
small company reporting

Vol. 22.3 winter 2013/14

A quarterly bulletin dealing with Accounting and

ISSN 0 968 8897

Auditing matters affecting the smaller company

www.smallcompanyreporting.co.uk

new rules for micro-entity accounts

At the end of November Parliament approved new regulations intended to simplify reporting by micro-entities – broadly companies falling within two, of three, thresholds of £632,000 turnover, £316,000 balance sheet total and 10 employees. As a result, such companies can produce a balance sheet showing only the alphabetical headings from the Companies Act formats, an eight line profit and loss account and notes on directors' advances credits and guarantees and on other financial commitments. The provisions are based on an EU directive and the FRC has proposed amendments to the FRSSE to take account of the changes. The new rules apply to periods ending on or after 30 September 2013, filed on or after 1 December last.

Micro-entities are not allowed to prepare abbreviated accounts, but need only file their simplified balance sheet and notes, not the profit and loss account or directors' report. The changes have been made by inserting a new section C into Part I of Schedule 1 to the Small Company Accounts and Reports Regulations, so are subject to the existing rules on use of the formats and the principles governing preparation of accounts. However, micro-entities must use the historic cost rules, not the valuation or fair value ones. Accordingly, the FRSSE is to be amended to exclude revaluation of fixed assets, use of market value for investments and to require investment properties to be treated as other tangible fixed assets, with depreciation being charged and no valuations being undertaken. Otherwise the rules on approval and distribution are as for a small company, except that the exemption statement on the balance sheet must refer to preparation in accordance with the micro-entity provisions.

Several categories are excluded, even when meeting the size criteria. These include all of the categories ineligible to use the small companies regime as well as various financial institutions and undertakings, charitable companies and those preparing or included in group accounts. At present there is no provision for LLPs to use the micro-entity provisions.

Many will welcome any change which reduces the information in small company accounts. However, those prepared under the new rules will not necessarily be more useful or reliable. For a start, it is not clear that the headings in the profit and loss account, which are based on, the rarely used, Format 2 from the Act, be useful in running most businesses and, over time, historic cost figures can become quite misleading. However, the most controversial feature of the new rules is that, although the accounts must show a true and fair view, in forming an opinion on whether they do, directors and auditors must disregard all requirements of accounting standards to show additional items or information about format items. It is obvious that, at times this injunction may stop the accounts being true and fair. For example, accordingly to the FRSSE and FRS 3, an item within a heading may be so significant, that its non-disclosure may stop the accounts being true and fair. This is precisely how exceptional items are defined. But under the new rules to show one would prevent the accounts complying with the Act. Few micro companies will have audits but, it is clearly unsatisfactory that an auditor could be required to say something is true and fair when it is not. It would probably be best to refuse to do an audit where the micro-provisions are to be used. Moreover, the issue also arises in compilation assignments, which could result in a firm putting its name on a set of misleading accounts fully in accordance with the Act.

Readers may be reminded of the following passage from *Alice through the Looking Glass*. "When I use a word," Humpty Dumpty said, in a rather scornful tone, "it means just what I choose it to mean - neither more nor less."

We all know happened to him!

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questions on the new micro-entity rules

directors' report

What do we need to put in the directors report?

The requirements for the directors' report are the same as for a small company, so in practice you only need to show the names of the directors and the statement saying that the company has taken advantage of the small companies exemption. If you leave this out you are required to include a strategic review. Political contributions have to be disclosed but are rare and both principal activities and charitable contributions disappeared last year. In theory a micro-company could be required to make a statement about employment of disabled persons but this only applies where there are more than 250 employees, which is most unlikely. Very few small companies are likely to opt for an audit but those that do must include the statement about disclosure of information to auditors and somewhere in the document there must be a statement about directors' responsibilities. It would also be usual to say something about reappointment of the auditors.

auditor's report

Are there any special rules governing the audit report?

No. The rules are the same as for any report on a small company, except regarding interpretation of true and fair, as noted on page one. However, there may have been an oversight in that no changes have been made to section 498 of the Act, which means that the auditor of a company using the micro-entirety provisions must state in his report if the company prepares accounts in accordance with the small companies regime, when not entitled to. Presumably this section should have been amended to refer additionally to use of the micro-entirety provisions. The same section also requires a statement about use of the small companies exemption in preparing the directors' report. This is appropriate because there is no special exemption for micro entities, which must use the small companies exemption, or provide a full report.

BALANCE SHEET – Format 1	
A	Called up share capital not paid
B	Fixed assets
C	Current assets
D	Prepayments and accrued income
E	Creditors: amounts falling due within one year
F	Net current assets (liabilities)
G	Total assets less current liabilities
H	Creditors: amounts falling due after more than one year
I	Provisions for liabilities
J	Accruals and deferred income
K	Capital and reserves
BALANCE SHEET – Format 1	
Assets A-D as above	
Liabilities A=K / B=I / C= E+H / D=J	
PROFIT AND LOSS ACCOUNT	
A	Turnover
B	Other income
C	Cost of raw materials and consumables
D	Staff costs
E	Depreciation and other amounts assets
F	Other charges
G	Tax
H	Profit or loss
NOTES TO THE ACCOUNTS	
<i>Where using format 2</i>	
Creditors – Show amounts falling due within a year and after one year..(Format Section C Note 1)	
<i>Where using either format</i>	
Information about directors' benefits: advances, credit and guarantees - see paragraph 6.4.1-6.4.5	
Guarantees and other financial commitments – see paragraph 5.8.7	

In practice this oversight is may be insignificant because few micro-entities are will opt for an audit. However, as suggested on page one, firms would be best advised to avoid audits of companies using the micro- entity provisions altogether.

use of the formats

Can we add things to the formats and do the accounts and notes need corresponding figures?

It's not entirely clear! Regulation 5A says "the only items which must be shown are those listed in the formats" Whilst the proposed paragraph 240 of the FRSSSE would require a micro-company to "prepare a balance sheet showing only those items listed in the formats". These statements do not mean the same thing. Paragraph 1.3 of Schedule 1, which applies both to micro-entity and small company accounts, allows greater detail to be shown and additional headings to be used, where not otherwise covered. Furthermore, the Act (s.393 (1A)) and the proposed FRSSSE (1.2(d) refer to "the inclusion of information additional to the minimum items", to which the provisions of accounting standards / the FRSSSE must be applied.

Paragraph 7 of Schedule 1 and paragraph 2.23 say that corresponding figures must be shown for all items in the balance sheet and profit and loss account, it is not clear whether the notes shown at the foot of the balance sheet are "in it". The FRSEE requires comparatives for items shown as notes to the accounts but the parts of the Regulations applicable to micro-entities do not refer to the matter. However, the disclosures required by s.413 only apply to advances, credits or guarantees "subsisting at any time in the financial year to which the accounts relate" which, presumably, means that no disclosure need be made about items entirely repaid in prior years,

notebook

This edition deals with developments in November and December 2013.

legal developments

micro-entities' accounts regulations

The Small Companies (Micro-Entities Accounts) Regulation 2013, issued as SI 213.3008, amend SI 2008.409 and various sections of the 2006 Companies Act. The provisions affecting micro-entity accounts and audits are reviewed on pages 1 and 2 of this edition. However, a few changes made to the rules govern general use of the small companies regime. In particular section 382 and 383 now refer to qualifying in a "subsequent year" and ceasing to "meet the qualifying conditions in two consecutive financial years". The effect of the new wording appears to be identical to the old. Paragraphs 21 and 26 of Schedule 1 to the Regulations now refer only to the treatment of development costs and items shown at a fixed amount under Section B, showing the Small Company formats.

financial reporting

accounting update

Since the last edition the FRC has issued its draft responses to some proposed changes to the IFS for SMEs, three FREDs and some FRRP guidance on the treatment of exceptional items:

- FRED 51 *Draft Amendments to FRS 101 – Reduced Disclosure Framework* which only affects subsidiary companies using International Accounting Standards so will not be considered here.

- FRED 52 - *Draft Amendments to the Financial Reporting Standard for Smaller Entities (effective April 2008) - Micro-entities* is reviewed below.
- FRED 53 *Draft Amendments to FRS 102 – Hedge Accounting* which proposes to update the requirements for hedge accounting in FRS 102 to allow entities "to apply hedge accounting when this reflects their economic and risk management strategies, without onerous conditions; and to use concepts and language that are, as far as possible, consistent with those included in IFRS 9 Financial Instruments", the IASB's standard that includes hedge accounting. We will incorporate the changes in Part 3 when implemented.

draft amendments to the FRSE - fred 52

FRED 52 sets out proposed amendments to the FRSE to facilitate its application by companies using the micro-entity provisions. Without these changes the only rules governing the determination of amounts in the accounts of such companies would be the accounting principles in the Small Company Accounts Regulations. If amended as proposed, the FRSE will require companies using the micro-entity provisions to apply the formats from the new section C in the regulations. All other disclosure requirements in the FRSE are to be ignored but, if additional items are shown, they must comply and the accounting treatments specified to format items must be applied. Revaluing tangible fixed assets and showing fixed asset investments at market value are both ruled out. Investment properties must be shown at cost, less any adjustments for impairment and depreciation. The text is available at:

www.frc.org.uk/OurWork/Publications/Accounting-and-Reporting-Policy/FRED-52-Draft-Amendments-to-the-Financial-Reporting-File.pdf

FRRP guidance on exceptional items

In December the FRC issued a reminder on the need to ensure consistency in the presentation of exceptional items. The statement recognised that "Many companies present additional line items in the income statement to provide clear and useful information on the trends in ... the income statement, as required by IAS 1 "Presentation of financial statements". However, it had identified a number of cases where the disclosure falls short of the consistency and clarity required. Accordingly, the FRRP has considered the relevant principles and identified the matters to which companies should have regard. Its views are framed in the context of International Standards and the requirements applicable to listed entities but some of the key ideas have wider application

- The approach taken should be even handed between gains and losses, clearly disclosed and applied consistently from one year to the next.
- Gains and losses should not be netted off unless otherwise permitted.
- Where the same category of material items recurs each year and in similar amounts (for example, restructuring costs), companies should consider whether such amounts should be included as part of underlying profit.
- Where amounts are unlikely to be finalised for a number of years or may subsequently be reversed, the effect should be similarly identified
- The tax effect should be explained.

It also commented on the impact on cash flow statements, directors' remuneration reports and management commentaries (strategic reports).

Companies not using IAS must show exceptional items under relevant statutory heading from the Companies Act formats but should, show components separately where necessary for a proper understanding. Under the Act netting off is prohibited and consistency required. So this guidance is of limited value for non-listed companies and guidance to “consider” inclusion in underlying profit is unlikely to ensure consistency!

prudence to return?

Most international standards require extensive use of market values at the expense of prudence, stewardship / accountability and reliability. This has been criticised by the FRC in its response to IASB's Review of the Conceptual Framework for Financial Reporting'. **Most subscribers to small company reporting will support the FRC campaign but it may not have any effect – or at least any an immediate one!**

frc guidance on applying frs 102

The FRC staff have prepared education notes illustrating application of FRS 102 to:

- Cash flow statements
- Debt instruments – amortised cost
- Impairments to trade debtors
- Investment properties
- Property, plant and equipment.
- Leases
- Revenue recognition
- Government grants
- Employee benefits – Short-term employee benefits and termination benefits
- Employee benefits – Defined benefit plans
- Forward exchange contracts
- Incoming resources from non-exchange transactions
- Transition to FRS 102
- Credit union financial statements
- Acquisitions and disposals of subsidiaries

Copies may be found at:

<https://frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/The-future-of-UK-GAAP/Staff-Education-Notes.aspx>

auditing

audit and assurance update

The FRC Audit and Assurance Council is working on non-major revisions of ISA 720 covering “other information” in annual reports and ISA 320 on materiality. Its deliberations can be followed at: <https://frc.org.uk/About-the-FRC/FRC-structure/Audit-and-Assurance-Council/Meetings/Audit-and-Assurance-Council-Agendas-and-Minutes.aspx>

frc report on auditor's materiality judgements

In December the FRC published the report of a review into auditor's consideration and application of materiality. The report identifies a requirement for greater focus by auditors on the needs and expectations of users in setting and revising overall materiality levels and for audit committees to seek to better understand the related judgements made by auditors. It also makes a number of recommendations to audit committees and encourages them to discuss with their auditors the basis for the materiality levels set including, in particular, how these reflect the needs and expectations of users of the entity's financial statements. It comments “Audit committees play a highly important role in safeguarding the quality of audit and should actively engage with their auditors in relation to the determination and application of materiality”. Details at:

<https://frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-issues-report-on-auditor-s-materiality-judgeme.aspx>

Whilst this mainly applies to larger companies, it clearly refutes the idea that materiality is “confidential” and cannot be revealed to the client. Indeed the recent revision of FRS 700 requires auditors of companies covered by the Corporate Code to explain the concept of materiality and specify the threshold used for the financial statements as a whole. In smaller audits, it would be sensible to discuss this with the client, but not to reveal the level used in testing, now referred to as performance materiality.

points arising

signature of the auditor's report

In the spring edition of the bulletin you stated that where an auditor practiced in his own name it was incorrect to say that the report was signed “for and on behalf of the firm” by the senior statutory auditor. The latest edition of audit news says that this is wrong and that all audit reports must be signed by a responsible individual on behalf of the firm. Have you changed your opinion?

No. I think the ARC is wrong. Section 503 of the CA06 refers to separately to signature “where the auditor is an individual” and “where the auditor is a firm”. Only in the latter case must the report be signed by the SSA. Thus if you accept appointment in your own name, (say) Joe Bloggs, you must sign in your own name. But where the firm “Joe Bloggs & Co” is appointed, the report must be signed on its behalf by the senior statutory auditor, who may be Joe Bloggs. Admittedly, at times, this can be a fine distinction. However, ICAEW audit regulation 2.01 refers to “members or firms accepting audit appointments” provided they are registered as auditors, which clearly admits the possibility of an individual acting as auditor. However, regulation 3.16 only refers to reports being issued by firms with no reference to them being signed by members. This is clearly anomalous and inconsistent with the provisions of the Act.

On a related point, the *Audit News* article ARC says that failure to sign an audit report in the name of an RI will be reported and may result in disciplinary action. It makes no mention of the fact that this requirement, also from Regulation 3.16, only applies “if required by law” So, whilst it applies to companies, banks, LLPs and a range of financial organisations, it does not apply to credit unions, unincorporated charities, charitable companies audited under the Charities Act, working men's clubs, pensions schemes, or housing associations. At least, if it does, someone had better tell the FRC so that they can amend the example reports in Bulletin 2010/2!

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publication and subscriptions

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update instructions

This update deals with changes arising from the introduction of new rules for micro entities from SI 2013.3008 and resulting changes to the FRSSSE. We have assumed that the latter will be implemented as proposed and will make any necessary future amendments in a future edition.

Introduction. *Replace pages 1,2 and 5-8,*

Part 1 – Small company checklist. Revision to contents - 1.1, and application checklist - 1.4. Clarification added to 1.6.1. Section 1.11 added. *Replace pages 1-2 Add 2/1, Replace 10 and 16. Add 45-47.*

Part 4 – Specimen accounts – New micro-entity example added. In correct reference to “Group” deleted from scope paragraph of small company regime example auditors report. *Replace page 1. Add pages 1/4-1/8. Replace page 4/3*

Part 5 – Companies Act Guide

Several headings and the following paragraphs added or updated 1.1.5, 1.2.1, 1.2.3, 1.2.5A, 1.3.1, 2.6.3, 3.3.1, 3.3.4, 3.5.2, 3.6.1.1, 3.6.8.1, 4.2.1, 4.4.1, 5.1.A.1-5.1.A.5, 5.2.1, 5.6.1 and 7.1.1. References in para 6.4.5 corrected. *Replace pages 2 and 4-5. Add page 5/1. Replace pages 6, 11,-12, 18-22, 24, 30, 33, 38. Add pages 38/1-38/2. Replace pages 39, 42, 44, 50, 59 and 64.*

Part 6 – Accounting Standards.

Updated to show addition or amendment of the following paragraph of the FRSSSE 1.2, 2.2A, 6.18, 6.23, 6.30, 6.35 and to add summary of FRED 52. *Replace pages 1/1-1/2, 1/6,1/8, 1/20 and 2/14*

scr procedures manual

Introductory notes / Update information *Replace pages 1 and 8-11*

Part 1 – Explanatory notes. Paragraph 5.1.2 amended. *Replace pages EN.15-17*

subscriptions

The subscriptions for 2014 include an increase of £5 to £100 for **scr** and **scrpm** separately and of £10 to £180 for a joint subscription, with the disc editions attracting VAT of £20 and £36 respectively. The last increase was in 2010, so this is the first for four years.

next edition

We had originally intended to issue a revised version of Part 3 – the checklist for large and medium-sized companies with this edition, reflecting the changes arising from FRS 102, to be applied to accounts starting in January 2015, but this will now appear in the next edition, to be published in April or early May. The new rules have to be applied for periods commencing on or after 1 January 2015.