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## ACCOUNTING AND AUDIT QUARTERLY UPDATE – QUARTER 4

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## 1 FRED 68 (LECTURE A605 – 9.21 MINUTES)

On 20 September 2017, the FRC issued 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*. FRED 68 was only open for comment until 20 October 2017 as the FRC are planning to finalise the issues raised in FRED 68 along with the changes announced in FRED 67 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland Triennial review 2017 – Incremental improvements and clarifications*.

FRED 68 was issued as the FRC became aware of significant differences in the accounting treatment for gift aid payments made by a subsidiary to its charitable parent. Gift aid payments are made during the nine months following the relevant balance sheet date and are regarded as a distribution to owners for accounting purposes, but a donation for tax purposes. Currently, it is common for such payments to be accrued at the balance sheet date and for the subsidiary to be treated as effectively tax exempt. The adoption of FRS 102 has caused some charitable groups to revisit this treatment.

### 1.1 Accounting issues

FRS 102 (September 2015) currently does not specifically deal with all the accounting treatments for gift aid payments and where FRS 102 does not deal with a transaction, event or condition, paragraphs 10.4 and 10.5 require judgement to be applied in developing an accounting policy which is relevant and reliable while having regard to other requirements which deal with similar and related issues. Paragraph 22.17 of FRS 102 requires distributions to owners to be recognised in equity.

The most common type of distribution are dividends to the shareholders and FRS 102 contains a number of requirements which apply to dividends, which should be regarded as applicable to other distributions to owners and this would include gift aid payments. Paragraph 32.8 of FRS 102 specifically prohibits dividends from being accrued at the balance sheet date if they have not been declared by the end of the balance sheet date and this rule also applies to gift aid payments. This is because if distributions are not declared by the balance sheet date, no obligation exists. The upshot of this treatment where a subsidiary is concerned is that it will have taxable profits and hence there will be a need to recognise a tax expense as paragraph 29.14 of FRS 102 prevents the tax effects of dividends being recognised before the dividend has been recognised.

The FRC did consider whether to provide an exemption from paragraph 32.8 of FRS 102. However, some charities put a deed of covenant in place, hence a liability would be recognised in these situations so it was concluded that an exception would not be appropriate for this type of distribution.

### 1.2 Proposed treatment for gift aid and associated tax

FRED 68 proposes to amend FRS 102 so that when it is probable (ie more likely than not) that a gift aid payment will be made in the nine months following the balance sheet date, the tax effects are to be taken into account at the reporting date. This reflects the fact that, in the majority of cases, subsidiaries will minimise their liability to corporation tax as a result of making the gift aid payments.

Special rules exist in tax legislation which allow a gift aid payment made *after* the balance sheet date to be granted tax relief in the earlier period hence the FRC

propose making an exception to paragraph 29.14 of FRS 102 to allow the tax effects of the expected gift aid payment to be recognised at the balance sheet date provided certain conditions are met. Proposed paragraph 29.14A will outline these conditions as follows:

29.14A As an exception, when:

- (a) an entity is wholly-owned by a charitable <sup>[\*footnote]</sup> parent;
- (b) it is probable that a gift aid payment will be made to the charitable parent within nine months of the reporting date; and
- (c) that payment will qualify to be set against profits for tax purposes,

the income tax effects of that gift aid payment shall be recognised at the reporting date. The income tax effects shall be measured consistently with the tax treatment planned to be used in the entity's income tax filings. A deferred tax liability should not be recognised in relation to such a gift aid payment.

<sup>[\*footnote]</sup> In this context charitable refers to an entity that has been recognised by HMRC as being eligible for certain tax reliefs because of its charitable purposes.

FRED 68 will also clarify the following points:

- the gift aid payment, as a distribution to owners, shall not be accrued at the balance sheet date (unless a deed of covenant is in place) and shall be recognised within equity; and
- the tax effects of the gift aid payment are to be recognised in profit or loss.

Paragraph 29.22A will be inserted into FRS 102 as follows:

29.22A As an exception to paragraph 29.22, an entity shall present the tax expense (income) effects of distributions to **owners** in profit or loss.

Should the amendments go through as exposed in FRED 68, divergent practices will be reduced which will improve consistency among reporting entities.

### 1.3 **Effective date**

The amendments proposed in FRED 68 are effective for periods starting on or after 1 January 2019 and earlier application will be permitted provided that all of the amendments (including those in FRED 67) are applied at the same time.

**2 FRS 102 SECTION 1A SMALL ENTITIES CASE STUDY**  
**(LECTURES A606/ 607 – 27.45/ 31.53 MINUTES)**

**2.1 Introduction and questions**

The following accounts are based upon real sets of accounts produced under FRS 102, Section 1A *Small Entities* disclosure requirements.

How many obvious over-disclosures can you see?

Which disclosures are not expressly required, but are (or arguably could be) needed to show a true and fair view?

What disclosures are missing?

Company Number 1234567891011

**Too Much Disclosure Limited  
Financial Statements  
Year Ended 31 December 2016**

Too Much Disclosure Ltd

Financial Statements

Year ended 31 December 2016

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**Too Much Disclosure Ltd**

**Company information**

**Year ended 31 December 2016**

<b>Company registration number</b>	1234567891011
<b>Directors</b>	O Verthetop X Essive
<b>Registered office</b>	Moorgate Lane FR5 5EE
<b>Solicitor</b>	XXXXXXXXXX XXXXXXXX
<b>Bankers</b>	XXXXXXXXXX XXXXXXXX
<b>Auditors</b>	Overkill & Glut Moorgate Lane FR5 5EE

**Too Much Disclosure Ltd**

**Directors' Report**

**For the year ended 31 December 2016**

The directors present their report and financial statements of the company for the year ended 31 December 2016.

**Principal activity**

The company designs and distributes striped paisley ties.

**Directors' responsibilities statement**

The directors are responsible for preparing the Director' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice), including Financial Reporting Standard 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of their profit or loss for that period.

In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the company and to prevent and detect fraud and other irregularities.

**Directors of the company**

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

O Verthetop

X Essive

**Disclosure of Information to the Auditor**

In accordance with Section 418(2) of the Companies Act 2006, each director in office at the date the Directors' Report is approved confirms that:

- so far as the director is aware, there is no relevant audit information of which the company's auditor is unaware; and
- he/she has taken all the steps that he/she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the company's auditor is aware of that information.

## **ACCOUNTING AND AUDIT QUARTERLY UPDATE – QUARTER 4**

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

By order of the Board

O Verthetop - Director

30 September 2017

### **Independent auditor's report to the members of Too Much Disclosure Ltd**

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

### **Respective responsibilities of directors and auditor**

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

### **Scope of the audit of the financial statements**

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

### **Opinion on financial statements**

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2016 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

### **Opinion on other 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 directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

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

### **Matters on which we are required to report by exception**

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

## **ACCOUNTING AND AUDIT QUARTERLY UPDATE – QUARTER 4**

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

Maximus Notes (Senior statutory auditor)

for and on behalf of:

Overkill & Glut

Moorgate Lane

FR5 5EE

Date 30 September 2017

**Too Much Disclosure Ltd**  
**Profit and Loss account**  
**For the year ended 31 December 2016**

	2016	2015
	£	£
Note		
<b>Turnover</b>	3,900,767	2,451,342
Cost of sales	(1,555,231)	(972,990)
<b>Gross profit</b>	<u>2,345,536</u>	<u>1,478,352</u>
Administrative expenses	4 (1,129,639)	(867,009)
Other operating income	3 18,000	10,000
Fair value gains on investment properties	12,000	10,000
<b>Operating profit</b>	5 <u>1,245,897</u>	<u>631,343</u>
Interest receivable and similar income	28	56
Interest payable and similar expenses	(19,787)	(25,989)
<b>Profit before taxation</b>	<u>1,226,138</u>	<u>605,410</u>
Tax on profit	(240,000)	(120,000)
<b>Profit for the year after taxation and profit for the financial year</b>	<u><u>986,138</u></u>	<u><u>485,410</u></u>

**Too Much Disclosure Ltd**

Company number: 1234567891011

**Balance Sheet**

**As at 31 December 2016**

	Note	2016 £	2015 £
<b>Fixed assets</b>			
Tangible assets	8	489,233	492,899
		489,233	492,899
<b>Current assets</b>			
Stocks	9	312,943	153,300
Debtors due within one year	10	439,881	278,933
Cash at bank and in hand		1,534,186	794,041
		2,287,010	1,226,274
<b>Creditors: amounts falling due within one year</b>	11	(728,933)	(439,833)
<b>Net current assets</b>		1,558,077	786,441
		2,047,310	1,279,340
<b>Total assets less current liabilities</b>		2,047,310	1,279,340
<b>Provisions for liabilities</b>		(156,798)	(134,966)
		1,890,512	1,144,374
<b>Net assets</b>		1,890,512	1,144,374
<b>Capital and reserves</b>			
Called up share capital	14	100	100
Profit and loss account – not distributable		120,000	110,000
Profit and loss account		1,770,412	1,034,274
		1,890,512	1,144,374
<b>Shareholders' funds</b>		1,890,512	1,144,374

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

The financial statements were approved and authorised for issue by the Board on 30 September 2017.

Signed on behalf of the board of director

O Verthetop

Director

**Too Much Disclosure Ltd**

**Notes to the Financial Statements**

**For the year ended 31 December 2016**

**1 General information**

The company is limited by shares, incorporated in England within the United Kingdom. The address of the registered office is Moorgate Lane, FR5 5EE.

**2 Summary of significant accounting policies**

The financial statements have been prepared using the historical cost convention and 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 principal activity is the design and distribution of striped paisley ties.

This is the first year in which the financial statements have been prepared in accordance with FRS 102. There are no adjustments necessary on transition to the standard.

The financial statements are presented in UK Sterling pounds (£)

**(a) Turnover and other income**

Turnover is measured at the fair value of the consideration received or receivable net of VAT and trade discounts.

Revenue from a contract to provide services is recognised in the period in which the services are provided in accordance with the stage of completion of the contract. Revenue for the sale of goods is recognised upon delivery.

Interest income is recognised using the effective interest method.

**(b) Goodwill**

Purchased goodwill is initially recognised at cost. After recognition purchased goodwill is amortised over its expected useful life and measured at cost less accumulated amortisation.

Goodwill is considered to have a finite useful life. If a reliable estimate of the useful life cannot be made, the useful life shall not exceed 10 years

**(c) Tangible fixed assets**

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

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

Buildings	50 years
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Plant and machinery etc. 25% reducing balance

### **(d) Investment properties**

Investment properties for which fair value can be measured reliably are measured at fair value at each reporting date with changes in fair value recognised in profit or loss.

## **Too Much Disclosure Ltd**

### **Notes to the Financial Statements (continued)**

#### **For the year ended 31 December 2016**

### **(d) Investment properties (cont)**

Properties are valued using RICS open market valuation on freehold basis, conducted annually by SSS Surveyors.

### **(e) Stocks**

Stocks are stated at the lower of cost and estimated selling price less costs to complete and sell. Cost includes all costs of purchase, costs of conversion and other costs incurred in bringing stock to its present location and condition.

### **(f) Short term debtors and creditors**

Short term debtors and creditors with no stated interest rate are recorded at transaction price. Any losses arising from impairment are recognised in the profit and loss account.

### **(g) Loans and borrowings**

Loans and borrowings are initially recognised at the transaction price including transaction costs. Subsequently, they are measured at amortised cost using the effective interest rate method, less impairment.

### **(h) Leases**

Assets acquired under finance leases are capitalised and depreciated over the shorter of the lease term and the expected useful life of the asset. Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding lease liability using the effective interest method.

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

### **(i) Current and deferred tax**

The tax expense for the year comprises current and deferred tax. Tax is recognised in the profit and loss account, except that a change attributable to an item of income and expense recognised as other comprehensive income or to an item recognised directly in equity is also recognised in other comprehensive income or directly in equity respectively.

Deferred tax balances are recognised in respect of timing differences that have originated but not reversed by the balance sheet date.

Current and deferred tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

### **(j) Employee benefits**

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

### **(k) Going concern**

## ACCOUNTING AND AUDIT QUARTERLY UPDATE – QUARTER 4

The financial statements have been prepared on the going concern basis because the directors consider the company to be a going concern.

### Too Much Disclosure Ltd

#### Notes to the Financial Statements (continued)

For the year ended 31 December 2016

#### 3 Other operating income

	2016	2015
	£	£
Other operating income	<u>18,000</u>	<u>10,000</u>

#### 4 Exceptional items

During the year £125,000 (2015 £nil) of legal expenses were incurred to fight a legal challenge. This was included in administrative expenses.

#### 5 Auditors' remuneration

Fees payable for the audit of the financial statements totalled £7,200 (2015 £5,950).

#### 6 Employees

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

	2016	2015
Employees	18	13

#### 7 Intangible assets

	£
Cost or valuation:	
At 1 January 2016	<u>150,000</u>
At 31 December 2016	<u>150,000</u>
Amortisation:	
At 1 January 2016	<u>150,000</u>
At 31 December 2016	<u>150,000</u>
Net book value:	
At 31 December 2016	<u>-</u>

**ACCOUNTING AND AUDIT QUARTERLY UPDATE – QUARTER 4**

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At 31 December 2015

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**Too Much Disclosure Ltd**

**Notes to the Financial Statements (continued)**

**For the year ended 31 December 2016**

**8 Tangible fixed assets**

	Investment properties	Land and buildings	Plant and machinery etc	Total
	£	£	£	£
Cost or valuation:				
At 1 January 2016	220,000	345,000	572,300	1,137,300
Additions	-	-	32,450	32,450
Fair value adjustment	10,000	-	-	10,000
At 31 December 2016	230,000	345,000	604,750	1,179,750
Depreciation:				
At 1 January 2016	-	147,001	497,400	644,401
Charge for the year	-	8,166	38,050	46,216
At 31 December 2016	-	155,167	535,450	690,617
Net book value:				
At 31 December 2016	230,000	189,933	69,300	489,233
At 31 December 2015	220,000	197,999	74,900	492,899

The investment property has been measured at fair value which is the open market value of the property. The fair value adjustment has been taken through the profit and loss account.

**Too Much Disclosure Ltd**

**Notes to the Financial Statements (continued)**

**For the year ended 31 December 2016**

**9 Stock**

	2016	2015
	£	£
Finished goods and goods for resale	312,943	153,300
	312,943	153,300

**10 Debtors**

	2016	2015
	£	£
Trade debtors	406,556	269,761
Other debtors	33,325	9,172
	439,881	278,933

**11 Creditors: amounts falling due within one year**

	2016	2015
	£	£
Bank loans and overdrafts	80,000	132,000
Trade creditors	244,678	49,562
Corporation tax	240,000	120,000
Other tax and social security	56,341	43,998
Finance leases	18,562	23,973
Other creditors	89,352	70,300
	728,933	439,833

**Too Much Disclosure Ltd**

**Notes to the Financial Statements (continued)**

**For the year ended 31 December 2016**

The bank loan of £80,000 (2016 - £132,000) is secured by a floating charge over the company's assets.

**12 Finance leases**

Minimum lease payments on finance lease fall due as follows

	2016	2015
	£	£
Within one year	2,314	2,314
Between 1-2 years	2,314	2,314
Between 2-5 years	<u>13,934</u>	<u>19,345</u>
	<u>18,562</u>	<u>23,973</u>

**13 Deferred tax**

	2016
	£
At beginning of the year	(12,250)
Charged to profit and loss	(2,000)
	<u>(14,250)</u>

The provision for deferred tax is made up as follows

	2016
	£
Accelerated capital allowances	<u>(14,250)</u>
	<u>(14,250)</u>

**Too Much Disclosure Ltd**

**Notes to the Financial Statements (continued)**

**For the year ended 31 December 2016**

**14 Share capital**

	2016	2015
	£	£
Shares classified as equity		
Allotted, called up and fully paid		
100 Ordinary shares of £1 each	100	100
	100	100
	100	100

**15 Pension commitments**

The company operates a defined contribution pension scheme. The assets of the scheme are held separately from those of the company in an independent administered fund. The pensions cost charge represents contributions payable by the company to the fund and amounted to £20,000 (2015: £20,000).

**16 Commitments under operating leases**

At 31 December 2016 the company had future minimum lease payments under non-cancellable operating leases as follows:

	2016	2015
	£	£
Land and buildings		
Not later than one year	3,041	4,205
Later than 1 year and not later than 5 years	8,314	9,345
Later than 5 years	-	1,222
	11,355	14,772
	11,355	14,772
Others		
Not later than one year	600	600
Later than 1 year and not later than 5 years	900	1,500
	1,500	2,100
	1,500	2,100

**Too Much Disclosure Ltd**

**Notes to the Financial Statements (continued)**

**For the year ended 31 December 2016**

**17 Financial commitments**

Other than operating lease commitments the company had total financial commitments, guarantees and contingencies which are not included in the balance sheet amounting to £2,000,000 (2015: £1,500,000).

**18 Post balance sheet events**

After the year end there was a fire then flood in the company's store incurring uninsured stock losses of £198,000

**19 Transactions with directors**

O Verthetop controls Perfect Paisley Ltd, which supplied design services to the company amounting to £100,000 (2015: £80,000). The services were supplied at arms length.

X Essive controls Seriously Stripy Ltd, which supplied design services to the company amounting to £10,000 (2015: £8,000). The services were not supplied at arm's length.

During the period, the company made a short-term loan to a director, O Verthetop, amounting to

£20,000. Interest at the rate of 5.5% per annum is payable half-yearly and the loan is repayable on 31 December 2020.

During the period, the company guaranteed the borrowing of a director, X Essive. The guarantee amounted to £70,000 and is in place until 31 March 2022, unless the underlying loan is repaid early.

**20 Controlling party**

X Essive is the controlling party because of his 51% shareholding.

## 2.2 FRS 102 Section 1A disclosure refresher

### 2.2.1 Disclosure requirements for small entities

The disclosure requirements for a small entity are split into two distinct Appendices:

- Appendix C *Disclosure requirements for small entities* – this Appendix outlines those disclosures which are required by law and which essentially reflect the provisions in the Companies Act 2006 as amended by 2015/980.
- Appendix D *Additional disclosures encouraged for small entities* – this Appendix outlines those disclosures which a small entity is required to consider in order that the financial statements give a true and fair view.

### 2.2.2 Disclosures required by law

Appendix C requires a small entity to provide the following disclosures which are required by the Companies Act 2006:

#### Accounting policies

- The entity's (material) accounting policies which must also include:
  - details of any changes in presentation, accounting policies and any corrections of prior period errors; and
  - where the small entity has departed from any of the company law requirements (true and fair override), provide particulars of the departure, the reasons for the departure and the effect of the departure.
- Notes supporting the balance sheet. If an asset or a liability relates to more than one item in the small entity's balance sheet, disclosure is required of the relationship of the asset or liability to such items.

#### Fixed assets

- Fixed assets, which will include the usual fixed assets reconciliation showing the composition of net book value. This disclosure requirement applies equally to:
  - investment property;
  - tangible fixed assets (property, plant and equipment);
  - intangible assets (also goodwill);
  - fixed asset investments;
  - biological assets (i.e. living animals or plants); and
  - heritage assets.

The reconciliations of fixed assets do not have to be presented for prior periods.

- Revalued fixed assets. When any fixed assets are measured at revaluation, the items that are revalued and the basis of valuation that has been adopted must be disclosed in the accounting policies section. In addition, the small entity must also disclose:
  - the years in which the fixed assets were valued (to the extent that this information is known by the directors);
  - where fixed assets have been revalued during the period, disclose the name of the person(s) that carried out the revaluation or details of their qualifications together with the basis of the valuation that they applied;

- for each revalued fixed asset, disclose the comparable amounts that would have been recognised had the revalued fixed assets been carried under the historic cost model (i.e. total cost, total accumulated depreciation and total impairment losses);
- movements in the revaluation reserve during the reporting period, together with an explanation of the tax treatment, and the carrying amount of the revalued fixed assets that would have been recognised in the balance sheet had the assets not been revalued (this is to be presented in tabular form); and
- the tax treatment of the amounts credited to or debited from the revaluation reserve.
- Where the reporting entity has a policy of capitalising borrowing costs, disclose the amount of interest that has been included within the cost of the asset(s).

### Impairment of assets

- Where any items of fixed assets (which also includes fixed asset investments) have been impaired, the small entity must disclose the provisions for impairment in the notes to the accounts if the small entity has not shown this amount separately in the profit and loss account.
- If the small entity has reversed any provisions for impairment on the grounds that the reasons for the impairment no longer exist, the value of such reversals must be disclosed. This disclosure can be made either separately for each type of reversal or in aggregate and should be shown in the notes to the accounts if not shown separately in the small entity's profit and loss account.

### Fair value measurement

- If the small entity measures any financial instruments or other assets at fair value, with changes in fair value going through the profit and loss account, disclose:
  - the significant assumptions used in the valuation models as well as the techniques applied to determine fair value;
  - for each class of financial instrument or other asset, the fair value of the assets within that class together with the change in value that is included directly in the profit and loss account or taken to the fair value reserve;
  - for each class of derivative financial instrument, the extent and nature of the derivative instruments which should also include significant terms and conditions which may affect the amount, timing and certainty of the future cash flows; and
  - if any amount is transferred to, or from, the fair value reserve during the accounting period, provide (in tabular form) the opening and closing balance of the fair value reserve and the amount that has been transferred to, or from, the reserve.

FRS 102 (September 2015) includes paragraph 1AC.25 which requires disclosure as to the tax treatment of amounts taken to the fair value reserve. This disclosure requirement is superfluous as it was repealed in SI 2015/980 and the FRC have confirmed that it will be removed in future editions of FRS 102 (the next edition is expected towards the end of 2017). Therefore, such a disclosure need not be made in the financial statements.

- In the extremely rare situation that a small company reports under EU-adopted IFRS, such standards allow certain financial instruments to be included in the accounts at fair value. Where this is the case for the small entity, the disclosures required by the relevant standards (e.g. IFRS 7 *Financial Instruments: Disclosures*) should be made.

### **Liabilities, guarantees and commitments**

- In respect of the total value of items within creditors, disclose the total value of any liabilities which are repayable otherwise than by instalments and fall due for settlement (or repayment) after the end of the period of five years which starts with the first day after the balance sheet date. Where any instalments fall due for payment after the five-year period, the small entity should also disclose these amounts.
- If any security has been pledged for any items shown within creditors in the balance sheet, disclose the aggregate amount of such debts together with the nature and form of the security pledged.
- Where the small entity has any financial commitments, guarantees or contingencies that have not been included in the balance sheet, disclose such amounts. Any commitments relating to pensions should be separately disclosed.
- If the small entity undertakes any commitments for the benefit of another undertaking in which the small entity has a participating interest, it must separately disclose such commitments from any commitments it undertakes for the benefit of:
  - a parent;
  - a fellow subsidiary; or
  - any subsidiary belonging to the small entity.
- When the small entity pledges any security for any commitments, guarantees or contingencies, then it must provide an indication as to the nature of form of such security.
- When the small entity has been a party to any an off-balance sheet arrangement and the risks or rewards from such arrangements are material, disclose the nature and business purpose of such arrangements. The disclosure must be sufficient enough for a user to understand and assess the financial position of the entity.

### **Other notes to be disclosed**

- If there are any exceptional sizes or incidences of individual items of income or expenses contained in the profit and loss account, these must be disclosed (such as an exceptional bad debt).
- A small entity is now required to disclose the average number of employees in the reporting period. In addition, this disclosure is required to be filed at Companies House as this disclosure relates to the employees within the business as a whole, rather than a payroll disclosure. Whilst the positioning of this disclosure in Section 1A is under the 'Notes supporting the income statement' section, the Financial Reporting Council do not consider the filing requirements at Companies House to be within their remit; so whilst the disclosure requirement

does seem to be at odds with what would be required to be filed in, say, a set of 'filleted' accounts, the average number of employees is required to be filed on the public record. This disclosure will also be moved following the FRC's triennial review.

### Related party disclosures

- Small entities which are subsidiaries should disclose the following information in respect of the parent of the smallest group for which consolidated accounts are prepared of which the small entity itself belongs:
  - the name of the parent that draws up the consolidated accounts;
  - the address of the registered office of the parent (this applies even if the registered office is outside of the UK); or
  - where the parent is an unincorporated entity, the address of its principal place of business.
- A small entity may enter into related party transactions with:
  - owners that have a participating interest in the small entity;
  - companies that the small entity itself has a participating interest; and
  - its directors or members of its governing body.

When the small entity enters into related party transactions with the above and those transactions are not undertaken on an arm's-length basis (referred to in the standard as not concluded under normal conditions), the small entity must disclose:

- the value of the transactions;
- the nature of the related party relationship; and
- any other information that will enable a user to understand the impact such transactions have had on the financial position of the entity.

The information above can be aggregated on the basis of the nature of the transactions. However, separate disclosure should be made if making such separate disclosures enables an understanding of the effect that the transactions have had on the financial position of the business.

It should also be noted that transactions between group members need not be disclosed. This exemption only applies, however, if any subsidiary that is a party to the transaction is wholly-owned within the group.

### Directors' transactions (advances, credits and guarantees)

The requirement to disclose directors' advances, credits and guarantees is dealt with in Section 413 of the Companies Act 2006.

- Where the small entity grants an advance or credit to a director, disclose:
  - a) the amount;
  - b) the interest rate;
  - c) the main conditions;
  - d) any amounts that have been repaid;
  - e) any amounts that have been written off; and
  - f) any amounts that have been waived.

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

- In respect of a guarantee, disclose:
  - a) its main terms;
  - b) the amount of the maximum liability that the small entity may incur; and
  - c) any amount that the small entity has paid and any liability that has been incurred to fulfil the guarantee which should also include any loss suffered by the small entity to enforce the guarantee.

Monetary amounts are required to be disclosed in respect of items b) and c).

### **Other disclosure requirements**

- The part of the UK in which the small company is registered.
- The registered number of the business.
- Whether the small entity is a public or a private company and if the company is limited by shares or by guarantee.
- The address of the registered office.
- Where appropriate, the fact that the small entity is being wound up.
- Where the small entity has prepared abridged financial statements (and hence has combined items which have been assigned Arabic numbers in the statutory formats), if any items combined are material, disclose the individual amounts of any such items in the notes to the accounts.
- Any non-adjusting post-balance sheet events.

### **2.2.3 Encouraged disclosures**

The directors of a small company have a legal obligation to prepare financial statements that give a true and fair view. Indeed, section 393 of the Companies Act 2006 prohibits directors from approving financial statements if they do not give a true and fair view.

The reduced disclosure requirements that the EU Accounting Directive brings effectively place more responsibility on the part of the directors to ensure that the financial statements which they approve give a true and fair view. This may mean that additional disclosures, over and above those required by Section 1A of FRS 102, are required.

To assist small company directors to discharge their legal responsibilities, the Financial Reporting Council included Appendix D to Section 1A Additional disclosures encouraged for small entities which requires the directors to consider whether any of the following are material and, if so, to make the required disclosures:

- A statement of compliance with FRS 102 (see paragraph 3.3 of FRS 102) which should be adapted so that it refers to Section 1A.
- Where the small entity is a public benefit entity, disclose such a statement as outlined in paragraph PBE3.3A.
- Where there are material uncertainties relating to the small entity's ability to continue as a going concern, provide the disclosures as set out in paragraph 3.9.
- Dividends that have been declared and paid (or payable) during the accounting period. Paragraph 6.5(b) of FRS 102 provides the requirements in this respect.
- On first-time adoption of FRS 102, the transitional disclosure information as required by paragraph 35.13.

### 3 AUDITOR REPORTING ON STRATEGIC REPORTS (LECTURE A608 – 22.13 MINUTES)

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

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

#### 3.1 Reporting

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

The new wording in the auditor's report is as follows, for a company that produces a strategic report:

##### 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.

#### 3.2 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?

#### 3.3 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.

### 3.4 **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 financial key performance indicators? S414C4(a)

### 3.5 **Case study**

The following strategic report example is based on a real report for a medium-sized company with a turnover of £30m. The details have been changed enough so as not offend the company who wrote it.

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**

##### **Clear Communications Limited**

Extract from the Strategic Report for the year-ended 30 June 2017.

##### **Fair review of the business**

The principal activity of the company during the year was that of the supply and manufacture of marine radio and communications equipment.

In the year, the company increased sales by 2% in comparison with the prior year.

The market was strong and the company performed well in the first six months of the year. However, as a result of movements in exchange rates and the economy in the Americas this was followed by a shrinking of the order books in the second half of the

year. Despite the downturn at the end of the period, the company has still increased profitability as a result of the careful management of its direct costs and overheads.

The company continues to pursue business development opportunities in several market sectors for future growth and has seen this development continue during the period with continued success in new markets and involvement in activities for future revenues. Asia and particularly Japan have proved to be promising new areas of growth. These customers are believed to be worth a great deal in future years and represent development of new markets both in terms of geographical area and customer base.

### **Principal risks and uncertainties**

This year has seen further development and support to other group companies based outside the UK where we continue to transfer product for production. In addition, we have also brought on board a North African joint venture to allow further expansion of our production base whilst also mitigating any risks through reliance on specific geographical areas of production.

Employee numbers have increased in the year due to the increase in demands for locally manufactured products. The company continues to invest heavily in the learning and development of its employees and has implemented many new initiatives to engage and retain key employees in terms of training and continuous improvement. In addition, the company's activities identify potential future skills gaps in order to ensure the company can meet the needs of both current and future customer requirements.

The company has won a number of important industry awards in the year including being recognised by its fellow manufacturing community through being awarded the Pyramid of Manufacturing Excellence in March 2017 and the Investment in Human Resources Award in September 2016.

Additional, stability has also been achieved in terms of overheads and direct costs as a result of continuous improvement activities, improvement in processes, strategic measures and development of activities to focus attention on the core business. New systems have enabled efficiencies to be achieved in stocking levels which has resulted in stock levels reducing from 2016 to 2017 despite maintaining current stock lines at agreed levels with customers allowing the company to continue to work towards achieving optimum stock levels.

### **Development and performance**

Whilst customer pressure will always be cost down, the company will continue to invest in continuous improvement activities which will enable the company to maintain and further improve profitability. The company has maintained accreditation for its internationally recognised quality control standards, including ISO9001, during the year, and has also actively looked at ways to improve operational activities in order to reduce the impact on the environment, resulting in the company being awarded runners up in the Ethical Business Awards.

The company continues to monitor market activities and KPIs such as order intake, order outstanding, aged debtors and creditors, stock values and turn, non-conforming products, delivery performance, customer pricing and product profitability and relationships with customers.

The directors believe that the company's success next year remains reliant on global economic conditions in line with the company's current customer base however the directors remain optimistic that the company can continue to win new customers in different market sectors and continue to develop the business.

The directors will continue to monitor forward ordering in view of the current economic conditions and the company is well placed to be able to react to volume changes in order to maintain net profit percentages.

The strategy of the company is to continue selling into its core market and increase market share through providing a value added service to customers. The company invests and targets new customers through our quality, costs, delivery and flexibility. We will continue to invest in training for our personnel.

Supply chain risk is reduced as the main source of our raw materials is via group central purchasing facility in Germany. The risk of logistical supply problems is reduced by the availability of core product held in stock in the UK and Italy. Furthermore, the company is well placed through its related companies throughout the work to be able to obtain labour for production between various global sites.

### 3.6 John Selwood’s solution

You might have noticed that I need to take some personal responsibility for this solution. In my experience when talking about compliance in strategic reports, opinions can be divided on the subject. This is somewhat inevitable given the paucity of guidance on the matter and the resulting need to use professional judgement.

For what it’s worth, this is what I think:

	Issue	John’s answer
Q1	Does the strategic report contain a <u>fair review of the company’s business</u> ?	I give it a strong maybe. The second and third paragraph is fairly clear and with a little more detail I would be happy. I can just about accept the report as it is, as being compliant in this area, but I would rather it was slightly more specific and detailed
Q2	Does the strategic report contain a <u>description of the principal risks and uncertainties</u> facing the company?	I am going to say, no. I think the risks are inferred rather than expressly stated. Bizarrely, more words are dedicated to how the risks are addressed than describing the risk themselves. I can understand why some auditors might accept this, but I think the risks need to be more clearly set out.
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 consistent with the size	No. What is missing for me, is balance. The ‘fluffy stuff’ on awards and improving the business, in my view, just clouds the more direct reporting. Also, the report is overly comprehensive which in my opinion

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	<u>and complexity of the business?</u>	leads to a lack of balance. The circumstances surrounding the shrinking of order books needed more focus and much of the rest of the report could have been lost.
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>	<p>No.</p> <p>If any auditors think that the review of the position of the business at the year end is adequate, then show me where!</p> <p>I would expect terms like solvency, liquidity, cash balances, lines of credit and recoverability to be mentioned.</p> <p>I know that the shrinking order book is mentioned but I would like more detail on that.</p>
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 financial key performance indicators?</u>	No.

#### 4 TOO MUCH DISCLOSURE LTD – SOLUTION

	Issue	Over-disclosure, under-disclosure and debatable issues
Company information	Typo?	The company number is too long!
Directors' report	Over-disclosure	There is no need to disclose principal activity – but it is understandable that companies might choose to.
Directors' report	Optional	The reappointment of auditors section is missing – but it is not a legal requirement.
Auditor's report	Missing/debatable	Bannerman! However, ACCA do not encourage the use of Bannerman (see section 8.1.1 below).
Auditor's report	Missing	The CA 2006 opinion on the directors' report being in compliance with applicable legal requirements.
Auditor's report	Wrong place	The statement on there being no misstatements in the directors' report is more commonly placed in the Reporting by exception section of the report.
Auditor's report	Filing	The audit report would be removed before filing and the s444(5) disclosures would be added when the filleted accounts are prepared.
P&L	Option missed	The P&L is not abridged. This is not a very popular option as it rarely shows a true & fair view and is pointless.
P&L	Optional	There is no requirement for an operation profit heading.
Balance sheet	Needed for true and fair?	There might need to be a provisions note to show a true & fair view.
Balance sheet	Not required	The separate P&L reserve (presumably in respect of the gains on the investment properties) is not required, but it is a common presentation. This could have been in the SOCIE.
Balance sheet	Interesting point	The s444 disclosure can appear in the full accounts but usually it gets inserted in the filleted accounts before filing.
Balance sheet	Option missed	The balance sheet is not abridged. This is a more common option but many accountants do not feel the need to use the exemption.
SOCIE	Encouraged	It might only be encouraged but most accountants include the SOCIE for a T&F view. Alternatively, a

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	presentation	SOIRE could have been produced.
Note 1	Interesting point	Arguably the s396 disclosure is inadequate because various details, such as the company number and the fact that it is a private company is missing. However, this sort of information is elsewhere in the accounts, including the company information page, or is self-evident.
Note 1	Missing	FRS 102 requires the principal place of business to be disclosed, where it is different from the registered office. In this case the registered office is clearly the auditor's office.
Note 2	Interesting point	There is no need to mention Section 1A in the statement of FRS 102 compliance, although it does no harm.
Note 2	Encouraged disclosure	The statement of compliance itself is only an encouraged disclosure.
Note 2	Over-disclosure	The principal activity does not have to be disclosed in small companies.
Note 2	Encouraged disclosure	The transition disclosure an encourage disclosure. Disclosure of the transition date is also, presumably, encouraged but when there are no transitional adjustments this seems superfluous. The statement that there are transitional adjustments is stated by ICAEW as 'good practice', and seems like a good idea.
Note 2	Over-disclosure	The statement on the presentation currency is not needed in small companies.
Note 2	Wrong disclosure	The revenue recognition note is wrong and uses boilerplate wording. The company does not supply services and needs something much more specific to its activities.
Note 2	Over-disclosure	The goodwill accounting policy note is superfluous as there is no goodwill in the balance sheet.
Note 2	Over-disclosure	The disclosure that the investment properties are valued by qualified surveyors is not required for small companies.
Note 2	Over-disclosure	A number of the other accounting policy notes could be superfluous as they do not represent significant accounting policies.
Note 2	Over-disclosure	The going concern note is not required. Going concern disclosure is only needed where there are material uncertainties casting significant doubt about the appropriateness of the going concern basis. If there were such concerns they would usually be disclosed

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		more prominently than the end of the accounting policy note.
Note 3	Over-disclosure	The other operating income note is not needed for small companies.
Note 5	Over-disclosure	The auditor's remuneration disclosure is not needed for small companies. This disclosure reduction was not available for early adoption unlike the rest of FRS 102 1A.
Note 7	Over-disclosure	The intangible assets note does not seem to add much, disclosing that the goodwill is fully amortised.
Note 11	Over-disclosure	The creditors note, unnecessarily, presents the corporation tax creditor separately. This could be included in the tax and social security heading.
Note 11	Interest point	The disclosure of the nature of the security <b>is</b> required by FRS 102 1A. The FRSSSE did not require this disclosure.
Note 12	Over-disclosure	The finance lease disclosures are not required for small companies.
Note 12	Error	The lease creditor due in less than one year is wrong.
Note 13	Over-disclosure	The deferred tax note is not required for small companies. Note. Neither is the current tax note.
Note 14	Over-disclosure	Small companies do not have to disclose the classes of shares, nominal values or the number of shares. All that needs to be disclosed in the split between allotted, called up and fully paid.
Note 15	Over-disclosure	This pension note is not required for small companies. All that has to be disclosed are year-end pension commitments and there are none, in this instance.
Note 16	Over-disclosure	FRS 102 1A only requires the disclosure of the aggregate of financial commitments, contingencies and guarantees. Yet to show a true and fair view it might be necessary to disclose the banding of the operating lease commitments. In this case the figures are not sufficiently material to need banding.
Note 17	Under-disclosure	Whilst FRS 102 1A only requires the disclosure of the aggregate of financial commitments, contingencies and guarantees, it is often necessary to disclose more than this to show a true and fair view. In this case more thorough disclosure is needed to understand the impact of such big potential commitments on the company.
Note 19	Over-disclosure	The transactions with Perfect Paisley Ltd and Seriously Stripy Ltd do not need to be disclosed because there is

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		no need to disclose transactions with companies under common control.
Note 19	Interesting issue	The other disclosures are s413 disclosures. Directors advances, credits and guarantees are required to be disclosed.
Note 20	Over-disclosure	The disclosure of controlling parties is not required in small company accounts. Although, small companies do have to disclose the name and address of their parent company if the parent prepares group accounts

## 5 MICRO-ENTITIES: EMERGING ISSUES (LECTURES A609 - 11.26 MINUTES)

FRS 105 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* is an optional standard for the smallest of companies which can meet two out of the following three criteria for two consecutive years:

- turnover not more than £632,000
- balance sheet total not more than £316,000
- not more than 10 employees

The rules in FRS 105 are prescriptive in that they do not allow micro-entities any accounting policy options; for example, there is no option to capitalise borrowing or development costs – such costs must be written off to the profit and loss account as they are incurred.

### 5.1 *Investment property in a micro-entity*

Two of the most common questions asked by practitioners at the current time where investment properties and micro-entities reporting under FRS 105 are:

- (a) Can I use a previous UK GAAP revaluation as deemed cost?
- (b) Must I depreciate investment property and, if so, could we not say that the residual value is equivalent to cost?

Investment property in a micro-entity is accounted for under the historical cost accounting rules as the micro-entities' legislation does not allow the use of the alternative accounting rules or the fair value accounting rules. As a consequence, all fair value and revaluation amounts **must** be removed on transition and the asset restated to the value it would be carried at had it always been accounted for under the historical cost accounting rules. Where investment property is concerned, there is a transitional option available in Section 28 *Transition to this FRS* at paragraph 28.10

- (c) which allows a first-time adopter an exemption from paragraph 12.15 of FRS 105 which requires component accounting to be applied. First-time adopters using the exemption in paragraph 28.10(c) can instead:
  - (i) Determine the total cost of the investment property including all of its components. Where no depreciation had been charged under the micro-entity's previous financial reporting framework, this can be calculated by reversing any revaluation gains or losses previously recorded in equity reserves.
  - (ii) The cost of land, if any, shall be separated from buildings.
  - (iii) Estimate the total depreciated cost of the investment property (excluding land) at the date of transition to this FRS, by recognising accumulated depreciation since the date of initial acquisition calculated on the basis of the useful life of the most significant component of the item of investment property (eg the main structural elements of the building).

- (iv) A portion of the estimated total depreciated cost calculated in paragraph (iii) shall then be allocated to each of the other major components (ie excluding the most significant component identified above) to determine their depreciated cost. The allocation should be made on a reasonable and consistent basis. For example, a possible basis of allocation is to multiply the current cost to replace the component by the ratio of its remaining useful life to the expected useful life of a replacement component.
- (v) Any amount of the total depreciated cost not allocated under paragraph (iv) shall be allocated to the most significant component of the investment property.<sup>1</sup>

### 5.1.1 Previous GAAP revaluation as deemed cost

A previous GAAP revaluation must not be used as a deemed cost on transition as this will effectively be a revalued amount which the legislation prohibits. As the micro-entities regime requires the historical cost accounting rules to be applied, all assets (including investment property) must be included at purchase price or production cost. This is reflected in the *Accounting Council's Advice to the FRC to Issue FRS 105* at paragraph 32 of the July 2015 edition of the standard.

If practitioners have inadvertently used a previous UK GAAP revaluation as deemed cost for a micro-entity client, this must be corrected by way of a prior period adjustment if the effect of the difference is material.

### 5.1.2 Depreciation charges

Depreciating investment property does somewhat sit at odds with some practitioners. If investment property had been depreciated under previous UK GAAP, this would have been incorrect as the FRSE required such properties to be measured at open market value at each balance sheet date. Changes in open market value were taken to a revaluation reserve.

Revaluations and fair value amounts cannot be used for investment property and the historical cost accounting rules require all tangible fixed assets to be depreciated.

Many practitioners ask whether depreciation should be charged if residual value is equal to cost? 'Residual value' is defined in the Glossary to FRS 102 as:

*'The estimated amount that an entity would currently obtain from disposal of an **asset**, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its **useful life**.'*<sup>2</sup>

Therefore, under FRS 105, the residual value of an investment property would be based on current prices, i.e. the amount which would currently be obtained on disposal of the asset, as opposed to the amount that is expected to be obtained at the end of the asset's useful life. For this purpose, expectations as to future increases or decreases in those disposal proceeds are ignored.

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<sup>1</sup> FRS 105 paragraph 28.10(c)(i) to (v)

<sup>2</sup> FRS 105 Glossary **residual value**

FRS 105 defines 'residual value' by referring to the **potential disposal value** of the asset if it were already of the age and in the condition expected at the end of its useful life. This is very much separate from the current fair value of the asset and in instances where the fair value of an asset may exceed its carrying amount, this does not remove the requirement to recognise depreciation.

### 5.2 *Additional disclosures*

*The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015* SI 2015/980 made changes to the reporting requirements for small and micro-entities. FRS 105 only currently requires two disclosures to be made at the foot of the micro-entity's balance sheet in respect of:

- advances, credits and guarantees to directors; and
- guarantees and other financial commitments.

When SI 2015/980 was transposed into company law, the amendments made to sections 410A and 411 removed references to the phrase '*In the case of a company that is not subject to the small companies regime, if in any financial year...*'. Section 410A requires disclosure of off-balance sheet arrangements and section 411 requires disclosure of employee numbers. The effect is that these should be disclosed in the micro-entity's financial statements along with the section 413 disclosures.

As a consequence, off-balance sheet arrangements and employee numbers are a required disclosure in a micro-entity's financial statements for periods commencing on or after 1 January 2016.

Therefore, the revised disclosure requirements under FRS 105 will be:

- (a) information about off-balance sheet arrangements as required by section 410A of the Act;
- (b) information about employee numbers;
- (c) advances, credit and guarantees to directors as required by section 413 of the Act; and
- (d) 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.

While disclosures relating to off-balance sheet arrangements and employee numbers are not currently in FRS 105 (July 2015), which micro-entities are currently reporting under, it is advisable to include them in current years' financial statements to ensure the financial statements are prepared in accordance with the legal requirements and hence the true and fair presumption will apply. It should also be noted that while the current edition of FRS 105 does not include the disclosures, company law prevails over FRS 105 and hence accentuates the recommendation to disclose off-balance sheet arrangements and employee numbers for periods starting on or after 1 January 2016.

## 6 FRS 102 EMERGING ISSUES: PART 2 (LECTURE A610 – 13.40 MINUTES)

We continue to examine some of the issues faced by practitioners as they transition to 'new' UK GAAP as a means of assisting firms produce financial statements under the new regime which can stand up to scrutiny and are technically correct. As noted in the previous accounting and audit update course, the introduction of new accounting standards invariably brings some uncertainties as to accounting treatments and disclosures and in all cases it is advisable to seek advice from a reputable training organisation or your professional body's technical helpline to ensure the financial statements reflect the correct accounting treatment or disclosure requirement.

In this quarter's update, we examine the following emerging issues:

- Goodwill
- Government grants
- Adjusting versus non-adjusting events
- Tax reconciliation note
- Abridged financial statements

### 6.1 Goodwill

Goodwill continues to be a contentious issue in terms of its treatment under FRS 102. Section 19 *Business Combinations and Goodwill* deals specifically with the issue of goodwill at paragraphs 19.22 to 19.24 with cross-references to paragraphs 18.19 to 18.24 in respect of amortisation (Section 18 deals with Intangible Assets other than Goodwill). A cross-reference to Section 27 *Impairment of Assets* is also included in paragraph 19.23(b) for measuring impairment of goodwill.

The Glossary to FRS 102 defines 'goodwill' as:

*'Future economic benefits arising from **assets** that are not capable of being individually identified and separately recognised.'*<sup>3</sup>

Goodwill arises when the cost of a business combination exceeds the net assets acquired. In addition, purchased goodwill can also arise in the financial statements of a company; for example, when a company acquires the net assets from the old sole trader business.

#### 6.1.1 Amortisation

FRS 102 does not allow goodwill to have an indefinite useful life. In contrast, previous UK GAAP contained a rebuttable presumption that the useful economic life of goodwill was 20 years. In some cases, goodwill was not amortised because management deemed it to have an indefinite useful life. For some smaller companies that have recognised goodwill on the balance sheet when the entity first incorporated, goodwill is still recognised at its original amount as it has never been amortised. It is this sort of treatment which must change under FRS 102.

<sup>3</sup> FRS 102 Glossary **goodwill**

Under previous UK GAAP, if goodwill was judged to have an indefinite useful life, it should have been tested for impairment at each balance sheet date. Where goodwill was being amortised, it was commonplace to amortise it over 20 years due to the rebuttable presumption contained in FRS 10 *Goodwill and intangible assets*. The 20-year amortisation method was also popular because if the entity chose a longer period, or assigned an indefinite life to goodwill, impairment provisions were triggered which can be arduous.

While there may have been some uncertainty when management chose the 20-year useful economic life, the uncertainty would have been around whether the life was longer, rather than shorter. On transition to FRS 102, entities are required to assess their accounting policies for compliance with FRS 102 and also assess whether they continue to remain appropriate. Where goodwill has, say, 15 years left to run at the date of transition, it would not be appropriate to reduce the useful life to a maximum of 10 years unless there was clear evidence that goodwill only has a remaining useful life of 10 years at the date of transition. If there is a need to reassess the useful life of goodwill, the new estimate is applied prospectively from the date of transition as changes in useful lives are changes in estimation which are accounted for prospectively (i.e. going forwards) under Section 10 *Accounting Policies, Estimates and Errors*.

### 6.1.2 Internally generated goodwill

Some entities have recognised internally generated goodwill on the balance sheet on the grounds that the business is successful and is worth more than the value of the net assets under the control of the company. Management justify this treatment by saying they have an efficient management structure, good customer relationships, a well-established reputation and increasing sales year-on-year.

While this may be true, recognising internally generated goodwill is not permitted under FRS 102 (paragraph 18.8C(f)), nor was it permitted under previous UK GAAP at FRS 10 (paragraph 8). Therefore, where internally generated goodwill has been recognised, it should be removed.

## 6.2 Government grants

Government grants are often provided to entities for various reasons, such as setting up operations in a deprived part of the country, towards the cost of an asset or to reimburse previously incurred costs. Government grants are dealt with in Section 24 *Government Grants*. Section 24 is based on the provisions in *IFRS for SMEs* which introduced a performance model (that was not contained in previous UK GAAP at SSAP 4 *Accounting for government grants*) but the FRC made amendments to Section 24 by introducing an accounting policy choice for entities so they can use either the performance model or the accrual model (the latter being the model used in old UK GAAP).

Micro-entities reporting under the provisions of FRS 105 cannot use the performance model; they must only apply the accrual model.

There appears to be some confusion as to the new performance model; presumably because it did not feature in old UK GAAP.

The performance model allows some grants to be recognised immediately in profit and loss, even if they relate to assets, provided that the 'performance-related conditions' have been met. The phrase 'performance-related conditions' is defined in FRS 102 as:

*'A condition that requires the performance of a particular level of service or units of output to be delivered, with payment of, or entitlement to, the resources conditional on that performance.'*

The performance model works as follows:

- (a) A grant that does not impose specified future performance-related conditions on the recipient is recognised in income when the grant proceeds are received or receivable.
- (b) A grant that imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.
- (c) Grants received before the revenue recognition criteria are satisfied are recognised as a liability.

Care must be taken, therefore, to ensure that the entity receiving the grant has complied with **all** the performance-related conditions attached to the grant prior to recognising it in the profit and loss account.

### 6.2.1 Accrual model

The accrual model works in the same way as it did under previous UK GAAP.

Under previous UK GAAP, some entities had incorrectly credited a capital-based grant to the cost of the asset to which it relates. This meant that the grant would have been recognised in the profit and loss account by way of reduced depreciation charges. The problem with this accounting treatment is that the Companies Act 2006 says that fixed assets measured under the historical cost accounting rules are to be stated at their purchase price or production cost. The statutory definitions of 'purchase price' or 'production cost' make no provision for any deduction from that amount in respect of grants.

FRS 102 does clarify at paragraph 24.5G that capital-based grants which relate to fixed assets must be recognised as deferred income and not deducted from the carrying amount of the asset.

For practitioners acting for academy schools which receive capital grants to acquire fixed assets, these must be recognised in the statement of financial activities and not deferred over the life of the asset (see paragraph 5.27 of the Charities SORP (FRS 102)).

### 6.3 Adjusting and non-adjusting events

Section 32 *Events after the End of the Reporting Period* provides the guidance an entity should follow where post balance sheet events are concerned. There are no differences between the requirements of Section 32 and previous UK GAAP (FRS 21 *Events after the balance sheet date*).

Adjusting events are those events which provide evidence of conditions that existed at the end of the reporting period. Classic examples include the bankruptcy of a customer shortly after the balance sheet date; sale of stock which confirms that estimated selling price is lower than cost (hence a write-down); and the discovery of fraud or error which show the financial statements are incorrect. Such adjusting events are reflected in the financial statements regardless of the fact that they arise after the balance sheet date but before the financial statements are authorised for issue (as their conditions were in existence at the balance sheet date).

Non-adjusting events are those which are indicative of conditions which arose after the end of the reporting period; i.e. their conditions did not exist at the balance sheet date. Paragraph 32.11 of FRS 102 outlines some examples of what it considers to be non-adjusting events including plans to discontinue an operation, the classic case of a fire destroying a production plant and commencement of major litigation arising out of events that occurred after the balance sheet date.

### 6.3.1 Dividends

Dividends frequently cause issues for practitioners in either recognising them as a liability or when it comes to disclosing them in the financial statements.

Paragraph 32.8 of FRS 102 confirms that dividends cannot be recognised in the financial statements until they are appropriately authorised and are no longer at the discretion of the entity.

When dividends are declared prior to the balance sheet date, but paid after the balance sheet date, it is necessary to consider whether the declaration is legally binding. In the case of a final dividend, the dividend becomes legally binding when it is declared in general meeting (for private companies by way of the passing of a written resolution). Interim dividends authorised under common articles of association will normally become legally binding when the dividend is paid. Therefore, if an interim dividend is announced before the balance sheet date, but paid after the balance sheet, this will usually not result in a liability being recognised at the balance sheet date (although measures may be put in place which create a legally binding liability for an interim dividend, hence it is important to establish whether such steps have created a liability for an interim dividend).

There are no disclosure requirements in FRS 102 concerning dividends declared after the balance sheet date. However, paragraph 43 of Schedule 1 to the Accounting Regulations requires the following to be disclosed:

- (a) any amount set aside or proposed to be set aside to, or withdrawn or proposed to be withdrawn from, reserves,
- (b) the aggregate amount of dividends paid in the financial year (other than those for which a liability existed at the immediately preceding balance sheet date),
- (c) the aggregate amount of dividends that the company is liable to pay at the balance sheet date, and
- (d) the aggregate amount of dividends that are proposed before the date of approval of the accounts, and not otherwise disclosed under sub-paragraph (b) or (c).

### 6.4 *Abridged financial statements*

SI 2015/980 amended the filing requirements for small and micro-entities and this continues to cause confusion among the profession. As practitioners will be aware, abbreviated financial statements are no longer with us. Some practitioners are under the impression that abridged financial statements are the new abbreviated accounts – which is not the case.

Abridged financial statements are those financial statements which are prepared for the shareholders, following unanimous consent by all the shareholders and a statement is made on the balance sheet that the shareholders have unanimously consented to the entity preparing abridged financial statements. The abridged profit and loss account (assuming a Format 1) will start with gross profit or loss; the abridged balance sheet will still look the same as if a full balance sheet had been prepared and the notes will be condensed as those items preceded by Arabic numerals will not feature in the notes (for example the fixed assets reconciliation table).

### 6.4.1 Approval protocol

The Act requires the shareholders to unanimously agree to the entity preparing abridged financial statements each year; in other words, one agreement cannot cover all subsequent accounting periods. This is because the shareholders can only agree to preparing abridged financial statements for the preceding financial year and the approval must be sought **BEFORE** the abridged financial statements are prepared.

Some practitioners are under the impression that abridged financial statements only need one approval by the majority of the shareholders (after the abridged financial statements have been prepared). This is not the case for the reasons stated above; nor is it a majority vote – if there are six shareholders, five agree to the entity preparing abridged financial statements and the one shareholder does not, the company cannot prepare abridged accounts.

Some practitioners are obtaining resolutions from the shareholders confirming their approval for the entity preparing abridged financial statements; others are requesting other forms of agreement such as letters. The important point is to ensure that you have a copy of the agreement of all the shareholders to protect yourself against any comeback if the shareholders are involved in a dispute.

### 6.5 Tax reconciliation note

Under previous UK GAAP, FRS 19 required a reconciliation of the current tax charge (credit) per the profit and loss account to the profit before tax multiplied by the applicable corporation tax rate. Reviews of files indicate the new requirements under FRS 102 are misunderstood.

FRS 102 at paragraph 29.27(b) requires a reconciliation between:

- (i) the tax expense (income) per the profit and loss account; and
- (ii) the profit or loss before tax multiplied by the applicable tax rate.

The relationship between the two can be affected by various items, such as tax-free income, disallowable expenditure, differing tax rates, adjustments to prior year tax values, changes in corporation tax rates and utilisation of tax losses.

The starting point for the tax reconciliation note is to determine the applicable tax rate. Paragraph 29.27(d) also requires an explanation of changes in the applicable tax rate(s) compared with the previous accounting period (again, small companies need not disclose this information).

**Example – Tax reconciliation note**

**8. Tax on profit**

The tax charge is made up as follows:

	2017	2016
	£'000	£'000
UK corporation tax at 19% (2016: 20%)	758	529
Adjustments to tax in previous years	(71)	(7)
Deferred tax:		
Origination and reversal of timing differences	(302)	(111)
Effect of decrease in tax rate on opening provision	(1)	-
Tax on profit	384	411
	2017	2016
	£'000	£'000
Profit before tax	1,247	1,191
Profit before tax multiplied by the standard rate of corporation tax in the UK of 19% (2016: 20%)	237	238
Expenses not deductible for corporation tax purposes	302	108
Decelerated capital allowances	(84)	72
Adjustments to tax in respect of previous years	(71)	(7)
Total tax expense	384	411

## 7 AUDIT PLANNING AND RISK ASSESSMENT (LECTURE A611 – 12.32 MINUTES)

With December 2017 year-ends fast approaching, attention will be being turned to the planning of these assignments. The planning and risk assessment phase of the audit is a critical aspect as it allows the auditor the opportunity to identify those areas of the financial statements which are prone to the risk of material misstatement; identify appropriate staff members to be deployed on the assignment and develop procedures to obtain sufficient appropriate audit evidence as a means of reducing audit risk (i.e. the risk that the auditor expresses an inappropriate opinion on the financial statements).

Adequate time should be devoted to the planning and risk assessment phase of the audit and it should not be viewed as a 'tick-box' or compliance exercise. Many audits are criticised by file reviewers and professional bodies, usually because of poor planning which, in turn, results in poor execution of audit procedures.

Audit planning is dealt within in the ISAs (UK) in the 300 series:

- ISA (UK) 300 (Revised June 2016) *Planning an Audit of Financial Statements*;
- ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*;
- ISA (UK) 320 (Revised June 2016) *Materiality in Planning and Performing an Audit*, and
- ISA (UK) 330 (Revised June 2016) and (Revised July 2017) *The Auditor's Responses to Assessed Risks* [note ISA (UK) 330 (Revised July 2017) is effective for audits of financial statements for periods commencing on or after 15 December 2017].

This course will not be examining all of the above ISAs (UK) in turn, but will take a look at some of the critical areas of ISA (UK) 300 which should be applied when planning an audit of financial statements.

### 7.1 Why bother with planning?

The first response to this question is that it is compulsory under the UK ISAs. Auditors cannot go into an audit blind because if they do, audit risk is increased significantly. It is unfortunately not uncommon for audit files to be severely criticised by file reviewers and professional bodies for either a lack of audit planning or, in some more serious cases, no planning. Practitioners sometimes respond with 'I have acted for the client for several years and have a full understanding of the client and its systems'. While this may be true, if the planning is not carried out properly, the firm cannot demonstrate that it has complied with the ISAs (UK) – this will be the case if the planning is not adequately documented. If the firm cannot demonstrate they have complied with the ISAs (UK) they risk heavy sanctions coming their way – in some cases, professional bodies will remove an audit firm's audit practising certificate and impose a heavy fine for doing so.

When an audit firm carries out adequate audit planning, the benefits are as follows:

- It helps the auditor to devote appropriate attention to important areas of the audit.
- It helps the auditor identify and resolve potential problems on a timely basis.
- It helps the auditor properly organise and manage the engagement so that it is performed in an effective and efficient manner.

- It assists in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- It facilitates the direction and supervision of engagement team members and the review of their work.
- It assists, where applicable, in coordination of work done by auditors of components and experts.

The overall objective of ISA (UK) 300 is for the auditor to plan the audit so that it will be executed in an effective manner. This, of course, has the added benefit that efficient audits will also be cost-effective for the audit firm, hence budgets will not be exceeded and firm losses will be minimised.

### 7.2 *Preliminary planning activities*

At the outset, the auditor must consider whether there are any factors which may impede on the firm's independence and objectivity. In other words, they must consider whether they are sufficiently independent to carry out the engagement and whether the firm's quality control procedures comply with the requirements of ISA (UK) 220 (Revised June 2016) *Quality Control for an Audit of Financial Statements*.

The auditor must be satisfied that the firm's procedures regarding acceptance and continuance of audit engagements have been carried out together with the conclusions thereon. In situations where information comes to light which would have resulted in the firm declining the audit engagement had the information been known earlier, the engagement partner informs the audit firm so that appropriate action can be taken. Where the firm is a sole practitioner, hence the principal is also the senior statutory auditor, the principal considers the most appropriate action to take in light of the new information acquired.

The auditor must also consider the requirements of the FRC's Ethical Standard (the 2016 edition) and whether compliance can be achieved.

Finally, the auditor must review the contents of the engagement letter and determine whether they are in accordance with the requirements of ISA (UK) 210 (Revised June 2016) *Agreeing the Terms of Audit Engagements*. This includes considering whether the client needs reminding of the terms of the engagement and whether it needs to be updated. It is surprising how many engagement letters for audit assignments are out-of-date!

Where engagement letters are concerned, these must be in accordance with ISA (UK) 210 (Revised June 2016) and should be tailored to be client-specific wherever possible. In addition, it is important to ensure that the 'preconditions' of the audit are present (see paragraph 6 of ISA (UK) 210).

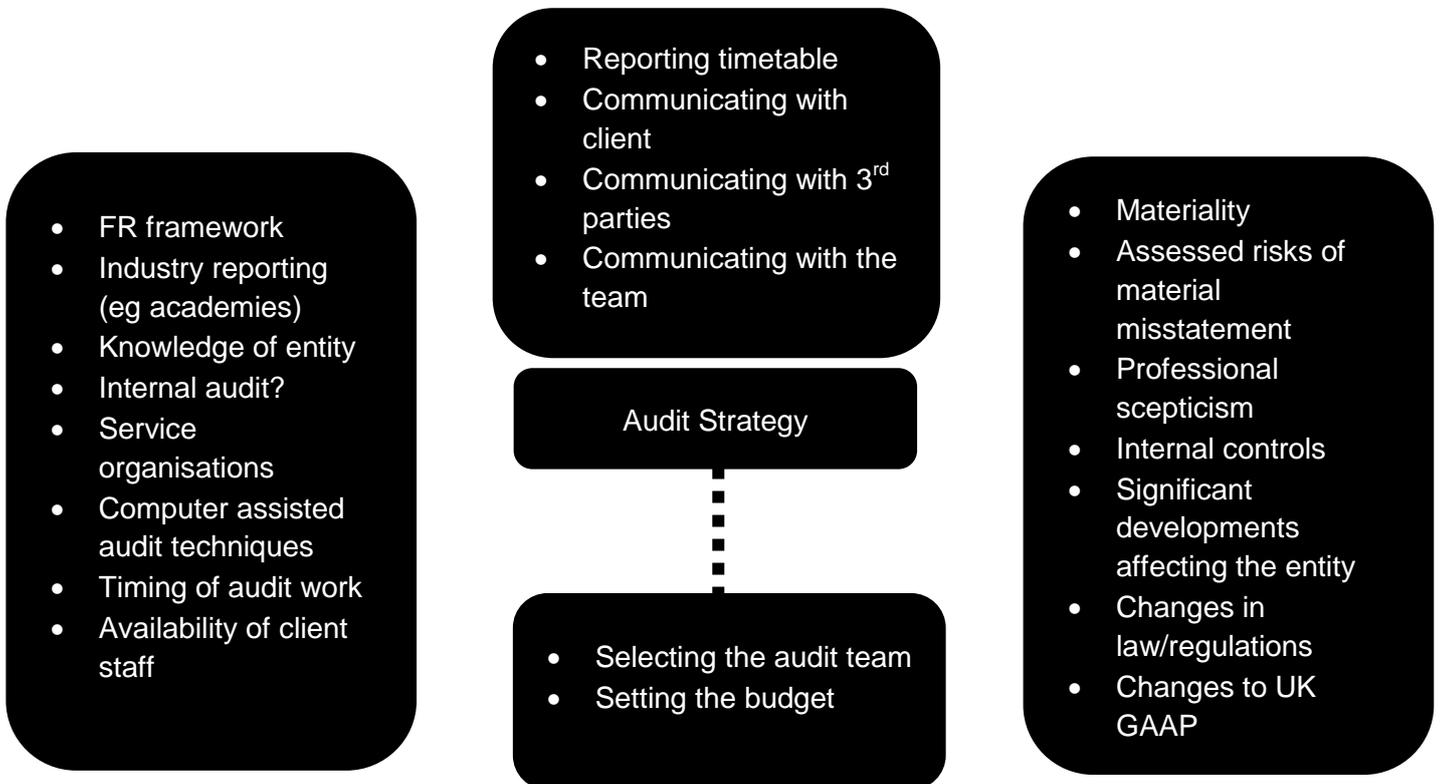
### 7.3 *Audit strategy*

An important part of the planning phase of the audit is for the auditor to develop an audit strategy. The audit strategy sets the scope, timing and direction of the audit and to achieve this the auditor:

- identifies the characteristics of the engagement;
- ascertains the reporting objectives so as to plan when the audit will be carried out and what forms of communication will be required;
- significant in directing the efforts of the audit team;

- consider the results of preliminary activities and whether knowledge gained by undertaking other work by the engagement partner for the entity is relevant; and
- deciding on the nature, timing and extent of resources to deploy on the assignment.

Developing the audit plan can be seen diagrammatically as follows:



The audit strategy is a 'high level' issue which allows the auditor to 'drill down' into the entity to help them develop the audit plan.

### 7.4 Audit plan

Once the audit strategy has been developed, the detailed audit plan can be drawn up. The idea of the audit plan is to address how the matters in the audit strategy (i.e. the diagram above) will be applied. Thus, the audit strategy sets the overall approach to the audit, whereas the audit plan deals with the operating level of how the audit strategy will be achieved.

Paragraph 9 of ISA (UK) 300 (Revised June 2016) says that the audit plan must include a description of:

- (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA (UK) 315 (Revised June 2016).
- (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA (UK) 330 (Revised June 2016).
- (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs (UK).

Once the audit strategy and audit plan have been developed, they must be updated as necessary as the audit progresses. In other words, they are not forgotten about when the planning is completed!

Where any significant changes are made during the engagement to the overall audit strategy or the audit plan, the reasons for such changes must be documented.

### 7.5 Assessing risks

An integral part of planning involves assessing risks. Risks usually comprise of three aspects:

- (a) business risk;
- (b) audit risk; and
- (c) the risk of material misstatement.

#### 7.5.1 Business risk

The term 'business risk' is defined in ISA (UK) 315 (Revised June 2016) as follows:

*'A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives or strategies.'*<sup>4</sup>

Business risk is a much broader concept than audit risk. At the planning phase of the assignment, firms should document the background of the business and then assess the business risks. Business risks are often linked to inherent risk, which itself is a component of audit risk. External circumstances often give rise to business risk, such as a company which operates in a high-tech industry and technological developments may mean that a company's inventory (stock) becomes obsolete quite quickly.

File reviews have indicated that business risks are not being documented adequately enough. Once the auditor has considered the relevant business risks, they should then consider whether these risks impact on any particular areas at the assertion level. For example, if a company's stock may become obsolete quickly, the auditor's attention should be devoted to the valuation of this inventory and whether write-downs to estimated selling price less costs to complete and sell may be necessary.

#### 7.5.2 Audit risk

Audit risk is the risk that the auditor will express an inappropriate opinion on the financial statements and is the broadest level of risk because it includes both inherent risk (which is the susceptibility of an assertion about a class of transaction, account balance or disclosure to misstatement before considering any related controls present at the entity) and detection risk. Detection risk is the risk that the auditor's procedures will not detect a misstatement which exists and which could be material. Detection risk is then sub-divided into:

- **sampling risk** which is the risk that the auditor's conclusion based on a sample is different from the conclusion which would be reached if the whole population were tested; and

<sup>4</sup> ISA (UK) 315 (Revised June 2016) paragraph 4(b)

- **non-sampling risk** which is the risk that the auditor's conclusion is inappropriate for any other reasons, such as performing inappropriate procedures or failing to recognise a misstatement.

### 7.5.3 Risk of material misstatement

The risk of material misstatement is the risk that the financial statements contain a material misstatement prior to the auditor starting the audit. The risk of material misstatement comprises both inherent risk and control risk (control risk being the risk that a misstatement could occur which could be material and which will not be corrected, or detected and corrected, on a timely basis by the entity's internal control system).

When assessing the risk of material misstatement, it is vital to consider the specific impact of the risk on the financial statements, including whether the potential misstatement is an over or understatement of amounts recognised in the financial statements, or whether the risk relates to a disclosure requirement in the notes to the financial statements.

An entity with a poor control environment will invariably have a higher risk of material misstatement than an entity with a sound control environment. However, auditors should keep in mind that just because an entity may have a good internal control environment, it will not completely eradicate the risk of material misstatement. For example, management override of internal control!

To reduce audit risk, the auditor must ensure that they carry out risk assessment processes carefully (rather than approach the process as a tick-box exercise) and ensure they devise appropriate responses to risks at the planning stage.

### 7.5.4 Responses to risk

At the planning stage, the auditor will first consider the business risks pertinent to the client and how these risks (could) impact the financial statements. Audit risks are then considered for which appropriate responses should be designed by the auditor. Typical auditor's responses to risk would be:

- assigning experienced audit staff to areas which contain a higher risk of material misstatement;
- performing more regular reviews of audit work and increasing supervision levels;
- increased unpredictability in sample selection;
- changing the nature, timing and extent of audit procedures;
- performing increased substantive testing on key high risk areas; and
- emphasising the need for the audit staff to maintain professional scepticism throughout the entire audit.

The final point concerning professional scepticism has been in the headlines a lot over the years and audit firms are frequently criticised for failing to maintain professional scepticism. Audit files should also demonstrate that the audit team has maintained professional scepticism; for example, by challenging management's estimates and judgements and considering how fraud COULD arise within the entity, rather than just concluding (at the planning stage) that fraud will not arise.

ISA (UK) 200 (Revised June 2016) defines 'professional scepticism' (the standard spells it 'skepticism') as follows:

*'An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.'*<sup>5</sup>

Professional scepticism requires the auditor to be alert to:

- Audit evidence which may contradict other audit evidence.
- Fraud or conditions which may give rise to fraud risk factors.
- Information that brings into question the reliability of documents and responses to enquiries to be used as audit evidence.
- Circumstances which may require the auditor to devise entity-specific audit procedures beyond those required by the UK ISAs.

### **Example – Professional scepticism**

The audit of Company A Ltd (a builders merchant) is currently underway and this is the first year the company has engaged you as the firm's auditors. The company reports under FRS 102 and is a large company in the eyes of the Companies Act 2006. The audit of the 2017 financial statements has just started with the planning exercise and the draft financial statements show a 35% increase in turnover and pre-tax profit which is consistent with the previous year.

During the course of the audit of the opening balances from the predecessor auditor's working papers file, the audit senior notes a provision for liabilities amounting to £8m, which has not moved since the previous year's audit (the previous year's auditor's report was unqualified). The predecessor auditor's working papers only show a lead schedule worded 'Provision for potential damages £8m (2015: £8m)' – there is no other audit evidence available.

The audit senior queries this provision with the finance director who provides the following response:

*'We operate in a very litigious state nowadays. We take pride in the fact that we are a prudent entity, but sometimes may not get everything right first time. In light of this, I have made a provision for potential claims against the company that may come in the future. I'm not sure if that is what your accounting laws allow, but we have always done this and will continue to do so in the future.'*

On first glance, it is becoming clear that the £8m provision is nonsense as you cannot recognise a provision unless there is an obligation as a result of a past event (the unqualified audit opinion in the previous year is also questionable if the £8m was material either in isolation or in aggregate as there is no other audit evidence on file). This provision is for unknown future claims against the entity. The audit team must apply professional scepticism where this client is concerned as there could be other items in the financial statements which become questionable, such as:

- incorrect cut-offs for sales (hence the 35% increase in turnover);
- additional provisions which have reduced profit to the same level as the prior year despite a 35% increase in turnover;
- fraud;
- fraudulent financial reporting (i.e. a focus on the bottom line and then working upwards to achieve a desired financial reporting position);
- a lack of understanding of accounting and accounting standards by those preparing the financial statements; and

<sup>5</sup> ISA (UK) 200 (Revised June 2016) **Professional scepticism**

- material misstatements in the prior year (and beyond).

Using the above as a typical example, the planning and risk assessment should incorporate a high risk of material misstatement, thus substantive procedures should be increased in those areas judged high risk by the auditor (which may be most areas).

## 8 ICAEW GUIDANCE ON AUDIT REPORTS (LECTURE A612 – 10.38 MINUTES)

As noted in previous update courses, the auditor's report per ISA (UK) 700 (Revised June 2016) *Forming an Opinion and Reporting on Financial Statements* is restructured. For example, no longer is the opinion paragraph situated at the end of the report, it is now situated at the top of the report as this was judged to be in the users' understanding of the auditor's report. Critics of the previous versions of the reports cited the unhelpful language used and the fact that they had to read all of the report before getting to the overall opinion of whether the financial statements give a true and fair view or otherwise.

The ICAEW has issued [guidance](#) on the new audit reports. The Helpsheets have been based on the FRC's Compendium of illustrative auditor's reports and confirm that as long as the auditor's report complies with the applicable requirements (i.e. they contain the required elements), audit firms may prefer alternative ways of presenting the required information. In practice, this is quite rare for smaller firms.

### 8.1 Use of Bannerman

The use of a Bannerman paragraph has proven to be crucial for audit firms (as noted in the case of *Barclays Bank v Grant Thornton* where the judge ruled that Grant Thornton had acknowledged it owed no duty of care to Barclays Bank in respect of their mutual client, Von Essen Hotel Group as it had included the Bannerman wording in its auditor's report).

The positioning of the Bannerman paragraph has caused an element of uncertainty as to whereabouts in the auditor's report it should go following the restructuring of the auditor's report.

The guidance in Audit 1/03 states that the Bannerman paragraph is included at the beginning of the Companies Act auditor's report. ISA (UK) 700 (Revised June 2016) now requires the auditor's report to start with the 'Opinion' paragraph, immediately followed by the 'Basis for Opinion' section.

The wording (for a company) in respect of the Bannerman paragraph is as follows:

*'This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.'*

Some publications and software locate the Bannerman paragraph within the wording which describes the responsibilities of the auditors. However, there is a concern about positioning the Bannerman paragraph here.

In *Barclays v Grant Thornton*, the important point was that the Bannerman paragraph was read because it was placed at the beginning of the auditor's report. It may potentially go unnoticed if it is positioned towards the end of the auditor's report in the restructured version.

It may be advisable to position the Bannerman paragraph immediately after the Basis for Opinion paragraph, but it remains for each audit firm to decide on its own approach to the positioning of the paragraph.

### 8.1.1 ACCA regulated firms

Firms regulated by ACCA should note that ACCA does not encourage the use of Bannerman paragraphs. Technical Factsheet 84 *The Use of Disclaimers in Audit Reports* outlines the reasons why ACCA take this view, which is primarily because they feel the use of disclaimers devalues the audit report. This position remains unchanged following the Barclays Bank PLC v Grant Thornton case.

ACCA does accept that member firms may wish to make specific disclaimers of responsibility in certain defined circumstances, but does not encourage such disclaimers on a regular basis. ACCA also confirms that if an audit is carried out properly, such disclaimers would be unnecessary to protect the auditor's interest.

ACCA's advice to member firms is for auditors to carry out their work in accordance with the ISAs (UK) and hence there should be no need to subject it to a disclaimer.

## 9 ISA (UK) 560 *SUBSEQUENT EVENTS*

ISA (UK) 560 *Subsequent Events* requires the auditor to obtain sufficient appropriate audit evidence that events taking place between the balance sheet date and the date of the auditor's report have been appropriately accounted for in accordance with Section 32 *Events after the End of the Reporting Period* which were discussed in section 6 of these notes.

ISA (UK) 560 usually kicks in after the auditor has completed the detailed audit fieldwork and is carrying out the completion and review exercise, which includes:

- Going concern procedures
- Evaluation of misstatements
- Obtaining written representations
- Undertaking an overall review of the financial statements
- Performing subsequent events procedures

### 9.1 *Purpose of subsequent events procedures*

Financial statements are prepared and audited after a period of time has elapsed between the balance sheet date and the date on which the financial statements are authorised for issue and the date of the auditor's report. During this period, events and conditions can arise which may need to be reflected and/or disclosed in the financial statements.

As noted in section 6 of these notes, Section 32 of FRS 102 identifies two types of events:

- adjusting events which are reflected in the financial statements as at the balance sheet date; and
- non-adjusting events which are not reflected but may be disclosed if they are material.

The auditor must also respond appropriately to facts that come to their attention which may have caused them to amend the auditor's report had they been known when the auditor's report was signed.

Non-adjusting events include the classic case of a fire destroying a major production plant after the year-end. While non-adjusting events require disclosure in the current year's financial statements where they are material, a non-adjusting event may have an impact on the going concern basis of accounting and become an adjusting event. For example, in the case of the fire destroying a production plant, the entity may not be able to buy or lease premises from which to operate and the costs involved may be excessive (particularly if the insurance company refuses to pay up, or the company is uninsured) and the company may have no choice but to cease trading. In this situation, the non-adjusting event becomes an adjusting event because the financial statements will have to be prepared on a basis other than the going concern basis of accounting (e.g. the break-up basis).

### 9.2 *Auditor's duties: between the balance sheet date and date of the auditor's report*

- Enquire of the directors if they are aware of any subsequent events which require adjustment in the financial statements.

- Enquire of management of their procedures for identifying subsequent events.
- Inspect minutes of board meetings for evidence of any subsequent events.
- Review budgets, forecasts, interim information and accounting records to identify any subsequent events.
- Inspect correspondence with legal advisers.
- If the financial statements show any provisions for liabilities or contingent liability disclosures, establish the status of the events giving rise to the liability or disclosure.
- Inspect after date cash from debtors, particularly any which are overdue.
- Inspect sales invoices in respect of any stock that has been slow-moving which may have been sold after the balance sheet date to establish if estimated selling price is less than cost.
- Obtain written representations from management that all subsequent events have been considered in the preparation of the financial statements.

### **9.3 *Auditors duties: between date of auditor's report and the date the financial statements are issued***

The auditor is not under any obligation to perform audit procedures once they have issued the auditor's report. However, where the auditor becomes aware of a fact which would have caused them to modify their opinion in any way, they must take action as follows:

- Discuss the facts with management and determine whether the financial statements require amendment.
- Where the financial statements require amendment, request that management actions the amendments.
- Perform audit procedures on the amendments to ensure they have been processed correctly.
- Issue a revised auditor's report.

If management does not amend the financial statements as requested by the auditor and the financial statements have not yet been issued, the auditor must notify management and those charged with governance not to issue the financial statements before the amendments have been made. If the financial statements have been issued, the auditor must take steps to prevent reliance on the auditor's report.

### **9.4 *Financial statements have been issued***

Again, once the auditor has signed the auditor's report on the financial statements, the auditor is under no obligation to perform further audit procedures. However, if facts become known to the auditor which would have caused them to modify the auditor's report or the opinion, they must take action as follows:

- Discuss the situation with management and establish whether the financial statements require amendment.
- Where the financial statements require amendment, request that management put the amendments through and ensure all those in receipt of the previously issued financial statements are informed.

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- Perform audit procedures on the amendments to ensure they have been put through correctly.
- Issue a new auditor's report including an emphasis of matter paragraph to draw attention to the fact that the financial statements and auditor's report have been reissued.
- If management refuse to recall the previously issued financial statements and put the amendments through, the auditor must take steps to prevent reliance on the auditor's report.