2020 Innovation

FRS 102 One year on – Practical problems

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Bill is well known as an authoritative and entertaining lecturer who specialises in auditing and financial reporting topics, and related areas such as the interaction between tax and accounts. He is the author of three Accounts Digests for CCH Wolters Kluwer, two on this area, and is co-author of the 5th Edition of ‘Accounting Principles for Tax Purposes’ for Bloomsbury Publishing published in June 2014. He is also the author of the CCH Transition Guide FRS 102 2014-15.

On 1 July 2015, Bill acquired an interest in Small Company Reporting Ltd following the retirement of Roger Bryant and became Editor of the 3 publications designed to support small practices:

(a) SCR Reporting – guidance on accounts preparation including specimen accounts and disclosure checklists;
(b) SCR Procedures – audit programmes and guidance for the small audit;
(c) SCR Charities – guidance on the preparation and audit of charity accounts.

Full details are available on www.smallcompanyreporting.co.uk

Bill has been involved in ICAEW matters over many years and has served on Council, the inaugural Audit Faculty board and Learning & Professional Development Board and has been President of the South East District Society President twice.
1 Introduction

1.1 Objectives
In this webinar we will review the audit implications relating to the adoption of new UK GAAP in the form of FRS 102, including the revisions published in December 2016 as a result of the triennial review (to be known as FRS 102 February 2018?). We will also review the practical implications of the issue of the ISAs UK and Ethical Standards for Auditors, effective for periods commencing on or after 17 June 2016.

1.2 The issues
The auditor needs to assess issues relating to GAAP as follows:

(a) What has changed since the previous year end? Are the changes mandatory or optional, and if optional, which options does the client wish to adopt?
(b) Did we get the accounts right in the previous year? There is now feedback from regulators, cold file reviews etc of the issues which created problems on transition to new UK GAAP, and it may be necessary to restate errors. FRS 102 requires restatement of material errors. FRSSE and FRS 3 only required restatement of fundamental errors. Note that the tax treatment of errors is by reference to the period that the error was made and not the period it was identified.

In addition, the auditor needs to consider the implications for his working papers:

(a) Changes in audit and ethical standards; and
(b) Deficiencies in previous files identified by cold reviews and point forward noted last year.

1.3 The timeline

1.3.1 FRS 102
New UK GAAP became mandatory for large and medium companies for periods ending on or after 1 January 2015. Therefore, 31 December 2017 will be the third year of applying new UK GAAP.

Small companies were able to adopt FRS 102, including section 1A for periods commencing on or after 1 January 2015 but its application did not become mandatory until periods commencing on or after 1 January 2016. Such companies are, of course, exempt from audit unless the directors choose not to take advantage of the exemption provisions or shareholders with the requisite holding require an audit. In practice where a funder or other outside party requires an audit, the directors don’t take advantage of the exemptions and the audit is carried out under company law.

1.3.2 FRS 102 updated
FRC issued amendments to FRS in December following the triennial review. In addition to changes arising from the consultation, FRC made a number of clarifications and amendments. As yet, an updated comprehensive version has not been published. It is expected to be published in February and will have the date on the front and be known as FRS 102 February 2018 (see 1.5 below).

The effective date is periods commencing on or after 1 January 2019, but entities can early adopt. Given that the major changes are simplifications, many are expected to do so. For others there will be no changes.

1.3.3 Revised audit standards and Ethical Standards for Auditors
These are effective for periods commencing on or after 17 June 2016. Given the significant changes in audit reporting they should not be early adopted.

1.4 FRS 102 and 105 version control

1.4.1 Introduction
It is important to remember that FRS 102 and FRS 105, like IFRS, are updated and it is important to appreciate which version is applicable at any particular time.

Note that, unlike FRSSE where was a specific requirement to state which version was being adopted, there is no such requirement under FRS 102. The only requirement applies in FRS 102 where, if an entity chooses to early adopt the triennial review amendments, it is required to say so.
1.4.2  **FRS 105**

FRS 105 was issued in July 2015 and updated in May 2016 to allow LLPS to use it. In December 2017, further amendments were made as part of the FRC triennial review, (see chapter 4 below).

1.4.3  **FRS 102**

FRS 102 September 2015 contained a number of significant changes deriving primarily from the amendments to small entities caused by the company law changes, but there had been previous amendments for basic financial instruments and hedge accounting and revisions relating to pensions obligations. It will be this version of the standard which most entities preparing 31 December 2015 and later accounts had adopted. Since that date the following amendments have been made:

(a) March 2016 – an amendment was made to change the basis of the fair value hierarchy disclosures for financial institutions and pension schemes. These changes are effective for periods commencing on or after 1 January 2017, but early adoption was permitted. Where an entity did not early adopt in their 2016 accounts, they will need to amend their disclosures in the 2017 accounts.

(b) December 2016 saw a change in the requirements for the use of the reduced disclosure frameworks in FRS 101 and FRS 102. Initially, there was a requirement that the shareholders be advised of the proposed use of these frameworks. Where objections were received from shareholders holding in aggregate 5% or more of the total allotted shares of the company, or more than 50% of the allotted shares not held by the parent, the reduced disclosures could not be applied. This requirement was removed for periods commencing on or after 1 January 2016. Most companies will already have benefited from this change, but others will not do so until their second (or later) year.

(c) March 2017 saw the immediate change to FRS 102 which gave a small company the accounting policy choice of including below market rate loans at transaction price rather than, as required by FRS 102, being included at the present value of the cash flows. The timing of this revision means that many small companies took advantage of the accounting policy choice and retained the FRSSE accounting in their first FRS 102 accounts. Where a small company finalised its accounts under the original requirements of FRS 102 it will now have to decide whether to continue with that treatment or adopt the transaction price. If it does, the amendment to FRS 102 makes it clear that full retrospective application is required.

(d) December 2017 saw the issue of amendments following the triennial review. At the same time, FRC included some incremental clarifications and amendments.

2  **Initial guidance and feedback**

2.1  **ICAEW TECH 13/14 AAF**

ICAEW published an excellent publication, TECH 13/14 AAF, Issues for auditors arising from the implementation of FRS 102, which still bears reading.

It considered the key issues for auditors under the following:

- The ethical issues associated with advising and assisting clients; and
- The technical issues of risk assessment and obtaining audit evidence.

The contents are as follows:

1. Introduction
2. Ethics and FRS 102
3. Issues for audited entities – what the auditor should expect management to be doing
4. Appendix 1 – Technical issues on compliance with specific issues
5. Appendix 2 – Support from ICAEW FR Faculty
6. Glossary of terms and abbreviations used

The following key issues were identified -

- Audit management
2.2 Feedback on transition

2.2.1 Feedback from ICAEW on early adopters

QAD saw very few FRC 102 audits before the end of 2016. The general approach to FRS 102 includes encouraging firms to do more where they appear to be light, as well as external file reviews. Where possible, and where errors are obvious, QAD point them out.

Overall, there were fewer than expected transitional adjustments and not many obvious errors. In a few cases, firms did not understand that FRS 102 applied. Documentation of considerations around the transition was a weak area.

It is rarely clear how many of the issues encountered are software issues.

The overall impression is favourable. The majority had no serious issues, and most were minor, however, the check was superficial and restricted to the accounts themselves.

The biggest audit problem was the lack of evidence of consideration of the impact of the changes in FRS 102 when compared to previous GAAP. The planning document might refer to “this is the first year under FRS 102” and the accounts then include “there were no transitional adjustments on transition to FRS 102”, but there was no audit trail to indicate whether, for example, the auditor had tested for financial instruments such as foreign exchange contracts previously off-balance sheet which should have been included at fair value!

Significant accounting issues giving rise to the risk of potential material errors included:

(a) incorrect accounting policies;
(b) presentation, classification and transitional disclosure issues (including the accounting policy note not being updated);
(c) transitions absent clear adjustments and no statement to that effect;
(d) using the true and fair override to justify an indefinite useful life for goodwill, amortisation over long periods without reason;
(e) inappropriate adjustments on increases in stakes in a subsidiary;
(f) business combinations post transition not revisited for the valuation of intangibles;
(g) no deferred tax on investment properties or revalued PPE;
(h) gains on investment properties and deferred tax going to OCI rather than P&L;
(i) missing primary statements, statements not adding up;
(j) issues with construction businesses

2.2.2 HMRC

HMRC have noted that the link between transitional adjustments in the accounts and the tax computation can be difficult to follow, and thus result in additional enquiries. HMRC have also identified the following issues:

(a) A previous accounting policy was incorrect, but the change to a correct policy was treated as a transition adjustment. It should have been dealt with as the correction of an error, and the computation of the period in which the error occurred reopened, if the period for amending the self-assessment tax return is open, or other options are available.
(b) A substantial prior period error not being dealt with in transition accounts, and therefore not accounted for tax. We assume that this means that the error was “lost” in the transitional
adjustment to equity but the previous year’s computations were not adjusted or HMRC not advised;

(c) Changes in estimates bundled in as a transitional adjustment, including one which was highly material. These should, of course have been dealt with as revisions of accounting estimates, accounted for when made and not reflected in the year of transition.

To minimise the risk of enquiries we suggest that clients ensure adequate disclosure of transitional adjustments in both the financial statements and in the tax computation.

3 Audit objectives and FRS 102

3.1 Introduction

In considering the implications of FRS 102 it is useful to remind ourselves of the objectives of an audit. ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, defines the overall objectives of an audit. In addition, each individual ISA describes objectives for that ISA.

There are no changes of substance in ISA 200, which sets out the overall objectives of the independent auditor and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the ISAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the ISAs.

Understanding this Standard is fundamental to understanding the challenge of ISAs. This standard sets the background to the application of that methodology and conduct of audits in practice. This ISA is about attitudes, approaches and responsibilities.

3.2 Overall objectives

Paragraph 11 of ISA 200 defines the overall objectives of an audit as:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable reporting framework; and

(b) To report on the financial statements, and communicate as required by ISAs (UK), in accordance with the auditor’s findings.

Individual ISAs include requirements relevant to that topic. ISA 200 makes clear that the auditor needs to consider whether compliance with the objectives within individual ISAs has resulted in compliance with the overall objectives in ISA 200.

This requires the auditor to use the objectives in planning and performing the audit, having regard to the interrelationships among the ISAs, to:

(a) Determine whether any audit procedures in addition to those required by the specific ISA are necessary in pursuance of the objectives stated in the ISA; and

(b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Paragraph 21).

ISA 200 goes on to state that the auditor is required to comply with each requirement of the ISA (UK) unless the entire ISA (UK) is not relevant or the requirement is conditional, and the condition does not exist. For example, where a client does not outsource, the whole of ISA 402 is not relevant. Similarly, where the group auditor audits all of the components of the group, those requirements relating to communication with component auditors are not relevant.

3.3 The risk-based audit an overview

The Guide includes the following graphical representation of a risk-based audit
This can be illustrated as follows:

This is an interesting variation on the traditional approach which considers auditing as a 3-phase process:

- Planning,
- Execution,
- Review.

It is important to note that the traditional planning includes some of the risk response phase as well as risk assessment.

The key to addressing implementation of FRS 102 is understanding the risks e.g. incorrect completeness and valuation of financial instruments, identifying an appropriate audit approach e.g. obtaining expert evidence or devising own tests and ensuring sufficient appropriate audit evidence.

4 Interesting issue – Can you audit a micro-entity

4.1 General

By definition a micro-entity is a small company. Therefore, its shareholders can require an audit.

Accounting considers there are two reporting frameworks as follows:

(a) A fair presentation framework; and
(b) A compliance framework.

The audit report under Companies Act 2006 includes three explicit opinions:

(a) The financial statements give a true and fair view – this is consistent with a fair presentation framework since there is a requirement that to achieve a true and fair view (or fair presentation) management may need to give disclosures beyond those required those in the Act or FRS.
(b) The financial statements are prepared in accordance with GAAP – since GAAP for a small or large company includes a requirement to depart from the accounting standard if necessary to give a true and fair view this is consistent with a fair presentation framework. For a micro it is not, it is a compliance framework.
(c) The financial statements have been prepared in accordance with the Companies Act 2006. As (b) above.

The question for the auditor is whether an audit report can be issued in true and fair terms!

An article in Audit and Beyond in February 2017 considered the issue and concluded as follows:

(a) Company law allows audit of a micro and requires the auditor to disregard “any provision of an accounting standard which would require the accounts to contain information addition to” the minimum disclosure requirements. Note that is additional information is included, the auditors must have regard to any provision of an accounting standard which relates to that item.
(b) ISA 230 *Agreeing the terms of audit engagement* identifies the risk that the audit report may be misunderstood as implying that the accounts have been prepared under a fair presentation framework, when, as noted above they have not. It is therefore suggested that this risk may be mitigated by the prominent inclusion of an “other matter” paragraph in accordance with ISA 706.

(c) Is this an acceptable risk?

(d) Are there alternatives

(i) Agree a non-statutory audit on a compliance framework basis?

(ii) Offer some alternative limited assurance service?

(e) If you agree to go ahead, consider the following:

(i) Tailor the engagement letter;

(ii) Consider content of letter of representation;

(iii) Tailor management letter;

(iv) Take care in drafting audit report;

(v) Need accounts disclosure checklist.

4.2 FRS 105 update

4.2.1 Introduction

The principal changes in FRS 105 are the incorporation of three disclosure requirements which probably should have been included previously, as they derive from the Companies Act 2006, rather than the accounting regulations. As with the previously required notes, these additional disclosure requirements must be shown at the foot of the balance sheet. This is generally considered to be above the signature block, and the statements relating to audit exemption, se of the micros regime etc.

4.2.2 Statutory information

Section 396(A1) of the Companies Act 2006 requires disclosure of the following information:

(a) The part of the United Kingdom in which the micro-entity operates;

(b) The micro-entity’s registered number;

(c) Whether the micro-entity is limited by shares or guarantee. Since a micro-entity cannot be a public company, it will have to disclose the fact that it is a private company;

(d) The address of the company’s registered office;

(e) If relevant, the fact that it is being wound up.

This note has been required for FRS 102 1A for small companies for the last year or so, and a number of firms (and software suppliers) cross refer this note to the company information page, usually found at the front of the accounts. The danger with this approach is when the accounts are filleted for filing at Companies House. If the company information page is excluded from the filed accounts, they do not comply with the requirements of the Act. The safest option is to include this information at the foot of the balance sheet for micro-companies (and within the notes to the accounts for small companies).

4.3 Nature/purpose of arrangements not on the Balance Sheet

Section 410A (1) now requires a small company, and therefore FRS 105 now requires a micro-entity to include disclosure where the company is, or has been, party to an arrangement during the year that is not reflected on the balance sheet, where the risks or benefits are material.

The required disclosures are:

(a) The nature and purpose of the arrangements; and

(b) The financial impact the arrangements of the company.

For many micro companies this may be covered by the disclosure of commitments already required, although the fact that company law only requires disclosure of the aggregate amounts of such commitments may not sufficiently disclose the nature and purpose of the arrangements. Others may need to disclose other arrangements, such as consignment stock, debt factoring or sale and repurchase arrangements.

Note the requirement for the risks and benefits to be material.

4.3.1 Average number of employees

Section 411 CA 2006 has required disclosure of the average number of employees for many years. Prior to SI 2015/1980 this was prefixed by words “in the case of a company not subject to the small companies’
regime, exempting small companies from this disclosure. These words were removed by the SI and we have been disclosing this for small companies since then, and this is one of the mandatory disclosures in FRS 102 Section 1A. Since micro-companies are small, the removal of these words should have resulted in the note appearing in FRS 105! This has now been rectified by the triennial amendments.

4.3.2 Effective date

These disclosures must be incorporated in financial statements for periods commencing on or after 1 January 2017. There is an error in FRS 105 in that the statutory information requirement above is included in section 3, and the requirement to include the notes from 1 January 2017 only relates to section 6. However, it is clear that since the requirements are imposed by the Companies Act, disclosure should be made earlier rather than later. We would advise that, if the software has been updated, the information could be used for earlier periods.

5 Technical Issue 1 – Classifying clients

5.1 The EU Audit Directive and Audit

The new EU Audit Directive and Audit Regulation came into force on 16 June 2014 and the UK implementation is included in The Statutory Auditors and Third Country Auditors Regulations 2016.

The Audit Directive applies to all audits whereas Audit Regulation applies only to auditors of public interest entities (see 5.2 below.)

In the revised ISAs and Ethical Standards, the FRC cross refers to specific requirements in the Directive and Regulation by use of the suffix D and R respectively in the paragraph numbering and by colour coded shading (blue for Directive and red for Regulation). Unfortunately, there is no colour coding in the shading in the printed book version.

In addition to the requirements relating to PIEs, there are differences relating to other listed entities and SME listed entities in relation to:

(a) Who regulates them;
(b) Whether an engagement quality control review (hot review) is required;
(c) Limitations on non-audit services;
(d) Whether the audit firm needs to rotate; and
(e) Whether the engagement partner needs to rotate.

In an excellent article in Audit and Beyond in June 2017 the classifications and their implications were summarised as follows:

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Public interest entity</th>
<th>Other listed</th>
<th>SME Listed</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hot review</td>
<td>FRC</td>
<td>FRC</td>
<td>RPB e.g. ICAEW</td>
<td>RPB e.g. ICAEW</td>
</tr>
<tr>
<td>Non-audit services</td>
<td>Some prohibitions</td>
<td>Some prohibitions</td>
<td>Threat based approach</td>
<td>Threat based approach</td>
</tr>
<tr>
<td>Firm rotation</td>
<td>Yes – after 20 years</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Partner rotation</td>
<td>Yes – after 5 years</td>
<td>Yes – after 5 years</td>
<td>Yes – after 5 years</td>
<td>No</td>
</tr>
</tbody>
</table>

The categories of entity are as follows:

- **Public Interest Entities (PIEs)** are entities with securities admitted to trading on a regulated market, banks, building societies, and insurers. The Government has not sought to include additional entities in the definition of a PIE so, for example Companies traded on AIM will not be PIEs.

- **Other listed or non-PIE listed entities** are those listed on a non-EU regulated market where the public can trade shares, stock or debt.

- **SME listed companies are companies with:**
  - Average market capitalisation < €200m on the basis of the last 3 years;
The company issues exclusively non-equity financial instruments where nominal value does not exceed €200m;
- According to the last accounts it meets at least 2 out of 3 of the following:
  - Average employees fewer than 250;
  - Total balance sheet not exceeding €43m;
  - Annual net turnover not exceeding €50m.

Most delegates will quickly see that they have no clients in any of the three categories which have special additional restrictions. If you think you may have, please refer to the detailed guidance in the article in Audit and Beyond.

6 Technical Issue 2 – Auditor reporting

6.1 Introduction

When ISAS were initially introduced in the UK, APB issued a UK and Ireland based reporting standard ISA 700, and not the IAASB version. FRC have now adopted the IAASB version with some UK pluses. Before looking at the general requirements in ISA 700, we need to consider a new ISA (ISA 701).

6.2 ISA 701 Communicating key audit matters in the independent audit report

6.2.1 Introduction

Having already implemented extended auditor reporting requirements, the FRC has adopted the IAASB version of ISA 701 “Communicating key audit matters in the independent audit report” whilst retaining some specific FRC requirements as UK pluses:

(a) The auditor’s report should “describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;” and

(b) The requirement in the Regulation for auditors of PIEs to include in support of the audit opinion “a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud”.

6.2.2 Application

In addition to listed entities the following are required to apply ISA 701:

(a) Entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code; and

(b) Other public interest entities; and

(c) Entities where the auditor otherwise chooses to communicate key audit matters in the auditor’s report.

6.2.3 Illustrative wording

The following is taken from the compendium of illustrative audit reports for a publicly traded AIM listed company:

Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) we identified, including those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA (UK) 701.]

Our application of materiality

[Explanation of how the auditor applied the concept of materiality in planning and performing the audit. This is required to include the threshold used by the auditor as being materiality for the financial statements as a whole but may include other relevant disclosures.4]
An overview of the scope of our audit

[Overview of the scope of the audit, including an explanation of how the scope addressed each key audit matter and was influenced by the auditor’s application of materiality.]

6.3 ISA (UK) 700 (Revised June 2016)

Appendix 1 is an example audit report for a small company for the period commencing on or after 16 June 2016. It should not be used for earlier periods but watch out for short periods!

Note that this audit report has been taken from the FRC Bulletin: Compendium of illustrative auditor’s reports on United Kingdom private sector financial statements for periods commencing on or after 17 June 2016. Unlike the previous Bulletin 2010/02 which had 48 reports including reports on specialist sectors, emphasis of matter example and modified reports, the FRC bulletin only covers companies and has only 8 examples – with no modified reports.

ICAEW has published a number of helpsheets on drafting audit reports e.g. limited company, charity, pension scheme and LLP. Additional helpsheets are planned and it is believed that they will include one on modified reports.

6.4 Opinion

6.4.1 Introduction

The opinion section includes two paragraphs:

(a) The introductory “we have audited …” paragraph; and
(b) The opinion itself.

6.4.2 Introductory paragraph

ISA 700 24(c) requires that the opinion section shall “identify the title of each statement comprising the financial statements”. This would appear to prohibit the old format of referring to page numbers.

Note that the FRC Bulletin example report for a small company does not refer to FRS 102 1A, it simply refers to FRS 102. This is different from the previous example report which referred specifically to FRSSSE and UK GAAP applicable to small entities.

Note also a specific requirement to incorporate “including a summary of significant accounting policies” after reference to notes when the contents are being specified.

There is no change in the audit opinion itself, merely its location in the audit report.

6.5 Respective responsibilities of directors and auditors and scope of the audit of the financial statements

Under the previous ISA 700, the introductory paragraph was followed by, and the opinion paragraph preceded by, two separate paragraphs:

(a) Respective responsibilities of directors and auditors; and
(b) Scope of the audit of financial statements.

The revised ISA effectively splits paragraphs (a) and (b) above into two separate paragraphs:

(a) Basis of opinion paragraph which picks up the some of the auditor’s responsibilities e.g. the requirement to audit under ISAs and Ethical Standards previously covered in the scope of the audit paragraph (see 6.6 below);
(b) Responsibilities of directors (see 6.9 below);
(c) Auditors’ responsibilities for the audit of financial statements (see 6.10 below).

6.6 Basis for opinion

6.6.1 Required wording

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.

6.6.2 **Comparison with previous ISA**

Under the old ISA the respective responsibilities of directors and auditors would note the auditors’ responsibility to comply with ISAs and Ethical Standards.

The revised report makes confirmatory statements that:

(a) The audit was conducted in accordance with ISAs and applicable law;

(b) The auditors are independent in accordance with the ethical requirements;

(c) The auditors have fulfilled their other ethical requirements; and

(d) They believe that they have obtained sufficient and appropriate audit evidence.

6.6.3 **Implications for modified audit reports arising from limitation in scope**

Where there is a limitation in scope, the auditor is unable to report under items (a) and (d) and will need to modify this paragraph in addition to modifying his opinion.

Under the old ISA there would be no modification of the responsibilities paragraph.

6.7 **Going concern**

This is new requirement to include a specific statement on going concern even when the entity is a going concern. This is consistent with the emphasis FRC has on going concern. There is a requirement to consider going concern is the strategic report, in the accounting policies note and related disclosures.

See chapter 9 below.

The standard wording is as follows:

**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.

Note the double-negative approach. The auditors agree that the going concern basis is appropriate and that adequate disclosure has been made, but do not express a positive opinion to that effect.

6.8 **Other information**

FRC has now adopted the IAASB version and the previous two-part ISA 720 has been dropped. This subject is considered in chapter 7 below.

6.9 **Opinions on other matters prescribed by the Companies Act 2006.**

There is no change in the opinions required but as discussed above, the FRC illustrative accounts includes the opinion relating to the identification of material misstatements in the strategic or directors’ report in the next section.

Note the difference in wording for small companies which refer only to the directors’ report.

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

As noted above this now includes the identification of material misstatements in the directors and strategic reports. This section also differs between small and non-small companies.
6.11 Responsibilities of directors

6.11.1 Standard wording

The standard wording is as follows:

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.

6.11.2 Comparison with old-style report

The items underlined in the above paragraph were not included in the old-style report. This does not actually change their responsibilities, merely the reporting of them, but it may be useful for auditors to remind the directors, even of small companies of their responsibilities in these areas.

Note again, the FRC emphasis (paranoia?) on going concern!

6.12 Auditors’ responsibilities for the audit of the financial statements

6.12.1 Standard wording

The standard wording is as follows:

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.

6.12.2 Comparison with old-style report

The only sentences in relation the auditors’ responsibilities were “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. These standards require us to comply with the Auditing Practice Board’s Ethical Standards for Auditors.”

As noted above, some of this is now in the basis of opinion paragraph.

6.12.3 Bannerman paragraph

To date ICAEW has not updated the guidance on the Bannerman paragraph in Audit 1/03. It is therefore unclear whether it should immediately follow the report or where else it should be placed. In their helpsheets, ICAEW have included it at the end, but it is expected when Audit 1/03 is updated that it will be moved to after the opinion and basis of opinion paragraph.

6.13 ISA (UK) 705 (Revised June 2016) Modifications to the opinion in the independent auditor’s report

6.13.1 Overview

There are no changes in the basis of modification of the audit report, which continue to be:

(a) Qualified opinion;
(b) Adverse opinion; and
(c) Disclaimer.

The type of opinion expressed also continues to be:

<table>
<thead>
<tr>
<th>Nature of matter giving rise to qualification</th>
<th>Auditors’ judgement about the pervasiveness of the effects or possible effects on the financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statements are materially misstated</td>
<td>Qualified opinion</td>
</tr>
<tr>
<td>Inability to obtain sufficient appropriate audit evidence</td>
<td>Qualified opinion</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Material but not pervasive</th>
<th>Material and pervasive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adverse opinion</td>
<td>Disclaimer of opinion</td>
</tr>
</tbody>
</table>

6.13.2 The ISA

The ISA has been reordered in line with ISA 700 and there are a number of minor changes relating to how modified reports are drafted.

The example reports do not follow UK formats and there are no example qualified reports in the compendium of reports issued by FRC.

6.13.3 Disclaimers

One new area relates to disclaimers of opinion. ISA 705.29 states that unless required by law or regulation, the audit report is not to contain a Key Audit Matters section (not likely to be an issue because of the limited application of ISA 701. Similarly, when an opinion is disclaimed, the other information section shall not be included.

7 Technical issue 3 – Other information

7.1 Introduction

One of the potentially most significant changes in the audit report relates to the audit of other information, not least because of the inclusion of a number of additional grey shaded paragraphs of application in the UK.

The ISAs differentiate between statutory other information and other “other information”. Statutory other information is defined as “for statutory audits of financial statements, those documents or reports that are required to be prepared and issued by the entity (including any reports or documents which are included by cross reference) in relation to which the auditor is required to report publicly in accordance with that legislation.

7.2 Requirements

For entities that are required to prepare other information, as described in ISA (UK) 720 (Revised June 2016) the auditor is required to report in the auditor’s report on that other information in accordance with the ISA (UK). Appendices 1 to 7B of ISA 720 include illustrative examples of Other Information sections. However, these are not tailored to UK circumstances.

The auditor’s opinion on the financial statements does not cover the other information, nor is the auditor required to obtain audit evidence beyond that required to form an opinion on the financial statements, except in the circumstances:

(a) where the auditor is required to express an opinion, based on the work undertaken in the course of the audit, on the statutory other information and state the nature of the work performed by the auditor; or
(b) otherwise in accordance with law or regulation.

7.3 Standard wording unmodified opinion

The standard wording in the illustrative audit report is as follows:

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 the other information, we are required to report that fact.

We have nothing to report in this regard.

7.4 Reporting where the auditor has identified a material misstatement of the other information

Where the auditor concludes that there may be an uncorrected material misstatement, it is necessary to decide whether the misstatement is in the financial statements or in the other information. If it is in the financial statements, the audit opinion will be qualified, unless the misstatement is corrected. If there is a misstatement of the other information, the auditor is required to include a statement in the auditor’s report that describes the material misstatement. ISA (UK) 720 (Revised June 2016).

Where the auditor concludes that there is an uncorrected material misstatement of the statutory other information, in addition to including the statement noted by the above paragraph, the auditor also considers the reporting implications for the specific opinions, conclusions or statements required by ISAs (UK), law or regulation.

Illustration 2

What is the implication for the auditor if your client refuses to include information required by law or accounting standards in the following clients:

(a) The client is a limited company?
(b) The client is an unincorporated charity?
(c) The client is a pension scheme?

Comments on Illustration 2

Part (a)

Since the client is a company, the strategic rand directors’ reports are statutory other information given the requirement for an explicit report on whether they are consistent with the financial statements and have been prepared in accordance with applicable legal requirements, together with the exception report required if a misstatement is identified.

The failure to include the required information is likely to result in a qualified opinion on other matters required by the Act. A Qualified Basis of Opinion paragraph will be required. As noted above, the opinion on material misstatements has been moved to the matters on which the auditor is required to report by exception. The report would be on the following lines:

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 the other information, we are required to report that fact.

As described in the Basis for qualified opinion on other matters prescribed by the Companies Act 2006 section of our report we have concluded that a material misstatement of the other information exists.

**Basis for Qualified Opinion on other matters prescribed by the Companies Act 2006**

Based on the work undertaken in the course of the audit, the information given in the trustees’ report including the strategic report has not been prepared in accordance with applicable legal requirements because of the omission of the following information [provide details].

**Qualified opinion on other matters prescribed by the Companies Act 2006**

Except for the matter described in the Basis for Qualified Opinion on other matters prescribed by the Companies Act 2006 section of our report, 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 have been prepared in accordance with applicable legal requirements.

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

Except for the material misstatement described in the Basis for qualified opinion on other matters prescribed by the Companies Act 2006 section of our report, 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.

**Part (b)**

The trustees’ report is statutory other information as there is an implied term of the audit report that it is consistent with the financial statements. Therefore, the auditor is required to qualify the report in a similar way to (a) above.

**Part (c)**

There is no requirement to report on the Trustees’ Report for a pension scheme.

Therefore, the auditor amends the report as follows and deletes the words struck through “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.

However, the auditor cannot include the statement “We have nothing to report in this regard.”

As noted above the omission of information is, potentially, a material misstatement and when the auditor concludes that there is a material misstatement he is required to “report that fact.” Since there is no opinion, there is no requirement for a basis of qualified opinion!

The report should be prepared on the following lines:

**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 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 the other information, we are required to report that fact.
We have concluded that a material misstatement of the other information exists because the trustees’ report has not been prepared in accordance with applicable legal requirements because of the omission of the following information [provide details].

8 Technical issue 4 – The audit of disclosures

8.1 Introduction

IAASB and FRC considered the audit implications of the increasing trends of disclosure of information, including information not traditionally included within the accounts given the requirements for auditors to report on its truth and fairness and compliance when in the financial statements, and its inclusion as other information if not.

The changes sought to clarify that disclosures are an integral part of the financial statements and emphasise the importance of early consideration of disclosures in the audit process.

Enhanced requirements and guidance focus on:

- requiring the auditor to understand relevant systems relating to information disclosed;
- identification and assessment of the risks of material misstatements in quantitative and qualitative disclosures;
- obtaining sufficient appropriate audit evidence relating to disclosures; and
- evaluating the overall presentation of the financial statements, including their relevance and understandability.

Key issues for the auditor include:

(a) The need to understand the systems for producing disclosures, taking into account that the information is not necessarily within the general ledgers. For example, the number of employees is not within the general ledger and needs to be extracted from the payroll / HR records. Other information may not even be available directly from the client, such as risk information concerning financial instruments;
(b) The review of the financial statements should consider whether the accounts as a whole make sense and that the true and fair view is not compromised by information being obscured or misstated;
(c) Disclosures should be reconciled to supporting information as well as to the information disclosed in the financial statements;
(d) The engagement letter should confirm the requirement for provision of detailed disclosures;
(e) Communication with management and those charged with governance and representations may be required to obtain and support disclosure information;
(f) The assertions have been strengthened to ensure that completeness and adequacy of disclosure are considered in relation to individual items and the financial statements as a whole;
(g) Specific consideration is needed in considering the risks associated with “qualitative” disclosures such as those relating to risk arising from financial instruments, contingent liabilities etc.
(h) One of the key messages is that the auditor needs to focus on disclosure earlier in the audit process.

8.2 The encouraged regime and the auditor

8.2.1 Introduction

Unlike micro-entity accounts which are presumed by the Companies Act to be true and fair, there is no such presumption and there is a requirement for accounts to be true and fair. FRS 102 has therefore adopted the following approach to presentation and disclosure

(a) Paragraphs 1A 16 and 17 outline the general approach to be adopted in determining the information to be presented in the notes to the financial statements (see 3.2) below;
(b) Appendix A gives guidance on adapting the balance sheet (see 3.3. below);
(c) Appendix B gives guidance on adapting the profit and loss account (see 3.4 below);
(d) Appendix C outlines the required disclosures (see 3.5 below); and
(e) Appendix D gives the additional encouraged disclosures encouraged (see 3.6 below).
8.3 The general approach

The following is taken from FRS 102 1A:

“A small entity shall present sufficient information in the notes to the financial statements to meet the requirement for the financial statements to give a true and fair view of the assets, liabilities, financial position and profit or loss of the small entity for the reporting period (1A.16).

A small entity is not required to comply with the disclosure requirements of Section 3 (to the extent set out in paragraph 1A.7) and Sections 8 to 35 of this FRS. However, because those disclosures are usually considered relevant to giving a true and fair view, a small entity is encouraged to consider and provide any of those disclosures that are relevant to material transactions, other events or conditions of the small entity in order to meet the requirement set out in paragraphs 1A.5 and 1A.16. In accordance with paragraph 3.16A a small entity need not provide a specific disclosure (including those set out in paragraph 1A.18 and Appendix C to this section) if the information is not material (1A.17).

As a minimum, where relevant to its transactions, other events and conditions, a small entity shall provide the disclosures set out in Appendix C to this section (1A.18).

The paragraphs of this FRS that are cross-referenced in Appendix C are also highlighted in those sections by including an * in the left-hand margin (1A.19).

In addition, a small entity is encouraged to make the disclosures set out in Appendix D to this section, which may nevertheless be necessary to give a true and fair view (1A.20).”

8.4 Additional disclosures encouraged for small entities

The FRS states that “A small entity may need to provide disclosures in addition to those set out in order to enable the financial statements to give a true and fair view” (1A.6);

(a) A small entity is encouraged but not required to include:
   (i) A STRGL (Statement of other comprehensive income) where there are gains or losses not recognised in the profit and loss account (1A.9(a));
   (ii) A Statement of changes in equity, or a Statement of income and retained earnings ((1A.9(b));

(b) Where relevant to the transactions, other events and conditions, a small entity is encouraged to provide the following disclosures:
   (i) A statement of compliance with this FRS adapted to refer to Section 1A;
   (ii) A statement that it is a public-benefit entity as set out in PBE 3.3A;
   (iii) The disclosures relating to going concern set out in paragraph 3.9. This would require it to disclose material uncertainties that cast doubt on its ability to continue as a going concern, and where relevant, the fact that the going concern basis has not been used, together with a note of the basis adopted;
   (iv) Dividends declared and paid or payable during the period (for example as set out in paragraph 6.5(b));
   (v) On first-time adoption of this FRS an explanation of how the transaction has affected its financial position and financial performance as set out in paragraph 35.13 (1AD.1).

The question in practice, is the extent to which auditors will conclude that the inclusion of the encouraged disclosures, and / or any of the other disclosures included within the standard, which are not mandatory is necessary for a true and fair view and in their absence will seek to qualify their audit report.

9 Technical issue 5 – Going concern

9.1 Introduction

As noted above there is now a specific requirement to refer to going concern in the audit report, even when there are no major concerns about the entity’s ability to continue as a going concern.

There are no significant changes in the audit requirements in relation to the work to be done on going concern.

Illustration 3

Brownlee Ltd has net current liabilities, makes a small loss and is dependent on the support of its shareholder / directors. They have indicated their willingness to continue to support the company for the
foreseeable future. It has a material overdraft facility which it uses regularly and is due for renewal in 18 months.

How would you report in the following alternative situations?

(a) The company has never exceeded its overdraft facilities and you have no reason to believe that the facility will not be renewed. The directors have agreed to include a note outlining the directors continuing support in the basis of preparation / accounting policies note.

(b) The company is unable to control cash flows and has in the past exceeded the overdraft facility and there is some uncertainty whether the facility will be renewed at a sufficiently high level to allow the company to maintain its cash flows.

(c) The directors refuse to include the necessary wording;

(d) The auditors conclude that the use of the going concern basis is inappropriate.

Comments on illustration 3

Part (a)
The auditors agree that the use of the going concern basis is appropriate and there is no material uncertainty, because of the directors’ continuing support. Further they consider, that the disclosures in relation to going concern are appropriate and complete – without the disclosures of the directors’ support, the company would appear not to be a going concern.

The difference between the old and new requirements is that, provided that there was adequate disclosure in the accounts, the auditor would not need to refer to going concern in the audit report.

The standard wording above can now be used.

Note that if Brownlee is a small company and does not include the encouraged disclosures in relation to going concern the auditor would need to consider qualifying the audit report on the grounds that the directors have not disclosed identified material uncertainties.

Part (b)

There is now a material uncertainty which has been appropriately disclosed. The standard wording is still appropriate as the auditor agrees with the use of the going concern basis and the adequacy of disclosure.

The auditor does not modify (qualify) the audit opinion, but includes an emphasis of matter paragraph in accordance with ISA 706, after the audit opinion, on the following lines:

Material uncertainties related to going concern

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

Part (c)

As under the previous ISAs, the audit opinion in relation to truth and fairness etc. is modified on the grounds of disagreement, if the matter is material but not pervasive. If the matter is pervasive an adverse opinion is given.

Additionally, now the auditors will need to modify the conclusions relating to going concern section of the audit report and the opinions on the financial statements themselves.

Part (d)
The auditors now need to qualify the opinion in relation to the conclusions relating to going concern section of the audit report and give an adverse opinion on the truth and fairness of the financial statements.
10 Technical issue 6 – Fixed assets

10.1 Intangible fixed assets

10.1.1 Disaggregation of intangible
FRS 102 changed the basis for recognition of intangible assets separately from goodwill. Previous GAAP prohibited capitalisation unless the asset was separable. FRS 102 required capitalisation when the asset arose from legal or contractual rights. The recent amendments to FRS 102 reverted to a default position of not recognising unless the intangible is both separable and related to legal or contractual rights but permit the recognition when an asset is either separable or related to legal / contractual rights.

As noted above the big error on transition was the failure to restate business combinations made in the comparative period. The transitional exemption permitting an entity not to restate business combinations, only related to those made before the date of transition.

Note that the change in FRS 02 must be made prospectively which means that any business combinations made after the date of transition to FRS 102 but before the adoption of the revised standard must recognise intangibles arising from legal and contractual rights.

10.1.2 Valuation
The auditor needs to assess the basis of valuation to ensure that it is consistent with the requirements of FRS 102 and the adequacy of the supporting evidence. Where the client uses an external valuer the auditor needs to assess the competence and independence and should review the instruction as well as the output.

Note that just because a valuation is included in a sale and purchase agreement, that does not mean that it is acceptable for FRS 102 purposes.

10.1.3 Assessing useful lives
FRS 102 requires intangibles to be written off over their useful lives, which may not exceed 10 years, if they cannot be measured reliably.

10.1.4 Eligibility for revaluation
Although FRS 102 permits revaluation of intangibles, the criteria for such valuations are restrictive, including for example the requirement for there to be an active market and cannot be applied to an asset that was not originally recognised at cost.

10.2 Tangible fixed assets

10.2.1 Accounting policy choice
FRS 102 retains the accounting policy choice of cost or valuation under old GAAP but there are two significant differences.

10.2.2 Valuation basis
Under FRS 15, revaluation was on an existing use basis, under FRS 102 it is on an open market basis.

10.2.3 Deferred tax
Deferred tax is now required to be included. Under FRS 19 it was not required unless there was a binding agreement for sale.

10.2.4 Residual value
Under FRS 15 and FRSSSE, residual value was set on acquisition. Under FRS 102 it is reviewed annually. There is some evidence that this being abused in relation to some property where the distinction between depreciable assets (buildings) and non-depreciable assets (land) are being blurred and depreciation not being provided when it should be.
11 Technical issue 7 – Investment property

11.1 Introduction
FRS 102 changes the treatment of the gain on investment property, such that the gain is recognised in profit and loss and not other comprehensive income. Additionally, deferred tax is required.

Two big changes related to properties let to other group members and mixed-use properties. These have been amended by the revisions to FRS 102.

11.2 Property let to another group member
Under FRS 102 this was investment property to be included at fair value, unless it would involve undue cost or effort. The revised standard provides an accounting policy choice of cost or fair value. If transitioning to the fair value model, an entity can use the fair value at the beginning of the comparative period (not the previous year end) as deemed cost.

11.3 Mixed use property
The revision now requires the inclusion of mixed use property if it can be sold or let under a finance lease. This is more restrictive when it could be excluded from the requirement for fair value if it involved undue cost or effort.

11.4 Transfers
Revised FRS 102 now gives clear guidance on transfers to and from investment property as follows:

(a) From investment property to inventory or tangible fixed assets. The property is transferred at fair value which becomes the deemed cost for the fixed asset or inventory.
(b) From tangible fixed asset to investment property. The property is revalued before transfer and the gain recognised in other comprehensive income and revaluation reserve.
(c) From inventory to investment property. Again, the property is revalued before transfer. In this case the gain is recognised in profit and loss.

12 Technical issue 8 – Financial instruments

12.1 Introduction
For many entities there were few issues on transition to new UK GAAP as they held basic financial instruments carried at amortised cost under old GAAP, such that the treatment did not change. The big problems arose as follows:

(a) Entities with derivative financial instruments previously only recognised at settlement, now required to be included at fair value;
(b) Those with significant transaction costs previously written off when incurred. FRS 102 requires them to be included in computing the effective interest rate for the amortised cost method;
(c) Entities with financing transactions such as interest free credit which are now required to taken into account the effects of the time value of money; and
(d) Those with interest free loans now required to be included at the present value of the cash flows.

12.2 Audit issues
The auditor’s key issues involved testing and confirming:

(a) Identification of all financial instruments;
(b) Classification between basic and covered by Section 11 and other dealt with in section 12;
(c) Computation of amortised cost and appropriate treatment of transaction costs;
(d) Fair value assessments, treatment and disclosures

12.3 FRS 102 updated
There is a new definition of basic financial instrument which may simplify the accounting for some.

There is now an accounting policy choice for loans with directors and close family members of small companies, provided that the director or close family member is a shareholder. That choice is to record the loan at transaction value or the resent value of the cash flows as initially required.
13 Technical issue 9 – Group accounts

13.1 Introduction
FRS 102 prohibits merger accounting except in the case of a business reorganisation meeting certain criteria. As this was rarely used previously, this has little effect in practice.

There is no change in the definitions of subsidiary or associate as FRS 102 has not yet adopted the changes in IFRS. There is a minor change in the treatment of joint ventures which are separate entities, which are now accounted for using the equity method. The previous gross equity method under which the venturer’s share of turnover was disclosed on the face of the profit and loss account, and the share of gross assets and gross liabilities were shown on the balance have been dropped.

We have already discussed the significant change in relation to the recognition of separate intangible assets which is the only change which a group with wholly owned subsidiaries might have seen.

The two other changes which were introduced, and have caused problems in practice are:

(a) The treatment of minority interest; and
(b) Treatment of subsequent purchases and sales of shares.

13.2 Treatment of minority interest

13.2.1 Introduction
One area where FRS 102 changes UK practice is in the treatment of minority interest which FRS 102 refers to as non-controlling interest.

Equity is “the residual interest in the assets of the entity after deducting all its liabilities”. In an individual company’s accounts, this is likely to be represented by share capital and other reserves including share premium account and retained earnings.

Clearly minority interest does not meet the definition of a liability (which is “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits”).

There is no obligation which is expected to result in an outflow to the minority, (other than dividends approved before the reporting date) except in the event of a winding up, and the financial statements are being prepared on the going concern basis. There is thus no expectation of an outflow of funds.

The minority interest is therefore part of the residual interest i.e. it is equity.

13.2.2 Treatment in income statement
Currently the minority interest in the profit for the year is shown as a charge in arriving at profit for the year. Under IFRS – and therefore under FRS 102 - it is shown as an appropriation of profit.

Similarly, the appropriation of other comprehensive income and total income between the shareholders of the parent and non-controlling interest need to be shown.

13.2.3 Treatment in statement of changes in equity
The movements in non-controlling interest will also be shown in the movements of equity. This will include share of profit for the year (plus other comprehensive income), dividends and other movements.

13.2.4 Interest in net liabilities
Where the subsidiary is loss making and the non-controlling interest is in net liabilities, under existing UK GAAP it would normally be necessary to treat this as a debtor and assess whether the amount is recoverable.

Under FRS 102, in exactly the same way that a credit balance on non-controlling interest is not a liability, a debit balance is not an asset. Therefore, there is no question of writing off such a balance, and it appears as a debit balance within equity.
13.3 Changes in parent’s ownership

13.3.1 General

An entity may make changes in ownership in a number of situations, for example:

(a) Changes which do not result in a loss of control which occur when the entity increases its holding or reduces its holding but retains control (usually below 50%).
(b) Loss of control which usually occurs when the shareholding falls below 50% but there are other situations in which control is lost.
(c) Sale of the subsidiary.

13.3.2 Change of parent’s ownership that do not result in a loss of control

Changes of a parent’s ownership interests which do not result in a loss of control are accounted for as equity transactions.

13.3.3 Purchase of additional shares

The carrying amounts of the parent and the non-controlling interest shall be adjusted to reflect the changes in their relative interests in the subsidiary, and any difference between the fair value of the consideration paid/received and the amount by which the non-controlling interests are adjusted shall be recognised directly in equity and attributed to the owners of the parent (FRS 102 9.19C-19D).

The identifiable assets and liabilities and provision for contingent liabilities are not revalued to fair value and there is no additional goodwill recognised.

Where a parent reduces its holding in a subsidiary and control is retained, it is accounted for as a transaction between equity shareholders and the resulting change in non-controlling interest shall be accounted for in accordance with paragraph 22.19 (FRS 102.9.19A).

No gain or loss is recognised at the date of disposal.

Paragraph 22.19 requires any difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid or received is recognised in equity and attributed to equity holders of the parent.

13.3.4 Loss of control and sale of subsidiary

The subsidiary is consolidated in the income statements for the year in which control is lost, until control is lost.

At the date control is lost the entity derecognises the assets and liabilities at their carrying amounts (including goodwill) together with the carrying amount of any non-controlling interests in the former subsidiary (including any components of other comprehensive income attributable to them).

A gain or loss on disposal is calculated as the difference between:

(a) The proceeds from the disposal (or the event that resulted in loss of control)); and
(b) The proportion of the carrying amount of the subsidiary’s net assets, including any goodwill, disposed of (or lost) at the date of disposal or date control is lost.

The gain or loss on disposal should include any gains previously recognised in other comprehensive income which are required to be reclassified (recycled) through profit and loss. Gains which are not recycled are transferred directly to retained earnings.

14 Ethical issue 1 – recognising application of the Ethical Standard

14.1 Introduction

A new FRC Ethical Standard has been issued to replace the existing APB standards. The good news is that many of the provisions are unaltered. The bad news is that you need to read the whole standard to conform what the changes are!

The new standard applies for audits of financial statements commencing on or after 17 June 2016, subject to certain transition exemptions.
14.2 Structure

As outlined above, the Revised Ethical Standard is a single standard that replaces the previous suite of Ethical Standards. It is structured as follows:

Part A:
Overarching Principals and Supporting Ethical Provisions

Part B:
Section 1: General Requirements and Guidance
Section 2: Financial, Business, Employment and Personal Relationships
Section 3: Long Association with Engagements and with Entities Relevant to Engagements
Section 4: Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation
Section 5: Non-audit / Additional Services
Section 6: Provisions Available for Audits of Small Entities (PAASE)

The overarching principles in Part A require that:

(a) The firm, its partners and all staff must behave with integrity and objectivity in all professional and business activities and relationships; and

(b) For each audit engagement, the firm and each covered person must ensure that they are free from conditions and relationships which would make it probable that an objective, reasonable and informed third party would conclude the independence of the firm or any covered person is compromised.

14.3 Covered persons

14.3.1 Introduction

The requirements of the Ethical Standard apply to “covered persons” and in some cases to members of the family or associates of such persons. It is therefore important that the audit firm identifies who is covered.

14.3.2 Who is a covered person?

The old Ethical Standards included a number of requirements that applied to ‘persons in the chain of command’. The Revised Ethical Standard replaces this term with the phrase ‘covered person’, which is also referred to in the second overarching principle above.

A ‘covered person’ is a person in a position to influence the conduct or outcome of the engagement.

The definition of a covered person includes:

1. Each member of the audit engagement team responsible for managing the performance of the engagement (including day-to-day on-site direction and supervision) and persons who provide engagement quality control review;
2. All other members of the audit engagement team;
3. Other individuals under the control of the firm involved in the audit (e.g. an external expert);
4. Any person in the firm with supervisory, management or other oversight responsibility over the conduct of the firm’s audits, the audit engagement, engagement partner or other key partners involved in the engagement.
5. Any other person in the firm or network who is in a position to influence the conduct or outcome of the audit (e.g. a mentor for a newly appointed partner).

Those with supervisory, management or other oversight responsibility includes each partner, principal, shareholder or other person in the firm:

(a) at each level of management, supervision or oversight relating to the audit up to management or governance of the firm; or
(b) in a position to prepare or approve the performance appraisal and/or remuneration of those falling within categories 1, 3 and 4 above.
14.3.3 Which audits are covered?

The provisions of the standard are primarily concerned with independence on individual audits, although the independence on individual audits can be influenced by firm-wide procedures or issues. Therefore, a typical engagement partner will be a covered person on all his (or her) audits, together with any others on which he (or she assists), for example acting as EQCR, providing consultancy etc.

The head of audit, audit compliance principal and managing partner are likely to be covered persons for all audits! If the audit engagement partner is a senior equity partner with management or oversight responsibility, that will also mean that he (or she) is covered on all audits.

14.3.4 Persons closely associated

When considering financial, business, employment and personal relationships the Revised Ethical Standard no longer refers to ‘immediate family’, instead referring to ‘persons closely associated’.

This revised term includes within its scope immediate family such as a spouse (or equivalent) and a dependent child (as defined in UK law) or a relative who has lived in the same household for at least one year.

For the purpose of looking at relatives living in the same household, FRC suggest using the HMRC definition of a relative (e.g. brother, sister, ancestor or lineal descendant, i.e. not cousins).

The Revised Ethical Standard still separately refers to close family, including non-dependent parents, children and siblings, in the context of certain other requirements.

15 Ethical issue 2 – Demonstrating independence

The important element of the Ethical Standard has been to clarify that safeguards have to reduce threats to “a level at which it is probable that an objective, reasonable and informed third party would not conclude that independence would be compromised” (rather than just saying reduce them to an “acceptable level”).

It is therefore that the firm can demonstrate its independence and that any safeguards introduced are appropriate.

16 And finally …

As part of audit planning the auditor should consider whether last year’s financial statements included errors which need to be corrected, and whether the auditor needs to revise any or all of the following:

(a) Engagement letter;
(b) Audit approach;
(c) Letter of representation;
(d) Audit report.
17 Appendix 1 – Example new style audit report

Appendix 1 – Audit report under new ISAs (periods commencing on or after 17 June 2016) Non-publicly traded company preparing financial statements under the small companies’ regime

- Company qualifies as a small company and 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

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.

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.

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.

**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.

**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.

**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.

**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.

**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.

[Signature]
John Smith (Senior Statutory Auditor)

For and on behalf of ABC LLP, Statutory Auditor

[Address]

[Date]