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PREPARING ACCOUNTS UNDER THE NEW SMALL/MICRO-ENTITIES' REGIME (LECTURES A555/556/557 – 19.51/32.51/5.37 MINUTES)

All accountancy firms should now be aware of the demise of the Financial Reporting Standard for Smaller Entities (the FRSSE) for accounting periods starting on or after 1 January 2016 and firms should, at this stage in the process, be in the realms of preparing for the transition.

While firms will rely on automated accounts production software systems, it is important to understand the impact of the new reporting regimes on the responsibilities of the directors.

Section 393, Companies Act 2006

Section 393 of the Companies Act 2006 prohibits directors from approving financial statements which do not give a true and fair view. The concept of 'true and fair' is retained for small companies and hence small company directors have a legal obligation to ensure that the financial statements give a true and fair view.

The Companies Act 2006 was revised to incorporate the provisions of the EU Accounting Directive and many small companies will prepare financial statements under the revised Act for accounting periods starting on or after 1 January 2016 (i.e. 31 December 2016 year-ends), although early-adoption of the revised legislation is permitted.

While the provisions in the revised Companies Act 2006 reflect the EU Accounting Directive, there has been no change to the requirement to produce true and fair financial statements. However, this is not the case for micro-entities due to the 'deeming provisions' which state that where a micro-entity prepares its accounts to the minimum requirements laid down in law, those financial statements are *presumed* to give a true and fair view.

Impact of the revised Companies Act 2006 on directors and advisers

The overarching objective of the Accounting Directive is to reduce the burdens placed on small companies (and micro-entities) in the preparation of their annual accounts. The Directive reduces the disclosure requirements, but in practice this will not always be 'plain-sailing'.

As mentioned above, the requirement to prepare financial statements that give a true and fair view is retained for small companies by virtue of section 393. The mere application of the legally required disclosures outlined in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* at Section 1A *Small Entities*, Appendix C *Disclosure requirements for small entities* may not be enough to achieve a true and fair view. In such situations, the directors will be required to determine the disclosures that are needed in the financial statements to achieve a true and fair view and make those disclosures in accordance with the relevant section(s) of FRS 102 dealing with the type of disclosure(s) needed.

There is little in the way of guidance as to what small company directors can do where additional disclosures are required; although the Financial Reporting Council (FRC) have published a document called True and Fair which may assist directors and their advisers. It is clear, therefore, that the reduction in disclosure requirements brought about by the Accounting Directive is going to mean more responsibilities are placed on the directors of small companies who, in practice, will rely on their accountants to assist (although care should be taken where the professional accountancy firm also acts in the capacity as auditor).

The FRC have included Appendix D *Additional disclosures encouraged for small entities* in Section 1A of FRS 102; although Appendix D only encourages, rather than mandates, these additional disclosures because the FRC cannot insist on small companies making anymore disclosures than those required by law. However, where the small company is materially affected by any of the encouraged disclosures outlined in Appendix D and it does not make the required disclosures, it will be very difficult to justify how the financial statements give a true and fair view. This may cause issues to be raised by professional body regulators (such as ICAEW's Quality Assurance Department and ACCA Monitoring Officers) as well as HM Revenue and Customs that employ a team of technical accountants that review financial statements submitted to them by companies.

The key message being sent out by FRC and professional bodies is that it is now more important than ever that professional accountants ensure that the financial statements of small companies **give a true and fair view**. Professional accountants should not adopt the attitude of 'if it is not in the legislation, it does not need disclosure' because the requirement for small companies to prepare true and fair accounts has not changed. If a professional accountant does not make sure that the financial statements give a true and fair view, the scope for professional negligence claims is inherently higher (something which all practitioners need to avoid at all costs).

The encouraged disclosures

There are five encouraged disclosures for small entities outlined in Appendix D of Section 1A of FRS 102, as follows:

a) a statement of compliance with this FRS as set out in paragraph 3.3, adapted to refer to Section 1A;
b) a statement that it is a public benefit entity as set out in paragraph PBE3.3A;
c) the disclosures relating to going concern set out in paragraph 3.9;
d) dividends declared and paid or payable during the period (for example, as set out in paragraph 6.5(b)); and
e) on first-time adoption of this FRS an explanation of how the transition has affected its financial position and financial performance as set out in paragraph 35.13.

The auditor's report on small company financial statements

Many small companies are subject to statutory audit; either voluntarily or because banks and other lenders insist on the company having an audit. Where the small company is subject to audit and reports under Section 1A of FRS 102, the auditor's report will need to refer to the relevant financial reporting framework adopted. An example auditor's report for a small company reporting under FRS 102, Section 1A is shown below (note terms in [square brackets] mean that the item may be deleted if it is not applicable to the small company).

Independent auditor's report to the members of SmallCo Ltd

We have audited the financial statements of Smallco Ltd Limited for the year ended 31 December 2016, set out on pages X to XX. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards including Financial Reporting Standard 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland' Section 1A (Small Entities).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law,

we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland)[1]. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the directors' report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies, we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2015 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit,

- the information given in the [strategic report and the] directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the [strategic report and the] directors' report [has]/have been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in [the strategic report and the] directors' report.

[1] For audits of financial statements commencing on or after 17 June 2016, the auditing standards are referred to as ISA (UK) rather than ISA (UK and Ireland).

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit; or
- the directors were not entitled to prepare the financial statements in accordance with the small companies' regime when not eligible and to take advantage of the small companies' exemption from the requirement to prepare a strategic report or in preparing the directors' report.

[Partner name] (Senior statutory auditor)

for and on behalf of:

Name of audit firm

City

Date

Illustrative financial statements of a small company

The following illustrative financial statements are not a comprehensive model of how the financial statements of a small entity reporting under FRS 102, Section 1A should look. Indeed, as mentioned above, disclosures over and above those required by Section 1A will often need to be made in order that the financial statements give a true and fair view.

These example financial statements have been prepared to show the requirements of company law as amended by SI 2015/980 The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 and Section 1A *Small Entities* of FRS 102, issued September 2015

FRS 102 applies to small companies applicable for periods commencing on or after 1 January 2016. Early application of these requirements is permitted for periods commencing on or after 1 January 2015.

Smallco Ltd

Company information

For the year ended 30 June 2017

Company registration number	99999999
Directors	J Smith B Jones
Registered office	987 Low Street Anytown AB1 2CD
Solicitor	Legal Eagles LLP 9 Legal Towers Anytown AB2 3EF
Bankers	National Bank PLC Anytown

Smallco Ltd

Report of the Directors

For the year ended 30 June 2017

The directors present their report and financial statements of the company for the year ended 30 June 2017.

Directors of the company

The directors who have served during the year were as follows:

J Smith

B Jones

The report of the directors has been prepared taking advantage of the small companies' exemption of section 415A of the Companies Act 2006.

By order of the Board

J Smith

Director

31 January 2018

Smallco Ltd

Profit and loss account

For the year ended 30 June 2017

	Note	2017 £	2016 £
Turnover		3,900,767	2,451,342
Cost of sales		(1,555,231)	(972,990)
Gross profit		2,345,536	1,478,352
Administrative expenses	2	(1,129,639)	(867,009)
Other operating income		20,000	10,000
Fair value gains on investment properties		10,000	10,000
Interest receivable and similar income		28	56
Interest payable and similar expenses		(19,787)	(25,989)
Profit before taxation		1,226,138	605,410
Tax on profit		(240,000)	(120,000)
Profit for the year		986,138	485,410

Smallco Ltd

Balance Sheet

As at 30 June 2017

Company registration number: 99999999

	Note	2017 £	2016 £
Fixed assets			
Tangible assets	4	489,233	492,899
		489,233	492,899
Current assets			
Stocks		312,943	153,300
Debtors due within one year	5	439,881	278,933
Cash at bank and in hand		805,253	794,041
		1,558,077	1,226,274
Creditors: amounts falling due within one year	6	(728,933)	(439,833)
Net current assets		829,144	786,441
Total assets less current liabilities		1,318,377	1,279,340
Provisions for liabilities		(156,798)	(134,966)
Net assets		1,161,579	1,144,374
Capital and reserves			
Called up share capital	7	100	100
Profit and loss account – not distributable		120,000	110,000
Profit and loss account		1,041,479	1,034,274
Shareholders' funds		1,161,579	1,144,374

These financial statements have been prepared in accordance with the provisions applicable to companies subject to the small companies' regime and the option not to file the profit and loss account has been taken under s444.

The company has taken advantage of audit exemption …

The financial statements were approved and authorised for issue by the Board on 31 January 2018.

Signed on behalf of the board of directors.

B Jones
Director

Smallco Ltd

Notes to the financial statements

For the year ended 30 June 2017

1 Summary of significant accounting policies

(a) General information and basis of preparation

The company is limited by shares and incorporated in England. The address of the registered office is given in the company information on page X of these financial statements. The company's principal activity is the manufacture of components.

The financial statements are presented in sterling which is the functional currency of the company and rounded to the nearest £.

The significant accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all years presented unless otherwise stated.

(b) Tangible fixed assets

Tangible fixed assets are stated at cost (or deemed cost) or valuation less accumulated depreciation and accumulated impairment losses. Cost includes costs directly attributable to making the asset capable of operating as intended by management.

Depreciation is provided on all tangible fixed assets, at rates calculated to write off the cost, less estimated residual value, of each asset on a systematic basis over their expected useful lives as follows:

Land	Nil
Buildings	30 years on a straight line basis
Plant and machinery etc.	25% straight line

(c) Investment properties

Investment properties for which fair value can be measured reliably without undue cost or effort are measured at fair value at each reporting date with changes in fair value recognised in profit or loss.

The methods and significant assumptions used to ascertain the fair value at the balance sheet date and fair value movement included in the profit for the year are as follows:

Properties are valued using RICS open market valuation on freehold basis, conducted annually by Smith & Co Chartered Surveyors.

Smallco Ltd

Notes to the financial statements (continued)

For the year ended 30 June 2017

(d) Stocks

Stocks are stated at the lower of cost and estimated selling price less costs to complete and sell. Cost includes all costs of purchase, costs of conversion and other costs incurred in bringing stock to its present location and condition. Cost is calculated using the first-in, first-out formula. Provision is made for damaged, obsolete and slow-moving stock where appropriate.

(e) Debtors and creditors receivable / payable within one year

Debtors and creditors with no stated interest rate and receivable or payable within one year are recorded at transaction price. Any losses arising from impairment are recognised in the profit and loss account in other administrative expenses.

(f) Loans and borrowings

Loans and borrowings are initially recognised at the transaction price including transaction costs. Subsequently, they are measured at amortised cost using the effective interest rate method, less impairment. If an arrangement constitutes a finance transaction it is measured at present value.

(g) Impairment

Assets not measured at fair value are reviewed for any indication that the asset may be impaired at each balance sheet date. If such indication exists, the recoverable amount of the asset, or the asset's cash generating unit, is estimated and compared to the carrying amount. Where the carrying amount exceeds its recoverable amount, an impairment loss is recognised in profit or loss unless the asset is carried at a revalued amount where the impairment loss is a revaluation decrease.

(h) Provisions

Provisions are recognised when the company has an obligation at the balance sheet date as a result of a past event, it is probable that an outflow of economic benefits will be required in settlement and the amount can be reliably estimated.

(i) Leases

Assets acquired under finance leases are capitalised and depreciated over the shorter of the lease term and the expected useful life of the asset. Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding lease liability using the effective interest method. The related obligations, net of future finance charges, are included in creditors.

Rentals payable and receivable under operating leases are charged to the profit and loss account on a straight line basis over the period of the lease.

Smallco Ltd

Notes to the financial statements (continued)

For the year ended 30 June 2017

(j) Tax

Current tax represents the amount of tax payable or receivable in respect of the taxable profit (or loss) for the current or past reporting periods. It is measured at the amount expected to be paid or recovered using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

Deferred tax represents the future tax consequences of transactions and events recognised in the financial statements of current and previous periods. It is recognised in respect of all timing differences, with certain exceptions. Timing differences are differences between taxable profits and total comprehensive income as stated in the financial statements that arise from the inclusion of income and expense in tax assessments in periods different from those in which they are recognised in the financial statements. Unrelieved tax losses and other deferred tax assets are recognised only to the extent that it is probable that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits.

Deferred tax is measured using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date that are expected to apply to the reversal of timing differences. Deferred tax on revalued, non-depreciable tangible fixed assets and investment properties is measured using the rates and allowances that apply to the sale of the asset.

(k) Turnover and other income

Turnover is measured at the fair value of the consideration received or receivable net of VAT and trade discounts. The policies adopted for the recognition of turnover are as follows:

Sale of goods

Turnover from the sale of goods is recognised at the point of sale.

Rendering of services

When providing day services, turnover is usually recognised on completion of the service and, for monthly engagements, it is recognised by reference to the stage of completion at the balance sheet date.

Interest receivable

Interest income is recognised using the effective interest method.

Smallco Ltd

Notes to the financial statements (continued)

For the year ended 30 June 2017

(l) Employee benefits

When employees have rendered service to the company, short-term employee benefits to which the employees are entitled are recognised at the undiscounted amount expected to be paid in exchange for that service.

The company operates a defined contribution plan for the benefit of its employees. Contributions are expensed as they become payable.

2 Exceptional items

During the year £125,000 (2016 - £nil) of expenditure of exceptional size or incidence was recorded and related to the write-down of a trade debtor. This was included in administrative expenses.

3 Employees

The average monthly number of employees, including directors, during the year was as follows:

	2017 Number	2016 Number
Employees	18	13

Smallco Ltd

Notes to the financial statements (continued)

For the year ended 30 June 2017

4 Tangible fixed assets

	Investment properties	Land and buildings	Plant and machinery etc	Total
	£	£	£	£
Cost or valuation:				
At 1 July 2016	220,000	345,000	572,300	1,137,300
Additions	-	-	32,450	32,450
Disposals	-	-	-	-
Revaluation	10,000	-	-	10,000
At 30 June 2017	230,000	345,000	604,750	1,179,750
Depreciation:				
At 1 July 2016	-	147,001	497,400	644,401
Charge for the year	-	8,166	38,050	46,216
Eliminated on disposals	-	-	-	-
At 30 June 2017	-	155,167	535,450	690,617
Net book value:				
At 30 June 2017	230,000	189,933	69,300	489,233
At 30 June 2016	220,000	197,999	74,900	492,899

5 Debtors

	2017	2016
	£	£
Trade debtors	406,556	269,761
Other debtors	23,449	3,449
Prepayments and accrued income	9,876	5,723
	439,881	278,933

Smallco Ltd

Notes to the financial statements (continued)

For the year ended 30 June 2017

6 Creditors: amounts falling due within one year

	2017 £	2016 £
Bank loans and overdrafts	80,000	132,000
Trade creditors	244,678	49,562
Corporation tax	240,000	120,000
Other tax and social security	56,341	43,998
Finance leases	18,562	23,973
Other creditors	5,000	5,000
Accruals and deferred income	84,352	65,300
	728,933	439,833

The bank loan of £80,000 (2016 - £132,000) is secured by a floating charge over the company's assets. Finance leases are secured over the assets to which they relate.

7 Share capital

	2017 £	2016 £
Allotted, called up and fully paid	100	100

8 Financial commitments

Total financial commitments, guarantees and contingencies which are not included in the balance sheet amount to £18,000 (2016 - £22,000).

9 Post balance sheet events

After the year end the company the company's store was destroyed by flood and fire incurring uninsured stock losses of £98,000

10 Directors' advances, credits and guarantees

During the period, the company made a short-term loan to a director amounting to £20,000 for the purposes of a house purchase. Interest at the rate of 5.5% per annum is payable half-yearly and the loan is repayable on 31 December 2020.

Illustrative financial statements of a micro-entity

These example financial statements have been prepared to show the requirements of company law for micro companies and FRS 105.

Micro Ltd

Profit and loss account

Year ended 31 December 2016

	2016	2015
	£	£
Turnover	300,000	285,000
Other income	10,000	5,000
Cost of raw materials and consumables	(70,000)	(50,000)
Staff costs	(20,000)	(15,000)
Depreciation and other amounts written off assets	(35,000)	(25,000)
Other charges	(110,000)	(105,000)
Tax	(15,000)	(19,000)
Profit	60,000	76,000

Micro Ltd

Balance Sheet

At 31 December 2016

	2016	2015
	£	£
Fixed assets	85,000	80,000
Current assets	125,000	185,000
Creditors: amounts falling due within one year	(95,000)	(85,000)
	-----------	-----------
Net assets	115,000	180,000
	-----------	-----------
	-----------	-----------
Capital and reserves	115,000	180,000
	-----------	-----------

Directors advances, credits and guarantees

During the year the company made a loan to a director amounting to £1,000 on an interest-free basis. This loan was repaid in full on 4 February 2017.

Outstanding obligations

The company had capital commitments contracted but not provided for in the financial statements totalling £19,000 (2015: £17,000).

For the year ending 31 December 2016 the company was entitled to exemption from audit under section 477 of the Companies Act 2006 relating to small companies.

[Insert directors' responsibilities]

[Insert signature/signatories of directors signing the accounts]

[Date]

Micro-entities wishing to make additional voluntary disclosures

While the legislation says that micro-entity financial statements prepared in accordance with the basic legal requirements are presumed to give a true and fair view, the directors of a micro-entity may wish to make additional voluntary disclosures over and above those outlined in the law or in FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Where the directors wish to do this, then they must apply the relevant sections of Section 1A in FRS 102 which relates to that information.

LOANS AT NON-MARKET RATES (LECTURE A558 – 13.42 MINUTES)

One of, if not *the*, most emerging issues being raised in respect of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* is the issue of loans which are not conducted at market rates. Such loans are more than likely to be entered into with connected parties and the method of accounting for such loans under FRS 102 means that particular attention to this area is needed; from both an accounting perspective as well as a distributable profit perspective.

Where loans are not repayable on demand and are off-market rate, there is a requirement to recognise the loan at present value and allocate interest using the effective interest method in Section 11 *Basic Financial Instruments*. An overview of the treatment required in shown in the following example:

Example – Calculation of present value and interest income/expense

Topco Ltd makes a loan to its wholly-owned subsidiary, Subco Ltd of £20,000 on 1 January 2016. The terms of the loan provide for a repayment date of 31 December 2017 and interest is charged on the loan at 2%. If Subco Ltd had taken the loan out through its bank it would have paid a market interest rate of 5%.

As the loan is off-market, the entries in the books are as follows:

Year	Cash flow	Discount factor	Present value
	£		£
2016	400	0.952	381
2017	20,400	0.907	18,503
			18,884

Topco Ltd	£	
Dr intra-group receivable	18,884	
Dr investment in subsidiary	1,116	(£20,000 less £18,884)
Cr cash at bank	20,000	

Subco Ltd	
Dr cash at bank	20,000
Cr intra-group creditor	18,884
Cr capital contribution	1,116

The interest will then be apportioned as follows:

Year	Opening balance	Interest charge (5%)	Cash flow	Closing balance
	£	£	£	£
2016	18,884	944	(400)	19,428
2017	19,428	972	(20,400)	-

Charge/credit in P&L

A summary of the initial accounting requirements for loans at off-market rates is shown in the table below:

Facts of the loan	Lender's books (Dr)	Borrower's books (Cr)
Parent lends to subsidiary	Cost of investment	Capital contribution (equity)
Subsidiary lends to parent	Distribution (equity)	Income from sub
Subsidiary to subsidiary (on the order of the parent)	Distribution (equity)	Capital contribution
Company to a director who is a shareholder	Dividend	-
Director-shareholder to the company	-	Capital contribution
Company to a director who is not a shareholder	Payroll expense (wages and salaries)	-
Company to an employee	As above	-

Are measurement differences and interest expense/income distributable or not distributable?

When an off-market loan is made, particular attention must be paid to the accounting entries in the context of distributable profit (i.e. realised gains and realised losses). TECH 05/16BL *Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006* issued by the ICAEW and ICAS is currently going through final stages of development and is going to replace TECH 02/10.

Parent makes a loan to a subsidiary: measurement difference

When a parent company makes a loan to its subsidiary, the debit to the cost of the investment will have no implications on distributable profit (assuming, of course, it does not result in a need to write-down the investment due to impairment). The credit to equity in the subsidiary's separate financial statements is **neither** an accounting profit **or** a profit in the context of law because the proceeds which the subsidiary has received are in consideration for taking on a liability. As the credit to equity is neither an accounting profit or a profit in the context of law, it is therefore not a realised profit.

Parent makes a loan to a subsidiary: interest expense and credit

The interest expense which is recognised by the subsidiary is an accounting charge. In the context of law, this accounting charge is not a loss. This is because the cumulative debit within equity that arises from this additional charge is available to eliminate the initial credit to equity for the capital contribution.

The interest income that has been recognised by the parent is done so that it accrues up to the value that will be repayable at the date of maturity. TECH 05/16BL does not consider this a linked transaction for two reasons:

- the loan has not been made with the intention, or purpose, to facilitate the payment of the interest; and
- the time between advance and repayment is such that circumstances of the subsidiary may change and repayment will not be made (in other words, a default will arise).

TECH 05/16BL makes the assumption that the loan has been entered into for genuine commercial reasons rather than with a specific intention to create distributable reserves.

Where making the loan and making the capital contribution are not regarded as linked transactions, the interest income that has been recognised by the parent will be a realised profit. However, this is different from the treatment of the capital contribution because a

capital contribution does not meet the definition of a profit as defined in paragraph 3.8 of TECH 05/16BL.

Subsidiary makes a loan to its parent

TECH 05/16BL clarifies that the act of making the loan and making a distribution are not to be regarded as linked transactions. On this basis:

- the distribution received by the parent is a realised profit;
- the interest expense recognised by the parent is a realised loss; and
- the interest income recognised by the subsidiary is a realised profit.

The measurement difference is treated as a distribution (i.e. a dividend) to the parent by the subsidiary. Company law would also view the transaction as a distribution on the basis that it is at undervalue because it is necessarily (and hence intentionally) the effect of an interest-free, or below market rate, loan. In reality the terms attaching to the loan would not arise had there not been a parent-subsidiary relationship.

Interest-free loans which are also legally repayable on demand may also be viewed as a distribution in law if it is at undervalue even though there is no distribution for accounting purposes.

Subsidiary makes a loan to a fellow subsidiary

When a lending subsidiary makes a loan to a borrowing subsidiary, the lending subsidiary accounts for a distribution and the second accounts for the receipt of a capital contribution. The parent entity's financial statements do not reflect any aspects of the loan.

Loan from a director-shareholder

Similar principles would be involved where a director-shareholder of a company makes a loan to the business at below market rates. For example, if a director-shareholder made a loan of £100,000 discounted to £95,300, hence the interest element is £4,700, the entries are:

Dr bank account	£100,000
Cr director's loan account	£95,300
Cr capital contribution	£4,700

Applying the principles in TECH 05/16BL, the debit to interest would not be a realised loss and the corresponding capital contribution would not be distributable. This is because the cumulative debit in respect of the interest charge is available to cancel out the capital contribution reserve, hence when the loan ends the effect on distributable reserves effectively resolves because the non-distributable capital contribution is matched by a non-realised expense.

FRS 102, 1A AND RELATED PARTIES (LECTURE A559 – 9.10 MINUTES)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* will become mandatory for small companies for accounting periods starting on or after 1 January 2016 (although early-adoption is permissible). The latest edition of FRS 102 is the September 2015 edition which caters for small entities by virtue of Section 1A *Small Entities*. Section 1A is not a 'one-stop-shop' and only outlines the presentation and disclosure requirements that a small entity, or a micro-entity choosing not to apply FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, is required to follow. In respect of recognition and measurement of amounts, these are based on full FRS 102.

The issue of related parties has often posed problems for accountants (and, indeed, auditors) largely because of their subjective nature and the Accounting Directive has effectively reduced the disclosure requirements which a small company is legally required to make in the financial statements.

Related party disclosures under FRS 102, Section 1A

Related party disclosures are outlined in paragraphs 1AC.34 to 1AC.36 of Section 1A in FRS 102. The disclosures are split into three categories:

- entities which are subsidiaries;
- transactions entered into with related parties; and
- directors' transactions.

Entities which are subsidiaries

When a small entity is a subsidiary, the following information is required to be given in respect of the parent of the smallest group for which consolidated financial statements are drawn up of which the small company is a member:

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

Transactions entered into with related parties

This is (potentially) where the problems may arise for small companies due to the subjectivity involved in deciding whether, or not, related party transactions need disclosure. Paragraph 1AC.35 says that particulars must be given of material transactions which the small entity has entered into *'… that have not been concluded under normal market conditions.'* The phrase in italics can be taken to mean that the related party transactions have not been undertaken on an arm's length basis, however FRS 102 does not use that terminology but it is taken to mean the same thing. There are three types of parties with whom related party transactions are disclosable:

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

The particulars which must be given in respect of related party transactions not concluded under normal market conditions include:

a) the amount of such transactions;
b) the nature of the related party relationships; and
c) other information about the transactions necessary for an understanding of the financial position of the entity.

The problem which many practitioners may face is interpreting what ‘normal market conditions’ are because the term is not defined in any of the standards.

Example – Normal market conditions

Company A Ltd trades with Company B Ltd. Company B Ltd (B) is owned and controlled by the wife of the director and majority shareholder of Company A Ltd (A) and hence under full FRS 102 would be a related party.

All transactions entered into between A and B are undertaken on normal commercial terms and no favourable rates or discounts are given.

Under Section 1A, this is not a related party transaction because close family members are not considered (although they would be under full FRS 102 due to the definition of a related party in the Glossary). In this scenario it can be said that all transactions between A and B are conducted under normal market conditions because no favourable rates or discounts are given, so even if Company B was deemed a related party because, for example, Company A had a participating interest in B, no disclosure would be needed. Had favourable rates or discounts been given to B (i.e. rates or discounts which would not be granted to non-related parties) then these transactions would require disclosure in the financial statements of both companies if the value of the transactions were material.

Example – Transaction not concluded under normal market conditions

Company C Ltd has four investment properties on its balance sheet which it values at fair value through profit or loss in accordance with Section 16 *Investment Property* in FRS 102. On 4 September 2016, an investment property with a market value of £350,000 was sold to the managing director, who holds a 52% share in the business, for £125,000.

In this example it cannot be said that this transaction has been undertaken under normal market conditions because the director has acquired an investment property from a company in which he is the majority shareholder at a significant discount. It is highly unlikely that the company would sell such a property to an unconnected third party for such a discount and hence this transaction would require to be disclosed in the entity’s financial statements.

In some cases, ‘normal market conditions’ can be fairly easy to decipher and hence it follows that any transactions involving such market conditions can be straightforward to establish whether, or not, they require disclosure.

One of the emerging issues that is beginning to be questioned is the issue surrounding directors’ remuneration in a small company. In practice it is not uncommon to organise directors’ remuneration and dividends in a tax-efficient manner; for example, small company directors are often paid a salary up the pay as you earn threshold with any additional remuneration taken in the form of dividends. Initially, many practitioners may be asking the question ‘why all the fuss?’ The issue is due to the fact that directors’ remuneration is no longer a legally required disclosure in the financial statements following the transposition of the EU Accounting Directive.

Directors' remuneration would require disclosure under paragraph 1AC.35 when it is concluded that such remuneration has not been undertaken under normal market conditions. Views differ on what 'normal market conditions' in this context mean. The upshot of the removal of the requirement in law to disclose directors' remuneration and only to disclose it as a related party transaction if such remuneration has not been concluded under normal market conditions essentially means that judgement will need to be exercised, both on the part of the small company directors and of the practitioner. Reliance on accounts production software systems should not be a reason for deliberately leaving out the disclosure as most systems will have functionality allowing directors' remuneration to be disclosed.

Where uncertainties are present, particularly surrounding the issue of directors' remuneration and disclosure *versus* non-disclosure, the advice is to document any decisions or conclusions reached. Practitioners are **strongly advised** to make a professional judgement call on whether the directors' remuneration issue is concluded under normal market conditions (some commentators argue that 'normal market conditions' is not 'market rate' whereas others bring in 'market rate' as a test to see if the transaction is under 'normal market conditions'). Documenting decisions reached on this, or any other issue that requires professional judgement, will be invaluable in case any of the judgements are questioned further down the line.

Paragraph 1AC.35 does try to steer the practitioner into making the disclosures by saying that the small entities choosing to disclose all transactions with related parties (including those concluded under normal market conditions) would be compliant with the law. However, the advice is to proceed with caution and document any decisions reached.

Directors' transactions

Directors' transactions include directors' remuneration and dividends paid to directors (see above section). However, any advances and credits granted by the small entity to the director(s) and guarantees of any kind entered into by the small company on behalf of its directors must be shown in the financial statements.

Advances and credits

The details required of an advance or credit are:

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

Monetary totals must be stated in respect of items a), d), e) and f).

Guarantees

The details required for 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).

Monetary totals must be stated in respect of items b) and c).

UPDATE TO THE LLP REPORTING (LECTURE A560 – 9.33 MINUTES)

On 17 May 2016, the Financial Reporting Council (FRC) issued amendments to FRS 105 following revisions to the Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016 by virtue of SI 2016/575. The Regulations amend the legislation governing the accounting and audit regulatory framework for limited liability partnerships (LLPs) by introducing an exemption from certain financial reporting requirements for very small (micro) LLPs and for very small (micro) partnerships, including LLPs which are 'qualifying partnerships' under the Partnerships (Accounts) Regulations 2008 (SI 2008/569).

The Regulations themselves are deregulatory in nature and aim to reduce the burden of financial reporting and audit obligations for small LLPs in order to achieve alignment with the financial reporting regime for small companies.

LLPs themselves are not subject to the EU Accounting Directive. They are, however, subject to a similar accounting regime to limited companies, including the requirement to lodge financial statements with Companies House together with the contents of, and auditing of, those accounts. The LLP Regulations have been amended to introduce similar changes that were brought in during 2015 for companies but now allow LLPs to benefit from a much less burdensome financial reporting regime than was previously the case. Amending the Regulations also has the advantage of aligning reporting requirements for companies and LLPs, especially as prior to the amendments there was significant divergence between the thresholds defining a small company (post transposition of the Accounting Directive) and the thresholds defining a small LLP (pre amending the LLP Regulations).

The government have estimated that there are some 58,000 LLPs in the UK and the vast majority of them (approximately 98%) are small and hence will benefit from these deregulatory changes. In turn, the changes will also benefit some medium-sized and large LLPs as well as groups that include both LLPs and companies within their overall structure.

A point worthy of note is that while the new financial reporting regime offers some useful deregulatory opportunities, it does not substantially change the LLP financial reporting regime. In addition, the limited number of LLPs means that the changes will have a limited impact and are unlikely to attract much in the way of public interest. The number of LLPs is, however, steadily increasing and this further supports the changes that have been made to the Regulations.

Overview of the legislative changes to the LLP regime

As mentioned above, the main changes brought about by the revised Regulations means that the financial reporting regime for small and micro LLPs is more or less aligned to that of the revised Companies Act 2006 for small and micro-entities. The main changes to the audit and accounting requirements:

- increase the thresholds used to determine the size of LLPs. This will enable around 400 medium-sized LLPs to be re-categorised as small and access the less burdensome small LLPs' accounting and audit regime. Similarly, around 40 large LLPs will be re-classified as medium-sized and will be able to take advantage of a less burdensome reporting regime;
- reduce the number of mandatory notes to the accounts required of LLPs;
- provide LLPs with the opportunity to adapt the profit and loss account and balance sheet formats, provided that the information given is at least equivalent to the information required by the standard formats;

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- allow a small LLP to prepare and publish an abridged balance sheet and profit and loss account if approved by all the members of the LLP; and
- permit the use of the 'equity method' of accounting in individual LLP accounts.

In addition, a subsidiary undertaking of a parent LLP can be excluded from consolidation if the costs of obtaining the necessary information would be disproportionate or obtaining that information would cause undue delay to the completion of the consolidated accounts. This has been achieved by the amendment of section 405(3)(b) of the Companies Act 2006 applicable to LLPs by the Regulations. However, under the amendment, a subsidiary can only be excluded in 'extremely rare circumstances' which may include where a subsidiary is located overseas and legal or political circumstances mean that the cost of obtaining the information is disproportionate or a potentially hazardous situation is preventing the obtaining of the information.

The Regulations also introduce a micro-entities regime for qualifying partnerships which are usually formed for investment purposes and are defined in Regulation 3 of the Partnerships (Accounts) Regulations 2008.

Qualifying as a micro-entity

An LLP qualifies as a micro-entity in the same way that a company qualifies as one. The qualifying conditions are met by an LLP in a year in which it satisfied two, or more, of the following requirements:

1. Turnover not more than £632,000
2. Balance sheet total (fixed assets plus current assets) not more than £316,000
3. Not more than **an average number** of 10 employees

Where the LLP's financial year is shorter than one year then the maximum figure for turnover must be proportionately adjusted (i.e. if the LLP only has a nine-month accounting period, the £632,000 figure is substituted with £474,000, being 9/12 x £632,000).

The average number of employees employed by the LLP in the year is calculated as follows:

- find for each month in the financial year the number of persons employed under contracts of service by the LLP in that month (whether throughout the month or not);
- add together the monthly totals; and
- divide by the number of months in the financial year.

Amendments to FRS 105

FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* was first published in July 2015. On 17 May 2016, the Financial Reporting Council issued amendments to FRS 105 in response to the changes made to the LLP Regulations. These amendments take effect for accounting periods starting on or after 1 January 2016, although early-adoption is permissible.

The amendments are as follows (note: insertions are underlined and deletions are ~~struck through~~):

Amendments to Section 1 *Scope*

Insertion of paragraph 1.5 as follows:

1.5 In May 2016 amendments were made to this FRS to extend its scope to include **limited liability partnerships (LLPs)** and **qualifying partnerships** following a

change in legislation. An LLP or a qualifying partnership which qualifies as a micro-entity and is applying the micro-entities regime shall apply this FRS for accounting periods beginning on or after 1 January 2016. Early application by a micro-entity that is an LLP or a qualifying partnership is:

(a) permitted for accounting periods beginning on or after 1 January 2015 provided that *The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016* (SI 2016/575) are applied from the same date; and

(b) required if the LLP or qualifying partnership applies *The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016* (SI 2016/575) to a reporting period beginning before 1 January 2016.

Amendments to Section 3 *Financial Statement Presentation*

Insertion of a new footnote

A new footnote (to be sequentially numbered) is inserted after the word 'Act' in paragraph 3.14 (subsequent footnotes are renumbered sequentially) as follows:

'[footnote] Or, when relevant, Regulation 12 of the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911).'

Amendments to Section 4 *Statement of Financial Position*

Paragraph 4.3 is amended and a new footnote (to be sequentially numbered) is inserted (subsequent footnotes are renumbered sequentially) as follows:

'A micro-entity shall present a statement of financial position in accordance with one of the formats set out in Section C of Part 1 of Schedule 1 to the **Small Companies Regulations** or Section C of Part 1 of Schedule 1 to the **Small LLP Regulations** [footnote], as ~~follows~~ illustrated below:'

Format 1	**CU**	**CU**
Called up share capital not paid		X
Fixed assets	X	
Current assets	X	
Prepayments and accrued income	X	
Creditors: amounts falling due within one year	(X)	
Net current assets / (liabilities)		X/(X)
Total assets less current liabilities		X
Creditors: amounts falling due after more than one year		(X)
Provisions for liabilities		(X)
Accruals and deferred income		(X)
		X
Capital and reserves		X

Format 2	**CU**	**CU**
Assets		
Called up share capital not paid		X
Fixed assets		X
Current assets		X
Prepayments and accrued income		X
		X
Capital, Reserves and Liabilities		
Capital and reserves		X
Provisions for liabilities		X
Creditors		
Amounts falling due within one year	X	
Amounts falling due after one year	X	
		X
Accruals and deferred income		X
		X

footnote LLPs shall describe the items as set out in the Small LLP Regulations in particular, 'Called up share capital not paid' shall not be used and 'Loans and other debts due to members' and 'Members' other interests' shall be used instead of 'Capital and reserves'.

Amendments to Section 5 *Income Statement*

Paragraph 5.3 is amended and a new footnote (to be sequentially numbered) is inserted (subsequent footnotes are renumbered sequentially) as follows:

'A micro-entity shall present its profit and loss for a period in an income statement in accordance with Section C of Part 1 of Schedule 1 to the **Small Companies Regulations** or Section C of Part 1 of Schedule 1 to the **Small LLP regulations**, as ~~follows~~ illustrated below:

	CU
Turnover	X
Other income	X
Cost of raw materials and consumables	(X)
Staff costs	(X)
Depreciation and other amounts written off assets	(X)
Other charges	(X)
Tax	(X)
Profit or loss [footnote]	X/(X)

footnote LLPs shall describe this item as 'Profit or loss for the financial year before members' remuneration and profit shares'.

Amendments to Section 6 *Notes to the Financial Statements*

Insertion of paragraph 6.3 as follows:

6.3 In accordance with Regulation 30 of the *Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008* (SI 2008/1911), the notes to the financial statements of an **LLP** which qualifies as a micro-entity shall be presented at the foot of the statement of financial position and shall include financial commitments, guarantees and contingencies as required by paragraph 55 of Part 3 of Schedule 1 to the **Small LLPs Regulations** (see paragraphs 6A.2 and 6A.3 in the Appendix to this Section).

Amendments to paragraphs 6A.2 and 6A.3 as follows:

6A.2 *The total amount of any financial commitments, guarantees and contingencies that are not included in the statement of financial position must be stated. (~~Schedule 1,~~ paragraph 57(1) of Schedule 1 to the Small Companies Regulations or paragraph 55(1) of Schedule 1 to the Small LLP Regulations)*

The total amount of any commitments concerning pensions must be separately disclosed. (~~Schedule 1,~~ paragraph 57(3) of Schedule 1 to the Small Companies Regulations or paragraph 55(3) of Schedule 1 to the Small LLPs Regulations)

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

(a) any parent, fellow subsidiary or any subsidiary of a micro-entity; or

(b) any undertaking in which a micro-entity has a participating interest,

must be separately stated and those within (a) must also be stated separately from those within (b). ~~(Schedule 1,~~paragraph 57(4) of Schedule 1 to the Small Companies Regulations or paragraph 55(4) of Schedule 1 to the Small LLPs Regulations)

The following paragraphs …

6A.3 *An indication of the nature and form of any valuable security given by the micro-entity in respect of commitments, guarantees and contingencies within paragraph 6A.2 must be given. (~~Schedule 1,~~paragraph 57(2) of Schedule 1 to the Small Companies Regulations or paragraph 55(2) of Schedule 1 to the Small LLPs Regulations)*

The following paragraphs …

Amendments to Section 7 *Subsidiaries, Associates, Jointly Controlled Entities and Intermediate Payment Arrangements*

Insertion of a footnote

A new footnote (to be sequentially numbered) is inserted after the word 'Act' in paragraph 7.3 (subsequent footnotes are renumbered sequentially) as follows:

footnote Or, when relevant, Regulation 5A of the *Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008* (SI 2008/1911).

Amendments to Section 22 *Impairment of Assets*

Footnote 1 in paragraph 22.19 is deleted (subsequent footnotes are renumbered sequentially).

Amendments to the Glossary

The Glossary to FRS 105 has been amended and the following terms and definitions are inserted in alphabetical order:

limited liability partnership (LLP)	A limited liability partnership formed under the Limited Liability Partnerships Act 2000 or the Limited Liability Partnerships Act (Northern Ireland) 2002.
qualifying partnership	A partnership meeting the definition of a qualifying partnership as set out in the Partnerships (Accounts) Regulations) 2008 (SI 2008/569).
Small LLP Regulations	The Small Limited Liability Partnership (Accounts) Regulations 2008 (SI 2008/1912).

The following terms and definitions are amended as follows:

micro-entity	~~Is an entity that meets all of the following conditions:~~ ~~(a) it is a company established under company law;~~ ~~(b) it qualifies as a micro-entity in accordance with section 384A of the **Act**; and~~ ~~(c) it is not excluded from being treated as a micro-entity under section 384B of the Act.~~ ~~Micro-entities are a subset of small companies as defined in the Act.~~ (a) A company meeting the definition of a micro-entity as set out in section 384A of the **Act**, and not prevented from applying the micro-entity provisions by section 384B of the Act; (b) an **LLP** which qualifies as a micro-entity and is not prevented from applying the micro-entity provisions in accordance with Regulation 5A of the *Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008* (SI 2008/1911); or (c) a **qualifying partnership** that would meet the definition of a micro-entity as set out in section 384A of the Act, and not be prevented from applying the micro-entity provisions by section 384B of the Act, if the partnership were a company.
micro-entity provisions	~~Means a~~ (a) Any provisions of Part 15, Part 16 or regulations made under Part 15 of the **Act**; or (b) any provisions of the **Small LLP Regulations**, relating specifically to the individual accounts of an entity which qualifies as a **micro-entity**.

micro-entities regime	The legal requirements and exemptions relating to the preparation of the **financial statements** of **micro-entities** as set out in the **Act**, the ~~and~~ **Small Companies Regulations** and the **Small LLP Regulations**.

INTANGIBLE ASSETS AND GOODWILL … EMERGING ISSUES

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with the issue of intangible assets (but not goodwill) at Section 18 *Intangible Assets other than Goodwill*. Unlike outgoing UK GAAP, goodwill is not dealt with in the intangible assets section, instead it is dealt with in Section 19 *Business Combinations and Goodwill*.

Intangible assets tend to cause some complexities because sometimes they can be extremely subjective items to account for and over recent months some questions have begun to emerge concerning the accounting treatment of certain items under FRS 102, which this section of the course will deal with.

Definition of an intangible asset

Paragraph 18.2 of FRS 102 defines an intangible asset as *'… an identifiable non-monetary asset without physical substance.'* The definition refers to the term 'identifiable' and FRS 102 says that an intangible asset is identifiable when:

a) it is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented, 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.

It follows, therefore, that all assets which are separable are identifiable. The concept of identifiability results in the recognition of intangible assets acquired in a business combination separately from goodwill, hence more work will need to be done once a business combination has taken place to identify intangible assets, rather than subsume them all in goodwill.

Separability is not, however, the only indication of identifiability. An asset which arises from contractual or legal rights can also be identifiable.

Example – Separable asset

Peter runs his own taxi company in the UK and needs a taxi licence in order to operate his taxi.

The taxi licence would be regarded as an identifiable asset because it is needed to operate the vehicle, hence is a critical aspect of his business and it also arises from legal rights despite the fact that the licence would not usually be separable from the underlying business as it would only be transferable to other taxi operators.

Recognition and measurement

Care also needs to be taken not to inappropriately recognise intangible assets on a company's balance sheet. For example, internally generated goodwill is strictly prohibited under paragraph 18.8C (as was the case in FRS 10 *Goodwill and intangible assets*) and

over the years many entities have recognised such goodwill on the balance sheet in contravention of accounting standards (in particular goodwill on incorporation of a sole trader business due to tax-driven motivators). The reason internally generated goodwill is prohibited is because it fails the recognition criteria.

Paragraph 18.4 of FRS 102 says that an entity shall recognise an intangible asset if, and only if:

a) it is **probable** that the expected future economic benefits will flow to the entity; and
b) the cost or value of the asset can be measured reliably.

Internally generated goodwill fails test b) because there is no reliable measure of cost, generally because there is no 'active market' from which to derive a reliable measure of cost. The term 'active market' is defined in the Glossary to FRS 102 as:

'A market in which all 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.'

Ordinarily, goodwill will only arise in a business combination under FRS 102, hence it being placed in Section 19 *Business Combinations and Goodwill*.

Software and website development costs

An issue which is generating debate is the accounting treatment for software and website development costs. FRS 102 does not address the classification of software and website development costs and therefore in the absence of specific guidance, reporting entities are required to develop and apply a suitable accounting policy to classify such costs as either tangible or intangible fixed assets.

When management are developing an accounting policy for items not dealt with in FRS 102, they must have regard to Section 2 *Concepts and Pervasive Principles* in terms of the general recognition and measurement concepts. An asset, liability, equity, income or expense is recognised when it satisfies the following criteria:

a) it is **probable**[2] that any future economic benefit associated with the item will flow to or from the entity; and
b) the item has a cost or value that can be measured reliably.

Software and website costs which are being developed internally are dealt with under Section 18 of FRS 102 as research and development costs. All research expenditure (pure and applied) must be written off to profit or loss as expenditure; there is no option at all to capitalise research expenditure. This is because in the research phase of a project, an entity will be unable to demonstrate than an intangible asset exists which will generate probable future economic benefits.

Once the research phase has completed and the project has been moved into the development phase, the entity may recognise software and website development costs if, and only if, an entity can demonstrate all of the following:

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.

[2] Defined as 'More likely than not'

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.

Accounting for website development costs

Website development costs should only be capitalised if they meet the recognition criteria of an asset; one of those criteria being that '*it is probable that the expected future economic that are attributable to the asset will flow to the entity*'.

To assess whether costs qualify for recognition on the balance sheet, the entity must look at the overall functionality of the website. If the website will allow third parties to place orders for goods or services, then this creates a revenue stream for the business (i.e. economic benefit). Provided the cost can be measured reliably and none of the expenditure relates to research costs, then the website may be capitalised on the balance sheet as an intangible asset and amortised over its useful economic life. **Please note that under FRS 102, intangible assets cannot have indefinite useful lives** (see 'Amortisation of intangible assets' below).

If the website does not generate income for the business, then it will fail to meet the asset recognition criteria and the costs must be written off to profit or loss.

Care must be taken with the accounting treatment for website development costs because mistakes can be costly (especially if the incorrect tax treatment is applied).

Accounting for software costs

When software costs meet the recognition criteria for an asset, again consideration must be given as to the type of software being capitalised. If the software is not critical for the hardware to operate then the software should be capitalised as an intangible fixed asset. However, if the software is a critical aspect of enabling the hardware to work (for example, a Windows operating system), then the software costs are capitalised as part of the hardware, i.e. as a tangible fixed asset.

Regardless of whether the software is capitalised as an intangible asset or a tangible asset, the software must be amortised or depreciated over its useful economic life.

Amortisation of intangible assets

As mentioned above, all intangible assets will have finite useful lives. This may mean, in practice, that some entities which have not previously amortised intangible assets on the grounds that management consider them to have indefinite useful lives, will have to change accounting practice on transition to FRS 102.

The useful life of an intangible asset which has arisen from contractual or other legal rights must not exceed the period of the contractual or other legal rights. However, it may be shorter depending on how long the entity expects to use the intangible asset.

FRS 102 places a cap of 10 years on amortisation **in exceptional cases only**. This 10-year rule has caused an element of confusion because some accountants believe this to be a maximum period for **all** intangible assets, which is not the case.

Paragraph 18.21 of FRS 102 says that intangible assets are amortised on a systematic basis over their useful lives. It would not be unreasonable for an intangible asset to have a longer life than 10 years and as long as management can provide evidence to support their assessment of that useful life, it would be acceptable to amortise the intangible assets over that said period. The 10-year rule in FRS 102 is triggered when management are unable to make a reliable estimate of the useful life of an intangible asset. Therefore, if management cannot arrive at a reliable estimate of the intangible asset's useful life, then they must amortise it up to a maximum of 10 years.

Many practitioners expressed concern about this cap and assumed that, on transition to FRS 102, any client with intangible assets having a remaining life of, say, 15 years would be required to accelerate five years' worth of amortisation on transition. This is categorically not the case; and the Financial Reporting Council are keen to emphasise that this would only be the case in exceptional circumstances.

Under outgoing UK GAAP (and indeed in FRS 102), assets cannot be carried in the balance sheet in excess of recoverable amount and this principle applies to fixed assets also. At each balance sheet date, an assessment should have been made as to whether assets are stated in excess of recoverable amount and where this was found to be the case, a write-down through an impairment loss should have been undertaken to bring the carrying value of the asset(s) down to recoverable amount. In the case of fixed assets, the entity would then assess the inherent variables, such as useful economic lives, depreciation/amortisation methods and residual values and adjust these prospectively (i.e. going forward). Had this rule been correctly applied at each balance sheet date, there would be no need to bring down the carrying value of intangible assets at the date of transition and in the prior year. In addition, management should also have corroboratory evidence supporting their initial assessment of the useful life of an intangible asset and therefore, it is likely that many entities will continue with their existing amortisation policies for intangible assets.

Under FRS 102, management should undertake assessments of the amortisation period and amortisation method for its intangible assets and paragraph 18.24 refers to factors such as a change in how an intangible asset is used, technological advancement and changes in market prices may indicate that residual values attached to intangible assets, or the useful life of an intangible asset has changed since the last reporting date. Where such indicators are present, management must review previous estimates and, where current expectations differ, amend the residual value, amortisation method or useful life accordingly. This amendment will be accounted for as a change in accounting estimate under Section 10 *Accounting Policies, Estimates and Errors* and hence will be applied prospectively (i.e. no retrospective restatement is needed).

Disclosure of amortisation rates

FRS 102 requires an entity to disclose the useful lives OR the amortisation rates used for each class of intangible asset together with the reasons for choosing those periods.

ANNUAL RETURN – ALL CHANGE (LECTURE A561 – 4.02 MINUTES)

The annual return for companies has now been replaced with a confirmation statement. This means that the annual return form will only be relevant for those companies due to file by 30th June 2016. After this point a confirmation statement is needed instead. This will affect those companies that file their own annual returns and accountants or others who might provide company secretarial services.

The idea is that most companies will complete the confirmation statement online with the option to have an email alert when it is due. The statement confirms the details of the company's:

- registered office;
- directors;
- secretary;
- the address where the company keeps its records;
- the statement of capital and shareholder information; and
- the SIC (standard industry classification code).

To complete your confirmation statement first go to the Companies House register, to check the information currently held. Then confirm the information, assuming it is correct, either online or using form CS01. It costs £13 to confirm online, but £40 by post. If you haven't yet got a Companies House password and authentication code then you will need to register for these first.

If the information held by Companies House isn't correct then changes to your statement of capital, shareholder information or SIC code can be made as part of the annual confirmation process. However, different forms are needed if there is a changes in the other information, such as the address or directors.

PSC register

The first time that you file your confirmation statement you will also need to provide the information from your PSC (Persons of Significant Control) register. The register has been required since April 2016, but prior to your first confirmation statement the information hasn't been reported to Companies House.

NEW RESIGNATION RULES FOR AUDITORS (LECTURE A562 – 15.14 MINUTES)

The Companies Act 2006 (Part 16) has been amended by Section 18 and Schedule 5 of the Deregulation Act 2015 for financial years starting on or after 1 October 2015. The objective of the Deregulation Act as it applies to auditors is to simplify the reporting protocol required to be followed when an auditor ceases to act.

Notifying Companies House

The Deregulation Act has removed the requirement in section 512 *Notice to registrar of resolution removing auditor from office* for a company to notify Companies House of the fact that it has removed its auditors before the end of the period in office. This relaxation means that it is now no longer necessary for a company to notify the removal of auditors on form AA03.

In addition, section 517 *Notice to registrar of resignation of auditor* has also been abolished which required an auditor to notify Companies House of their resignation. This means that the auditor's resignation letter need not be lodged with Companies House and filed on the public record.

Statement of reasons on ceasing to hold office

Section 519 *Statement by auditor to be deposited with company* has been amended so that it always requires the auditor of a 'public interest company' (rather than a 'quoted company') to send the company a statement of reasons when the auditor ceases to hold office prior to the end of their term of office (and to lodge a copy of that statement at Companies House). A 'public interest company' is defined as any company whose transferable securities are listed on the Official List or whose equity share capital is officially listed in a European Economic Area state. This statement must always be sent to the company regardless of the timing, or reasons, for ceasing to hold office.

There are certain exceptions that have been introduced for auditors of non-public interest companies. These exceptions apply when:

- the auditor's term of office has come to an end, which for a private company would be the end of a period for appointing auditors; or
- the auditor ceases to hold office during their term of office and their reasons are 'exempt' reasons (see below) and there are no connected matters which the auditor considers needs to be brought to the attention of creditors or members of the company.

Rights of resigning auditor

The right of the auditor to call a shareholders' meeting to explain his/her reasons for resigning will not apply where the auditor's statement confirms that their reason for ceasing to hold office, and no connected matters, need to be brought to the attention of shareholders or creditors. Section 520 *Company's duties in relation to the statement* and section 521 *Copy of statement to be sent to registrar* reflect the new provisions such that the effect will be that where the auditor's statement includes such a declaration that there are no connected matters which the auditor considers needs to be brought to the attention of creditors or shareholders, then there is no need to circulate a copy of the auditor's statement to its shareholders and creditors and the auditor does not need to send a copy of the statement to Companies House.

Resignation of the auditor

Section 516 *Resignation of auditor* has been amended at subsection (2) which said that a notice of resignation sent by an auditor of a company is ineffective if that notice is not accompanied by the statement required by the current section 519. The amendment to section 516 means that an auditor's notice of resignation will only be ineffective if the auditor is resigning from a public interest company and that notice is not accompanied by a statement pursuant to the revised section 519.

Notification to the audit authority

In the UK, the audit authority for listed companies is the Financial Reporting Council (FRC). For unlisted companies the audit authority is the relevant professional body. Section 523 *Duty of company to notify appropriate audit authority* has been amended to exempt companies from the requirement to notify the FRC of the fact that its auditors have ceased to act where the company reasonably believes that the auditor's reasons for ceasing to hold office were all 'exempt reasons' (see below). The revised section 523(2A) says that the company's notice to the relevant audit authority must be a statement by the company of what it believes to be the reasons for the auditor's departure. New section 523(2B) and (2C) also allows, as an alternative, a company to provide an 'endorsed' copy of the auditor's statement under new section 519(1) if it agrees with that statement and the company receives it on time. This must be sent within 28 days of the auditor ceasing to hold office.

Section 522 *Duty of an auditor to notify appropriate audit authority* previously specified various circumstances in which an auditor was required to notify the audit authority of his/her reasons for leaving office. The effect of the amendments to section 522 will mean that the auditor is only required to notify the appropriate authority if they are required to send a statement to the company in accordance with the new section 519(1).

Electronic communication

The requirements for documents to be 'deposited' in Part 16, Chapter 4 have been replaced with the word 'sent' so as to facilitate the use of electronic communication.

Information provided to the audit authority

The requirement in section 524 *Information to be given to accounting authorities* for an audit authority to inform the accounting authorities (the FRC's Conduct Committee and the Secretary of State) about an auditor's departure has been removed, but it still allows them to do so.

Exempt reasons

Exempt reasons for the purpose of section 519(3) include:

- auditor ceases to practise as an auditor (e.g. before of retirement or a change of career);
- the company that the auditor is ceasing to act for qualifies for one of the exemptions from audit under the Companies Act 2006;
- the auditor is ceasing to act for a 'subsidiary' company of a UK incorporated parent because the accounts of the subsidiary are to be audited as part of the audit of the group accounts by the parent's auditor; and
- the company that the auditor is ceasing to act for is being liquidated through an insolvency procedure.

ISA (UK) 570 *GOING CONCERN* *(LECTURE 563 – 10.26 MINUTES)*

The Financial Reporting Council (FRC) has revised several of the UK International Standards on Auditing (ISAs (UK)) as part of the transposition of the Audit Regulation and Directive into the Companies Act 2006. The revised ISAs (UK) are effective for audits of financial statements for periods commencing on or after 17 June 2016.

Going concern basis of accounting

ISA (UK) 570 (Revised June 2016) *Going Concern* confirms that under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. It then goes on to clarify that general purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

If the entity's management does intend to liquidate the entity, cease operations or has no realistic alternative but to do so, the accounts must not be prepared on a going concern basis. Therefore, in cases where the going concern basis is not appropriate an alternative basis such as the 'break up' basis will be used.

Assessing going concern

Management are responsible for the assessment of going concern - this is not the responsibility of the auditor. ISA (UK) 570 (Revised June 2016) outlines certain factors which are relevant to management's judgement when assessing going concern:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgement regarding the outcome of events or conditions.
- Any judgement about the future is based on information available at the time at which the judgement is made. Subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made.

Responsibilities of the auditor

As mentioned in the section above, it is not the auditor's responsibility to assess the going concern ability of an entity and this responsibility rests with management. The auditor's responsibilities are to obtain sufficient, appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements and to conclude, based on that audit evidence, whether a material uncertainty exists about the entity's ability to continue as a going concern. The auditor's responsibilities in this respect apply even if the financial reporting framework used by the audited entity does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

Of course, the auditor is unable to predict the future and ISA (UK) 200 (Revised June 2016) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance*

with International Standards on Auditing acknowledges that the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions which may cause an entity to cease as a going concern. As a result, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in the auditor's report is not to be viewed as a guarantee as to the entity's ability to continue as a going concern.

Objective of ISA (UK) 570 (Revised June 2016)

ISA (UK) 570 (Revised June 2016) sets out three objectives for the auditor:

a) to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
b) to conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
c) to report in accordance with this ISA (UK).

Risk assessment

Risk assessment procedures are required under ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*. As part of this process, the auditor is required to consider whether events or conditions exist which may cast significant doubt on the entity's ability to continue as a going concern. The auditor must determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

a) if such an assessment has been made, the auditor must discuss the assessment with management to identify if management has identified events or conditions which, individually or collectively, might cast significant doubt on the entity's ability to continue as a going concern, and, if so, what management intends to do to address those significant doubts; or
b) where no assessment has yet been made, the auditor must discuss with management their basis for the intended use of the going concern basis. The auditor must also inquire of management as to whether there are any events or conditions which, individually or collectively, might cast significant doubt on the entity's ability to continue as a going concern.

The auditor must also remain alert throughout the course of the entire audit as to evidence of any events or conditions which could bring into question the entity's ability to continue as a going concern.

Evaluating management's assessment

The auditor must then evaluate management's assessment of going concern. In undertaking this evaluation, the auditor must use the same period as that used by management. However, if the period covered by management is less than 12 months from the date of approval of the financial statements, the auditor must ask management to extend its period of assessment to at least 12 months from that date.

It is worth emphasising that ISA (UK) 570 (Revised June 2016) is more arduous in its requirements than mainstream ISA 570 *Going Concern* issued by the International Auditing and Assurance Standards Board. Mainstream ISA 570 requires an assessment of going concern to be undertaken for a period of at least 12 months from the balance sheet date; ISA (UK) 570 (Revised June 2016) requires the assessment to be 12 months from the date of approval of the financial statements, so care needs to be taken to ensure the correct assessment period is used.

Events or conditions casting significant doubt on the going concern ability are identified

When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor must obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists. This is done by performing additional audit procedures which should also include considering any mitigating factors. These audit procedures must include:

- where management have not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make that assessment;
- evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances;
- where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
    - evaluating the reliability of the underlying data generate to prepare the forecast; and
    - determining whether there is adequate support for the assumptions underlying the forecast;
- considering whether any additional facts or information have become available since the date on which management made its assessment; and
- requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

Adequacy of the disclosures relating to going concern: reporting

Following completion of the relevant audit procedures, there should be four outcomes:

- adequate disclosure of a material uncertainty is made;
- adequate disclosure of a material uncertainty is not made;
- management are unwilling to make, or extend, its assessment;
- use of the going concern basis is inappropriate.

Adequate disclosure of a material uncertainty is made

If adequate disclosure about a material uncertainty is made in the financial statements, the auditor expresses an unqualified opinion. The auditor's report must include a separate section under the heading 'Material Uncertainty Related to Going Concern' in order to:

- draw attention to the note in the financial statements that discloses the matter(s); and

- state that these events or conditions indicate that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and the auditor's report is not qualified in this respect.

This approach is different than what was the case under ISA (UK and Ireland) 570 *Going Concern*. Under the previous UK and Ireland ISA 570, the auditor would include reference to the going concern disclosures in an Emphasis of Matter paragraph. This is not the case under ISA (UK) 570 (Revised June 2016) and so auditors need to be aware of the new reporting requirements.

Example auditor's report – Material uncertainty which has been adequately disclosed

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly [or give a true and fair view] of the financial position of the Company as at 31 December 20X1 and [of] its financial performance and its cash flows for the year then ended in accordance with [insert financial reporting framework].

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs) (UK). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [insert jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Relating to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended 31 December 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Key Audit Matters

Only required for listed companies reporting under ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.

Other Information

Reporting in accordance with ISA (UK) 720 (Revised June 2016) *The Auditor's Responsibilities Relating to Other Information*.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Reporting in accordance with ISA (UK) 700 (Revised June 2016) *Forming and Opinion and Reporting on Financial Statements*.

Auditor's Responsibilities for the Audit of the Financial Statements

Reporting in accordance with ISA (UK) 700 (Revised June 2016).

Report on Other Legal and Regulatory Requirements
Reporting in accordance with ISA (UK) 720 (Revised June 2016).

Adequate disclosure of a material uncertainty is not made

When the auditor concludes that a material uncertainty exists and adequate disclosure of that material uncertainty is not made in the financial statements, the auditor must:

a) express a qualified opinion, or adverse opinion, as appropriate in accordance with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*; and
b) in the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern.

Management are unwilling to make, or extend, its assessment

When management are unwilling to make or extend its assessment of going concern when the auditor makes such a request, the auditor must consider the implications for the auditor's report.

Use of the going concern basis is inappropriate

When management have prepared the financial statements on a going concern basis, but in the auditor's judgement, management's use of the going concern basis is inappropriate, the auditor must express an adverse opinion.

The auditor may judge the going concern basis to be inappropriate, for example, where the reporting entity has suffered recurring losses and is in an insolvent position and the bank/financiers have 'called in' loans and overdrafts with no real prospects of the company having the ability to refinance. If the going concern basis has been adopted in such an instance, the auditor must express an adverse opinion and describe the basis for the adverse audit opinion in the Basis for Adverse Opinion paragraph which immediately precedes the Opinion paragraph.

Communication with those charged with governance

ISA (UK) 570 (Revised June 2016) requires that unless all of those charged with governance are involved in managing the entity, the auditor must communicate with those charged with governance events or conditions that have been identified which may cast significant doubt on the ability of the entity to continue as a going concern. There are four issues which must be communicated to those charged with governance as follows:

a) whether the events or conditions constitute a material uncertainty;
b) whether management's use of the going concern basis of accounting is appropriate in the preparation of the financial statements;
c) the adequacy of the related disclosures in the financial statements; and
d) where applicable, the implications for the auditor's report.

Significant delays in approving the financial statements

When there is a significant delay in the approval of the financial statements by management, or those charged with governance after the date of the financial statements, the auditor must

enquire as to the reasons why there is a delay. When the auditor believes that the delay could be related to events or conditions concerning the going concern assessment, the auditor must perform the procedures outlined on page 42 of these notes and conclude whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

ISA (UK) 315 (REVISED JUNE 2016) *IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH*

UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT (LECTURE A564 – 9.56 MINUTES)

ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and its Environment* is effective for audits of financial statements commencing on or after 17 June 2016. As with all the other revised UK ISAs, early adoption is permitted. This revised ISA contains some revisions to the assertions in the financial statements which should be borne in mind by auditors performing audits that apply this revised UK ISA.

Objective of the auditor

ISA (UK) 315 says that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thus providing a basis for designing and implementing responses to the assessed risks of material misstatement.

In all cases, this understanding must be documented and quite often audit files are criticised because they contain weak documentation regarding the auditor's understanding of the entity and its environment.

Risk assessment procedures and related activities

It is mandatory for the auditor to undertake risk assessment procedures and related activities for an audit client. The aim of risk assessment procedures is to provide a basis for the identification of risks of material misstatement at both the financial statement and assertion levels. If appropriate risk assessment procedures are not undertaken, or not undertaken properly, by the auditor this will increase audit risk (the risk that the auditor forms an incorrect opinion on the financial statements), which must be avoided at all costs.

Notwithstanding the fact that the auditor performs adequate risk assessment procedures, these procedures, by themselves, will not provide sufficient appropriate audit evidence on which to base the audit opinion.

Risk assessment procedures must include:

- inquiries of management, or appropriate individuals within the internal audit function (where such a function exists), and of others within the entity who, in the auditor's judgement, may have information that is likely to assist in identifying the risks of material misstatement due to fraud or error;
- analytical procedures; and
- observation and inspection.

The auditor must also consider whether information that they have obtained from their ongoing customer due diligence processes or acceptance processes is relevant to identifying the risks of material misstatement. In addition, if the audit engagement partner has undertaken other engagements for the entity, the partner must consider whether information obtained is relevant to identifying the risks of material misstatement.

Use of prior year audit experience

If the auditor intends to use information that has been obtained from previous experience with the entity and from audit procedures performed in previous audits (such as tests of

control), the auditor must determine whether changes have taken place since the previous audit that may affect the relevance of that information to the current year's audit.

Audit team discussion

It is mandatory for the audit team to hold a discussion at the planning stage of the audit which must involve the audit engagement partner and other key engagement team members. That discussion must include the susceptibility of the financial statements to material misstatement, and the application of UK GAAP to the entity's facts and circumstances.

For those audit team members that were not involved in the discussion, the audit engagement partner must consider which matters are to be communicated to them.

Understanding the entity and its environment

ISA (UK) 315 requires the auditor to obtain an understanding of the entity and its environment, including the entity's internal control. The auditor must, therefore, obtain an understanding of the following:

- relevant industry, regulatory, and other external factors including the applicable financial reporting framework;
- the nature of the entity, including:
  - its operations;
  - its ownership and governance structures;
  - the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
  - the way that the entity is structured and how it is financed,

  to enable the auditor to understand the classes of transactions, account balances and disclosures to be expected in the financial statements;
- the entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor must evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry;
- the entity's objectives and strategies, and those related business risks which may result in risks of material misstatement; and
- the measurement and review of the entity's financial performance.

Internal control environment

The auditor must obtain an understanding of the entity's internal control environment. Whilst most controls which will be relevant to the audit will be financial reporting controls, not all such controls will be relevant to the audit and hence the auditor must use their professional judgement to isolate such irrelevant controls.

The auditor must evaluate the design of those controls and determine whether they have been implemented by performing tests of control (often referred to as 'compliance tests').

Example – Test of control

Management have informed the auditor that the bank reconciliations are reviewed on a monthly basis by the finance director who signs the face of the bank reconciliation to evidence her review. This is done as part of the company's internal control processes.

The auditor can undertake a test of control on the bank reconciliations by reviewing a sample to check if there is evidence of such a review taking place. Where it is apparent that the bank reconciliations are reviewed by a finance director, this can be taken as evidence that the control has operated effectively throughout the year. Where it is not apparent that the reconciliations have been reviewed, the auditor should consider whether this is a failing in the control itself.

Components of internal control

There are five components of internal control according to ISA (UK) 315 (Revised June 2016):

- Control environment;
- The entity's risk assessment process;
- The information system, including the related business processes, relevant to financial reporting, and communication;
- Control activities relevant to the audit; and
- Monitoring of controls.

Control environment

As part of obtaining an understanding of the control environment, the auditor must evaluate whether:

a) management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behaviour; and
b) the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and consider whether those other components are not undermined by deficiencies in the control environment.

The entity's risk assessment process

The auditor must understand whether the entity has a process for:

a) identifying business risks relevant to financial reporting objectives;
b) estimating the significance of the risks;
c) assessing the likelihood of their occurrence; and
d) deciding about actions to address those risks.

If the entity has such a process, the auditor must obtain an understanding of it and the results thereof. When the auditor subsequently identifies risks of material misstatement which management failed to identify, they must evaluate whether there was an underlying risk of a kind which the auditor expects should have been picked up by the entity's risk assessment process. Where there is such a risk assessment process, the auditor obtains an understanding as to why that process failed to identify it and evaluate whether the process is appropriate to its circumstances or determine that there is a significant deficiency in internal control insofar as the entity's risk assessment process is concerned.

Where there is no established process, or the entity has an ad-hoc process, the auditor must discuss with management whether business risks relevant to financial reporting objectives have been identified as well as how they have been addressed. In addition, the auditor must also evaluate whether the absence of a documented risk management process is appropriate in the company's circumstances, or determine whether it represents a significant deficiency in internal control.

The information system, including the related business processes, relevant to financial reporting, and communication

The auditor must obtain an understanding of the information system, including the related business processes that are relevant to financial reporting. This must include the following areas:

a) the classes of transactions in the entity's operations that are significant to the financial statements;
b) the procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the nominal ledger and reported in the accounts;
c) the related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions. This includes the correction of incorrect information and how information is transferred to the nominal ledger. These records may be in electronic or manual form;
d) how the information system captures events and conditions, other than transactions, that are significant to the financial statements;
e) the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
f) controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

ISA (UK) 315 requires the auditor's understanding of the information system relevant to financial reporting to include relevant aspects of that system which relates to information disclosed in the financial statements which has been obtained from within, or outside of, the general and subsidiary ledgers.

The auditor must also obtain an understanding as to how the entity communicates financial reporting roles and responsibilities as well as significant matters relating to financial reporting, including:

a) communications between management and those charged with governance; and
b) external communications, such as those with regulatory authorities.

Control activities relevant to the audit

The auditor must obtain an understanding of the control activities relevant to the audit which are those activities that the auditor judges are necessary to understand in order to assess the risks of material misstatement at the assertion level and then design further audit procedures which are responsive to those assessed risks. This includes the auditor obtaining an understanding of how the entity has responded to risks arising from IT.

Monitoring of controls

The auditor must obtain an understanding of the major activities which the entity uses to monitor internal control relevant to financial reporting, including those related to control activities relevant to the audit and how the entity initiates remedial actions to address deficiencies in controls.

Where an internal audit function exists, the auditor must obtain an understanding of the nature and function, organisational status and the activities performed, or to be performed.

The auditor must obtain an understanding of the sources of the information used in the entity's monitoring activities together with the basis upon which management considers the information to be sufficiently reliable for this purpose.

Identifying and assessing the risks of material misstatement

The auditor is required to identify and assess the risks of material misstatement at:

a) the financial statement level; and
b) the assertion level for classes of transactions, account balances and disclosures (see below).

Undertaking this type of risk assessment will provide the basis for the auditor to design and perform further audit procedures.

In addition, the auditor must also:

a) Identify risks throughout the process of obtaining an understanding of the entity and its environment which must include understanding the relevant controls which relate to the risk and by considering the classes of transactions, account balances and disclosures in the financial statements.
b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.
c) Relate the identified risks as to what could go wrong at the assertion level, taking into consideration any relevant tests of control that the auditor may wish to perform.
d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement could result in a material misstatement.

Determining risks which may be significant risks

The following factors must be considered by the auditor in determining whether a risk is a significant risk:

a) whether the risk is a risk of fraud;
b) whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires special attention;
c) the complexity of the transactions;
d) whether the risk involves significant transactions with related parties;
e) the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
f) whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

Where a risk is judged to be a significant risk, the auditor must obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Revision of the entity's risk assessment

The auditor may judge it necessary to revise the risk of material misstatement at the assertion level during the course of the audit. This can arise for a variety of reasons, such as obtaining additional knowledge of circumstances or facts which the auditor was previously unaware, or the discovery of fraud risk factors.

When the auditor revises the risk assessment, he/she must also modify the further planned audit procedures accordingly.

Documentation

As noted above, one of the most frequent criticisms file reviewers make during file reviews is the lack of supporting documentation, particularly at the planning stage of the audit. ISA (UK) 315 requires the following to be included in the planning documentation:

a) The discussion among the engagement team where required by paragraph 10 of ISA (UK) 315) and the significant decisions that were reached.
b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 of ISA (UK) 315 and of each of the internal control components specified in paragraphs 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed.
c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25 of ISA (UK) 315.
d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30 of ISA (UK) 315.

Assertions relating to the financial statements

Assertions used by the auditor in considering the different types of potential misstatements may fall into the following categories:

Assertions about classes of transactions, events and related disclosures:

- **Occurrence** – transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
- **Completeness** – all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Accuracy** – amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have ben appropriately measured and described.
- **Cutoff** – transactions and events have been recorded in the correct accounting period.
- **Classification** – transactions and events have been recorded in the proper accounts.
- **Presentation** – transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

The above assertions relate to profit and loss items. Under the revised ISA (UK) 315, ‘presentation’ is now included in the above. Under the previous ISA (UK and Ireland) 315, it was carved out into separate assertions relating to ‘presentation and disclosure’.

Assertions about account balances and related disclosures:

- **Existence** – assets, liabilities and equity interests exist.
- **Rights and obligations** – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

- **Completeness** – all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Accuracy, valuation and allocation** – assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded and related disclosures have been appropriately measured and described.
- **Classification** – assets, liabilities and equity interests have been recorded in the proper accounts.
- **Presentation** – assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

The above assertions relate to the balance sheet. The assertions in revised ISA (UK) 315 are different than the previous ISA (UK and Ireland) 315 relating to the balance sheet as that included, 'existence', 'rights and obligations', 'completeness' and 'valuation and allocation'.

AUDITING SMALL COMPANIES REPORTING UNDER FRS 102
(LECTURE A565 – 13.07 MINUTES)

While the audit thresholds have increased for small companies, essentially meaning fewer companies will be subject to audit, unless the small company voluntarily chooses to have an audit or lenders require the company to have its financial statements audited, there are some small companies that do choose to have an external audit. Notwithstanding the criticisms that the audit regime has received from the profession, provided the audit has been carried out in accordance with UK International Standards on Auditing, they are more credible than those financial statements which have not been audited as the auditor is forming an opinion (i.e. providing reasonable assurance) as to whether the financial statements give a true and fair view.

Early-adoption of FRS 102, Section 1A

All small companies are mandatorily required to apply FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* for accounting periods starting on or after 1 January 2016. For those companies which have chosen to apply the revised Companies Act 2006 early by virtue of SI 2015/980 (i.e. to December 2015 year-ends) because they now fall into the small companies' regime due to the increased thresholds, an audit will still be required. This is because there is no option to early-adopt the revised audit thresholds as the uplifted thresholds can only be applied for audits of accounting periods starting on or after 1 January 2016.

Small companies that choose not to early-adopt SI 2015/980 will automatically be moved under its scope for December 2016 year-ends.

Initial planning

Of course, in the year of transition additional work is going to have to be done by the auditor on the transition itself. Audit programmes need to contain sufficient procedures in order that the auditor can obtain sufficient appropriate audit evidence which gives reasonable assurance that the transition process has not resulted in the financial statements containing material misstatement.

Ethics

Smaller clients are generally going to ask for advice on accounting or assistance in the transition. Whenever a client makes a request for assistance from the auditor, this creates an ethical threat to independence and objectivity. Ethical Standards require the auditor to identify and assess the significance of any threats to objectivity and independence. Threats that need to be considered are:

- self-interest threats;
- self-review threats;
- management threats;
- advocacy threats;
- familiarity/trust threats; and
- intimidation threats.

Safeguards should be put in place to mitigate the identified threats to an acceptable level (which should be documented). Where the auditor is unable to apply any safeguards, the work should not be carried out.

Valuation services

There are strict prohibitions on the auditor undertaking an engagement to provide a valuation. If the entity is a listed entity and the valuation would have a material effect on the listed entity's financial statements (either separately or in aggregate with other valuations provided), the service must not be performed. In respect of any other entity, where the valuation would both involve a significant degree of subjective judgement and have a material effect on the financial statements (either separately or in aggregate with other valuations provided) the auditor must not undertake the work.

ICAEW TECH 13/14AAF *Issues for auditors arising from the implementation of FRS 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'* confirms that the threats arising from the provision of valuation services are self-review and management threats. Where the self-review threat is concerned, this threat is considered too high to allow the provision of valuation services which involve the valuation of amounts with a significant degree of subjectivity which also have a material effect on the accounts.

However, the auditor may be called upon to provide advice in relation to valuation matters which come to the auditor's attention during the course of the audit. TECH 13/14AAF says that such matters may include:

- comments on valuation assumptions and their appropriateness;
- errors identified in a valuation calculation and suggestions for their correction; and
- advice on accounting policies and any valuation methodologies used in their application.

Where the auditor provides advice on such matters, this would not constitute a valuation service. In addition, where the auditor is engaged to collect and verify the accuracy of data to be used in a valuation to be performed by others, such engagements would also not be construed as valuation services.

Where valuation services are concerned, the key is that the auditor must ensure that they are not involved in arriving at any of the assumptions inherent in the valuation because this will give rise to a management and self-review threat.

In some cases, FRS 102 does not require entities to obtain a valuation where one would normally be required if obtaining such a valuation would give rise to undue cost or effort. However, in such circumstances, the decision as to whether the cost or obtaining valuations outweighs the benefit should be made and supported by management.

Tax services

For small, unlisted entities, the auditor is permitted to prepare current or deferred tax calculations for the purpose of preparing accounting entries. Those calculations must now involve initiating transactions or taking management decisions and must be of a technical, mechanical or an informative nature. In such cases, the auditor must ensure appropriate safeguards are applied.

What should management be doing?

The auditor must consider the audited entity's transition exercise as early as possible in order to cater for any additional work or difficulties that may be encountered during the course of the audit to ensure that the audit runs as smoothly as possible. The overarching objective where the auditor and the transition exercise is concerned is to gather sufficient appropriate audit evidence that the financial statements are not materially misstated as a result of the transition.

TECH 13/14AAF outlines some questions which the auditor may wish to ask management so that they can assess the quality of the entity's transition process as follows:

- Has management laid out a realistic and achievable timetable for transition to FRS 102?
- Has management got commitment throughout the organisation as needed (e.g. board, subsidiaries or other business units, IT)?
- Has management properly assessed the extent to which it has resources with the necessary skill and knowledge to manage the transition process?
- Does management have sufficient access to the specialist expertise that will be required in applying some of the accounting policies required by FRS 102, such as valuation?
- Has management rigorously evaluated the significance of the changes that will affect the entity on transition to FRS 102 (e.g. identification and classification of financial instruments)?
- Is the entity undertaking a thorough exercise to understand the accounting policy changes necessary on transition to FRS 102?
- Have the wider impact of transition (e.g. dividend planning, profit-related remuneration schemes) been identified and assessed?
- Does management have records of their distributable reserves, separate to the financial statements?
- Has management consulted with advisers, including considering possible tax elections which may need to be made?
- Has consideration been given to whether or not systems and processes are able to capture sufficient, reliable data that will now be required to produce financial statements that comply with FRS 102?
- Has management communicated details of the change to shareholders and other stakeholders?
- Has management reviewed bank covenants whose terms are linked to the financial statements (e.g. interest cover or gearing ratios) and contacted lenders to renegotiate the terms of such borrowings if necessary?

What do auditors need to do?

Auditors are responsible for forming an opinion as to whether the financial statements give a true and fair view. Keep in mind that the requirements of FRS 102 are retrospective in that the rules have to be applied as far back as the date of transition.

Understanding FRS 102

Without detailed knowledge of FRS 102, the auditor is not going to be able to carry out the work needed. Indeed, executing an audit without detailed knowledge of FRS 102 would be reckless.

Auditors need to have an awareness of the impact that retrospective application of the rules will have on the audit client's financial statements. In particular, they must refer to ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*.

Additional time will have to be spent on audits where transitions have taken place and therefore consideration must be given to resource needs. Resource needs are not just confined to the number of audit staff deployed to the audit engagement; they also include:

- technical expertise;

- training resources;
- fair value accounting specialists or experts;
- other experts (e.g. deferred tax);
- valuation techniques; and
- tax experts.

Wherever auditor's experts are used, the requirements in ISA (UK) 620 *Using the Work of an Auditor's Expert* will be triggered.

Engagement considerations

In all cases, the auditor should consider the requirements of ISA (UK) 210 (Revised June 2016) *Agreeing the Terms of Audit Engagements* and consider whether the audited entity should be reminded of the engagement terms, or whether those terms and conditions need to be revised.

Whenever the audited entity requests the audit firm provide additional services, and adequate safeguards are applied to maintain independence and objectivity, the auditor must issue a separate letter of engagement covering the additional services requested. Therefore, it is important that the nature of the engagement(s) is considered at the outset.

Some audit clients may call upon the auditor to undertake procedures on a transition prior to attending the client to carry out the main detailed audit fieldwork. Again, the auditor needs to carefully consider such requests in terms of the timescales involved (particularly if the firm has several audits), as well as clarifying the respective responsibilities in writing.

Planning

Additional planning will be needed to cater for the transitional work. In this respect the auditor should:

- agree with management the nature of the auditor's involvement and reporting throughout the transitional process;
- determine the nature, extent and quality of audit evidence needed in relation to the judgements made and conclusions reached by management in the transition to FRS 102 and in their preparation of the first FRS 102 financial statements;
- consider any changes to the audit plan which may be required as a result of the transition to FRS 102 (such as those that make use of audited comparative numbers to set expectations etc.);
- communicate any information needs to management on a timely basis; and
- explain to management how transitioning to a new financial reporting framework will affect the audit.

Risk assessment

The auditor will need to carefully consider the specific circumstances of the entity for the audit of the first set of FRS 102 financial statements together with the sources of possible risks of material misstatement.

Materiality

The auditor will need to take into consideration the extent to which unadjusted misstatements at the transition date balance sheet (as well as for the comparative period)

which have been identified during previous audits and do not eliminate on transition to FRS 102 together with the potential impact on the audit opinion.

Materiality levels will need careful consideration at the planning stage, and throughout the whole audit process, where the first set of FRS 102 financial statements are concerned.

Accounting policies, management bias and fraud risk factors

FRS 102 requires a greater level of subjectivity and judgement on the part of management and hence the auditor should consider the increased risk of management bias and/or fraudulent financial reporting. It should be borne in mind that a transition to a new financial reporting framework increases audit risk because material misstatement may arise through application of management bias and their choice of accounting policies. This should be reflected in the risk assessment process and revised accordingly throughout the course of the audit.

Accounting estimates and use of fair values

The requirements of ISA (UK) 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* will more than likely be of even more relevance in many audits under FRS 102 than was the case under previous UK GAAP.

Auditors must bear in mind that FRS 102 places more emphasis on the use of fair values and hence determining what 'fair value' is will require more judgement and more estimation uncertainty.

Changes to internal controls

A transition to FRS 102 may result in the entity making changes to internal controls. In this respect, the auditor is required to:

- update any existing systems notes;
- assess the design and implementation of controls relevant to the audit (particularly those which relate to significant risks);
- reconsider the consequences for the extent of assurance derived from tests of controls, particularly those which may have been tested on a cyclical basis that may not have operated throughout the entire period of review;
- give consideration as to whether or not to plan to derive assurance from any new controls over the preparation of the financial statements under FRS 102; and
- report to management on a timely basis any weaknesses which the auditor has identified.

Changes to the IT environment

The auditor needs to determine where risks of material misstatement arise through continuing use of the entity's IT system (including the choice of accounting software). Risks of material misstatement are likely to arise where an existing system has not been updated for the effects of FRS 102. In addition, risks are likely to increase where the IT systems and controls are:

- bespoke systems, designed specifically for the entity being audited;
- complex, involving multiple applications and interfaces;
- networked or involve connectivity across multiple sites;
- part-manual or require manual intervention; or

- easily overridden by management.

Risks relating to transitional arrangements

The following examples provide some guidance on the areas which may give rise to risks of material misstatement on transition:

Transitional requirements

The auditor will need to determine whether the entity has applied the transitional requirements properly as per Section 35 *Transition to this FRS* in FRS 102 and has only taken advantage of any elections or exemptions on transition where the standard allows.

Previously unidentified misstatements

The auditor will perform work on opening balances and comparatives and may identify errors within the financial statements which have previously not been reported. The auditor should keep in mind that prior year misstatements should be dealt with as such and should not be presented as transitional adjustments.

Restatement of comparative information

The auditor must perform additional procedures to determine whether comparative information has been appropriately presented within the financial statements. This is likely to involve the auditor performing additional audit procedures to assess whether the comparative information has been accounted for, and presented, in accordance with FRS 102 in all material respects.

Disclosure of the reconciliations required by Section 35

FRS 102 requires the first set of financial statements prepared under the framework to make a number of disclosures and reconciliations which disclose the effect of the transition to FRS 102. This includes a reconciliation of equity determined under previous UK GAAP to equity under FRS 102 as at the date of transition and at the end of the comparative period. There may be a risk that misstatements are made in these disclosures.

Application of 'undue cost or effort'

The auditor should endeavour to establish, at an early stage, any intention by management to claim undue cost or effort as a rationale for non-compliance with FRS 102 (for example when the entity has not obtained a fair value for investment property or other types of financial assets which need to be fair valued). Undue cost or effort might be a way of introducing management bias.

Classification of financial instruments

FRS 102 requires most financial instruments that meet the definition of 'basic financial instruments' to be accounted for at amortised cost. Those financial instruments which do not meet the definition of a basic financial instruments must be accounted for under Section 12 *Other Financial Instruments Issues* and accounted for at fair value through profit or loss, unless hedge accounting is being applied.

Certain financial instruments are difficult to classify and judgement will be needed in these cases. The auditor should consider whether the nature of the financial instruments held by the entity is such that an inappropriate classification will result in material misstatement in the carrying value of the financial instrument(s) in the financial statements.

Financing transactions

FRS 102 requires that financing transactions should be measured at the present value of the future payments, discounted at a market rate of interest for similar debt instruments. To

comply with this requirement, it will be necessary for the lender and the borrower to determine the market rate of interest for a similar debt instrument.

These situations (particularly in group situations also) present more opportunity for bias or manipulation of amounts reported in the financial statements. The auditor will therefore need to understand whether the terms and conditions of the financing transaction are sufficiently formalised so that it is clear as to whether any resultant financial instrument is repayable on demand or not, and, where relevant:

- determine the materiality of any discounting to be applied;
- ascertain how management will determine a market rate of interest for a similar debt instrument and the availability of that information;
- ascertain how management determines such a market rate at the transition date; and
- consider the extent to which the auditor intends to use the work of a third party as audit evidence and whether the auditor needs to involve an internal or an external third party.

Financial instruments at amortised cost

For financial instruments at amortised cost, the auditor will be concerned with management's ability to calculate an effective interest rate and how they have used certain assumptions in that calculation.

Financial instruments at fair value

The auditor must consider the following issues where financial instruments are measured at fair value:

- how material are the financial instruments?
- what is the source of the valuation and who has conducted the valuation?
- what qualifies the valuer to do so and is that valuer independent and objective?
- how has the valuation been carried out and how will the auditor obtain information directly from the valuer?
- does the auditor need to involve their own internal or external experts to determine the valuation?

The auditor must ensure that the audit evidence they obtain for financial instruments at fair value is both sufficient and appropriate. Among other things, the auditor should ensure they obtain an understanding of how the valuation has been determined, the competence and capabilities of the issuer in forming such valuations and the assumptions that were involved.

Use of fair values for the first time

To comply with the requirements of ISA (UK) 540, the auditor will need to consider how management has determined the amounts to include where FRS 102 requires the use of fair values.

If the auditor considers that a particular fair value accounting estimate involves a high degree of estimation uncertainty, this will be identified as a significant risk of material misstatement and hence audit procedures must reflect this assessment of risk.

The auditor may develop a range of possible appropriate outcomes against which they can measure the value provided by management. In forming this range the auditor should not accept or assume responsibility for determining the appropriate fair value and it must be made clear that responsibility for this lies with management.

Residual values

Under FRS 102, management must consider depreciable amount through comparison of a cost to a residual value which is based on an estimated amount which the entity would

currently obtain from the disposal of an asset. Previous UK GAAP based residual values on the value at the time of acquiring the asset. The auditor must therefore assess the value used in calculating the depreciation charges and consider whether it is appropriate at transition and the risk that current prices at each balance sheet date will have changed such that the depreciation charge is materially misstated.

Intangible assets and goodwill

All intangible assets, including goodwill, have to be amortised on a systematic basis over the useful economic lives. Where management cannot arrive at reliable estimate of the useful economic life, the amortisation period is capped to 10 years.

The auditor will be concerned with how management have arrived at their useful economic lives and the reliability of the information supporting those lives. The auditor must also keep in mind that investigations into the appropriateness of the useful economic lives of goodwill and intangibles may give rise to evidence that the useful economic life, as previously assessed, was not appropriate.

Defined benefit schemes

FRS 102 does not require the use of an independent actuary to determine net liabilities arising under defined benefit pension schemes. The auditor must consider whether the figures included in the accounts and/or the disclosures are materially misstated. Audit risk is increased where the entity does not use an independent actuary and management are not suitably competent to perform the valuation.

Where an independent actuary is not used, the auditor must undertake a robust assessment of:

- how the value of the assets and liabilities had been determined and the assumptions used;
- the evidence available to be able to determine whether the amounts included in the accounts and the related disclosures are appropriate; and
- whether the auditor will need to involve their own expert and therefore charge the cost of that expert to the entity.

Going concern

A transition to FRS 102 may result in more volatility in reported profits. Such volatility may impact on existing covenants and other agreements with lenders/financiers.

The auditor will need to establish whether, and how, an entity's agreements and contracts with third parties have been reconsidered and renegotiated where necessary.

If there are possible breaches in the terms and conditions of such agreements, the auditor should perform procedures to check whether the possible implications for the going concern status have been appropriately considered by management in its assessment of going concern and adequately disclosed in the financial statements.

Hedge accounting documentation

In order to use hedge accounting, certain conditions have to be fulfilled under FRS 102 and one of those criteria specifies that certain information must be documented by management.

Where an entity has used hedge accounting, the auditor must undertake procedures to verify that appropriate documentation has been put in place as required by FRS 102 and that this documentation has been approved by appropriate individuals in the organisation.

Disclosures

The auditor must ensure they have access to a reliable and up-to-date disclosure checklist or establish policies to determine how they will assess whether the disclosures are complete.

QUARTERLY ROUNDUP

The following are Press Releases from the FRC's website over the last three months:

Revised operating procedures for reviewing corporate reporting

01 April 2016

The Financial Reporting Council has published a revised version of its Conduct Committee's operating procedures for reviewing corporate reporting. The changes to the operating procedures, which take effect from today (1 April 2016), primarily reflect the changes being made to the FRC's governance and executive structure.

In its corporate reporting review work the FRC seeks to ensure that the financial information provided by public and large private companies to investors and other stakeholders complies with relevant reporting requirements.

A further review of the operating procedures will take place over the coming months. This is likely to result in more extensive changes being proposed which will be subject to public consultation.

ICAS/FRC research explores audit skills of the future

07 April 2016

New research by ICAS and the UK Financial Reporting Council (FRC) has investigated the skills required for audits of the future.

In 2013 ICAS and the FRC commissioned two international teams of researchers to investigate what mix of skills and qualities are needed in an audit team for it to perform high quality public interest audits in a modern and complex global business environment. The resulting research have now been published here.

Guidance on the going concern basis of accounting and reporting on solvency and liquidity risks

18 April 2016

The Financial Reporting Council (FRC) has today issued guidance for directors of companies which brings together the requirements of company law, accounting standards, auditing standards, other regulation and existing FRC guidance relating to the going concern basis of accounting. The guidance also covers, within the context of principal risks and uncertainties disclosed in the strategic report, solvency and liquidity risks.

The guidance aims to assist directors of companies that do not apply the UK Corporate Governance Code in assessing:

- the going concern basis of accounting, material uncertainties, solvency and liquidity risk;
- the periods of assessment; and
- the relevant disclosure requirements.

Clear & Concise reporting is paramount and when thinking about disclosures, directors are encouraged to consider the application of materiality in providing company-specific information.

Melanie McLaren, Executive Director, said:

'The FRC encourages companies to take a broader longer-term view of the risks and uncertainties facing their businesses. We have seen an evolution in corporate reporting in recent years. The Sharman Inquiry and the Strategic Report with its forward looking-orientation have been catalysts for change and it is important for our Codes, Standards and Guidance to remain current against this backdrop. Directors have told us that they welcome practical guidance.'

Revised UK Corporate Governance Code, Guidance on Audit Committees, and Auditing and Ethical Standards

27 April 2016

The Financial Reporting Council (FRC) has today issued final draft updates to the UK Corporate Governance Code and the associated Guidance on Audit Committees to reflect forthcoming UK legislation on audit committees and auditor appointments. The FRC has committed to avoid further updates to the Code until at least 2019.

At the same time the FRC has issued final drafts of revised Auditing and Ethical Standards to support the work of audit practitioners in delivering high quality audit, and thereby underpin investor confidence. The revised standards reflect the FRC's own view of ethical matters, changes to legislation which, after Parliamentary Scrutiny, are intended to take effect on 17 June 2016, and developments in international standards. The FRC has introduced all of the changes in a single revision to standards to ease the process of implementation as well as reduce costs.

The changes strengthen auditor independence by applying prohibitions to a range of engagements that could result in an auditor facing a conflict of interest. Reflecting the FRC's commitment to proportionate regulation, the revised standards contain some reliefs which will allow, in certain circumstances, an auditor to provide additional assistance to smaller and medium-sized entities.

The FRC has issued the final drafts now to enable companies and their auditors to familiarise themselves with the new requirements in good time.

Melanie McLaren, Executive Director, Audit, said:

'The updates to the Code, Guidance and Standards implement a significant change in audit regulation in the UK which will be overseen by the FRC as a competent authority with the support of the accountancy professional bodies. The changes will support further innovation by the audit profession in the UK and ensure that auditors act in a way that is genuinely independent and seen to be in the public interest. The UK has led the way om promoting audit transparency and competition on quality so that investors can have confidence in corporate reporting.'

FRC published Plan & Budget for 2016/17

28 April 2016

The Financial Reporting Council (FRC) has today published its Plan & Budget, including its levies, for 2016/17. The FRC will invest in its significant new role as Competent Authority for audit regulation under the EU Audit Regulation and Directive, which will commence in June 2016. Other priorities include the FRC's work to highlight good practice in corporate culture, promoting effective engagement between investors and companies, a continuing focus on the importance of clear and concise corporate reporting, and updating the FRC's suite of actuarial technical standards.

In finalising its Plan & Budget, the FRC has taken into account the important and helpful comments received from stakeholders on its proposals, which were published in December 2016, including on how it finances its operations and priorities.

Stephen Haddrill, CEO of the FRC, said:

'We are grateful for the constructive feedback we received from stakeholders in response to the draft Plan and Budget published in December. We are committed to maintaining an effective and proportionate regulatory framework for corporate governance and reporting. Stakeholder support is important for our ongoing work to enhance investor confidence by promoting trustworthy information and behaviour. We have reflected the feedback we received in the finalised Plan & Budget.

We aim to embed regulatory changes introduced since the crisis and continue our work in highlighting the importance of good corporate culture and high quality reporting while taking on the significant new responsibilities we have been given as Competent Authority under the EU Audit Regulation and Directive.'

The responses to the FRC's consultation on its Draft Plan & Budget and Levy Proposals 2016/17 are available here.

FRC promotes confidence in actuarial work through revised Technical Actuarial Standards

05 May 2016

The Financial Reporting Council (FRC) has today published for consultation proposed changes to Technical Actuarial Standards (TASs). High quality technical actuarial work promotes well informed decision making, so mitigating risk to the public interest. For this reason, the development of a revised framework for Technical Actuarial Standards framework has been an important strategic objective for the FRC.

The consultation invites comments on revisions to proposed changes to Specific TASs for specified areas of work in insurance, pensions and funeral plan trusts where there is a high degree of public interest.

The consultation also seeks views on the risk assessment process which considered the risks to the public interest relating to different areas of technical actuarial work to determine the work to be included in scope of the revised Specific TASs.

The FRC has also published a feedback statement on its November 2014 consultation, *A new framework for Technical Actuarial Standards*, which proposed changes to the FRC's framework for technical actuarial standards. This statement also includes the new FRC actuarial standard, Technical Actuarial Standard 100: Principles for Actuarial Work 'TAS 100', which will be applicable to all technical actuarial work.

The revised TASs are expected to come into force in the summer of 2017.

Melanie McLaren, Executive Director, Audit, said:

'High quality technical actuarial work is vital in promoting trust in financial markets among the millions of UK pensioners and savers and the many investors who allocate capital. The proposals are designed to provide further confidence to users who rely on actuarial information. The standards are proportionate and we believe the simplified structure should make the standards easier to apply.

The risk assessment process ensures that our standards are focussed on areas of technical actuarial work where there is a high degree of risk to the public interest.'

The FRC would welcome feedback on the proposals and in particular views on the risk assessment process it has developed to inform decisions on the scope of the Specific TASs and the output of that process.

The Pre-Emption Group publishes Monitoring Report and good practice template resolutions to assist companies

05 May 2016

The Pre-Emption Group has released a monitoring report looking at implementation of the Statement of Principles, which were updated in 2015 to reflect market changes.

The report shows that over the course of the first year the revised principles were generally adhered to and reinforces the importance of open dialogue and engagement between investors and the companies to which they have allocated their capital.

After considering the findings of this report, the Pre-Emption Group has decided to assist companies by publishing a template resolution outlining good practice in its requests for disapplication. The template recommends companies propose two separate resolutions to cover the disapplications envisaged by the Statement of Principles.

- The first resolution requests a five per cent disapplication to be used on an unrestricted basis.
- The second resolution, to be put forward by companies when appropriate, requests authority to disapply in cases when boards consider the use to be for the purpose of an acquisition or specified capital investment in accordance with the Statement of Principles.

When an additional five per cent disapplication authority is used, investors would expect companies to disclose in the relevant placing announcement the circumstances that have led to its use and detail the consultation process undertaken by the company.

Companies are encouraged to consider using the draft template resolution at their next meeting, however the PEG would expect companies to use this template for meetings held from 1 August 2016.

The Statement of Principles provides a framework for early and effective dialogue between a company and its shareholders. However, companies should note that consultation on the basis on which disapplication is sought must be specific and unequivocal to be considered appropriate.

The Statement of Principles is supported by the Pensions and Lifetime Savings Association and The Investment Association as representatives of asset owners and investment managers. The Statement of Principles is clear that companies that do not comply with its spirit and letter are likely to find their shareholders less inclined to approve subsequent requests for disapplication. Moving forward, the Pre-emption Group expects continued improvement in disclosures on the disapplication of pre-emption rights and increased levels of engagement between shareholders and investors.

Revised guidance for Irish Credit Union audits published

13 May 2016

Credit Union auditors in Ireland will have enhanced support for their audits of accounts for the year ended on 30 September 2016, with revised guidance that has been issued by the Financial Reporting Council (FRC).

The revised Practice Note has been developed in conjunction with Chartered Accountants Ireland, to provide 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).

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, FRC's Executive Director for Audit, said:

'The aim of this revised guidance is to support the delivery of high quality audit.

Credit Unions plan an important role for their members, therefore it is vital the audit is robust and takes proper account of the up-to-date legal and regulatory framework.'

FRC issues amendments to FRS 105 to bring limited liability partnerships and qualifying partnerships within the scope of the micro-entities regime

17 May 2016

The Financial Reporting Council (FRC) has today issued *Amendments to FRS 105 – Limited Liability Partnerships and Qualifying Partnerships.* Following a change in legislation which comes into force today, limited liability partnerships (LLPs) and qualifying partnerships can apply the micro-entities regime and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* has been amended to reflect this.

Paul George, Executive Director, Corporate Governance and Reporting, said:

'In issuing these amendments we are reflecting a change in the law, which makes the simplified micro-entities regime that is already available to the smallest companies, also available to eligible LLPs and qualifying partnerships.'

Respondents to a consultation by the Department for Business, innovation and Skills (BIS) supported extending the micro-entities regime to LLPs and qualifying partnerships, including permitting early application from 1 January 2015. This has been reflected in these amendments to FRS 105, which are applicable for accounting periods beginning on or after 1 January 2016, with early application permitted from 1 January 2015 in conjunction with the changes in legislation. BIS estimates that approximately 3,500 LLPs might be able to benefit from these changes.

Audit quality review reports published by FRC

19 May 2016

Reports on audit quality of the six largest audit firms have been published today by the Financial Reporting Council (FRC). The reports set out the principal findings arising from 2015/16 reviews of BDO, Deloitte, EY, Grant Thornton, KPMG and PwC.

The FRC has responded to feedback, from audit committee chairs and others, as to how the content of its reports on individual firms could be further developed to provide more useful information. The reports focus on the key findings of our reviews, why they matter and the actions the firms are taking to address them. The key findings reported cover matters arising from the FRC's reviews of both individual audits and each firm's policies and procedures to support and promote audit quality, with the balance of findings in these two areas differing significantly between the six firms.

The report also sets out some examples of good practice identified at each firm that contributed to audit quality.

Melanie McLaren, FRC's Executive Director for Audit, said:

'This year's reports on our reviews of individual audit firms reflect the FRC's focus on promoting continuous improvement in audit quality.

For the first time, we asked the firms to carry out a root cause analysis into each of our key findings before developing proposed actions and discussing these with us. The firms responded positively to this request and engaged in a constructive dialogue with us on the outcome of their work and how this had informed the actions they intend to take.

We are pleased that the firms have recognised the opportunity to demonstrate their commitment to audit quality.

We will be reviewing the implementation of firms' actions and the extent to which they are effective in practice in enhancing audit quality.'

Later in 2016, the FRC intends to issue, in view of its forthcoming role as the UK's competent authority for audit, its first report monitoring and assessing developments in UK audit quality encompassing developments in standards and policy, professional oversight, audit quality reviews and enforcement.

Succession planning should be aligned to company strategy

23 May 2016

The Financial Reporting Council (FRC) has issued a feedback statement on its discussion paper, UK Board Succession Planning, which sought views on issues surrounding board succession for both executives and non-executives.

An active nomination committee is key to promoting effective board succession. Committees should consider carefully the future membership of their boards and ensure that this is aligned to company strategy, both current and future.

FRC Chairman, Sir Win Bischoff commented: '*We were pleased to have received so many valuable insights into board succession. Companies which plan ahead effectively for board renewal are more likely to achieve a better combination of diverse skills and experience needed for long-term success. The nomination committee should also consider its role in developing the talent pipeline within the company.*'

There was some support for further guidance, in particular on the issues of the role of the nomination committee and reporting on succession planning. Given the strong links with the FRC's Culture Coalition Project, guidance in this area will be considered as part of the revision of the Guidance on Board Effectiveness, which will begin later this year. The FRC has committed to avoiding further updates to the UK Corporate Governance Code until at least 2019.

FAQs on ESMA APM Guidelines

25 May 2016

The Financial Reporting Council (FRC) has today responded to some Frequently Asked Questions on the application of the European Securities and Markets Authority's Guidelines on Alternative Performance Measures ('the Guidelines') which were issued in October 2015.

The Guidelines are to be applied from 3 July 2016 by companies with listed shares or debt when presenting APMs outside the financial statements in Annual Reports, Half-yearly reports or preliminary announcements. They are also to be applied in other ad-hoc

communications, such as RNS announcements and press releases, which are subject to the Transparency Directive or the Market Abuse Regulation and in the preparation of prospectuses.

When APMs are presented in an Annual Report, compliance with the Guidelines will help ensure that, taken as a whole, it is fair, balanced, comprehensive and understandable. The FRC's Corporate Reporting Review team will take material inconsistencies with the Guidelines into account when deciding whether the strategic report is fair, balanced and comprehensive and, as a result, whether enforcement action is required. For example, a failure to properly explain how an APM is calculated or to highlight any changes in its calculation year on year may prompt further enquiries.

Paul George, Executive Director, said:

'There has recently been wide public debate on the use of APMs and the role they can play in communicating to investors relevant information on a company's performance, position and cash flows. Compliance with the Guidelines will help ensure that investors have a clear and comprehensive understanding of the APMs presented. Our Financial Reporting Lab will consider the benefit of instigating a project in 2017, bringing together investors and preparers to further improve the quality of APM disclosures.'

FRC issues amendments to FRS 103 to update it for changes in the regulatory framework for insurers

26 May 2016

The Financial Reporting Council (FRC) has today issued Amendments to FRS 103 – Solvency II. These limited amendments to FRS 103 *Insurance Contracts* updates it for changes in the regulatory framework, following the introduction of Solvency II.

Paul George, Executive Director, Corporate Governance and Reporting, said:

'These amendments to FRS 103 principally update a number of definitions following the introduction of Solvency II. They do not require insurers to change their accounting policies. However, we recognise that some insurers may wish to do so to make them more consistent with Solvency II, and these amendments clarify that.'

The amendments are effective for accounting periods ending on or after 1 January 2016.

FRC comments on issues arising in relation to accounting for social housing loans

02 June 2016

Many entities are currently in the process of applying FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* for the first time. The Financial Reporting Council (FRC) recently became aware that issues of interpretation have arisen in relation to the accounting for loans provided to registered providers of social house, which could have a significant impact on their financial statements. Similar loans may exist in other sectors, though they appear most prevalent in the social housing sector.

The issue relates to the classification of loans as 'basic' or 'other' by registered providers of social housing, which then impact on whether the loans are measured on a cost or fair value basis. Paragraph 11.9 of FRS 102 sets out the conditions for a loan to be classified as basic and consequently measured on a cost basis.

It is common for loan agreements to include a provision setting out amounts to be paid by the borrower to the lender as compensation should the borrower repay the loan early and

current market interest rates are lower than the fixed rate specified in the agreement. FRS 102 explicitly states that such provisions do not prevent the loans being classified as basic.

We have been informed that many other straight-forward fixed rate loan agreements, particularly in the social housing sector, include a variant of such a provision. These provisions require the borrower to pay the lender or the lender to pay the borrower, depending on whether current market interest rates are below or above the agreed fixed rate.

FRS 102 does not explicitly address compensation that can be paid to the borrower. We understand that there are divergent views, based on differing interpretations of one of the qualifying conditions, over whether such loans can be classified as basic. Those advocating a basic classification have also argued that the resulting measurement of the liability, based on cost, provides more relevant information, by better reflecting the intentions of the contracting parties in entering into the agreement and their expectations of future actions.

The FRC notes that FRS 102 does not explicitly address every transaction, other event or condition that an entity may need to account for, and preparers and auditors will need to apply judgement in the application of FRS 102. This may lead to diversity in practice in some areas. In some cases the FRC may take action to reduce diversity in the future by making amendments to standards.

In situations where standards do not specifically address the required accounting, different, valid interpretations can, and do, occur. The classification of loans with two-way compensation clauses appears to be one such case. The FRC reviews areas where it is aware of significantly conflicting interpretations emerging, and in this case will consider any need to revise the requirements of FRS 102, in due course, and after due process, with a view to clarifying the accounting requirements whilst ensuring that the economic substance of the agreements is reflected.

In relation to this specific issue, the FRC notes that diversity in practice may arise and reminds preparers that FRS 102 (paragraph 8.6) requires disclosure about judgements that have had a significant effect on the amounts recognised in the financial statements. Looking forward, the FRC is starting work on the triennial review of FRS 102, and expects to reconsider the conditions in paragraph 11.9 as part of that process. As well as considering this compensation clause, this will also include consideration of any other issues raised in relation to the application, in practice, of paragraph 11.9. As a result, any amendments will reflect wide experience of applying FRS 102. The FRC expects to consult on any proposed amendments early in 2017, which would be effective from 1 January 2019, although early application may be available.

Statement from Stephen Haddrill, Chief Executive of the Financial Reporting council, regarding the implementation of the EU Audit Regulation and Directive

17 June 2016

'Following Parliamentary approval of legislation to implement the 2014 EU Audit Regulation and Directive (ARD), its requirements have now come into force.

The Government has designated the FRC the UK Competent Authority for audit with responsibility for the regulation of statutory audit; including setting auditing and ethical standards, monitoring and enforcement. We will seek to promote high quality audit that underpins investor confidence.

The FRC will work closely with the audit recognised supervisory bodies in promoting the quality of audit and, where possible, will delegate regulatory functions to them.

New UK auditing and ethical standards published today provide auditors with a comprehensive basis to comply with their updated obligations. The changes to the ethical standard set out the principles that underpin high quality, independent audit and, particularly for the audits of Public Interest Entities (PIEs)[1] strengthen auditor independent by prohibiting or restricting a range of engagements that could result in a conflict of interest. Reflecting the FRC's commitment to proportionate regulation, the revised standards contain some flexibility to allow an auditor to provide some additional assistance to smaller and medium-sized entities.

We have also issued updates to the UK Corporate Governance Code and Guidance on Audit Committees to reflect changes arising from the legislation on audit committees and auditor appointments. We will avoid further updates to the Code until at least 2019.

We have developed a new audit enforcement procedure which is published today, following earlier consultation. This provides a new administrative procedure where there has been breach of regulatory requirements which is aimed at promoting the early conclusion of enforcement cases.'

[1] PIE includes entities incorporated in an EU member state with securities listed on regulated market, credit institutions and insurers.

Key Facts

1. The Statutory Auditors and Third Country Auditors Regulations 2016 ('SATCAR 2016') comes into effect on Friday 17 June. SATCAR 2016 makes the FRC the UK's Competent Authority for audit, recognises the role of the professional bodies and places obligations on PIEs in connection with auditor appointments, including retendering and rotation requirements.
2. The FRC, Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) have effected changes alongside SATCAR to implement PIE-related requirements. In particular, the FRC has now finalised previously published draft material which is aligned to the final legislation, including:
    a. The Corporate Governance Code and Guidance on Audit Committees;
    b. The Ethical Standard for Auditors; and
    c. Auditing and Quality Control Standards, including revised auditor reporting requirements. (Alongside which the FRC is issuing a revised Scope and Authority of Audit and Assurance Pronouncements document).
3. The FRC will delegate regulatory tasks to recognised supervisory bodies (RSBs). This is in line with a Ministerial Statement made in July 2015 and will be carried out in accordance with a **Secretary of State direction**. Accordingly, the FRC has reviewed and carried forward the recognition of each RSB and each RSB has entered into a delegation agreement with the FRC. The delegation agreements are based on the FRC and RSB having a common objective to promote audit quality. At present they are temporary delegation agreements in order to facilitate implementation by the effective date. Longer term arrangements will be made by September 2016.
4. The RSBs will approve and register statutory auditors. The FRC has published eligibility criteria; and the Audit Register Regulations.
5. The FRC will monitor directly the quality of PIE audits and certain other retained classes of audit bringing some 50 firms into scope compared to 10 firms currently. The FRC published on 1 April its inspection scope for 2016/17.
6. The FRC will carry out enforcement and sanctioning in connection with PIE audits and any other retained classes. Following consultation, the FRC has issued a new

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audit enforcement procedure and supporting documents, together with a feedback statement. Consequential changes have been made to the Audit Regulatory Sanctions Procedures and related guidance.

7. The FRC may, on receipt of applications made to it by PIEs or statutory auditors, determine the date a PIE audit engagement began and authorise the extension of the duration of an engagement by up to two years or the relaxation of the financial cap on non-audit services. The FRC may also apply to court for an order to remove auditors. The FRC has published miscellaneous processes on how it will deal with these matters and publicise them.

8. In order to be able to discharge its responsibilities and comply with the requirements of the legislation, the FRC has reviewed and amended its Governance Bible, including its Articles of Association.

Public Audit Forum designated SORP-making body

21 June 2016

The Financial Reporting Council (FRC) has designated the Public Audit Forum as the SORP-making body for the revision of Practice Note 10 (Revised): *Audit of financial statements of public sector bodies in the United Kingdom*. This is in accordance with the FRC's Policy on Developing Statements of Recommended Practice.

The Public Audit Forum has now commenced a three month public consultation on the revised document, which can be found at http://www.public-audit-forum.org.uk/publications/, and which closes on 23 September.

FRC statement following the referendum vote to leave the EU

24 June 2016

'Stakeholders have asked about the implications of the referendum result for our regulatory work. Our regulatory framework is unchanged and we will continue to apply it. The FRC will also continue to play its part in representing the interests of the UK internationally. We will pay close attention to the decisions now taken by the Government and Parliament, and continue to work in collaboration with our key stakeholders, particularly investors, business and the professionals we regulate, in order to ensure our work continues to support economic growth.'

FRC issues Key Facts and Trends report on UK accountancy profession

29 June 2016

The Financial Reporting Council (FRC) has today issued the fourteenth edition of *Key Facts and Trends in the Accountancy Profession*.

Membership of the UK professional accountancy bodies in the UK has increased in the UK and around the world, but student numbers have declined in the UK and Ireland for the past two years. The report brings together data on accountancy bodies' membership and their business over the past four years.

Key facts and trends from the report include:

- Combined membership of the seven accountancy bodies continues to grow steadily with 342,000 members in the UK and Ireland (up 2.4% in four years) and 497,000 members worldwide (up 3.2% in the last four years).

- Student numbers in the UK and Ireland have fallen slightly (1.1%) with a worldwide increase of 3.1% between 2011 and 2015.
- The number of registered audit firms continue to decline gradually with a fall of 304 firms (4.6%) since December 2014.
- In comparison to 2014, the largest four firms experienced increases in growth across all categories of fee income, in contrast to other firms who audit public interest entities. However, all saw an increase in audit fees. Audit fees remained a steady proportion of all fees.
- More listed companies outside of the FTSE 350 are being audited by the Big Four in 2015 than in previous years.

Melanie McLaren, Executive Director, Audit at the FRC, said:

'The FRC provides independent oversight of the UK accountancy bodies and is the UK competent authority for audit, working closely with the relevant bodies in supervision of their members to promote high quality audit. Today's report provides evidence on the size and nature of the profession which continues to grow in the UK and internationally.'

Smaller quoted companies should continue to report under IFRS for consistency and comparability agree respondents

30 June 2016

In *Update on the discussion paper: Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies,* the Financial Reporting Council (FRC) summarises the feedback to its report on the quality of reporting by smaller quoted companies and sets outs progress against its proposals.

Respondents:

- urged the FRC to avoid imposing additional regulatory burdens on small quoted companies;
- agreed that International Financial Reporting Standards (IFRS) should continue to be used by small and large quoted companies alike;
- welcomed the proposal to issue annual reminder letters aimed at smaller quoted companies highlighting key areas of focus for investors;
- encouraged the development of practical guidance for audit committees on evaluating the adequacy of the finance function and process; and
- strongly supported the proposal to explore ways to provide more focussed and practical support for preparers through training and CPD regimes.

The update follows the publication by the FRC last year of a discussion paper on improving the quality of reporting by smaller listed and AIM quoted companies.

In that paper, the FRC reported that smaller quoted companies believe investors pay little attention to their annual reports and hence do not prioritise their preparation. However, investors say annual reports do matter to them, particularly because there are fewer analysts' reports in that segment of the market.

Paul George, FRC's Executive Director for Corporate Governance and Reporting, said:

'Overall feedback from respondents was generally supportive of the measures we proposed in our discussion paper. Good progress has been made on implementation and we will continue to focus on the issues raised in the discussion paper to play our part in ensuring high quality company reporting is achieved by smaller quoted companies.