

AUDITOR REPORTING ON STRATEGIC REPORTS –CASE STUDY

(Lecture A618 – 17.30 minutes)

For periods commencing 1 January 2016, SI 2015/980 has extended auditors responsibilities to report on the directors' report and the strategic report.

Where companies early adopted the new accounting regime (for periods commencing 1 January 2015), auditors were also expected to adopt the new auditor reporting requirements. Early adoption was usually done to take advantage of the new increased small company thresholds or to adapt the financial statements for a medium-sized or large company.

1.1 *Reporting*

The new requirements in the auditor's report relate to reporting on whether the strategic report and the directors' report have been prepared in accordance with applicable legal requirements and whether they contain and material misstatements.

For a company that is required to produce a strategic report, the new wording in the auditor's report is as follows:

Opinions on other matters 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 been prepared in accordance with applicable legal requirements.

Matters on which we are required to report by exception

In the 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 or the directors' report.

1.2 *So what?*

The big issue is that the responsibility to report that the ***strategic report is prepared in accordance with applicable legal requirements*** is not just a new element in the report, it is also a new responsibility.

It is an onerous responsibility, too. Many strategic reports are half-hearted at best and some are worse than that.

The core issue is: 'what is compliant and what is not?'

1.3 *The applicable legal requirements – s414c*

The Companies Act 2006 contains the following requirements for the content of the strategic report:

414C Contents of strategic report

- (1) The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).
- (2) The strategic report must contain—
 - (a) a fair review of the company's business, and
 - (b) a description of the principal risks and uncertainties facing the company.
- (3) The review required is a balanced and comprehensive analysis of—
 - (a) the development and performance of the company's business during the financial year, and
 - (b) the position of the company's business at the end of that year, consistent with the size and complexity of the business.
- (4) The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—
 - (a) analysis using financial key performance indicators, and
 - (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.
- (5) In subsection (4), "key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.
- (6) Where a company qualifies as medium-sized in relation to a financial year (see sections 465 to 467), the review for the year need not comply with the requirements of subsection (4) so far as they relate to non-financial information.
- (7) In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—
 - (a) the main trends and factors likely to affect the future development, performance and position of the company's business, and
 - (b) information about—
 - (i) environmental matters (including the impact of the company's business on the environment),
 - (ii) the company's employees, and
 - (iii) social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies.

If the report does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii), it must state which of those kinds of information it does not contain.

- (8) In the case of a quoted company the strategic report must include—
 - (a) a description of the company's strategy,
 - (b) a description of the company's business model,
 - (c) a breakdown showing at the end of the financial year—
 - (i) the number of persons of each sex who were directors of the company;
 - (ii) the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph (i)); and
 - (iii) the number of persons of each sex who were employees of the company.
- (9) In subsection (8), "senior manager" means a person who—
 - (a) has responsibility for planning, directing or controlling the activities of the company, or a strategically significant part of the company, and
 - (b) is an employee of the company.
- (10) In relation to a group strategic report—
 - (a) the reference to the company in subsection (8)(c)(i) is to the parent company; and
 - (b) the breakdown required by subsection (8)(c)(ii) must include the number of persons of each sex who were the directors of the undertakings included in the consolidation.
- (11) The strategic report may also contain such of the matters otherwise required by regulations made under section 416(4) to be disclosed in the directors' report as the directors consider are of strategic importance to the company.
- (12) The report must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.
- (13) Subject to paragraph (10), in relation to a group strategic report this section has effect as if the references to the company were references to the undertakings included in the consolidation.
- (14) Nothing in this section requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

1.4 *The applicable legal requirements – in practice for unquoted companies*

In reality there are five major elements to an unquoted company's strategic report. The questions that an auditor needs to ask are:

- Q1 Does the strategic report contain a fair review of the company's business? S414C2(a)
- Q2 Does the strategic report contain a description of the principal risks and uncertainties facing the company? S414C2(b)

- Q3 Does the review give a balanced and comprehensive analysis of the development and performance of the company's business during the financial year consistent with the size and complexity of the business? S414C3(a)
- Q4 Does the review give a balanced and comprehensive analysis of the position of the company's business at the end of that year, consistent with the size and complexity of the business? S414C3(b)
- Q5 Does the review, to the extent necessary for an understanding of the development, performance or position of the company's business, include analysis using key performance indicators? S414C4(a)

1.5 Case study

The following strategic report example is for a large company with a turnover of £50m.

Without the context of having done the audit or access to the full financial statements this will not be easy, but do you think that it has been prepared in compliance with s414c? When you ask the above five questions, is it good enough?

Example strategic report

Farmers Diversified Limited

The directors have pleasure in presenting their strategic report for the year ended 31 December 2017.

Principle activities

The company began as a mixed arable and dairy farm and this activity continues alongside the retail of organic and local foodstuffs and events management, namely the *Organicfest* music festival.

Fair review of the business

In general, the company has made good progress in the year but not all activities have performed equally well. Revenue and profits are growing and the directors expect this growth to continue in 2018. Central overheads have grown significantly in the period, up 15% because of the additional marketing and management resources needed to grow the

Organicfest and retail businesses.

Organicfest music festival

The festival goes from strength to strength. In 2017, attendance was up to 23,450, from 21,800, in the previous year. Income was £15.4m, up £2.6m from the previous year. Glamping and the Airstream parks have been very successful additions to the festival's offerings. Operating costs have increased proportionally and profitability has still increased.

Bookings for 2018, at the year end are better than 2017 at that point in time.

Retail

Retail sales have grown in the period by 12%, year on year. Most of this growth is from online sales. Margins have also grown in the period and retail is now making a very substantial contribution to the company's profitability.

The company is investing in targeted advertising and the directors expect this rate of growth to continue.

Farming

Revenue from farming continues to fall. Whilst milk and grain volumes have increased in the year, market prices remain depressed, particularly for milk. The dairy produce sold direct to the customer by the company continues to be profitable but sales to supermarkets have very tight margins.

Position at the end of the year

The company has a good cash position at the year-end because of the strong retail and festival cash flows.

The current assets ratio is 1.2, which is equivalent to last year.

The cash flow demands created by farming continue to have less effect on the company's trading position, year on year, as this element of the business reduces in size and more dairy goods are sold direct to the customer.

Bank borrowing continues to reduce as there have been no new capital projects in the year that required funding.

Principal risks and uncertainties

Organicfest – this presents the largest risks faced by the company. Low ticket sales or operational risks during the festival (such as security, flooding and power outages) are the biggest issues. The directors manage these risks by contracting with all suppliers and music acts in a way that the festival could be scaled back should ticket sales be below budget. Operational problems are mitigated against through meticulous contingency planning and built-in redundancy strategies. Where economically viable, risks are addressed with insurance.

Farming and retail risks – these risks centre around volatility in market prices. Margins are regularly monitored and the directors make decisions about which foodstuffs to sell or produce to ensure that margins are maintained at a sustainable level in the long term.

Interest rate risk – interest on the company's bank borrowing is all at a fixed rate.

On Behalf of the board
M Burnham - Director

1.6 Your solution

	Issue	Answer
Q1	Does the strategic report contain a <u>fair review of the company's business</u> ?	
Q2	Does the strategic report contain a <u>description of the principal risks and uncertainties</u> facing the company?	
Q3	Does the review give a balanced and comprehensive analysis of the <u>development and performance</u> of the company's business during the financial year <u>consistent with the size and complexity of the business</u> ?	
Q4	Does the review give a balanced and comprehensive analysis of the <u>position of the company's business at the end of that year, consistent with the size and complexity of the business</u> ?	
Q5	Does the review, <u>to the extent necessary</u> for an understanding of the development, performance or position of the company's business, include <u>analysis using key performance indicators</u> ?	