclosed in the audit report; and

(ii) was influenced by the auditor's application of materiality disclosed in (a) above.

Paragraph 16-2 requires the matters described in the auditor's report to be set out in such a way that:

- enables a user to understand their significance in the context of the audit as a whole and not as discrete opinions on separate elements of the financial statements;
- enables the disclosures to be directly related to the specific circumstances of the entity and so they are not considered to be generic or abstract matters which are couched in standardised language; and
- for entities applying (or voluntarily applying) the provisions of the UK Corporate Governance Code, to explain how they have (or have not, as the case may be) applied the Code. This description should be in a manner which complements the description of significant issues relating to the financial statements and which is required to be set out in the separate section of the annual report describing the work of the audit committee in discharging its responsibilities.

Communicating with those charged with governance

ISA (UK and Ireland) 701 requires that the auditor communicates with those charged with governance:

(a) those matters that the auditor has determined to be key audit matters; or

(b) where applicable, depending on the facts and circumstances of the client, the auditor's determination that there are no key audit matters which are to be communicated in the auditor's report.

Documentation

ISA (UK and Ireland) 701 requires the following to be included in the audit documentation:

(a) The matters that required significant auditor attention as determined in accordance with paragraph 9* and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter in accordance with paragraph 10.

(b) Where applicable, the rationale for the auditor's determination that there are no key audit matters to communicate in the auditor's report or that the only key audit matters to communicate are those giving rise to a qualified opinion or going concern.

(c) Where applicable, the rationale for the auditor's determination not to communicate in the auditor's report a matter determined to be a key audit matter.

*see the section *'Determining key audit matters' (a) to (c) above.*

ISA (UK AND IRELAND) 705 *MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT* (REVISED JUNE 2016) (LECTURE A552 – 14.40 MINTES)

ISA (UK and Ireland) 705 *Modifications to the Opinion in the Independent Auditor's Report* has been revised as part of the implementation of the Audit Regulation Directive. This revised ISA (UK and Ireland) is effective for audits of financial statements for periods commencing on or after 17 June 2016 and early adoption is permitted.

ISA (UK and Ireland) 705 applies when the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary and it also outlines how the form and content of the auditor's report is affected when the auditor expresses a modified opinion.

The objective of ISA (UK and Ireland) 705 is for the auditor to express clearly an appropriately modified opinion on the financial statements which is necessary when:

(a) the auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

The term 'modified opinion' means a qualified opinion (e.g. qualified 'except for'), an adverse opinion or a disclaimer of opinion and it is crucial that the auditor expresses the most appropriate opinion on the financial statements.

Within ISA (UK and Ireland) 705 is the term 'pervasive'. This term is defined in paragraph 5(a) as follows:

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

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

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

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.' [14]

Circumstances when a modification is required

A modified audit opinion is usually only expressed as a last resort because if the auditor can avoid expressing a modified audit opinion, they usually will. However, situations may present themselves when the expression of a modified opinion is unavoidable and paragraph 6 of ISA (UK and Ireland) 705 outlines two situations when a modification to the auditor's opinion is required as follows:

(a) the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

[14] ISA (UK and Ireland) 705 (Revised June 2016) paragraph 5(a)

(b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Qualified opinion

The auditor must express a qualified opinion on the financial statements when:

(a) the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually and in aggregate, are material, but not pervasive, to the financial statements; or

(b) the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Example – Qualified opinion

During the course of the audit of Company A Ltd, the auditor discovers a significant amount of expenditure which has been capitalised as an intangible asset. The financial controller has confirmed that this expenditure is part of a new project which the company is undertaking, but the company is currently unsure whether, or not, the project will actually go ahead because the project is currently in its research phase. The company is reporting under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

The auditor has performed substantive procedures and all the capitalised expenditure relates to research expenditure which paragraph 18.8E of FRS 102 prohibits from being capitalised. The finance director is adamant that the expenditure is to be treated as capital and is refusing to amend the financial statements.

In this situation, the company has breached paragraph 18.8E of FRS 102 and the expenditure should not be treated as an intangible asset. If the financial statements are not amended and assuming that this is the only material error, then the auditor should issue a qualified opinion due to disagreement of an accounting treatment. There should be a Basis for Qualified Opinion paragraph outlining the issue giving rise to the qualified opinion and the Opinion paragraph should be qualified ‘except for’.

Adverse opinion

Paragraph 8 of ISA (UK and Ireland) 705 says that the auditor must express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in aggregate, are both material and pervasive to the financial statements.

Example – Adverse opinion

Company B Ltd has been making losses for the last three years and at 31 December 2015 the balance sheet is showing an insolvent position. The bank has recalled the loan and the bank overdraft for immediate payment because of increasing concerns over the entity’s ability to afford the repayments and the directors have not been successful in obtaining any other sources of finance.

The financial statements have been prepared on the going concern basis and no disclosures have been made concerning the material uncertainties relating to the entity’s ability to continue as a going concern. Having undertaken appropriate audit procedures, the auditor is of the opinion that the financial statements should not be prepared on the going concern basis and the directors would have no realistic alternative but to liquidate the company. The directors are refusing to make any amendments to the financial statements on the grounds that if they do make such disclosures it may affect the decision of any potential lender.

In this scenario the company is clearly not a going concern and therefore the auditor will express an adverse audit opinion. There should be a Basis for Adverse Opinion paragraph outlining the issue giving rise to the adverse opinion and the Opinion paragraph should state that the financial statements do not give a true and fair view.

Disclaimer of opinion

A disclaimed opinion is quite rare in real life, but they do arise. The auditor must express a disclaimer of opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In addition, paragraph 10 of ISA (UK and Ireland) 705 says that the auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Example – Disclaimer of opinion

In the year to 31 December 2015, Company C Ltd changed their accounting systems and did not run the old and the new systems in parallel. There were significant problems encountered in transferring the opening balances and whilst the finance director has managed to complete the draft financial statements, many of the problems are unresolved and hence debtors, creditors and stock contain 'best estimates'.

The auditor has undertaken various substantive procedures and tests of control but is unable to form an opinion as to whether the financial statements give a true and fair view because of the uncertainties and their possible cumulative effect on the financial statements.

In this situation the auditor must disclaim an audit opinion because the effects of the material misstatements could be both material and pervasive. There should be a Basis for Disclaimer of Opinion paragraph outlining the issue giving rise to the adverse opinion and the report should state that the auditor does not express an opinion on the accompanying financial statements.

Management-imposed limitation of scope

If the auditor accepts an audit engagement, but then becomes aware that management has imposed a limitation on scope of the auditor which the auditor considers is likely to result in the need to express a qualified opinion or a disclaimer of opinion, the auditor must first request that management remove the limitation.

If management refuse to remove the limitation, then the auditor must communicate the matter to those charged with governance (unless all of those charged with governance are involved in managing the company). In addition, the auditor must also undertake alternative procedures to obtain sufficient appropriate audit evidence.

Where the auditor is unable to undertake alternative procedures, the provisions in paragraph 13 of ISA (UK and Ireland) 705 will come into effect. This says that the auditor must determine the implications as follows:

(a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or

(b) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:

  (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or

  (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements. [15]

Where the auditor withdraws from the audit, the auditor must communicate to those charged with governance any matters regarding misstatements identified during the audit which would have given rise to a modified audit opinion.

Paragraph 15 of ISA (UK and Ireland) 705 also says that where the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the audit report must not include an unqualified opinion on a single financial statement or one, or more, specific elements, accounts or items of a financial statement. If the auditor were to do this, it would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.

Form and content of the audit report when the opinion is modified

A modified audit report will mean that the auditor's opinion is either qualified, adverse or disclaimed as appropriate.

Qualified opinion

Where the auditor expresses a qualified opinion due to material misstatement in the financial statements, the audit report will state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:

- if the entity is reporting under a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) in accordance with [the applicable financial reporting framework]; or
- when reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

Where the auditor has been unable to obtain sufficient appropriate audit evidence, then the auditor must adopt the corresponding phrase *'except for the possible effects of the matter(s) …'* for the modified opinion.

Adverse opinion

Where the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph:

[15] ISA (UK and Ireland) 705 (Revised June 2016) paragraph 13

- if the entity is reporting under a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) in accordance with [the applicable financial reporting framework]; or
- when reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

Disclaimer of opinion

Where the auditor disclaims an audit opinion because they have been unable to obtain sufficient appropriate audit evidence, the auditor must:

- state that the auditor does not express an opinion on the accompanying financial statements;
- state that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- amend the statement required by paragraph 24(b) of ISA (UK and Ireland) 700 (Revised June 2016), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Basis for opinion paragraph

Where the auditor modifies the audit opinion, they must amend the heading 'Basis for Opinion' to 'Basis for Qualified Opinion', 'Basis for Adverse Opinion' or 'Basis for Disclaimer of Opinion' as appropriate. They must also include a description of the matter(s) giving rise to the modification.

Where the material misstatement relates to specific amounts within the financial statements (including quantitative disclosures), the auditor must include in the Basis for Opinion paragraph a description and quantification of the financial effects of the misstatement unless this is impracticable. If it is impracticable, the auditor must state this fact in the Basis for Opinion paragraph.

Where the material misstatement relates to disclosures, the Basis for Opinion paragraph must include an explanation as to how the disclosures are misstated. However, where the material misstatement relates to non-disclosure of information which GAAP requires disclosure, then the auditor must:

(a) discuss the non-disclosure with those charged with governance;

(b) describe in the Basis for Opinion paragraph the nature of the omitted information; and

(c) unless prohibited by law or regulation, include the omitted disclosures if it is practicable to do so and the auditor has obtained sufficient appropriate information relating to the omitted information.

Where the modification arises because the auditor has been unable to obtain sufficient appropriate audit evidence, the auditor must describe in the Basis for Opinion paragraph the reasons for that inability.

If the auditor disclaims an opinion, the audit report must not include the elements required by paragraphs 28(b) and 28(d) of ISA (UK and Ireland) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements*. Those elements are:

(a) a reference to the section of the auditor's report where the auditor's responsibilities are described; and

(b) a statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Even where the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, ISA (UK and Ireland) 705 requires the auditor to describe in the Basis for Modification paragraph the reasons for any other matters of which the auditor is aware which would have required a modification to the opinion together with the effects thereof.

Description of auditor's responsibilities when the opinion is disclaimed

Where the auditor has disclaimed an opinion because of an inability to obtain sufficient appropriate audit evidence, the auditor's responsibilities described in the auditor's report have to be amended to include only the following:

(a) a statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with ISAs (UK and Ireland) and to issue an auditor's report;

(b) a statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) the statement about auditor independence and other ethical responsibilities required by paragraph 28(c) of ISA (UK and Ireland) 700 (Revised June 2016).

The auditor will not include a 'Key Audit Matters' or 'Other Information' section where the auditor disclaims and audit opinion unless this is required by law or regulation.

Communication with those charged with governance

Where the auditor expects to issue a modified audit opinion, the standard requires the auditor to communicate with those charged with governance concerning the circumstances giving rise to the modified opinion together with a discussion as to the proposed wording of the modification.

ISA (UK AND IRELAND) 550 *RELATED PARTIES*

The issues concerning the accounting and financial reporting aspects for related parties have been discussed earlier in these notes. It would seem sensible, therefore, to address the auditing aspects because quite often the issue of related parties gives rise to firms receiving criticism from reviewers because of inappropriate procedures being adopted or missing information which may render the audit evidence in this area insufficient and inappropriate.

Related parties can often be complex and contain a degree of subjectivity. In recognition of this, a separate auditing standard exists to enable auditors to undertake the procedures necessary to obtain reasonable assurance that the financial statements are not materially misstated due to related party relationships and transactions which is that of ISA (UK and Ireland) 550 *Related Parties*.

ISA (UK and Ireland) 550 recognises that whilst many related party transactions are undertaken in the normal course of business and hence carry no higher risk of material misstatement than those with unrelated parties, the nature of related party relationships and transactions may, in some situations, give rise to higher risks of material misstatement. The standard cites three examples of such situations:

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

Auditor's responsibilities

It is important to emphasise, at the outset, that the auditor is not responsible for concluding on whether, or not, material uncertainties exist which cast significant doubt on the entity's ability to continue as a going concern. This responsibility rests with management and those charged with governance of the entity.

The auditor's responsibilities are to perform audit procedures to identify, assess and respond to the risks of material misstatement which arise from the entity's failure to appropriately account for, or disclose, related party relationships, transactions or balances in accordance with UK GAAP.

In addition, the auditor's responsibility is to evaluate management's assessment that the entity is a going concern.

To that end, the auditor is required to obtain an understanding of the entity's related party relationships and transactions so as to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

(a) achieve fair presentation (for fair presentation frameworks); or

(b) are not misleading (for compliance frameworks).

In recognition of the fact that transactions with related parties may give wider scope for the opportunity of fraud or fraudulent financial reporting, ISA (UK and Ireland) 550 requires the auditor to evaluate whether one, or more, fraud risk factors are presented. This is also a requirement of ISA (UK and Ireland) 240 (Revised June 2016) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

The standard requires the auditor to apply professional scepticism throughout the course of the audit, keeping in mind the possibility that the auditor may not be aware of all related party relationships and/or transactions. Notwithstanding the fact that the audit has been properly planned and performed in accordance with UK and Ireland ISAs, there is a risk that some material misstatements may not be detected and ISA (UK and Ireland) 550 recognises this is greater where related parties are concerned because:

- management may be unaware of the existence of all related party relationships and transactions; and
- related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

ISA (UK and Ireland) 550 definition of a related party

Paragraph 10(b) defines a related party as follows:

'Related party – A party that is either:

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

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

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

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

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

i. Common controlling ownership;

ii. Owners who are close family members; or

iii. Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.' [16]

Requirements of ISA (UK and Ireland) 550

ISA (UK and Ireland) 550 requires the auditor to understand the entity's related party relationships and transactions and this understanding will then serve to enable the auditor to identify the risks of material misstatement associated with those relationships and transactions.

[16] ISA (UK and Ireland 550 paragraph 10 (b)

Team discussion

It is mandatory for the audit engagement team to discuss the susceptibility of the financial statements to material misstatement due to fraud or error which could arise from the entity's related party relationships and transactions. This discussion is **in addition** to the normal fraud discussion that the audit engagement team has at the planning phase.

Many firms have been criticised by file reviewers in the past because there is no evidence that this discussion has taken place and hence it is important to adequately document such discussions.

It is important that when the team have this discussion they consider (and document) how fraud is likely to occur in respect of the entity's related party relationships and transactions. It is not enough to demonstrate compliance with this area of the UK and Ireland ISA by stating that fraud in relation to related parties is not expected or has not occurred. Considering how fraud is likely to occur demonstrates a degree of professional scepticism.

Inquiries of management

The auditor must make inquiries of management regarding:

(a) the identity of the audit client's related parties and also inquire if there have been any changes from the prior year in respect of these related parties;

(b) the nature of the relationships between the entity and these related parties; and

(c) whether any transactions have been entered into with these related parties during the period and, if so, the type and purpose of the transactions.

These inquiries need not be limited to management alone; indeed, the auditor can make inquiries of anyone they deem necessary to obtain such information.

Internal controls

The auditor must make necessary inquiries of management (and others within the entity if this is deemed necessary) as well as perform other risk assessment procedures to enable the auditor to understand the controls, if any, which management have established to:

(a) identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;

(b) authorise and approve significant transactions and arrangements with related parties;

(c) authorise and approve significant transactions and arrangements which are outside the ordinary course of business.

Professional scepticism

It is important that the auditor maintains professional scepticism and alertness when inspecting records and other documentation because these procedures may indicate additional related parties or transactions which management have not previously disclosed or notified to the auditor.

Paragraph 15 of ISA (UK and Ireland) 550 requires the auditor to inspect the following for indications of the existence of related party relationships or transactions which management may not have previously disclosed or notified to the auditor:

(a) Bank and legal confirmations obtained as part of the auditor's normal procedures.

(b) Minutes of meetings of shareholders and of those charged with governance.

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Identification of significant transactions outside the ordinary course of business

In reviewing the above documents, the auditor may come across significant transactions outside the ordinary course of business. Where the auditor encounters such transactions, they must inquire of management about:

(a) The nature of these transactions.

(b) Whether related parties could be involved.

At all stages in the audit process, the auditor must share relevant information with the audit engagement team concerning the entity's related parties because the team, themselves, may come across such relationships or transactions during the course of their work.

It is also important to bear in mind that the UK and Ireland ISA regards significant transactions outside the entity's normal course of business with related parties as giving rise to a significant risk. Therefore, appropriate audit procedures must be implemented to address this significant risk.

Audit risks and response

ISA (UK and Ireland) 330 (Revised June 2016) *The Auditor's Responses to Assessed Risks* requires the auditor to respond to the assessed levels of risks and, therefore, the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions.

Example – Auditor discovers related party relationships and transactions

Sarah is the audit senior at Smith & Co who is auditing their client, Jones Limited for the year-ended 31 December 2015.

The audit planning programme contains a schedule of all the client's related party relationships and transactions (as well as potential transactions). The risk assessment in respect of related parties has been deemed to be medium risk.

During the detailed audit fieldwork, Sarah discovers various transactions with a new supplier during the year, the amounts of which collectively are significant. Information held at Companies House confirms that the managing director has a controlling stake in this business but no related party disclosures have been made in the financial statements; nor are any references to this supplier made on the related parties schedule on the audit file.

In this example, the provisions of paragraph 22 would come into play. Sarah has identified related parties and transactions which management has not previously identified or disclosed, and therefore she is required to:

(a) Promptly communicate the relevant information to other members of the engagement team.

(b) Request management to identify all transactions with the newly-identified related party so such transactions can be evaluated by the auditor.

(c) Make inquiries with management as to why the entity's controls over related party relationships and transactions have failed to enable the identification or disclosure of the related party relationships or transactions.

(d) Perform substantive procedures to the newly-identified party and the transactions.

(e) Reconsider the risk that other related parties or significant related party transactions might exist which management have not previously identified or disclosed to the audit team and perform additional procedures as considered necessary.

(f) If Sarah suspects that the non-disclosure by management is intentional (and hence indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

Significant related party transactions outside the ordinary course of business

If the auditor comes across any significant related party transactions which are considered to be outside the ordinary course of business, the auditor must:

(a) Inspect the underlying contracts or agreements (if any) and consider whether:

  (i) the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to misappropriate assets;

  (ii) the terms of the transactions are consistent with the explanations received from management; and

  (iii) the transactions have been appropriately accounted for and disclosed; and

(b) Obtain audit evidence that the transactions have been appropriately authorised and approved.

Related party transactions on an arm's length basis

As part of the financial statement preparation process, management will identify and disclose all material related party relationships and transactions. This may also involve a disclosure within the financial statements confirming that the related party transactions have been undertaken on normal commercial terms; i.e. on an arm's length basis.

Management should not make this assertion within the financial statements if the transactions have not been undertaken on an arm's length basis. As a result, the auditor has a responsibility to obtain sufficient appropriate audit evidence that the assertion made by management is, in fact, not materially misleading.

Example – Inappropriate assertion relating to an arm's length transaction

The financial statements of North Ltd contain a disclosure in the related parties section that all transactions with related parties have been conducted on terms equivalent to those prevailing in an arm's length transaction.

The auditor has undertaken substantive procedures on the related party transactions. During the year, the company sold one of its investment properties for £75,000 to a senior executive director. The profit and loss account shows a loss of £130,000 on disposal.

Upon further investigation, the auditor discovers that similar properties in the same area are being sold for around £200,000.

Having enquired into the significant loss on disposal and the fair value of other properties in the area, the managing director informed the auditor:

'We decided to let the director buy the property for a massively reduced sum. He's one of our top-performing directors and so we felt it only fair that he gets something in return for his efforts. I know it's not strictly market value, but I'm sure nobody will challenge the disclosure.'

The directors cannot, and should not, make the assertion that the transaction has been conducted on an arm's length basis because if the property had been sold to an unconnected third party, it would have been sold for its open market value, not at a significantly reduced price. There is a material misstatement in the directors' assertion and hence this should be amended and, if not, the auditor considers the implications for the auditor's report.

Evaluating the accounting and disclosure of related party relationships and transactions

In order to form an opinion on the financial statements, the auditor must evaluate the accounting and disclosure aspects of related party relationships and transactions in the financial statements. This requires the auditor to consider:

(a) whether the identified related party relationships and transactions have been correctly accounted for and disclosed in accordance with UK GAAP; and

(b) whether the effects of the related party relationships and transactions:

  (i) prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or

  (ii) cause the financial statements to be misleading (for compliance frameworks).

Written representations

The auditor must obtain from management and, where appropriate, those charged with governance, written representations which confirm that management and, where appropriate, those charged with governance have:

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

(b) appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of UK GAAP.

An important point to note where written representations are concerned is that they **must not** be used as sole audit evidence; in other words, they cannot be a substitute for the auditor performing appropriate audit procedures. ISA (UK and Ireland) 580 *Written Representations* confirms that written representations, on their own, are weak forms of audit evidence because they are internally generated.

Communication and documentation

ISA (UK and Ireland) 550 says that unless all of those charged with governance are involved in managing the entity, the auditor must communicate with those charged with governance any significant matters which have arisen during the course of the audit in connection with the entity's related parties.

In addition, the standard requires the auditor to document the names of the identified related parties together with the nature of the related party relationships.

QUARTERLY UPDATE

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

Review of audit firms' quality monitoring to boost confidence in audit

5 January 2016

Audit firm's internal quality control procedures are designed to ensure that audit engagement teams consistently deliver high quality audits for the benefit of investors.

The *Audit Quality Thematic Review: Firms' audit quality monitoring*, which has been published today by the Financial Reporting Council (FRC), considers the monitoring performed by nine audit firms over both the quality of completed audit engagements and the effectiveness of their overall quality control systems and seeks to share good practice and improve overall effectiveness.

Paul George, FRC's Executive Director of Conduct, said:

'We welcome audit firms' commitment to audit quality and ensuring that their quality control systems for audit are effective. Given the importance of these control systems to deliver high quality audits we would expect firms to challenge individual audit engagement teams more rigorously and apply a consistently equivalent level of resources to monitoring the effectiveness of the firm's overall controls.'

FRC comments on new international standard on lease accounting

13 January 2016

The Financial Reporting Council (FRC) welcomes the publication of IFRS 16 *Leases*, by the International Accounting Standards Board (IASB), a major achievement after more than 10 years of joint work by the IASB and the US Financial Accounting Standards Board.

FRC's Executive Director for Codes and Standards, Melanie McLaren, commented:

'The FRC is pleased that this standard has now been issued and will be fully involved in considering its endorsement in Europe.'

Quality of corporate governance in the UK remains high

14 January 2016

The overall quality of corporate governance in the UK remains high according to the Financial Reporting Council's (FRC) Developments in Corporate Governance and Stewardship 2015 report.

There has been a slight dip in strict compliance with the Code which is largely accounted for by new entrants to the market explaining evolving governance; and companies deciding to await the implementation in law of the EU Audit Regulation and Directive (ARD) requirements on audit retendering and rotation. Nevertheless, this has been accompanied by an improvement in the quality of explanations, which demonstrates a more thoughtful approach to governance.

While there have been signs of improved engagement and more purposeful dialogue between large companies and investment managers, reporting against the Stewardship Code's principles is of inconsistent quality. The FRC proposal to tier signatories, announced in December last year, will promote better engagement and ensure that asset owners and managers follow-through on their commitment to the Code's principles.

FRC Chairman Sir Win Bischoff, said:

'Over the past few years, the FRC has taken a series of actions to deal with the outcomes of the global economic crisis. In 2014, we amended the UK Corporate Governance Code to improve the management and reporting of risk, and encourage companies and investors to take a long-term view. In order to help companies focus on implementing and benefitting from these changes, we will not substantially revise the Code for at least the next three years, but rather focus on market-led and collaborative initiatives on succession planning and corporate culture.

We are very pleased with the response to our call to participate in the Culture Coalition. We have found a real willingness from a wide range of organisation – who might not otherwise have found reason to work together – to collaborate with us and with each other.

The UK Stewardship Code has led to improvements in the quality and quantity of engagement between investors and companies. Effective dialogue between investors and the companies in which they allocate funds is imperative to achieve sustainable long term growth in the UK economy. We wish to maintain momentum by ensuring that signing up to the Code is a true market of commitment.'

Other key messages from the report include:

Governance

- Overall levels of compliance with the UK Corporate Governance Code remain high with 90 per cent of the FTSE 350 complying with all but 1 or 2 provisions.
- Board succession planning remains key. The FRC will be following up on its recent discussion paper in 2016.
- While there has been very good progress on reporting of boardroom gender diversity policies, a disappointing number of companies make no reference to the broader concept of diversity including race and experience.
- In the FTSE 100 there has been an increase from 37 per cent in 2014 to 51 per cent in 2015 of companies having longer share retention periods with regards to remuneration.

Reporting and audit

- The Code requirement for boards to confirm that the annual report and accounts is fair, balanced and understandable has had a significant impact on the perceived standard of reporting.
- There have been improvements in audit committee reports, with 72 per cent of FTSE 350 companies now giving more detailed descriptions of the work they do versus 65 per cent in 2014.
- Audit retendering has improved with 46 FTSE 350 companies putting their external audit out to tender this reporting season as opposed to 27 previously. FTSE 350 companies disclosures on external auditor appointments have increased from 2 per cent in 2008 to over 50 per cent this year.
- Early take-up of the 2014 Code changes has been low with companies taking time to think through reporting on risk management, internal controls and the longer term viability reporting.

Stewardship and engagement

- Feedback on engagement between companies and investors was positive in 2015 with many feeling that the quality of dialogue has improved and that companies are more responsive.

- 2015 saw an increase in shareholder voting activities at companies meetings with 73 per cent voter turnout in the UK.
- In 2014 there was increasing concern expressed about the role of proxy advisors. In 2015, the FRC convened discussions between proxy advisors, company and investor representatives. All agreed that proxy advisors provide an important service, however, there are still ongoing tensions around perceived box-ticking. The FRC will continue to promote best practice in this area.

Investors welcome continued improvements in auditor's reports

28 January 2016

Auditors continued to develop high quality, accessible reports in the second year of extended auditor reporting according to an FRC survey 'Extended auditor's reports: A further review of experience'.

Investors have welcomed extended auditor reporting and the additional information it provides about the companies being audited.

The key findings from the survey include:

- Investors welcome the information included in extended auditor's reports, and particularly for smaller companies where there tends to be less independent information available;
- The reports which have earned the greatest praise from investors tend to be well structured, signposting key information and often making innovative use of graphics, diagrams and colour;
- In general, auditors have continued to move away from generic language and descriptions of risk, making their reports more relevant and insightful;
- Descriptions of the scope of audit work and the approach to materiality continue to improve.

An increasing number of auditors now provide users of financial statements with an outline of what they have found in the course of their work. The FRC introduced new reporting requirements for financial years beginning on or after 1 October 2012 at the same time as enhancements to the UK Corporate Governance Code, including more detailed annual reporting by audit committees. They were designed to improve the level of investor confidence in and understanding of audit. The survey looks at the second year of experience.

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

'Confidence in UK audits underpins investor confidence in UK capital markets and we are pleased that we have led the way internationally in extended auditor reporting, which is being adopted more widely following changes to international standards on auditing.

'The FRC supports the continuing development of good quality auditor reporting and the trend towards more granular descriptions of risk, more transparent and accessible reporting of audit findings for assessed significant risks of material misstatement and the disclosure of performance materiality.'

FRC comments on new IFRS requirement on debt disclosure

4 February 2016

The Financial Reporting Council (FRC) welcomes improved debt disclosure standards.

Commenting on the publication of 'Amendments to IAS 7', by the International Accounting Standards Board (IASB), Director of the FRC's Financial Reporting Lab, Sue Harding, commented:

'The Financial Reporting Lab's work on net debt reconciliations demonstrated that investors need more information on significant cash and non-cash changes in debt. The new requirements will provide welcome transparency on this. We encourage the IASB to continue its consideration of enhanced disclosure of the accessibility of cash and cash equivalent balances.'

FRC highlights role of Engagement Quality Control Reviewer in overall audit quality

8 February 2016

Today the Financial Reporting Council issues a thematic review undertaken by its Audit Quality Review (AQR) team on the work performed by engagement quality control reviewers (EQCR) in the audit of financial statements.

One of the FRC's concerns is that firms' do not maintain a consistently high standard of auditing. Whilst excellent work is performed by many, some in the same firm fall short of expectations. This engagement quality control (EQC) review process should ensure consistently high quality. Often it does improve quality but we also found evidence in some audits where weaknesses were not identified by the review. Firms can do more to evaluate the effectiveness of the EQC review and implement additional procedures, where appropriate, to reduce the occurrence of audit weaknesses that are not identified.

Paul George, Executive Director, Conduct Division, commented:

'The EQCR plays an important role in the quality control process on an audit and is key to safeguarding audit quality. It is imperative that firms do more to evaluate the effectiveness of the EQC review and for firms to require EQCRs to obtain formal feedback on their performance.'

FRC consults on revised guidance for Irish Credit Union audits

11 February 2016

The Financial Reporting Council has today issued for consultation revised guidance for auditors of Credit Unions in the Republic of Ireland. The revised Practice Note, developed in conjunction with Chartered Accountants Ireland, provides updated guidance on the legal and regulatory context applicable to Credit Unions in Ireland, as well as updated contextual material, derived from Auditing Standards (UK and Ireland) to support high quality audit.

The revised guidance provides material setting out the rights and duties of auditors operating in this sector, and sets out the legal framework for credit unions which is set and overseen by the Central Bank of Ireland.

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

'The credit union sector is a significant, and vibrant element of the Irish financial services sector, with over three million account-holding members. It is, therefore, in the public

interest that the FRC develops and consults on revised guidance to support the delivery of high-quality audit in this important sector.'

The consultation closed on 8 April 2016.

Electronic tagging of charity accounts supported by consultation

15 February 2016

Proposals to enable the electronic tagging of charities' accounts have been welcomed by respondents to a consultation carried out by the Financial Reporting Council (FRC) and the Charity Commission (CC).

The finalised tagging charity convention ('taxonomy'), in line with the recently issued Charity SORP (Statement of Recommended Practice) FRS 102, has been issued today.

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

'On the whole, responses to the consultation have been positive. The digital taxonomy will help make data more accessible and transparent. Some smaller charities expressed concern that implementing digital tagging will be costly and cause more work for them. However, the Charity Commission has said that it will not be obligatory to carry out digital filing.'

BIS consultation on the UK implementation of the EU Directive on disclosure of non-financial and diversity information

16 February 2016

We draw attention to the Department of Business Innovation and Skills (BIS) consultation on the UK implementation of the EU Directive on disclosure of non-financial and diversity information.

The Directive introduces European-wide disclosure requirements for environmental, social, employee, human rights, anti-corruption and bribery matters, and Board diversity. Many of these requirements are aligned with existing UK requirements for the Strategic Report.

In particular, BIS is seeking input on:

- The scope of the proposals.
- Member state options, whether:
  - the non-financial information should be placed outside the annual report; and
  - there should be assurance around the non-financial statement.
- Whether there are existing narrative reporting requirements that can be repealed.
- Costs and benefits of the proposals.

The consultation is open for comment until 15 April 2016 and a copy of the consultation document is available here if viewing these notes electronically, or at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/500760/BIS-16-35-non-financial-reporting-directive-consultation-February-2016.pdf

Following the outcome of the consultation, the FRC will consider any consequential amendments to the Guidance on the Strategic Report to reflect any changes in regulation.

We note that the European Commission has also recently published a consultation seeking input on the form and content of non-binding European guidelines for reporting non-financial information. As the disclosure requirements in the EU non-financial reporting Directive are

similar to those in the Strategic Report, UK companies may use the FRC's Guidance on the Strategic Report as a source of reference.

Further information on the FRC's activities on non-financial reporting is available here if viewing these notes electronically, or at:

https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Clear-and-Concise-Reporting/Narrative-Reporting/EU-Directive-on-non-financial-reporting.aspx

FRC joins UK Regulators Network

22 February 2016

The Financial Reporting Council (FRC) has joined the UK Regulators Network (UKRN) and will work with the network on projects that support its regulatory objectives. Joining the UKRN gives the FRC an opportunity to both learn from, and share best practice with, other regulators facing similar perceived strategic challenges.

The FRC has recently consulted on its 2016/19 strategic programme which includes proposed changes to its regulatory approach and the more effective sharing of best practice to support continuous improvement. The FRC will also be considering how to best respond to the new requirements on regulators set out in the Enterprise Bill.

FRC responds to request for guidance on volatility and uncertainty for corporate reporting season

8 March 2016

The FRC offers pointers for the 2016 corporate reporting season against a backdrop of increased uncertainty and/or volatility. The FRC has responded to requests for guidance on how matters such as volatile asset prices and uncertainty over interest rates in certain jurisdictions should be dealt with in annual reports and accounts. A letter from Stephen Haddrill, Chief Executive Officer was sent to Audit Committee Chairs, a copy of which is shown overleaf:

FRC Financial Reporting Council

Dear Audit Committee Chair,

Stephen Haddrill
Chief Executive Officer

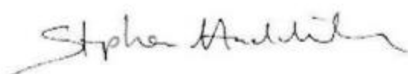
I wrote in the latter part of 2015 to provide some pointers for the 2016 corporate reporting season which is now in train against a backdrop of increased uncertainty and/or volatility. For example, asset prices have been volatile, oil prices have moved further, in certain jurisdictions interest rates have fallen and the UK's referendum on EU membership has been announced.

Recognising that not all businesses are affected by the same uncertainties nor to the same degree, we have been asked if we could give further guidance on how such matters should be dealt with in the annual report and accounts. We highlight that:

- The Strategic Report in particular provides an opportunity to provide the most current view of prospects. Your business may be very close to reporting and so the Strategic Report may need careful review by the board before it is issued to ensure that statements which may have been drafted some time ago in preparation for the reporting season remain pertinent.;
- Key to an understanding of the company's prospects will be disclosure of the directors' judgements as to the **principal** risks and their potential impact. It is for directors to determine which are the principal risks and why. In some cases the range of potential outcomes may be wider than previously and accordingly you may need to provide more disclosure as to sensitivities to aid understanding;
- Accounts should be drawn up on the basis of the conditions existing at the balance sheet date. Events or information coming to light at a later date which affect valuations need careful consideration and may need to be disclosed. The range of outcomes you have considered to be reasonably possible may need to be revisited;
- Financial Reporting Standards require companies to disclose material post balance sheet events including the nature of each event and its estimated financial impact or a statement that such an estimate cannot be made; and
- You may also need to consider whether the events have a material effect on the preparation of the accounts on a going concern basis of accounting and/ or whether there are material uncertainties relating to that assessment requiring disclosure.

I would welcome your feedback as to whether my writing to you in this way is helpful in promoting high quality corporate reporting.

Yours sincerely



FRC issues amendments to fair value disclosures in FRS 102

8 March 2016

The Financial Reporting Council (FRC) has today issued *Amendments to FRS 102 – Fair value hierarchy disclosures.* The amendments simplify the preparation of disclosures about financial instruments for financial institutions and retirement benefit plans.

The amendments have been finalised following an overwhelmingly positive response to the consultation. As well as simplifying the preparation of the disclosures, the amendments will provide more meaningful information for users of the financial statements.

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

'In publishing these amendments we are responding to issues raised by stakeholders, who have confirmed the benefits they will bring, including reducing the potential costs of compliance with FRS 102 and improving the information available to users.'

The amendments more closely align the relevant disclosure requirements with those in IFRS 13 *Fair Value Measurement* and are effective for accounting periods beginning on or after 1 January 2017, with early application permitted. This will mean that entities can apply the changes in financial statements for accounting periods that ended on 31 December 2015 if those financial statements have yet to be approved.

The amendments only apply to financial institutions and retirement benefit plans; other entities applying FRS 102 are unaffected by these amendments.

FRC invites feedback on FRS 102 to inform its future development

22 March 2016

The Financial Reporting Council (FRC) is inviting comments from stakeholders on their experiences implementing the new UK and Ireland accounting standards, particularly FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, in order to inform the first triennial review.

The FRC is committed to periodically reviewing UK and Ireland accounting standards to ensure they continue to require high-quality and cost effective financial reporting from entities within their scope.

Comments on any aspect of FRS 102 and its implementation, or any other UK and Ireland accounting standard can be sent to ukfrsreview@frc.org.uk. This might include views on the benefits of the new standards, as well as suggestions for improvements or areas where implementation was challenging.

The comments received will be used to inform the development of proposals for changes to accounting standards, which will be subject to formal consultation at a later date, expected to be during 2017, in advance of a planned effective date of 1 January 2019. The FRC may publish a summary of the feedback as part of its explanation for proposed changes to accounting standards.

Comments may be provided at any time during the triennial review process. Comments received by 31 October 2016 will be taken into account in developing formal proposals for changes; comments received after this date will be taken into account in the later stages of the review.

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

'The new UK and Ireland accounting standards became effective on 1 January 2015 and, whilst any changes arising from the triennial review won't be effective before 1 January 2019, we are providing an opportunity, now, for those interested in financial reporting to give feedback as they are preparing their first financial statements complying with the new standards. Providing feedback this year will be an important first stage in shaping the future development of the standards.'

Consultation on the FRC's Audit Enforcement Procedure

23 March 2016

The Financial Reporting Council (FRC) has today launched a consultation on proposals for the Audit Enforcement Procedure, developed to implement its forthcoming responsibility for audit enforcement.

The EU Audit Regulation and Directive (ARD) comes into force on 17 June this year. As the Competent Authority for audit regulation the FRC is consulting on an enforcement procedure designed to respond to the new audit regulatory framework and to assist with the promotion of high quality audit. The procedure will apply to the investigation and sanctioning of breaches of the various requirements of the statutory auditors of Public Interest Entities (PIEs) and any other cases retained by the FRC. It is intended that the FRC will delegate the vast majority of investigation and sanctioning of non-PIE cases to the professional bodies.

The proposed new Audit Enforcement Procedure will, in relation to statutory audit cases, replace the FRC's existing sanctions procedure and disciplinary tribunal scheme and will provide a single, streamlined procedure for audit enforcement.

Responses to the FRC's consultation should be sent by email to consultation@frc.org.uk by 4 May 2016.

The FRC will arrange other opportunities to gather feedback on the proposals.