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## 1. THE FRC'S TRIENNIAL REVIEW

On 14 December 2017, the Financial Reporting Council (FRC) issued the final amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* Triennial Review 2017 Incremental improvements and clarifications.

With the exception of the amendments to FRS 105 in respect of disclosures, all the other amendments must be mandatorily applied for accounting periods starting on or after 1 January 2019. Early adoption is permissible, provided that all the amendments are also early adopted. The only two amendments that can be early adopted separately are the directors' loans concession (see 1.4 below) and the gift aid accounting clarification (see 1.10 below).

The disclosure requirements of FRS 105 (see 1.16 below) must be applied for accounting periods starting on or after 1 January 2017. They are legally required disclosures that should have been applied for periods starting on or after 1 January 2016, but as 2016 year-ends have now been and gone, the FRC have introduced the effective from date for periods starting on or after 1 January 2017.

The amendments are not to be viewed as 'wholesale' changes but, as the title suggests, are incremental improvements to the standard which should prove beneficial to reporting entities. The FRC have also included clarifications in certain areas, such as the inclusion of a description of a basic financial instrument (see 1.3 below) and the accounting for gift aid (see 1.10 below). As a result, UK GAAP should be easier to work with and reflects most of the implementation feedback from users since it was first introduced for periods starting on or after 1 January 2015.

When FRS 102 was first issued in March 2013, the FRC indicated that they would review the standard every three years. This is consistent with the International Accounting Standards Board's (IASB) *IFRS for SMEs*. However, paragraph 18 of the Basis for Conclusions confirms that periodic reviews of FRS 102 are likely to take place every four to five years to allow time for experience of the most recent edition of FRS 102 to develop before seeking stakeholder feedback.

That said, it is important to emphasise that should an emerging issue prove to be of an urgent nature, the FRC may deal with it as an ad-hoc amendment to FRS 102 (or other FRS as applicable). Clearly, the FRC want as few divergent practices as possible and hence it may be necessary to deal with isolated issues through separate consultations. However, the FRC have suggested that future comprehensive reviews of UK GAAP may be carried out on a four- or five-year cycle.

Many commentators suggest that FRS 102 is aligned to IFRS or *IFRS for SMEs*. This is not strictly correct. While FRS 102 is based on the *IFRS for SMEs* issued in March 2009, the FRC has modified the *IFRS for SMEs* substantially both in terms of scope and accounting treatments provided. For example, Section 29 *Income Tax* in FRS 102 is notably different than Section 29 in *IFRS for SMEs*. In addition, the FRC have to develop accounting standards in accordance with five principles which ensure the financial reporting standards:

*FRS 102 Summary  
paragraph (iii)*

- a) have consistency with international accounting standards through application of an IFRS-based solution, unless an alternative clearly better meets the overriding objective;
- b) reflect up-to-date thinking and developments in the way entities operate and the transactions they undertake;
- c) balance consistent principles for accounting by all UK and Republic of Ireland entities with practical solutions, based on size, complexity, public interest and users' information needs;
- d) promote efficiency within groups; and
- e) are cost-effective to apply.

The IASB may introduce new standards, make amendments to existing standards or withdraw a standard. It is not strictly the case that the FRC will follow suit. In some cases, existing accounting treatments may achieve a better outcome for the UK and Republic of Ireland, or UK GAAP may already be at the stage where the IASB is seeking to be hence the FRC may choose not to follow the same course of action which the IASB has when it comes to introducing, amending or withdrawing accounting standards.

This is evidenced by the removal of the undue cost or effort exemptions in the FRC's triennial review (see 1.1 below). The FRC removed the undue cost or effort exemptions when comprehensively reviewing FRS 102, whereas when the IASB undertook their comprehensive review of *IFRS for SMEs* in 2015, they included more undue cost or effort exemptions.

The majority of the amendments to FRS 102 are editorial in nature. However, there are some amendments which have a direct impact on the financial statements themselves, which are discussed below.

### 1.1 **Undue cost or effort exemptions**

The FRC have taken the decision to remove the undue cost or effort exemptions in FRS 102 on the grounds that these were not being applied correctly. It became apparent to the FRC that the undue cost or effort exemptions were being applied as accounting policy options, which was never the intention.

The Glossary to FRS 102 does not define 'undue cost or effort' and hence there have been interpretational issues faced by entities leading to the confusion. Paragraph 2.14B of the *IFRS for SMEs* states that:

*'Applying a requirement would involve undue cost or effort by an SME if the incremental costs (for example, valuers' fees) or additional effort (for example endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information.'*

*IFRS for SMEs  
paragraph 2.14B*

While the undue cost or effort exemptions have been removed because they were being applied as accounting policy choices, in some cases they have been replaced by accounting policy options. For example, where properties are rented out to group members (see 1.2 below).

The removal of the undue cost or effort exemptions will have an impact on some reporting entities; particularly those that have investment properties which they have not fair valued at each reporting date as they have previously exercised the undue cost or effort exemptions. Unless the property is rented out within a group, all investment property must be measured at fair value at each balance sheet date, with changes in fair value going through the profit and loss account. Also don't forget to bring deferred tax into account!

Areas of FRS 102 where undue cost or effort exemptions have been removed are:

- Section 14 *Investments in Associates* – paragraph 14.10
- Section 15 *Investments in Joint Ventures* – paragraph 15.15
- Section 16 *Investment Property* – paragraphs 16.1, 16.3, 16.4 and 16.10
- Section 17 *Property, Plant and Equipment* – paragraph 17.1(a)

It is important that practitioners carefully check that where they have previously exercised an undue cost or effort exemption, that they review the revised edition of FRS 102 when they are applying the amended version to ensure they do not continue applying an exemption that is no longer in the standard.

### **1.2 *Investment properties within a group***

As noted in 1.1 above, the removal of the undue cost or effort exemptions means that all investment properties, which are not occupied in a group context, will have to be measured at fair value at each balance sheet date with fair value fluctuations being taken through the profit and loss account. This is the treatment required by Section 16.

In order to address implementation issues, the FRC have introduced an accounting policy choice in situations where a group rents property out to other group members. This will prove to be extremely useful for groups because under the September 2015 edition of FRS 102, there was no scope exemption from groups measuring investment property at fair value as there was in previous SSAP 19 *Accounting for investment properties*.

Under the September 2015 edition of FRS 102, a group that owned a property which was let out to another group member, would have had to reclassify that property as investment property in its individual financial statements, replace the depreciation charge with a fair value gain or loss and bring deferred tax into account. This would all then be reversed out by way of consolidation adjustments in the group accounts as the property would be treated as property, plant and equipment (i.e. an owned property) as group accounts must reflect the economic substance of the group, which is that of a single reporting entity. Therefore, all intra-group transactions are eliminated.

Clearly, this caused quite a lot of additional work, with some groups even refusing to account for such properties in accordance with FRS 102, claiming undue cost or effort would be incurred by having to account for the property under Section 16 in the individual financial statements of the group member owning the property and then under Section 17 in the consolidated financial statements.

To address this issue, the FRC have included paragraphs 16.4A and 16.4B in FRS 102 which relate to group entities. Paragraph 16.4A states:

*'An entity that rents investment property to another group entity shall account for those properties either:*

FRS 102 paragraph 16.4A

- (a) at fair value with changes in fair value recognised in **profit or loss** in accordance with this section (the Appendix to Section 2 provides guidance on determining fair value); or*
- (b) by transferring them to property, plant and equipment and applying the cost model in accordance with Section 17.*

*An entity choosing to apply (b) above shall provide all the disclosures required by Section 17, other than those related to fair value measurement.'*

Paragraph 16.4B states:

*'When only part of a property is rented out to another group entity and the remainder is used for other purposes (such as being rented to an external third party or owner-occupied), paragraph 16.4A only applies to the component of that property that is rented out to another group entity.'*

FRS 102 paragraph 16.4B

It is likely that most investment property in a group context will be measured under paragraph 16.4A(b) as this effectively restores the position in previous SSAP 19 (i.e. measuring the property at cost, less depreciation and impairment).

It is to be emphasised that the above accounting policy option only relates to **investment property rented to another group entity**. This option does not apply to non-group investment property which must be measured at fair value through profit or loss at each balance sheet date (even for small companies). Micro-entities applying FRS 105 can only measure investment property at cost less depreciation (with the exception of the land on which the property stands) less impairment.

### 1.3 **Financial instruments**

It is fair to say that the wording in Section 11 *Basic Financial Instruments* is far from basic. Financial instruments are possibly the most complex area of UK GAAP and Section 11 has seen some significant amendments to it through the triennial review. Prior to the triennial review, a financial instrument had to meet the detailed conditions outlined in paragraph 11.9 if the instrument were to be classed as basic. There are examples at the foot of paragraph 11.9 to aid application of the conditions and the FRC have included additional examples as part of the triennial review to further aid an understanding.

In addition, the FRC have included a description of a basic financial instrument. Even if the financial instrument does not meet the conditions for classification as basic in paragraph 11.9, but meets the description, then it can still be classed as basic and accounted for under Section 11. This will mean that for a relatively small number of financial instruments, they can be treated as basic rather than non-basic and use the amortised cost method which will provide relevant information for the users.



The description of a basic financial instrument according to paragraph 11.9A is as follows:

*'A debt instrument not meeting the conditions in paragraph 11.9 shall, nevertheless, be considered a basic financial instrument if it gives rise to cash flows on specified dates that constitute repayment of the principal advanced, together with reasonable compensation for the time value of money, credit risk and other basic lending risks and costs (eg liquidity risk, administrative costs associated with holding the instrument and lender's profit margin). Contractual terms that introduce exposure to unrelated risks or volatility (eg changes in equity prices or commodity prices) are inconsistent with this.'*

FRS 102  
paragraph  
11.9A

### **Accounting policy choice to apply IAS 39 Financial Instruments**

FRS 102 has been amended to retain the option in Section 11 and Section 12 *Other Financial Instruments Issues* to apply the recognition and measurement requirements of IAS 39 *Financial Instruments*. The option is available until the impairment requirements in FRS 102 (Section 27 *Impairment of Assets*) are amended to reflect IFRS 9 *Financial Instruments*, or the FRC decide not to amend FRS 102 any further in respect of IFRS 9. The IAS 39 EU-carve out option also continues to be available.

In addition, paragraph 11.42 also requires an entity to disclose information which enables the users to evaluate the significance of financial instruments on the entity's financial position and performance. Therefore, an entity which has taken the accounting policy choice to apply the recognition and measurement requirements of IAS 39 or IFRS 9 may need to consider additional disclosures based on IFRS 7 *Financial Instruments: Disclosure*.

When the IASB finalised IFRS 9, amendments were also made to IFRS 7 to reflect the new requirements in IFRS 9. Financial assets must be tested for impairment using an expected credit loss model (rather than an incurred credit loss model) and therefore the disclosure requirements of IFRS 7 were changed to reflect the recognition of expected credit losses. This means that some of the disclosures in FRS 102 are inconsistent with the application of the recognition and measurement requirements of IFRS 9 and hence a number of changes have been made to the disclosure requirements so as to ensure that when an entity applies the recognition and measurement principles of IFRS 9, they are providing relevant information concerning the impairment of financial assets.

### **Investments in shares**

There was an anomaly in FRS 102 prior to the amendments. The September 2015 edition of FRS 102 requires investments in non-convertible preference shares and non-puttable ordinary shares or preference shares to be measured at fair value, unless fair value cannot be measured reliably. Certain preference shares which are liabilities of the issuer (and measured at amortised cost) are treated differently by the holder.

Reference to such investments in shares in FRS 102 has been amended to non-derivative instruments which are equity of the issuer. This improves the accounting for those instruments which are liabilities of the issuer as they are

measured at amortised cost if the instrument is accounted for under Section 11 (i.e. it is basic).

### ***Loans with two-way compensation clauses***

The FRC issued commentary in June 2016 concerning the accounting for social housing loans; notably the classification of loans with two-way compensation clauses. Respondents did not agree that the inclusion of a description of a basic financial instrument (which has been included in paragraph 11.9A) sufficiently addressed the issue. To alleviate concerns in this respect, paragraph 11.9(c) has been amended which confirms that compensation could be paid by either the holder (the lender) or the issuer (the borrower).

### ***Macro hedging***

Fair value hedge accounting for a portfolio of financial instruments was not included in FRS 102 and therefore entities wishing to apply macro hedging applied the provisions in paragraph 11.2 (and 12.2) and used the recognition and measurement provisions in IAS 39/IFRS 9.

FRS 102 has been amended to cross-refer to the IAS 39 requirements for macro hedging.

## **1.4 Directors' loans**

Prior to the finalisation of the amendments to FRS 102 from the triennial review, on 8 May 2017 the FRC took an unprecedented step and announced a change to UK GAAP which was to come in with immediate effect for small companies that had received a loan from a director-shareholder, or a close family member of the director-shareholder.

The way that an off-rate market loan is accounted for under FRS 102 has not been without controversy. Many practitioners have expressed their disapproval of having to discount off-rate loans using a market rate of interest. There are 'workarounds' where discounting is concerned; for example, if there are no terms in place, FRS 102 would regard the loan as being repayable on demand and hence will be measured as a current asset or current liability at the undiscounted amount of cash payable. In practice, most off-rate loans are unstructured (e.g. directors' loans and intra-group loans) and therefore discounting may be avoidable.

The FRC recognised that using the amortised cost method (and effective interest rate method) in Section 11 for loans which are provided by a director-shareholder, or close family member of that director-shareholder does prove arduous, with costs outweighing benefits. The FRC's Press Release on 8 May 2017 confirmed that loans to a small company from a director-shareholder or close family member of that director-shareholder can be measured at transaction price rather than at present value. The FRC took this unprecedented step on the grounds that they were not expecting any pushback from commentators disapproving of the need *not* to discount the loan!

The triennial review extends this concession slightly to small groups of the director's family. Paragraph 11.13A states:

*FRS 102 paragraph 11.13A*



*‘As an exception to paragraph 11.13, the following financing transactions may be measured initially at transaction price:*

- (a) *a basic financial liability of a **small entity** that is a loan from a person who is within a director’s group of close family members* <sup>[\*footnote 1]</sup>, *when that group contains at least one shareholder* <sup>[\*footnote 2]</sup> *in the entity; and*
- (b) *a public benefit entity concessionary loan (see paragraph PBE11.1A).* <sup>[\*footnote 1]</sup> *In this context, a director’s group of close family members shall be the director and the close members of the family of that director (see glossary definition of **close members of the family of a person**). This includes a person who is the sole director-shareholder of an entity.* <sup>[\*footnote 2]</sup> *For small LLPs this shall be read as a member who is a person.’*

The definition of ‘close members of the family of a person’ per the Glossary to FRS 102 is as follows:

*‘Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:*

- (a) *that person’s children and spouse or domestic partner;*
- (b) *children of that person’s spouse or domestic partner; and*
- (c) *dependants of that person or that person’s spouse or domestic partner.’*

*FRS 102 Glossary  
close members of  
the family of a  
person*

Therefore, loans to small entities from a director who is not a shareholder, and has no close family members that are shareholders, will not qualify for the exemption. Loans to small entities from a directors’ group of close family members (including the director) will qualify when that group also includes a shareholder in the small entity.

The relief is also available to small LLPs.

It is important to emphasise that the relief does not apply to loans to a director from a company, nor does it apply to intra-group loans. If there are no workarounds to discounting the loan (e.g. if the loan is unstructured or if it is not a 53-week loan), the loan must be discounted to present value using a market rate of interest.

The concession is available for small companies from December 2016 year-ends onwards. The FRC brought forward the relief for small companies to allow those small companies with a December 2016 year-end the opportunity of taking advantage of it. Had they not brought it forward, a small company with a December 2016 year-end would have had to discount such loans, only to then reverse the effects of discounting in the December 2017 year-end; but a small company with a March 2017 year-end would have been able to take the option if they used the full nine-months’ filing grace from Companies House. This was due to the timing of the finalisation of the amendments to FRS 102 (December 2017).

It should be noted that where a director-shareholder, or close family member of that director-shareholder, provides a loan to the small entity at below market rates of interest or at zero rates of interest, the loan will be caught by the related party disclosure requirements in paragraph 1AC.35 of Section 1A *Small Entities*;

hence the loan must be disclosed as a related party transaction as it has not been concluded under normal market conditions.

## 1.5 *Intangible assets*

The definition of an intangible asset in FRS 102 is different than under previous UK GAAP and gave rise to the need to recognise additional intangible assets that were acquired in a business combination (i.e. where a parent acquires a subsidiary). This has increased costs of compliance in some instances, which the FRC have recognised goes against the principles of standard-setting.

The FRC decided to amend Section 18 *Intangible Assets other than Goodwill* so as to provide entities with an accounting policy choice of either separately recognising intangible assets acquired in a business combination or including them within goodwill. If the entity chooses to separately recognise intangible assets, they must apply this policy to all intangible assets in the same class and on a consistent basis.

Paragraph 18.8 of FRS 102 has been heavily amended and the amended paragraph 18.8 states:

*'Intangible assets acquired in a **business combination** shall be recognised separately from goodwill when all the following three conditions are satisfied:*

FRS 102 paragraph  
18.8

- (a) *the recognition criteria set out in paragraph 18.4 are met;*
- (b) *the intangible asset arises from contractual or other legal rights; and*
- (c) *the intangible asset is separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or **liability**).*

*An entity may additionally choose to recognise intangible assets separately from goodwill for which condition (a) and only one of (b) or (c) above is met. When an entity chooses to recognise such additional intangible assets, this policy shall be applied to all intangible assets in the same class (ie having a similar nature, function or use in the business), and must be applied consistently to all business combinations. Licences are an example of a category of intangible asset that may be treated as a separate class, however, further subdivision may be appropriate, for example, where different types of licences have different functions within the business.'*

## 1.6 *Financial institutions*

The definition of a financial institution in the Glossary to FRS 102 has been amended to remove references to '... generate wealth or manage risk through financial instruments.' The removal of this phrase means there should be less uncertainty about how the definition should be applied and hence fewer entities will fall under the definition of a financial institution.

The Glossary provides a list of institutions that fall under the definition of a financial institution. The FRC have also removed 'retirement benefit plans' from the list, which will be a welcome change as they are not similar to the rest of the entities within the Glossary's definition. In addition, retirement benefit plans are

also subject to their own disclosure requirements in Section 34 *Specialised Activities*.

## **1.7 Key management personnel compensation**

The requirement to disclose key management personnel compensation in total is in paragraph 33.7 of FRS 102. Paragraph 33.7A has been inserted by the FRC which states that when an entity is required to disclose directors' remuneration (or equivalent) under law or regulation, it is exempt from the requirement of paragraph 33.7 provided that key management personnel and the directors are the same.

Care needs to be taken where this is concerned, because the definition of 'key management personnel' is quite broad and includes all individuals who have authority and responsibility for planning, directing and controlling the entity, whether directly or indirectly. The definition includes directors (whether executive or otherwise) and so it may not necessarily be the case that key management personnel and the directors are the same body of individuals; although in a smaller entity, this could well be the case.

## **1.8 Net debt reconciliation**

For those entities which are required to prepare a cash flow statement, the net debt reconciliation is brought back into FRS 102. This has been done on the grounds that the FRC consider the reconciliation provides useful information to users. As preparers will already be familiar with the net debt reconciliation, the costs of compliance will be negligible and software providers will usually include this reconciliation within their accounts production software systems in any event.

## **1.9 Small entities**

Section 1A *Small Entities* in FRS 102 has been extensively amended as part of the triennial review due to small entities in the Republic of Ireland being brought within the scope of Section 1A due to the enactment of the Companies (Accounting) Act 2017. The small companies' regime for entities in the Republic of Ireland is available for periods starting on or after 1 January 2017. However, entities in the Republic of Ireland can early adopt the requirements as far back as periods beginning on or after 1 January 2015 provided that the financial statements have not yet been approved.

Section 1A sets out the presentation and disclosure requirements which a small company is required to follow in the preparation of their financial statements. Recognition and measurement is still based on full FRS 102.

The disclosure requirements for small entities in the UK are set out in Appendix C of Section 1A *Disclosure requirements for small entities in the UK* (as was the case in the September 2015 edition of FRS 102). The disclosure requirements which a small entity in the Republic of Ireland is legally required to make are contained in Appendix D *Disclosure requirements for small entities in the Republic of Ireland*. The five encouraged disclosures that were contained in Appendix D in the September 2015 edition of FRS 102 have been moved into Appendix E *Additional disclosures encouraged for small entities*. An additional paragraph has been inserted into Appendix E encouraging small entities in the Republic of Ireland to provide the disclosures in paragraphs 1AE.1(b), (c) and (e). These relate to the fact that an entity is a public benefit entity (if applicable),

going concern disclosures and transitional disclosures on first-time adoption of FRS 102.

### 1.10 *Gift aid*

The FRC issued a separate FRED (FRED 68 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* Payments by subsidiaries to their charitable parents that qualify for gift aid).

While FRED 68 was separately issued, it was part of the triennial review.

There have been divergent practices emerging where gift aid payments are concerned which were brought to the FRC's attention. For accounting purposes, gift aid payments are a distribution, but for tax purposes they are a donation. A legal opinion obtained by the ICAEW confirmed that gift aid payments are a distribution and hence should be treated in much the same way as a dividend. There is an ICAEW technical release (TECH 16/14BL REVISED *Guidance on donations by a company to its parent charity*).

The problem that gift aid payments presented was whether they should be accrued at the balance sheet date where no Deed of Covenant was in place. Where a Deed of Covenant was in place, the treatment was less complex because the Deed of Covenant satisfies the recognition of a gift aid payment as a liability where payment is made by the subsidiary to the charitable parent after the year-end.

Paragraph 85 of the Basis for Conclusions of FRS 102 confirms that gift aid payments are to be recognised as a distribution to owners as they are similar to dividends (i.e. they are recognised within equity). Paragraph 85 also cross-refers to paragraph 32.8 of FRS 102 which specifically deals with dividends and states that where an entity declares a dividend **after** the balance sheet date, that dividend is not to be recognised as a liability. The same principles must be applied to gift aid payments and an expected gift aid payment must not be accrued unless a legal obligation to make the payment exists at the balance sheet date. Paragraph 85 of the Basis for Conclusions confirms that a board decision to make a gift aid payment to a charitable parent, which has been taken prior to the reporting date, is not sufficient to create a legal obligation.

More than half of the respondents to FRED 68 stated that, in their opinion, a liability should be recognised for an expected gift aid payment if, for example, there is a past practice of making such payments. The FRC concluded that this is inconsistent with the requirements of FRS 102 (i.e. paragraph 32.8 and dividends) and they did not agree that this reflects the substance of the transaction which is that of a distribution to owners and hence no amendment was made to FRS 102 in this respect.

As noted above, gift aid payments are distributions for accounting purposes and donations for tax purposes. When a subsidiary does not have a legal obligation to make a distribution of its profits to its owners at the balance sheet date, it will have taxable profits and hence will need to recognise a tax expense. This is because paragraph 29.14 of FRS 102 prohibits the tax effects of dividends being recognised before the dividend itself has been recognised.

The amendments to FRS 102 state that when it is **probable** (i.e. more likely than not) that a gift aid payment will be made within nine months of the reporting date

to the same charitable group, or charitable venturer, and the payment will qualify to be set against profits for corporation tax purposes, the gift aid payment can be accrued.

The gift aid payment is recognised as a distribution to owners and the tax effects are recognised in profit and loss.

### **1.11 Fair value guidance**

The fair value guidance which was included in paragraphs 11.27 to 11.32 of FRS 102 has now been moved into the new Appendix in Section 2 *Concepts and Pervasive Principles*. This was done on the grounds that the FRC acknowledged that the fair value guidance is applied generally, rather than confined to financial instruments and illustrate a measurement basis described in Section 2. Hence, it was sensible to remove the guidance from Section 11 *Basic Financial Instruments* and include it within Section 2.

### **1.12 Analysis of expenses**

Paragraph 5.11 of FRS 102 required an entity to present an analysis of expenses using a classification based on either the nature or function of the expenses within the entity. This paragraph has been removed as it effectively duplicated the requirements in paragraph 5.5 as the profit and loss account formats in the Regulations include requirements for the classification of expenditure.

### **1.13 Debt for equity swaps**

Paragraph 22.8A has been inserted to address concerns by stakeholders that FRS 102 was silent on the accounting for debt for equity swaps because, in some cases, such transactions can be significant. Paragraph 22.8A states that no gain or loss is recognised in profit or loss as a result of a debt for equity swap if:

- the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder;
- the creditor and the entity are controlled by the same party/parties both before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity; or
- the extinguishment is in accordance with the original terms of the financial liability.

### **1.14 Business combinations**

When a parent entity acquires a subsidiary, it is required to use the purchase method to account for the acquisition. The purchase method uses fair values to account for the assets acquired, liabilities and contingent liabilities assumed.

The purchase method outlined in paragraph 19.7 of FRS 102 has been amended to include more steps as a means of clarifying exactly what must happen for the purchase method to be applied correctly. In practice, the amendments are not expected to have any significant effects, but the amendments also mean that paragraph 19.7 is now consistent with the steps in IFRS 3 *Business Combinations*.



The definition of a group reconstruction has also been amended to incorporate, in certain circumstances, the transfer of a business in addition to the transfer of equity holdings.

### **1.15 Comparatives for disclosures only required by a SORP**

The FRC have confirmed that when a disclosure is not required by FRS 102, but is required by a SORP, comparatives should be provided.

### **1.16 Effects on other standards in the suite of UK GAAP**

All other FRSs in UK GAAP have seen some amendments arising as a result of the triennial review. Some of the more notable amendments are discussed below:

#### **FRS 100 Application of Financial Reporting Requirements**

The abbreviations and definitions that were contained in paragraph 3 have been deleted.

In addition, paragraph 10A has been inserted into FRS 100 which confirms that the amendments arising from the triennial review are to be applied for accounting periods starting on or after 1 January 2019. Early adoption is permissible provided that all the amendments are early adopted at the same time.

#### **FRS 101 Reduced Disclosure Framework**

FRS 101 reflects the changes made to the definition of a financial institution. In addition, Appendix II: *Note on legal requirements* has been amended at paragraph A2.10A to make it clear that a qualifying entity which has a disposal group may need to make additional disclosures either on the face of the balance sheet or within the notes to the financial statements.

Where the items are material, paragraph A2.10A requires this to be done on the face of the balance sheet.

#### **FRS 103 Insurance Contracts and FRS 104 Interim Financial Reporting**

There are few changes made to FRS 103 and FRS 104. The changes made mainly relate to the wording of those standards and confirmation of the effective date of the amendments.

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

It was expected that FRS 105 would see significant amendments as it is based on the provisions in FRS 102. The most notable change in FRS 105 is the inclusion of micro-entities in the Republic of Ireland which have been brought within the scope of the micro-entities' regime by virtue of the Companies (Accounting) Act 2017.

Micro-entities in the Republic of Ireland (RoI) are now able to apply FRS 105 for periods starting on or after 1 January 2017. Early adoption of FRS 105 is permissible provided the Companies (Accounting) Act 2017 is applied from the same date.





For UK micro-entities, there are two additional disclosure requirements which must be made at the foot of the balance sheet as follows:

- a) information about off-balance sheet arrangements as required by section 410A of the Act; and
- b) information about employee numbers as required by section 411 of the Act.

These disclosures apply for periods starting on or after 1 January 2017. They are a legal requirement and hence should have been included in financial statements for periods starting on or after 1 January 2016, but were omitted in the July 2015 edition of FRS 105.

Disclosures in respect of off-balance sheet arrangements and employee numbers were included as a result of amendments by *The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015* SI 2015/980. SI 2015/980 made amendments to sections 410A and 411 by removing the phrase '*In the case of a company that is not subject to the small companies regime*'. This meant that all companies must disclose off-balance sheet arrangements and employee numbers.

In addition, the disclosure information required by s396(A1) is required which requires the micro-entity's accounts to state:

- the part of the UK in which the company is registered;
- the company's registered number;
- whether the company is a public or a private entity and whether it is limited by shares or by guarantee;
- the address of the company's registered office; and
- where appropriate, the fact that the company is being wound up.

### **1.17 Areas not actioned from FRED 67**

There were some proposals for change announced in FRED 67 which have not, in fact, been actioned as part of the triennial review. These are as follows:

#### ***Consolidated financial statements***

FRED 67 proposed amendments to FRS 102 to update it for the control model in IFRS 10 *Consolidated Financial Statements*. The FRC felt that updating FRS 102 to reflect the control model in IFRS 10 would result in better financial reporting as it addresses concerns about the boundary of the reporting entity.

In practice, for many entities, there would be no effect on the financial statements as they would be required by law to prepare group accounts. In addition, feedback suggested that the cost of implementation of the control model in IFRS 10 would outweigh the benefits due to there being no actual effect for groups; the revised control model would merely have to go through an exercise to confirm there had been no change in the group structure.

FRS 102 has not been amended to reflect the control model in IFRS 10, but an additional disclosure regarding unconsolidated structured entities (e.g. special

purpose entities) has been introduced which has been derived from IFRS 12 *Disclosure of Interests in Other Entities*.

### **Leases**

The Consultation Document proposed to enhance the disclosure requirements in respect of leases in advance of any revised requirements based on the new IFRS 16 *Leases*. This was met with disapproval from respondents who suggested that it would be difficult for entities to provide more information concerning obligations arising from operating leases without first determining a detailed approach as to how FRS 102 will be updated for the effects of IFRS 16.

The FRC decided not to update FRS 102 in respect of lease disclosures.

### **Option to purchase own shares**

The FRC proposed to insert a new example in Section 22 *Liabilities and Equity* which related to a written option to purchase own equity instruments. Respondents raised concerns to the FRC that there may be unintended consequences and hence the example has not been included in Section 22. However, the FRC may review this issue again in the future.

### **Revenue**

FRED 67 proposed to amend Section 23 *Revenue* so as to provide greater clarity to the requirements for recognition of revenue from separately identifiable goods and services provided under a single transaction. This amendment was primarily proposed due so that Section 23 was slightly more aligned to that of IFRS 15 *Revenue from Contracts with Customers* which contains a five-step model for revenue recognition.

Concerns were raised that Section 23 was not causing any notable difficulties for preparers and that including principles from IFRS 15, when there was no implementation feedback, was too soon. Therefore, FRS 102 was not amended in this respect.

### **Share-based payment**

The Consultation Document requested feedback as to the cost-effectiveness of applying Section 26 *Share-based Payment* by private companies.

The FRC confirmed that responses were mixed. Some respondents suggested that as the requirements had been in place for 10 years, they were well-established. Others noted that small private entities have difficulty in obtaining reliable and meaningful fair values for share-based payment arrangements. Other suggested that a disclosure-only approach could be considered if the legislation were to be changed in the future (currently it is not possible to include additional legislation in company law under the EU Accounting Directive).

No wholesale changes have been made to Section 26 of FRS 102, although minor improvements to the wording have been made to align it more to IFRS 2 *Share-based Payment*. The FRC may revisit this area in the future if the legislation is changed such that additional disclosures could be mandated for small entities.

### ***Major changes to IFRS***

In 2017, the FRC stated that they may issue a further exposure draft announcing changes to UK GAAP to reflect major changes in IFRS, notably:

- IFRS 9 *Financial Instruments*;
- IFRS 15 *Revenue from Contracts with Customers*; and
- IFRS 16 *Leases*.

Further changes reflecting these IFRSs were potentially going to be effective for accounting periods starting on or after 1 January 2022.

Following feedback from commentators suggesting implementation feedback from IFRS reporters is necessary prior to considering any changes to FRS 102 as a result of these IFRSs, the FRC took the decision not to propose any changes to UK GAAP for the effects of IFRSs 9, 15 and 16. However, it should be noted that eventually there will be consultations on changing UK GAAP for the effects of these IFRSs (but not for the foreseeable future).

## 2. CHARITIES: THE INDEPENDENT EXAMINATION

On 4 September 2017, the Charity Commission issued updated guidance for independent examiners in the form of *Independent examination of charity accounts: Directions and guidance for examiners* (CC32). The guidance includes three new directions concerning conflicts of interest, related parties and the charity's financial circumstances as follows:

- Direction 2: Check for any conflict of interest that prevents the examiner from carrying out their independent examination.
- Direction 7: If the accounts are prepared on an accruals basis and one or more related party transactions took place the examiner must check if these were properly disclosed in the notes to the accounts.
- Direction 9: The examiner must check whether the trustees have considered the financial circumstances of the charity at the end of the reporting period and, if the accounts are prepared on an accruals basis, check whether the trustees have made an assessment of the charity's position as a going concern when approving the accounts.

### 2.1 *Guidance supporting the regulations*

The Charity Commission has also made amendments to the guidance supporting the regulations to include phrases such as 'must', 'should', 'recommended' or 'may'. The word 'must' means that something is a legal or regulatory requirement or duty which the independent examiner must comply with or follow when carrying out their examination. 'Should' means that guidance is best practice which the Charity Commission expects the independent examiner to consider when undertaking their examination. 'Recommended' and 'may' is used where the Charity Commission believe that the independent examiner will find useful when carrying out their work although the independent examiner will have to exercise their own judgement where a recommendation or practice is concerned.

The updated guidance and Directions must be followed by independent examiners when carrying out their independent examination of the charity's accounts. Where the independent examiner's report is dated on or after 1 December 2017, the new Directions and guidance must have been followed. The Charity Commission encouraged examiners to follow the new Directions and guidance straight away, rather than wait until the mandatory date of 1 December 2017, but the Charity Commission will accept independent examiner's reports based on the old Directions and guidance provided these are signed on or before 30 November 2017.

It is important to emphasise that if the independent examiner has not followed the new Directions and guidance from 1 December 2017, the Charity Commission state that the examiner will not have carried out their independent examination properly.



## 2.2 *Who qualifies to be an independent examiner?*

An independent examination can be carried out by any person that is independent, has the necessary knowledge and experience and provided that the gross income of the charity is £250,000 or less. Charities are required to have an audit for financial years ending on or after 31 March 2015 if either its gross income exceeds £1m, or its gross income exceeds £250,000 and the gross assets exceeds £3.26m. The governing document may also require an audit to be carried out if these thresholds are not met so the examiner must also check this document and ask the trustees whether an audit may be required for another reason.

If the gross income for the year is £25,000 or less, an independent examination is not required, but the trustees may choose to have one, if they wish.

For an examiner to be independent, they must have no connection with the charity's trustees which may impact on impartiality. This does not mean that the examiner cannot be a member or supporter of the charity, but they should not be a material donor.

CC32 states that the term 'independence' means that the examiner is not influenced, or perceived to be influenced, by either close personal relationships with the trustees or by a day-to-day involvement in the administration of the charity being examined. Whether a connection with the charity amounts to a close personal relationship with the trustees which will have an impact on independence must be judged in light of the particular circumstances.

Examiners cannot independently review their own work; hence this will preclude the charity's book-keeper from being the examiner. In practice, many charities appoint the services of a professional accountancy firm to carry out the independent examination.

## 2.3 *Directions*

The revised Directions contained in CC32 have been reproduced as an Appendix to this section of the notes.

## 2.4 *Reporting*

Appendix 4 in CC32 contains 12 illustrative examiner's reports. There are two kinds of examiner's report; one for non-company charities and another for charitable companies. Most charities are non-company charities, but where a charity is set up under the Companies Act, these are regarded as charitable companies. The wording of an unqualified report for a non-company charity preparing accruals accounts, with a gross income of £250,000 or less is as follows:

### **Independent examiner's report to the trustees of XYZ Charity**

I report to the trustees on my examination of the accounts of XYZ Charity (the Charity) for the year ended 31 December 2017.

### **Responsibilities and basis of report**

As the charity trustees of the Charity you are responsible for the preparation of the accounts in accordance with the requirements of the Charities Act 2011 ('the Act').

I report in respect of my examination of the Charity's accounts carried out under section 145 of the 2011 Act and in carrying out my examination I have followed all the applicable Directions given by the Charity Commission under section 145(5)(b) of the Act.

### **Independent examiner's statement**

I have completed by examination. I confirm that no material matters have come to my attention in connection with the examination giving me cause to believe that in any material respect:

1. accounting records were not kept in respect of the Charity as required by section 130 of the Act; or
2. the accounts do not accord with those records; or
3. the accounts do not comply with the applicable requirements concerning the form and content of accounts set out in the Charities (Accounts and Reports) Regulations 2008 other than any requirement that the accounts give a true and fair view which is not a matter considered as part of an independent examination.

I have no concerns and have come across no other matters in connection with the examination to which attention should be drawn in this report in order to enable a proper understanding of the accounts to be reached.

Signed:

Name:

Relevant professional qualification or membership of professional bodies (if any):

Address:

Date:

## **2.5 Relevant professional bodies**

Once a charity's gross income exceeds £250,000, the examiner has to be a person who is a member of one of the following bodies. The examiner must also ensure that they comply with their relevant professional body's rules when undertaking the role of examiner. The listed bodies are:

- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants in Scotland
- Institute of Chartered Accountants in Ireland
- Association of Chartered Certified Accountants
- Association of Authorised Public Accountants
- Association of Accounting Technicians
- Association of International Accountants
- Chartered Institute of Management Accountants
- Institute of Chartered Secretaries and Administrators
- Chartered Institute of Public Finance and Accountancy
- Fellow of the Association of Charity Independent Examiners
- Institute of Financial Accountants
- Certified Public Accountants Association

## 2.6 Appendix: Schedule of Directions

Direction	Direction heading (first line only)	Applicable to receipts and payments	Applicable to accruals accounts
1	Check whether the charity is eligible to have an independent examination	✓	✓
2	Check for any conflict of interest that prevents the examiner from carrying out their independent examination	✓	✓
3	Record your independent examination	✓	✓
4	Plan the independent examination	✓	✓
5	Check that accounting records are kept to the required standard	✓	✓
6	Check that the accounts are consistent with the accounting records	✓	✓
7	If the accounts are prepared on an accruals basis and one or more related party transactions took place the examiner must check if these were properly disclosed in the notes to the accounts	-	✓
8	Check the reasonableness of the significant estimates and judgments and accounting policies used in accounting for the types of fund held and in the preparation of the accounts	Part	✓
9	The examiner must check whether the trustees have considered the financial circumstances of the charity at the end of the reporting period and, if the accounts are prepared on an accruals basis, check whether the trustees have made an assessment of the charity's position as a going concern when approving the accounts	Part	✓
10	Check the form and content of the accounts	✓	✓
11	Identify items from the analytical review of the accounts that need to be followed up for further explanation or evidence	✓	✓
12	Compare the trustees' annual report with the accounts	✓	✓
13	Write and sign the independent examination report	✓	✓
-	Statutory duty to report matters of material significance to the Commission	✓	✓

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-	Examiner's discretion to report relevant matters to the Commission	✓	✓
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### 3. PRACTICE NOTE 15 (REVISED)

In November 2017, the Financial Reporting Council (FRC) issued Practice Note 15 (Revised) *The audit of occupational pension schemes in the United Kingdom* (PN 15). PN 15 contains guidance on the application of auditing standards issued by the FRC to the statutory audit of trust-based occupational pension schemes established under the Pension Acts in the UK.

The PN itself is intended to assist auditors in applying the requirements of, and should be read in conjunction with, relevant ISAs (UK) which apply to audits carried out in the UK for periods commencing on or after 17 June 2016.

#### 3.1 What is the issue?

An amendment was made to *The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996* SI 2016/229. Paragraph 2C was inserted stating:

*‘The requirement to obtain an auditor’s statement in accordance with paragraph (1)(b) does not apply in relation to a scheme for a scheme year in which, on the first day of that scheme year, the scheme has at least 20 participating employers.’*

*The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 paragraph 2C.*

There appears to be a drafting error in PN 15 at paragraph 44. Paragraph 44 deals with the annual report and refers to the auditor’s statement concerning contributions payable to the scheme. The fifth bullet point refers to schemes with less than 20 participating employe**es**, when it should be 20 participating employers.

Firms must ensure that they do not incorrectly apply paragraph 44 because while paragraph 2C of the Regulations would only apply to the very largest of pension schemes, most schemes will continue to require a report.

The Financial Reporting Council have been advised of the anomaly.

## 4. MICRO-ENTITIES: WHEN TO USE FRS 105 OR FRS 102

(contributed by Steve Collings)

With more degree of flexibility under the new reporting regime, many practitioners question whether their micro-entity clients are better off using FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* or FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Ultimately, it must be borne in mind that it is the company directors who are responsible for the financial statements; not the practitioner and the decision to use FRS 105 or FRS 102 (Section 1A *Small Entities*) should be the client's; although, in practice, the client is likely to be advised by the accountant.

FRS 105 is not as complex a standard as FRS 102 due to its target audience and contains a number of simplifications in comparison to FRS 102. At the outset, this may seem like a no-brainer for a micro-entity client that meets the eligibility criteria to use FRS 105. However, consideration has to be given to client-specific issues because while FRS 105 may be suitable for the vast majority of micro-entity clients, including micro-entity LLPs and (more recently) companies in the Republic of Ireland, it will not be suitable for them all. The message, certainly from some of the professional bodies, is to consider FRS 105 on a case-by-case basis. Some of the key technical points that are encountered in practice where micro-entity clients and FRS 105 are concerned and should be considered by practitioners and micro-entity clients when deciding which standard to use include the following:

### 4.1 *Accounting policy choices*

One of the most notable features of FRS 105 is that it offers no accounting policy choices to micro-entities. When the FRC developed FRS 105, they concluded that allowing accounting policy choices for micro-entities would add complexity for preparers and would cause confusion for the users due to the lack of detail in the formats of the financial statements as well as the lack of supporting disclosures. The EU Accounting Directive prohibits the FRC from mandating any additional disclosures which are outside its scope.

Transactions such as development costs and borrowing costs must therefore be written off to the profit and loss account. They cannot be capitalised on the balance sheet as capitalisation of such costs is an accounting policy choice. Where a micro-entity wishes to capitalise borrowing or development costs (which, in practice, is not significantly common), they will have to report under FRS 102.

### 4.2 *Fair value and revaluation amounts*

FRS 105 does not allow the application of the fair value or alternative accounting rules found in the Companies Act 2006. Therefore, a micro-entity is unable to measure any assets at revaluation or at fair value and hence a revaluation reserve should never be presented in a micro-entity's balance sheet (all revaluation or fair value amounts used under previous UK GAAP must have been removed on transition to FRS 105).



Many practitioners have asked whether they are able to use a previous UK GAAP revaluation as deemed cost and then measure the asset using the historical cost accounting rules going forward. This is not possible, as the asset has to be measured at cost ('cost' being the purchase price or production cost according to the Companies Act 2006) less depreciation less any impairment. As previous revaluation amounts are not the purchase price or production cost, the use of a previous UK GAAP revaluation would be inconsistent with the law.

### 4.3 *Disclosure notes*

The significantly reduced disclosure regime found in FRS 105 is proving to show a split between those practitioners which favour it and those which do not. In addition to the s396(A) general information which has to be disclosed (see 1.16 above), there are now four disclosure requirements under FRS 105 (two of which have recently been introduced as part of the FRC's triennial review) as follows:

- Advances, credit and guarantees granted to directors as required by section 413 of the Companies Act 2006.
- Financial commitments, guarantees and contingencies as required by Regulation 5A of, and paragraph 57 of Part 3 of Schedule 1 to, the Small Companies Regulations.

The two additional ones which have to be included in a micro-entity's financial statements for periods commencing on or after 1 January 2017 (note the effective from date is sooner than the other amendments arising as part of the triennial review) are:

- Off-balance arrangements; and
- Employee numbers.

The reasons why these have been introduced into FRS 105 have been examined in section 1.16 of these notes.

For UK micro-entities, the disclosures are shown at the foot of the balance sheet; they are not presented as a separate section of the financial statements as is the case with small companies reporting under FRS 102, Section 1A. Micro-entities in the Republic of Ireland have more comprehensive disclosures to make in their financial statements within a separate section of the financial statements, 'Notes to the financial statements'. Micro-entities in the Republic of Ireland cannot place the notes at the foot of the balance sheet as is the case in the UK.

Some practitioners have expressed concern about how useful such a limited number of disclosures actually are. The significantly reduced disclosure regime was borne out of the EU Accounting Directive, although a micro-entity is permitted, but not required, to make additional disclosures as they feel necessary. Some lenders (e.g. Santander) have also been known to make a request for additional information in respect of micro-entity financial statements, so this is worth keeping in mind if the client is reliant on, or is perhaps seeking, bank finance.

#### 4.4 *Deferred tax*

This simplification has been widely welcomed. Micro-entities are prohibited from accounting from deferred tax. Therefore, there should be no provision for deferred tax in the micro-entity's financial statements on the grounds that the lack of disclosure in a micro-entity's financial statements means it is impossible to distinguish between current and deferred tax; hence only current amounts of tax are shown.

#### 4.5 *Off-rate loans*

There is no requirement to impute market rates of interest for off-rate loans (i.e. loans at below market rates or at zero rates of interest); nor is there a requirement to use the effective interest method which is used in FRS 102. Such loans will simply be measured at cost and this will prove a welcome simplification from potentially having to discount loans to present value using a market rate of interest under FRS 102. In practice, most off-rate loans in a small company (e.g. intra-group loans and loans to directors) have no terms attached to them and are therefore repayable on demand, thus presented as current assets/liabilities under FRS 102 at cost.

#### 4.6 *Financial statement formats*

Only a Format 2 profit and loss account is allowed under FRS 105. In practice, a Format 1 profit and loss account is usually prepared for a limited company client which analyses expenses by function (cost of sales, distribution costs, administrative expenses and such like). The Format 2 profit and loss account (expenses by nature) is structured as follows:

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	<u>X/(X)</u>

Some practitioners have also expressed concern about the lack of detail where some of the balance sheet amounts are concerned. Under FRS 105, either a Format 1 or Format 2 balance sheet can be prepared provided there is consistency (a change from one format to another would constitute a change in presentation, hence should be applied retrospectively). However, there is no disaggregation of the balance sheet in the notes to the financial statements because the statutory formats of the micro-entity financial statements are only preceded by letters; they are not followed by Roman or Arabic numerals. Therefore, items such as fixed assets, current assets and current liabilities are not broken down in the notes.

This could result in requests for additional non-statutory information such as a breakdown of current assets (possibly in an attempt to identify any overdrawn directors' current accounts).

#### 4.7 *Other factors that should be considered*

Some practitioners argue that FRS 105 is ‘the way forward’ for micro-entities; whereas others do not like the standard due to the lack of information conveyed in the accounts. Each argument has its own merits, but some additional factors which should be considered when deciding on whether the client should be advised to use FRS 105 or FRS 102 include:

- **The pace of growth of the client.** If the micro-entity is expected to grow rapidly in a short period of time, it may outgrow FRS 105 fairly quickly. This will then result in a transition to FRS 102 having to be done; hence for a new start-up client that is expected to grow very fast, it may be worth ‘biting the bullet’ and going straight onto FRS 102 (and applying Section 1A *Small Entities*). In addition, if the client wants to see more detailed information in the financial statements, FRS 102 should be used. The client can still file ‘filleted’ financial statements with Companies House if it chooses to report under the small companies’ regime which, as a minimum, requires the balance sheet plus the balance sheet-related notes.
- **Ease of use of the standard.** FRS 105 is the least complex standard in the suite of UK GAAP and where a micro-entity has a relatively stable amount of revenue and assets, is owner-managed and is not expected to outgrow FRS 105, then it may be worthwhile advising the client to report under FRS 105.
- **Companies House filing requirements.** The micro-entity is only required to file the balance sheet and the notes (which are located at the foot of the balance sheet) with Companies House. UK micro-entities are not required to file the profit and loss account. Directors’ reports are no longer required for a micro-entity in the UK, hence this is not an issue for such clients.
- **Revaluation of assets.** If the client wishes to revalue an asset (e.g. a building) or has an investment property which it wishes to measure at fair value, then it will not be able to report under FRS 105; it must apply FRS 102 as a minimum. Conversely, some clients may not want any disclosure about the value of its properties and hence may wish to take a restatement to historical cost accounting rules as the price to pay for reduced disclosure.
- **Impact on distributable profit.** Certain transition adjustments may have an impact on distributable profit (e.g. restatement of amounts to historical cost accounting rules values) which may meet with disapproval by the client, so FRS 102 may be the way to go.
- **Client discussions.** The client may want to see more detailed information in the financial statements rather than the limited information produced by FRS 105 and hence FRS 102 may be a more suitable standard.



## 5. FRS 102 1A – DISCLOSURE AND PRESENTATION FAQs

### 5.1 *Do small companies have to disclose the presentation currency?*

Yes! Neither the Appendix to FRS 102, Section 1A *Small Entities*, nor the Companies Act 2006 expressly require the disclosure. However, the exclusions in disclosure, contained in Section 1, for small companies, do not extend to Section 3.23d. So the disclosure is required, despite the fact it has no asterisk next to it.

There is an argument that including the pound sign (£) is sufficient, which most people seem to accept. However, there are other currencies that use this symbol other than the British Pound Sterling.

### 5.2 *Is a stock note needed in small company accounts?*

Generally, no. There is no requirement in FRS 102, Section 1A. Occasionally, the Companies Act 2006 disclosure might be needed in respect of the relevant Arabic numerals as follows:

1. Stocks
2. Payments on account

But this will be very rare.

### 5.3 *Exactly what disclosures are needed in relation to investment properties in small company accounts?*

1. Opening balances, movements in the year and closing balances
2. The significant assumptions underlying the valuation models and techniques used to determine the fair value

### 5.4 *Is a director an employee for disclosure purposes?*

Views differ and no conclusive guidance exists.

Some say, no. Directors are directors not employees, even when on the payroll.

Alternatively, there is a view that directors are always employees when engaged in any sort of employment role.

In reality, nobody cares much unless the number is near a threshold such as 10 for micro-entities or 50 for small companies!

This remains a matter for personal judgement.

### **5.5 In the statement of compliance do you have to mention Section 1A?**

Firstly, let us not forget that the statement of compliance is an encouraged presentation and not a requirement. Nevertheless, everybody seems to, quite rightly, feel suitably encouraged to include it.

Also, do not forget that there will be a statement of compliance with the small company regime on the balance sheet.

There is no definitive view on whether to specifically mention Section 1A in the FRS 102 statement of compliance, but there is a consensus that it would be a good idea.

It could read as follows:

*The financial statements have been prepared using FRS 102 The Financial Reporting Standard applicable in the UK and the Republic of Ireland, including the disclosure and presentation requirements of Section 1A, applicable to small companies.*

The exact wording of this can differ and sometimes accountants forget that Section 1A contains only the presentation and disclosure requirements (recognition and measurement is based on full FRS 102), so accounts cannot be prepared only in accordance with that one section, alone.

### **5.6 Do you have to disclose which version of FRS 102 is being used?**

No. Except where there is a requirement to disclose early adoption of new version of the Standard.

## 6. GEARING UP FOR GDPR

Accountants should, by now, have measures in place that will allow them to be prepared for the General Data Protection Regulation (GDPR) that replaces the Data Protection Act 1998. GDPR has been well publicised throughout the profession and its aim is to bring legislation over data protection up-to-date, recognising the fact that we now work in a 'Digital Age', hence the risk to clients' data is higher.

The GDPR applies to all members of the EU from 25 May 2018 who process the personal data of subjects residing in the EU, regardless of the company's location. Despite the fact that the UK is going to leave the EU in 2019, we will still need to comply.

In the UK, the majority of what accountants did under the Data Protection Act 1998 will mean that they will likely meet the requirements of GDPR.

### 6.1 Steps to take now

The Information Commissioner's Office, who are responsible for enforcement of GDPR in the UK, have prepared a useful document *Preparing for the General Data Protection Regulation (GDPR) 12 steps to take now* which is summarised as follows:

#### **Step 1: Awareness**

Ensure that everyone in the firm is aware that GDPR is the law and will be enforced from 25 May 2018.

#### **Step 2: Document the information in your possession**

The firm should document what personal data is in its possession, where it came from and who you share it with. In practice, this could prove a challenge so an 'action plan' may be needed as to who will do this task and when.

#### **Step 3: Communicating privacy information**

Firms must review their current privacy notices and instigate a plan for making any necessary changes in time for 25 May 2018.

#### **Step 4: Individuals' rights**

Firms should ensure their procedures cover all the rights individuals have, including how someone's personal data would be deleted or provide data electronically.

#### **Step 5: Subject access requests**

Procedures should be updated so they incorporate how the firm will deal with subject access requests within the new timescales and provide any additional information.

#### **Step 6: Lawful basis for processing personal data**

Firms should identify the lawful basis for their processing activity within the GDPR, ensure it is documented and that privacy notices are updated to explain it.



### ***Step 7: Consent***

Firms should review how they seek, record and manage consent and whether any changes are needed. Where existing consents do not meet the GDPR standard, they will have to be amended accordingly to comply.

### ***Step 8: Children***

Systems may need to be put into place to verify individuals' ages and to obtain parental or guardian consent for any data processing activity in respect of children.

### ***Step 9: Data breaches***

Procedures need to be in place which are GDPR compliant which detect, report and investigate a personal data breach.

### ***Step 10: Data Protection by Design and Data Protection Impact Assessments***

Firms will need to familiarise themselves with the ICO's code of practice on Privacy Impact Assessments as well as the latest guidance from the Article 29 Working Party and then work out how, and when, to implement them within the firm.

### ***Step 11: Data Protection Officers***

Someone in the firm must take responsibility for data protection compliance and assess where this role will sit within the organisational structure and governance arrangements. Firms should also consider whether they will be required to formally designate a Data Protection Officer. Data Protection Officers will be needed in the case of:

- a) Public authorities;
- b) Organisations which engage in large-scale systematic monitoring; or
- c) Organisations that engage in large-scale processing of sensitive personal data.

### ***Step 12: International***

Where an organisation operates in more than one EU member state, firms will have to determine the lead data protection supervisory authority and document this.

## **6.2 Non-compliance**

When an organisation fails to comply with the GDPR, they can be fined up to 4% of annual global turnover or €20 million. This is the maximum fine which can be imposed on an organisation for serious breaches of the GDPR (or a serious failing to comply). A tiered approach to fines exists, for example a company can be fined 2% for not having their records in order, not notifying the supervising authority and data subject about a breach or not conducting an assessment.

## 7. AUDITOR REPORTING ON STRATEGIC REPORTS – NEW CASE STUDY

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.

### 7.1 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 any 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.

### 7.2 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?'

### 7.3 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.

#### **7.4 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)

## 7.5 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



**7.6 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> ?	

## 8. ASSESSING GOING CONCERN

The collapse of the building firm, Carillion, will undoubtedly reverberate for several months while investigations continue into the company's collapse. As is usually the case in these matters, questions are being asked as to how the auditors signed off accounts and corroborated management's assessment that the entity was a going concern for the foreseeable future.

Of course, issues arise during the course of business which cannot be foreseen, but it seems a sensible time to recap on the auditor's responsibilities where going concern is concerned and the signs to watch out for when corroborating management's assertion that the going concern basis of accounting is appropriate.

Auditors must apply ISA (UK) 570 *Going Concern* when undertaking procedures on an entity's ability to continue as a going concern. ISA (UK) 570 uses the term 'going concern' as follows:

*'The term "going concern" applies to any entity unless its management intends to liquidate the entity or to cease trading, or has no realistic alternative to liquidation or cessation of operations.'*

ISA (UK) 570

ISA (UK) 570 uses the term 'ability to continue as a going concern' as follows:

*'The term "ability to continue as a going concern" is equivalent to the term "ability to continue to adopt the going concern basis of accounting" in the future.'*

### 8.1 Significance of going concern

Whether or not a company can be regarded as a going concern affects how its financial statements are prepared.

Ordinarily, financial statements are prepared on the basis that the entity is a going concern. Accounting standards (FRS 102 and IAS 1 *Presentation of Financial Statements*) states that an entity should prepare its financial statements using the going concern basis of accounting, unless:

- management intends to liquidate the entity, or to cease trading; or
- the directors have no realistic alternative but to do so.

When circumstances are such that the directors have no realistic alternative but to cease trading, or they intend to liquidate the entity, the going concern basis of accounting must not be used. UK GAAP does not specify which basis should be used when the going concern basis of accounting is not applied, but usually the financial statements will be prepared on a 'break-up' basis under which:

- the basis of preparation and the reason why the entity is not regarded as a going concern is disclosed;
- fixed assets are restated to their recoverable amount;
- stock, work in progress and trade debtors often need to be written down as stock will be sold for a lower price or may be scrapped and some trade debtors may be irrecoverable; and
- additional liabilities may need recognition (e.g. redundancy costs and the costs of closing the business down).

## 8.2 *Management's responsibility*

It is the responsibility of management to assess whether the going concern basis is appropriate in the company's circumstances when the financial statements are being prepared. In order to do this, a business may often use forecasts to help assess whether they are likely to be able to continue trading for the foreseeable future.

In the UK, the directors must carry out an assessment of the entity's ability to continue as a going concern for a period of at least 12 months from the date of approval of the financial statements. It is important to emphasise that this requirement is for **at least** 12 months and could be longer in certain situations.

Paragraph 26 of IAS 1 is not as arduous in its requirements as this only requires management to take into account all available information about the future, which is at least, but not limited to, 12 months from the end of the reporting period. However, this should be extended for the purposes of the UK as footnote 4a to paragraph 13 of ISA (UK) 570 confirms that in the UK, the period used by those charged with governance in making their assessment is usually at least one year from the date of approval of the financial statements. Periods less than this will have reporting implications for the auditor.

If management become aware during their assessment of the entity's going concern of any material uncertainties which may affect the entity's ability to continue as a going concern, they should disclose those uncertainties in the financial statements.

### Example – Going concern uncertainty

A company has a large contract with the government which generates around 90% of its income. The financial statements for the year-ended 31 March 2018 are being prepared and the contract has to go out to tender on 30 June 2018. There is no guarantee that the company will be awarded the contract and the decision as to who will be awarded the contract will be made in August 2018, by which time the financial statements will have been audited and approved.

This is an indicator of a material uncertainty related to the entity's ability to continue as a going concern. If the company is not awarded the contract, they stand to lose around 90% of its income, which will clearly have a material impact. Therefore, such material uncertainties need to be disclosed in the financial statements.

There are a number of factors which the directors must take into consideration when carrying out a going concern assessment, such as:

- current and expected levels of profitability;
- the ability to repay debt on time; and
- sources of financing.

### 8.3 *Indicators that an entity may have going concern problems*

Carillion collapsed with around £900m worth of debt and a huge pension deficit of some £587m (although recent press reports indicate the buy-out value of this pension deficit is more like £2bn). Notwithstanding these issues, the board claimed the firm had substantial liquidity and a large amount of available funding (approximately £1.5bn).

Between July and November, the company issued three profit warnings resulting in its shares crashing by around 90%. Fast forward to 2018, and the company failed to secure financing to secure a rescue plan with the government refusing to use taxpayers' money to rescue the firm. This saw Carillion file for compulsory liquidation.

When a corporate disaster like this strikes, the auditors are always questioned and Carillion is no exception. The auditor's report on the financial statements for the year-ended 31 December 2016 confirm that KPMG had nothing to report in respect of the entity's use of the going concern basis, nor on the directors' viability statement.

At the present time, there is nothing to suggest that the auditors were at fault; nor whether the audit work was deficient. On 29 January 2018, the FRC confirmed that they will be reviewing the audit work performed by KPMG on Carillion for the year-ends 31 December 2014, 2015 and 2016.

Auditors are not able to see into the future, but during the audit of management's assessment of going concern, professional scepticism must be applied which will enable the auditor to challenge management's assertions and enable the auditor to have a questioning mind. Merely accepting management's assessment that '*of course the company is a going concern*' and obtaining a representation from the client confirming this is not enough.

Indicators that a problem has going concern problems are as follows (note, the list below is not exhaustive):

- net current liabilities, or an overall net liability position on the balance sheet indicates that the company may not be able to meet debts as they fall due;
- borrowing facilities are not renewed or they are nearing their renewal date which may mean that a lack of cash is available which will make it difficult for a company to manage its cash operating cycle;
- the company has defaulted on loan agreements which could result in the bank or financier 'calling-in' the debt which will place pressure on the cash operating cycle;
- tax payments are being missed or arrangements to pay are frequently put in place which would indicate a lack of working capital;
- staff are paid late which is also due to a lack of working capital;
- negative cash flows in the cash flow statement which indicates overtrading;
- suppliers credit is being withdrawn which indicates a failure to pay suppliers on time indicating a lack of working capital;

- successful legal claims are brought against the company which will place pressure on cash and may result in the company going into liquidation;
- over-reliance on a small number of key customers, staff or suppliers, the loss of which may result in an inability to trade;
- customers ceasing to trade (particularly large customers) which will result in bad debts and hence an inability to recover payment;
- uninsured/under-insured catastrophes which may mean the company will not have enough money to survive;
- changes in laws and regulations which may mean the costs of compliance may be more than the company can afford; and
- emergence of successful competitors which will impact revenue if customers switch.

## 8.4 Auditor's responsibilities

ISA (UK) 570 sets out the auditor's objectives at paragraph 9 which are:

ISA (UK) 570  
paragraph 9

- '(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).'*

The auditor is not responsible for assessing the entity's going concern ability as this is a management responsibility. The auditors are responsible for obtaining sufficient appropriate audit evidence about management's assessment of going concern and to conclude on whether, or not, a material uncertainty related to going concern exists.

## 8.5 Audit procedures

The audit procedures which can be applied to assess management's evaluation of going concern are set out below. The list below is not exhaustive, and other entity-specific procedures may be applied:

- evaluate management's assessment of going concern;
- assess the same period that management have used in their assessment and if this is less than 12 months from the date of issuance of the financial statements (i.e. approval), ask management to extend their assessment; and
- consider whether management's assessment includes all relevant information.

If there is any doubt over the entity's ability to continue as a going concern, the auditor may carry out the following procedures:

- analyse and discuss the entity's cash flow statement, profit and other relevant forecasts with management;
- analyse the latest available management accounts and compare these to the cash flow statement to see if there are any inconsistencies;
- review the terms of loans and debentures to assess if any have been breached;
- read minutes of board meetings and meetings with shareholders to establish if there is any reference to financing difficulties;
- review correspondence to identify if there are any legal claims that have been brought against the company;
- if there are legal claims that are ongoing at the balance sheet date, assess the reasonableness of management's assessments of their outcome and the estimate of financial implications (this may need to be done in conjunction with the client's lawyers);
- review correspondence with customers for evidence of any disputes;
- review correspondence with the bank for indications that a bank loan or overdraft may be recalled;
- review correspondence with suppliers for evidence of any issues regarding payments which may impact the entity's ability to continue as a going concern; and
- obtain written representations from management regarding its future plans and how it plans to address the going concern issues.

### **8.6**     ***Disclosures in the financial statements***

Where there are material uncertainties related to going concern, the directors should include adequate disclosures which explain:

- the principal events or conditions which cast significant doubt on the entity's ability to continue as a going concern together with the directors' plans to deal with them; and
- that the company may be unable to realise its assets and discharge its liabilities in the ordinary course of business.

Small companies are encouraged to make the going concern disclosures in order to achieve a true and fair view. If the directors do not make these disclosures, citing there is no legal requirement to make them, the financial statements will not give a true and fair view and hence the auditor will have to qualify their auditor's report. Even where the financial statements of a small entity are not subject to audit, the directors still have a legal duty to prepare financial statements that give a true and fair view and any non-disclosure of material uncertainties related to going concern will still render the financial statements as failing to give a true and fair view.

In April 2016, the Financial Reporting Council published updated guidance in the form of '*Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks – Guidance for directors of companies that do not apply The UK Corporate Governance Code*'. While this guidance is non-mandatory, it is viewed as best practice for unlisted entities.



## 8.7 Auditor reporting

### ***Going concern basis is appropriate and there are no material uncertainties***

Under ISA (UK) 570, auditors' reports will make reference to going concern, even when the auditor concludes that there is no material uncertainty related to going concern and management's use of the going concern basis of accounting is appropriate. In such cases, the auditor reports by exception in a separate paragraph of the auditor's report headed up 'Conclusions related to Going Concern' or other appropriate heading.

#### **Example – Conclusions related to Going Concern**

##### **Conclusions related to Going Concern**

We have nothing to report in respect of the following matters to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

### ***Going concern basis is appropriate and there are material uncertainties***

When the auditor concludes that management's use of the going concern basis is appropriate in the circumstances, but nonetheless a material uncertainty exists, the auditor must determine whether the financial statements adequately disclose the principal events or conditions which may cast significant doubt on the going concern ability of the entity and disclose clearly in the auditor's report that there is a material uncertainty related to going concern.

ISA (UK) 570 requires a separate paragraph in the auditor's report headed up 'Material Uncertainty Related to Going Concern' when the going concern basis is appropriate but there are material uncertainties. The auditor no longer uses an Emphasis of Matter paragraph to flag up going concern uncertainties as was the case under the previous ISA (UK and Ireland) 570 *Going Concern*.

#### **Example – Disclosure of a material uncertainty related to going concern in the auditor's report**

##### **Material Uncertainty Related to Going Concern**

We draw attention to Note 23 in the financial statements, which indicates that the company incurred a net loss of £X during the year to 31 December 2017 and, as of that date, the company's current liabilities exceeded its total assets by £X. As stated in Note 23, these events or conditions, along with other matters as set forth in Note 23, indicate that a material uncertainty exists which may cast significant doubt on the company's ability to continue as a going concern. Our opinion is not modified in this respect.



### ***Going concern basis is not appropriate***

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

The Basis for Adverse Opinion paragraph will explain that the financial statements have been prepared using the going concern basis inappropriately.

The Opinion paragraph will state that the financial statements do not give a true and fair view and have not been properly prepared in accordance with the financial reporting framework and legislative requirements.

### ***Adequate disclosure of a material uncertainty is not made***

Where management have not adequately disclosed a material uncertainty related to going concern, the auditor must express a qualified opinion or adverse opinion as appropriate.

The Basis for Qualified (Adverse) Opinion paragraph in the auditor's report will state that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

## 9. GIFTS AND HOSPITALITY

An issue which is currently receiving attention by the ICAEW is in respect of gifts and hospitality. The FRC's Ethical Standard (ES) deals with the issue of gifts and hospitality in paragraphs 4.61D to 4.65.

Paragraph 4.61D of the Ethical Standard states:

*'A firm, its partners and any covered person, and persons closely associated with them, shall not solicit or accept pecuniary and non-pecuniary gifts or favours, including hospitality, from an entity relevant to the engagement, or any other entity related to that entity, unless an objective, reasonable and informed third party would consider the value thereof as trivial or inconsequential.'*

FRC Ethical  
Standard paragraph  
4.61D

Paragraph 4.62 of the ES then goes on to confirm that when gifts, favours or hospitality are accepted from an audit client, or from others related to the audit client, a self-interest and familiarity threat to integrity, objectivity and independence are created. In addition, familiarity threats are also created where gifts, favours or hospitality are offered to an audit client, its partners or any other covered person.

Consider the following scenarios:

### Scenario 1

An audit team of four staff attend an audit client's premises for two weeks to carry out the detailed audit fieldwork. During the course of that two weeks, the managing director's personal assistant regularly provides the audit team with tea, coffee and biscuits.

The provision of tea, coffee and biscuits (even on a daily basis) is unlikely to cause an ethical threat to integrity, independence and objectivity and hence it would be acceptable for the audit team to accept these refreshments.

### Scenario 2

The financial statements of North Co Ltd for the year-ended 31 October 2017 have just been approved and the auditor's report thereon signed by the audit engagement partner. The chief executive officer (CEO) of North Co has offered to take the audit engagement partner out for a business lunch at North Co's expense.

Again, the provision of a business lunch in this scenario is unlikely to cause any ethical issues. This is also accentuated by the fact that the business lunch has taken place after the financial statements have been approved and the auditor's report signed. It would, therefore, be acceptable for the audit engagement partner to accompany the CEO for lunch.

### Scenario 3

The audit of South Co Ltd completed on 10 December 2017 after a number of problems were found in the entity's internal control environment that caused some misstatements in the financial statements, which have now been corrected.

To thank the team for their efforts, the finance director has sent the audit engagement partner £300 worth of Amazon vouchers to be split among the four team members.

Each audit team member would receive £75 (£300 / 4) worth of vouchers. This is likely to cause an ethical problem and hence the audit engagement partner/team members should politely decline the gift. Christmas gifts from an audit client are unlikely to cause any ethical threats where they are very small (e.g. gifts where the value is less than £25).

#### Scenario 4

The audit engagement partner has attended a number of lunch/dinner engagements with the managing director of West Co Ltd. In addition, the managing director has invited the audit engagement partner and his Wife to his son's wedding in June 2018.

Attending regular lunches/dinners would indicate a familiarity threat. This is accentuated by the fact that the engagement partner and his Wife have both been invited to the managing director's son's wedding. Safeguards should be put in place to minimise this threat to an acceptable level, or the audit engagement partner rotated off the audit.

Paragraph 4.63 of the ES states:

*'The firm shall establish policies on the nature and value of gifts, favours and hospitality that may be accepted from and offered to an entity relevant to an engagement, or any other entity related to that entity, their directors, officers and employees, and shall issue guidance to assist partners and staff to comply with such policies.'*

FRC Ethical  
Standard paragraph  
4.63

Where gifts and hospitality are accepted by the audit firm, or are offered more than once, the view of an objective, reasonable and informed third party of the **cumulative** effect is considered. Therefore, to comply with this requirement, a record of such gifts and hospitality (and offers thereof) should be retained by the audit firm.

When there is any doubt as to the acceptability of gifts, favours or hospitality by the audit team, the team must discuss the situation with the engagement partner. Where the audit engagement partner has any doubts as to the acceptability of gifts, favours or hospitality, he/she must refer the issue to the firm's ethics partner/ethics function. Whenever there are doubts in such cases, it would always be advisable to decline the offer as, in such cases, if there are doubts in the minds of the audit engagement team, it is usually the case that the view of an objective, reasonable and informed third party would be that an ethical threat has been created.