SCR Reporting

Bulletin 2017/2

Introduction

In this Bulletin, we deal with an immediate change to FRS 102 for small companies, simplifying the manner in which loans between companies and their directors are accounted for, proposals for updating FRS 102 as a result of the triennial review and give guidance on the new form audit report required for periods commencing on or after 16 June 2016. We also outline how these changes will be reflected in our publications.

FRC changes guidance on below market rate loans for small companies - with immediate effect

Introduction

FRS 102 introduced the requirement for loans at below market rate to be measured at the present value of the cash flows. This has no impact if the loan is repayable on demand, but does require accounting adjustment where the loan is repayable after more than one year.

FRED 67 (see below) proposed to remove this as a **requirement** for small companies only, and to give them an accounting **policy choice** of recording the loan at transaction value, or at the present value of the cash flows.

Note that the change applies only for small entities and for loans between the company and natural persons who are directors and shareholders. Therefore, the change does not apply to inter-company loans, loans between companies and corporate directors or loans between companies and directors who are not shareholders.

FRC have changed FRS 102 **with immediate effect**, and without consultation, to permit small companies moving to FRS 102 from FRSSE for periods commencing on or after 1 January 2016, to carry on with the previous practice. Had they not made this change small companies would have been faced with changing from transaction value (as was the position under FRSSE) to the present value of the cash flows under FRS 102 for (say) 31 December 2016 year-ends, and then reverting to transaction value at 31 December 2017. This would have involved two full sets of transitional adjustments. This is very pragmatic of the FRC and is extremely welcome.

Clients who have not yet finalised their first FRS 102 accounts

These small companies now have the accounting policy choice and the simple approach is to leave the loan at the transaction value i.e. face value of the loan. This avoids any accounting adjustments in the current year, or subsequently, unless of course the lender considers the loan is not recoverable and needs to record a provision for doubtful debts.

This does not change the **disclosure requirements** for such loans. A loan **to** a director would require disclosure under S413 CA 2006.We would argue that a loan **by** a director to the company is only disclosable if it is material and not made under normal market conditions. In our opinion, normal market conditions for a small company involve the directors part funding the company with a non-interest bearing loan and, therefore, such loans do not require disclosure, unless it is necessary for a true and fair view.

Small companies which have already finalised their first FRS 102 accounts

These entities will have the opportunity to revert to transaction value when preparing the next set of accounts, but they will need full restatement of comparatives in that year.

Could the guidance change again?

In theory, yes, but as FRC have based this change on initial responses to FRED 67, and have taken soundings from stakeholders it is unlikely. Even if it does change there is still a benefit from adopting the new accounting policy of leaving the loan at the transaction price (which is, of course the old policy), as it delays any need to move to present value of cash flows for a year.

Other changes in FRED 67

Introduction

FRED 67 was published on 23 March 2017, the closing date for consultation is 30 June and the anticipated date for publication of the update standard is December. The changes will be mandatory for periods commencing on or after 1 January 2019 and earlier adoption will be permitted. However, the anticipated publication date of December will be too late for clients with a year-end of 31 December 2016, and for most clients with years ended before 31 March 2017, to take advantage of the changes.

Investment properties occupied by other group members

Prior to the adoption of FRS 102, investment properties let to other group members were exempt from the requirement to be included at market value, and could be included under tangible fixed assets at depreciated cost.

FRS 102 does not include a similar exemption, and does require such property to be included at fair value. However, where the fair value cannot be obtained without undue cost or effort the property can be included at depreciated cost as under old GAAP.

FRED 67 proposes to change the treatment to provide an accounting policy choice for such properties. The accounting policy choice is between depreciated cost or fair value.

The problem here is that, given the proposed publication date above, clients will have to finalise December 2016 and March 2017 accounts under the existing regime without the accounting policy choice. One might wish to argue that the cost or effort of obtaining a fair value for one year only is undue, and therefore continue to carry it at depreciated cost this year, and then carry it on the same basis as your accounting policy for future years.

Where a client has already adopted the requirements of FRS 102 and included such properties at fair value, they can change their accounting policy when the changes are finalised. They can use the existing transitional exemption of using the previous revaluation as deemed cost, or they can revert to the original cost on a depreciated cost basis.

It should be emphasised that this is an accounting policy choice, and therefore an entity can continue to include such property as investment property at fair value.

Basic financial instruments

FRED 67 includes a new paragraph 11.9A which introduces a description of a basic financial instrument to support the detailed conditions for classification as basic.

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

FRC considers that making this change will result in a relatively small number of financial instruments, that breach the detailed conditions for classification as basic, now being considered to be basic and measured at amortised cost. In these cases, measurement at amortised cost will provide relevant information for users of the financial statements.

In our opinion, however, using paragraph 11.9A can serve as a proxy for the detailed requirements in 11.9 itself, since if it meets the requirements of 11.9A it is a basic financial instrument. The fact that it also meets the detailed criteria in 11.9 adds or detracts nothing!

In practice, we have always argued that where the entity can plot the cash flows, it should be able to use the amortised cost basis, and the instrument is a basic financial instrument. and we consider that this change confirms our approach. The one issue which FRS 102 clarifies is that, to be basic, any compensation for risks etc. must be reasonable and this includes the lender’s profit margin.

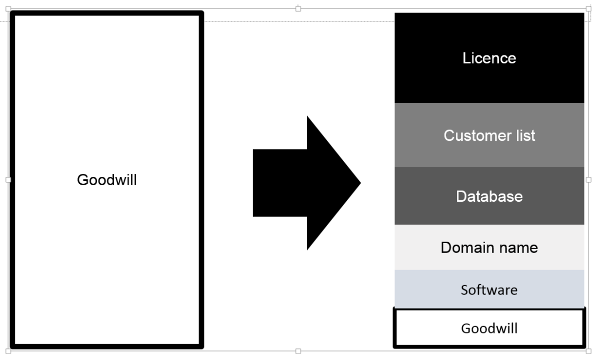
We therefore consider that entities which have not yet finalised their first FRS 102 accounts can apply this approach without acting contrary to the current requirements of FRS 102.

Intangible fixed assets

FRED 67 introduces some important changes to the recognition of intangible assets acquired in a business combination. FRS 10 and FRSSE precluded recognition of intangible assets separately from goodwill unless they were separable.

FRS 102 currently states that an intangible asset acquired in a business combination is normally recognised as an asset because its fair value can be measured reliably. It is only when there is no history or evidence of the fair value of the intangible assets arising from legal or other contractual rights that FRS 102 precludes recognition.

FRED 67 permits entities not to recognise assets separately from goodwill, but does require them to be recognised if they are separable. It also permits an entity to recognise any or all intangibles separately from goodwill, but it must do so consistently.



The box on the left-hand side of the diagram illustrates the typical accounting under FRS 10 in connection with a business such as a financial services business. The licence to provide financial services is not separable, because without it the business could not trade. Similarly, the other assets would not be considered separable and therefore under FRS 10, would all be subsumed in a single figure of goodwill.

The boxes on the right-hand side of the diagram represent assets which the buyer has acquired and for which a fair value can be recognised, and therefore which FRS 102 currently requires to be recognised as separate assets and amortised over their useful lives.

The proposed amendment gives the entity three options for **<u>future</u>** business combinations:

(a) It can continue to recognise each of the separate classes of assets;
(b) It can recognise a single figure for goodwill i.e. revert to the treatment under FRS 10; or
(c) It can recognise some of the assets separately from goodwill, and subsume others within goodwill.

One of the factors that will influence that decision may be tax allowability. Where these figures arise only on consolidation and are therefore never allowable for tax, the inclusion of a lump sum for goodwill is easy.

Where the acquisition is of trade and assets, and arises after 8 July 2015, such that tax relief is no longer available for goodwill and customer related intangible assets, the entity may decide to aggregate those assets (in our illustration above this would be the goodwill, order book and customer list) whilst recognising the licence, domain name and software as separate assets. If they have similar useful lives they could be aggregated as a separate class of asset. Having made that initial decision, the same approach must be applied to all future business combinations.

An entity is not permitted to apply the revised treatment for intangibles to business combinations made after the date of transition to FRS 102 but before the date of transition to updated FRS 102. Therefore, an entity which transitioned to FRS 102 for year ended 31 December 2015 and moves to revised FRS 102 for the year ended 31 December 2019, is required to recognise separately identified intangibles in 2016, 2017 and 2018. Those assets recognised up to and including 31 December 2017 remain on the balance sheet and continue to be amortised over their separate useful lives. Those recognised in 2018, which would not have been recognised under the revised policy are removed in the transition process for the year ended 31 December 2019.

Revised definition of a financial institution

The definition of a financial institution has been revised. This will result in a reduction in the number of entities required to include the additional disclosures about financial instruments, primarily included in FRS 102 34.17 – 33, although all entities will need to consider whether the risks associated with financial instruments require disclosure under the disclosure requirements of sections 11 or 12.

There are two issues which may affect the typical small practitioner:

(a) The definition removes pension schemes from the definition, and, therefore the requirements in Section 34 and elsewhere for additional disclosures;
(b) A company which manages the personal investment portfolio of individuals will no longer be caught by the definition and therefore, again, will no longer be subject to additional disclosures. Since many such companies probably did not realise that they should have been included in the previous definition there may be no change in practice.

Small Company Reporting

The relevant checklists and illustrative accounts will be updated once FRED 67 is finalised.

Revised audit standards

FRC has issued revised Auditing and Ethical Standards applicable for periods commencing on or after 16 June 2016. In practice, therefore, they apply to years ended 30 June 2017 or later, although care is needed for short periods.

We are currently reviewing the Audit Manual and Audit Procedures Manual, audit programmes and checklists and our initial assessment is that very few changes will be required as the new standards are substantially the same as the old ones in terms of required steps in obtaining and recording evidence. If you need to sign off an audit under the new ISAs the existing programmes will suffice.

There are, of course changes, particularly, in the Ethical Standards and ISQC 1, on factors to consider in, say, answering the questions in the audit programmes.

There are also some significant changes in the audit requirements of public interest entities, but few uses of the SCR audit manuals will audit such entities. We are currently considering whether we include such requirements within our revised manuals, or make it applicable only to entities which are not PIEs. We would be interested in feedback from our users as to whether you do audit such entities. In overview, public interest entities are listed companies, banks, building societies and insurance companies. Given the additional regulatory requirements imposed on the auditors of such entities, including being directly monitored by FRC, we anticipate that some firms which currently audit only one or two will give up such clients, which will further indicate that our audit procedures need not cover these additional requirements.

Revised audit report

In the last update to Small Company Reporting we included the latest version of the audit report, but without comment or guidance.

Given that such reports will need to be given relatively soon, we include the illustrative report for small companies, with some comments and guidance to help users understand the changes.

This report should not be used for periods commencing before 16 June 2016.

This example report is taken from the FRC Compendium of Audit Reports and is for

- A small company which is not a public interest entity;
- Financial statements are prepared in accordance with FRSs 100 and 102 (UK GAAP);
- Directors take advantage of the small companies' exemption in preparing the directors' report and from the requirement to prepare a strategic report;
- Company does not prepare group financial statements or ISA (UK) 600 (Revised June 2016) does not otherwise apply;
- Description of the auditor's responsibilities for the audit of the financial statements is included by reference to the location of such a description included on the FRC's website;
- Auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA (UK) 701

The example report does not include a 'Bannerman' paragraph as we are awaiting guidance from ICAEW as where such a paragraph is placed.

Independent auditor's report to the members of [XYZ Limited]

Opinion

We have audited the financial statements of [XYZ Limited] (the 'company') for the year ended [*date*] which comprise [*specify the titles of the primary statements*] and notes to the financial statements, including a summary of significant accounting policies. 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* (United Kingdom Generally Accepted Accounting Practice).

In our opinion, the financial statements:

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

There is no change in the title or addressees of the audit report

The opinion section now appears at the beginning of the report, an introductory paragraph and then the opinion itself.

Note the requirement to specify the titles of the financial statements. It is no longer permitted to refer to page numbers.

Also note the specific requirement to include the words 'including a summary of significant accounting policies' after the notes to the financial statements

Note there is no requirement to refer to FRS 102 1A, in the way that the previous audit report would have referred to FRSSE.

The opinion on the financial statements is unchanged, apart from removal of the reference to 'applicable to small entities' after reference to UK GAAP.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard [, and the provisions available for small entities, in the circumstances set out in note [X] to the financial statements], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

In the previous report a single paragraph covered the respective responsibilities of the directors and the auditor. The two are now split into separate sections of the report.

The previous report stated only that 'our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards (UK and Ireland). Those standards require us to comply with the Auditing Practice Board's Ethical Standards for Auditors [including the Provisions available for smaller entities (revised) in the circumstances outlined in note [x] to the financial statements.'

The first change in this section is updating the reference to ISAs (Now UK only) and the Ethical Standards (now FRC's).

The other change is the requirement for the auditor to make explicit statements that:

- *(a) 'We are independent…';*
- *(b) 'We have fulfilled our other ethical responsibilities…'; and*
- *(c) 'We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.'*

This does not change the auditors' responsibilities but may make them think carefully when signing the report.

Conclusions relating to going concern

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

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

This is a significant change in that it requires the auditor to report on going concern even when there are no material uncertainties.

Note that the report is effectively a double-negative. The idea is not to extend the auditor's responsibilities, which might have been construed had the report been in positive terms such as 'in our opinion the use of the going concern basis is appropriate'.

Where the auditor considers that the use of the going concern basis is appropriate and that all necessary disclosure have been given, and there are no material uncertainties, this wording is appropriate.

Where there are material uncertainties an emphasis of matter paragraph is required.

Where disclosures are omitted a qualified opinion is required.

Where the going concern basis is not appropriate, an adverse opinion is required.

Where the auditor is unable to obtain sufficient evidence to report, a qualified or adverse opinion is required.

The problem in drafting the report is where to place the relevant paragraphs and also the need to consider the impact of the opinion on truth and fairness.

Other information

The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon. In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

We have nothing to report in this regard.

For many companies, this will be totally new. The only reference to information that was not in the financial statements was in the scope of the audit of financial statements which included the words 'In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the financial statements and to identify any information that is apparently materially incorrect based or, 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 inconsistences we consider the implications for our audit report.'

Where the audit report included a cross-reference to the FRC website, these words did not appear in the audit report.

The important question for the auditor, before drafting or reviewing this paragraph is 'Am I required to express an opinion on this other information?' – If the answer is Yes, the auditor reviews that information and reports as required. For a limited company this is required for the directors' report and strategic report (see next paragraph).

Where the auditor is not required to report explicitly on that information, they are required to read it and consider it in the light of their knowledge obtained in the audit. For example, the auditor of an unincorporated charity is not required to report explicitly on the trustees' report.

Where inconsistencies or apparent misstatements are identified, the auditor is required to identify whether the problem is in the financial statements, in which case the opinion is qualified, or in the other information. If in the other information, the auditor reports this misstatement, by deleting the words 'we have nothing to report in this regard' and including details of the misstatement.

Note that the ISAs confirm that reference to 'misstatements' includes omissions.

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 directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the directors' report has been prepared in accordance with applicable legal requirements.

Note that in this example, FRC have split the revised opinions introduced by the amendments to company law included in SI 2015 / 980 whereby the auditor, in addition to reporting that the information in the directors' report, and strategic report where required, is consistent with the financial statements, is now required to report that:

(a) The information has been prepared in accordance with applicable legal requirements, and

(b) In the light of the auditor's knowledge and belief and its environment, the auditor has not identified material misstatements in the directors' report, and strategic report where applicable.

Paragraph (b) is now included within matters on which the auditor is required to report by exception.

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 directors' report.

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

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

As noted above, the first paragraph is the relatively new paragraph relating to material misstatement in the directors' report.

If the auditor identifies material misstatement (see also the other information paragraph above) and is required to qualify this element of the report, a basis for qualified opinion will be required and the other information paragraph cross referenced to that paragraph. The basis of qualified opinion paragraph should also be referred to in the qualified opinion.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement [set out on page ...], the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

The requirement to have a separate directors' responsibilities statement continues, but the content of the paragraph in the audit report itself outlining those responsibilities is much enhanced.

Note that it includes specific reference to responsibility for matters such as:

- *(a) the preparation of the accounts,*
- *(b) their truth and fairness;*
- *(c) internal control necessary to enable preparation of accounts free form material error; and*
- *(d) assessing going concern.*

Previous wording simply stated that 'the directors are responsible for the preparation of the financial statements and that they give a true and fair view'

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: [*website link*]. This description forms part of our auditor's report.

The first paragraph is an explanation of the nature of audit and the level of assurance which can, and cannot, be assumed from an audit opinion.

The second paragraph cross refers to the detailed explanation on the FRC website.

[*Signature*]

John Smith (Senior Statutory Auditor)

For and on behalf of ABC LLP, Statutory Auditor

[*Address*]

[*Date*]

There is no change in the signature requirements under company law of professional guidance.