1 GENERAL REQUIREMENTS OF THE COMPANIES ACT 2006

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INTRODUCTION

In the United Kingdom and Republic of Ireland (RoI), financial statements are prepared using Generally Accepted Accounting Practice (GAAP) and legislation prescribed in the form of the Companies Act 2006. Additional legislation also applies to certain financial statements (for example, the Charities Act) but this publication will only consider the Companies Act 2006 in relation to accounting by companies. At the outset of this chapter it is important to emphasise that the small companies regime in the UK is planned for significant change and these changes are discussed in more detail in Chapter 4. Readers are advised to keep up to date with all developments in this area by regularly reviewing the Department for Business Innovation and Skills' website as well as the Financial Reporting Council's website, as consultation documents were issued in September 2014 outlining proposals to overhaul the small companies regime in the light of the EU Accounting Directive. This chapter examines some of the proposals, with more detail being examined in Chapter 4, but at the time of writing, no final framework had been issued by the Department for Business Innovation and Skills nor the Financial Reporting Council.

Accounting standards are issued and amended by the Financial Reporting Council (FRC). The Regulations consist of the *Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* (SI 2008/409) and the *Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410). The application of accounting standards and the requirements of the Companies Act 2006 have the objective of enabling financial statements to give a true and fair view of the state of a company's financial affairs as at the reporting date, satisfying the directors' duty.

The Consultative Committee of Accountancy Bodies (CCAB) are committed to the promotion and compliance with accounting standards by their members, whether they are auditors or preparers of financial information. The CCAB is made up of:

- The Association of Chartered Certified Accountants (ACCA)
- The Chartered Institute of Public Finance and Accountancy (CIPFA)
- The Institute of Chartered Accountants in England and Wales (ICAEW)
- The Institute of Chartered Accountants in Ireland (ICAI)
- The Institute of Chartered Accountants in Scotland (ICAS)

Whilst the Chartered Institute of Management Accountants (CIMA) is no longer part of the CCAB, it also expects conformance and compliance with accounting standards by its members.

Significant departures from accounting standards and the requirements of the Companies Act 2006 must be adequately disclosed within the financial statements in order that the users can have an understanding of the reasons why the departure is considered to be appropriate. This can arise in certain issues where fair value accounting is concerned. Investment properties, for example, are required to be carried in a company's balance sheet (statement of financial position) at fair value at each reporting date under GAAP. The Companies Act 2006 requires fixed assets to be depreciated on a systematic basis; however, where investment properties are concerned the requirement to depreciate such properties is overridden (known as the 'true and fair override') because to carry such properties in the balance sheet at open market value as at the balance sheet date is considered to give more relevant and reliable information. Such a departure from the requirements of the Companies Act 2006 should be disclosed within the notes to the financial statements (often within the Accounting Policies section). An example of such a disclosure is as follows:

Example – Illustrative disclosure when the true and fair override is invoked

No depreciation is provided for in respect of investment properties as they are accounted for under the provisions in Section 16 of FRS 102. Such properties are held for their investment potential and not for consumption within the business. This is a departure from the Companies Act 2006 which requires all properties to be depreciated and the directors consider that to depreciate them would not enable the financial statements to give a true and fair view. Investment properties are stated at their market value at the reporting date.

ACCOUNTING REQUIREMENTS UNDER THE COMPANIES ACT 2006

Part 15 of the Companies Act 2006 deals with Accounts and Reports related to a company's financial statements. It outlines the distinction between companies that are subject to the small companies regime and those that are not.

Every company prepares financial statements to a reporting date (a financial year). The Companies Act 2006 says that a company's financial year:

- Begins with the first day of its first accounting reference period and
- Ends with the last day of that period or such other date, not more than seven days before or after the end of that period, as the directors may determine.

For subsequent financial years, these will:

- Begin with the day immediately following the end of the company's previous financial year and
- End with the last day of its next accounting reference period or such other date, not more than seven days before or after the end of that period, as the directors may determine.

The requirement to prepare annual financial statements is laid down in Chapter 4 to Part 15 of the Companies Act 2006. Section 394 requires the directors of every company to prepare financial statements for the company for each of its financial years, unless the company is exempt from that requirement under section 394A. These financial statements are referred to as the company's 'individual accounts'. Under section 394A, a company is exempt from the requirement to prepare individual accounts for a financial year if:

- It is itself a subsidiary undertaking,
- It has been dormant throughout the whole of that year and
- Its parent undertaking is established under the law of an EEA state.

The section then goes on to say that exemption is conditional upon compliance with all of the following conditions:

- All members of the company must agree to the exemption in respect of the financial year in question,
- The parent undertaking must give a guarantee under section 394(C) in respect of that year,
- The company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with:
  - The provisions of the Seventh Directive (83/349/EEC) or
  - International Accounting Standards,
- The parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirement to prepare individual accounts by virtue of this section and
- The directors of the company must deliver to the registrar within the period for filing the company's accounts and reports for that year:
  - A written notice of the agreement referred to in subsection (2) (a),
  - The statement referred to in section 394(C) (1),
  - A copy of the consolidated accounts referred to in subsection (2) (C),

- A copy of the auditor's report on those accounts and
- A copy of the consolidated annual report drawn up by the parent undertaking.

The filing requirements are also laid down in the Companies Act. Private companies must file their financial statements with the Registrar of Companies (Companies House) within nine months after the financial year-end (although different filing requirements apply to a newly incorporated entity). Public companies must file their financial statements within six months after the financial year-end.

Thresholds for small and medium-sized companies and groups

A company is deemed to be 'small' and hence can apply the small companies regime if it satisfies the small company thresholds for two out of three consecutive years. The thresholds are as follows (**note that these thresholds are planned to be changed in 2015 – see Chapter 4 for further details of these changes**).

Size	Turnover	Balance sheet total	Employees
Small company	£6.5m	£3.26m	50
Small group	£6.5m net £7.8m gross	£3.26m net £3.9m gross	50
Medium company	£25.9m	£12.9m	250
Medium group	£25.9m net £31.1m gross	£12.9m net £15.5m gross	250

Where reference to 'net' or 'gross' is made this relates to intra-group trading. 'Net' means that intra-group trading (and the effects thereof) have been eliminated, whilst 'gross' means that intra-group trading (and the effects thereof) have not been eliminated. A point to note is that a company may satisfy the qualifying criteria using gross or net figures and it is permissible to mix the use of gross and net figures in any year. Rather than eliminating intra-group transactions, the gross criteria should be checked first and the net size criteria checked only if required.

Financial statement content

A small company has a choice of preparing full UK GAAP financial statements without taking advantage of any of the concessions. In reality this is uncommon as small companies will often take advantage of the small companies regime in the Companies Act 2006. Where advantage is taken to prepare financial statements in accordance with the small companies regime, the company will use the Financial Reporting Standard for Smaller Entities (FRSSE) (or another alternative regime if the FRSSE is withdrawn following the overhaul of the small companies regime). Small companies must also file abbreviated financial statements with the Registrar of Companies. The fact that a company may file abbreviated financial statements with Companies House does not absolve them from any other responsibility for preparation of full financial statements for the shareholders or any other regulatory body to whom the financial statements may be submitted (for example, the Charities Commission).

Where the financial statements contain an auditor's report, the audit report is the special audit report contained in section 449 of the Companies Act 2006. This auditor's report states that in the auditor's opinion:

- The company is entitled to deliver abbreviated accounts in accordance with the section in question and
- The abbreviated accounts to be delivered are properly prepared in accordance with regulations on that section.

If the auditor's report is qualified, section 449(3) (a) requires the special report to set out the qualified auditor's report in full as well as outlining any further material deemed necessary so that users are able to understand the reasons for the audit qualification. In addition, where the auditor's report contains a statement under:

- Section 498(2) (a) or (b) (accounts, records or returns inadequate or accounts not agreeing with records and returns) or
- Section 498(3) (failure to obtain necessary information and explanations),

the special report must set out that statement in full.

A table outlining the financial statement requirements is shown below:

	Full financial statements	*Full balance sheet only*	*Abbreviated financial statements*	*Abbreviated balance sheet only*
Formats under Companies Act 2006	Schedule 1	Schedule 1	Schedule 4	Schedule 4
Companies Act 2006 accounts or IAS accounts	Option available for both	Option available for both	Option not available for IAS accounts	Option available for both
Statement in a prominent position on balance sheet	Yes – Companies Act 2006, section 414(3)	Yes – Companies Act 2006, section 444(5)	Yes – SI 2008/409 Schedule 4, paragraph 2	Yes – Companies Act 2006, section 444(5)
Copy of profit and loss account	Yes	No	No	No
Copy of directors' report	Yes	No	No	No
Audit report (where audit exemption does not apply)	Yes – Companies Act 2006, section 495	Yes – Companies Act 2006, section 495	Yes – Companies Act 2006, section 449 (special auditors' report)	Yes – Companies Act 2006, section 495
Notes to the financial statements	Yes	Yes	Yes, although limited to those referred to under SI 2008/409 Schedule 4	Yes, although limited to those referred to under SI 2008/409 Schedule 4

The balance sheet formats are set out in Schedule 1 to SI 2008/409 and take the form of Format 1 and Format 2. Format 1 is the most commonly used format for the balance sheet and is referred to below, although Format 2 permits identical combinations of headings.

Format 1 balance sheet (Large and Medium Companies and Groups (Accounts and Directors' Report) Regulations 2008)	*Format 1 balance sheet (Small Companies and Group (Accounts and Directors' Report) Regulations 2008)*
A. Called up share capital not paid	A. Called up share capital not paid
B. Fixed assets	B. Fixed assets
B I. Intangible assets	B I. Intangible assets
1. Goodwill	1. Goodwill
2. Development costs	2. Other intangible assets
3. Concessions	
4. Payments on account	
B II. Tangible assets	B II. Tangible assets
1. Land and buildings	1. Land and buildings
2. Plant and machinery	2. Plant and machinery, etc.
3. Fixtures and fittings	
4. Payments on account	
B III. Investments	B III. Investments
1. Shares in group undertakings	1. Shares in group undertakings and participating interests
2. Participating interests	2. Loans to group undertakings and undertakings in which the company has a participating interest
3. Loans to group undertakings	3. Other investments other than loans
4. Loans to undertakings, etc.	4. Other investments
5. Other investments other than loans	
6. Other loans	
7. Own shares	
C. Current assets	C. Current assets
C I. Stocks	C I. Stocks
1. Raw materials, etc.	1. Stocks
2. Work in progress	2. Payments on account
3. Finished goods/goods for resale	
4. Payments on account	
C II. Debtors	C II. Debtors
1. Trade debtors	1. Trade debtors
2. Amounts owed by group undertakings	2. Amounts owed by group undertakings and undertakings in which the company has a participating interest
3. Amounts owed by undertakings in which the company has a participating interest	3. Other debtors
4. Other debtors	
5. Called up share capital not paid	
6. Prepayments and accrued income	
C III. Investments	C III. Investments
1. Shares in group undertakings	1. Shares in group undertakings
2. Own shares	2. Other investments
3. Other investments	
C IV. Cash at bank and in hand	C IV. Cash at bank and in hand
D. Prepayments and accrued income	D. Prepayments and accrued income

E. Creditors: amounts falling due within one year	E. Creditors: amounts falling due within one year
1. Bank loans and overdrafts	1. Bank loans and overdrafts
2. Trade creditors	2. Trade creditors
3. Amounts owed to group undertakings	3. Amounts owed to group undertakings and undertakings in which the company has a participating interest
4. Amounts owed to undertakings in which the company has a participating interest	4. Other creditors
5. Debenture loans	
6. Payments received on account	
7. Bills of exchange payable	
8. Other creditors including taxation and social security	
9. Accruals and deferred income	
F. Net current assets (liabilities)	F. Net current assets (liabilities)
G. Total assets less current liabilities	G. Total assets less current liabilities
H. Creditors: amounts falling due after one year	H. Creditors: amounts falling due after one year
1. Bank loans and overdrafts	1. Bank loans and overdrafts
2. Trade creditors	2. Trade creditors
3. Amounts owed to group undertakings	3. Amounts owed to group undertakings and undertakings in which the company has a participating interest
4. Debenture loans	4. Other creditors
5. Payments received on account	
6. Bills of exchange payable	
7. Other creditors including taxation and social security	
8. Accruals and deferred income	
I. Provisions for liabilities	I. Provisions for liabilities
1. Pensions and similar obligations	
2. Taxation, etc.	
3. Other provisions	
J. Accruals and deferred income	J. Accruals and deferred income
K. Capital and reserves	K. Capital and reserves
K I. Called up share capital	K I. Called up share capital
K II. Share premium account	K II. Share premium account
K III. Revaluation reserve	K III. Revaluation reserve
K IV. Other reserves	K IV. Other reserves
1. Capital redemption reserve	
2. Reserves for own shares	
3. Reserves provided for by articles	
4. Other reserves	
K V. Profit and loss account	K V. Profit and loss account

The formats above will remain relevant under FRS 102 because the Financial Reporting Council decided that company law formats could continue to apply under the new regime and hence preparers will not see much change in the overall format of the financial statements themselves under FRS 102.

The Companies Act 2006 allows small companies to adopt the use of any of the four alternative formats of the profit and loss account, which are set out in Schedule 1 to SI 2008/409.

Format 1 profit and loss account

Turnover	X
Cost of sales	X
Gross profit or loss	X
Distribution costs	X
Administrative expenses	X
Other operating income	X
Income from shares in group undertakings	X
Income from participating interests	X
Income from other fixed asset investments	X
Other interest receivable and similar income	X
Amounts written off investments	X
Interest payable and similar charges	X
Tax on profit or loss on ordinary activities	X
Profit or loss on ordinary activities after taxation	X
Extraordinary income	X
Extraordinary charges	X
Extraordinary profit or loss	X
Tax on extraordinary profit or loss	X
Other taxes not shown under the above items	X
Profit or loss for the financial year	X

Format 2 profit and loss account

Turnover	X
Change in stocks of finished goods and in work in progress	X
Own work capitalised	X
Other operating income	X
Raw materials and consumables	X
Other external charges	X
Staff costs	
Wages and salaries	X
Social security costs	X
Other pension costs	X
Depreciation and other amounts written off tangible and intangible fixed assets	X

Exceptional amounts written off current assets	X
Other operating charges	X
Income from shares in group undertakings	X
Income from participating interests	X
Income from other fixed asset investments	X
Other interest receivable and similar income	X
Amounts written off investments	X
Interest payable and similar charges	X
Tax on profit or loss on ordinary activities	X
Profit or loss on ordinary activities after taxation	X
Extraordinary income	X
Extraordinary charges	X
Extraordinary profit or loss	X
Tax on extraordinary profit or loss	X
Other taxes not shown under the above items	X
Profit or loss for the financial year	X

Format 3 profit and loss account

Charges	
Cost of sales	X
Distribution costs	X
Administrative expenses	X
Amounts written off investments	X
Interest payable and similar charges	X
Tax on profit or loss on ordinary activities	X
Profit or loss on ordinary activities after taxation	X
Extraordinary charges	X
Tax on extraordinary profit or loss	X
Other taxes not shown under the above items	X
Profit or loss for the financial year	X
Income	
Turnover	X
Other operating income	X
Income from shares in group undertakings	X
Income from participating interests	X
Income from other fixed asset investments	X
Other interest receivable and similar income	X
Profit or loss on ordinary activities after taxation	X
Extraordinary income	X
Profit or loss for the financial year	X

Format 4 profit and loss account

Charges	
Reduction in stocks of finished goods and work-in-progress	X
Raw materials and consumables	X
Other external charges	X
Staff costs	
Wages and salaries	X
Social security costs	X
Other pension costs	X
Depreciation and amounts written off tangible and intangible fixed assets	X
Exceptional amounts written off current assets	X
Other operating charges	X
Amounts written off investments	X
Interest payable and similar charges	X
Tax on profit or loss on ordinary activities	X
Profit or loss on ordinary activities after taxation	X
Extraordinary charges	X
Tax on extraordinary profit or loss	X
Other taxes not shown under the above items	X
Profit or loss for the financial year	X
Income	
Turnover	X
Increase in stocks of finished goods and work-in-progress	X
Own work capitalised	X
Other operating income	X
Income from shares in group undertakings	X
Income from participating interests	X
Income from other fixed asset investments	X
Other interest receivable and similar income	X
Profit or loss on ordinary activities after taxation	X
Extraordinary income	X
Profit or loss for the financial year	X

At the time of writing, the Department for Business Innovation and Skills were consulting on only having Format 1 and Format 2 for the profit and loss account as Formats 3 and 4 are rarely used, although no final decision had been made.

TRUE AND FAIR AND ADEQUATE ACCOUNTING RECORDS

The directors of a company are required, in law, to prepare financial statements that give a true and fair view of the state of the company's affairs as at the reporting

date. The concept of true and fair has been enshrined in company law for many years and the directors are prohibited from approving financial statements that do not give a true and fair view.

Section 396 of the Companies Act 2006 outlines that financial statements must:

- In the case of the balance sheet, give a true and fair view of the state of affairs of the company as at the end of the financial year and, in the case of the profit and loss account, give a true and fair view of the profit or loss of the company for the financial year.
- Comply with the provisions made by the Secretary of State by regulations as to the form and content of the balance sheet and profit and loss account and additional information to be provided by way of notes to the accounts.

In many cases, companies will achieve compliance with both sections 396(2) and (3) by the application of accounting standards and compliance with legislation. However, there are some instances where the requirements of the Companies Act 2006 may be overridden (the true and fair override). Section 396(4) says:

- If compliance with the regulations and any other provision made by or under this Act as to the matters to be included in a company's individual accounts or in notes to those accounts, would not be sufficient to give a true and fair view, the necessary additional information must be given in the accounts or in a note to them.

Section 396(5) also requires the particulars of such departures from the Companies Act 2006, together with the reasons for such a departure and its effect. The majority of departures from the requirements of the Companies Act 2006 derive from the provisions laid down in accounting standards where the applicable accounting standard is inconsistent with the requirements of the Companies Act 2006. An example of such a departure would be the non-depreciation of investment properties that are carried in the balance sheet (statement of financial position) at open market value (fair value) at each reporting date; hence no depreciation would be charged on such properties despite the Companies Act 2006 requiring depreciation to be charged against fixed assets.

The term 'adequate accounting records' is derived from the Companies Act 2006 and it is the duty of every company to keep adequate accounting records. Section 396(2) defines the constitution of adequate accounting records and says that adequate accounting records means records that are sufficient:

- To show and explain the company's transactions,
- To disclose with reasonable accuracy, at any time, the financial position of the company at that time and
- To enable the directors to ensure that any accounts required to be prepared comply with the requirements of this Act (and, where applicable, of Article 4 of the IAS Regulation).

Companies are required to maintain accounting records that record the company's assets and liabilities as well as containing records that detail the day-to-day

transactions (monies received and expended by the company) and the matters in respect of which the receipt and expenditure takes place. When a company is involved in the buying and selling of goods, the accounting records must contain:

(a) A statement of stock held by the company at the end of each financial year of the company,
(b) All statements of stocktakings from which any statement of stock as is mentioned in paragraph (a) has been or is to be prepared and
(c) Except in the case of goods sold by way or ordinary retail trade, statements of all goods sold and purchased, showing the goods and the buyers and sellers in sufficient detail to enable all these to be identified.

When it is evident that a company has failed to maintain adequate accounting records, every officer of the company is guilty of an offence under section 387(1). Where an officer(s) of a company is proved guilty, the punishments outlined in section 387(3) (a) and (b) are:

- On conviction on indictment, to imprisonment for a term not exceeding two years or a fine (or both).
- On summary conviction:
  - In England and Wales, to imprisonment for a term not exceeding twelve months or to a fine not exceeding the statutory maximum (or both);
  - In Scotland or Northern Ireland, to imprisonment for a term not exceeding six months or to a fine not exceeding the statutory maximum (or both).

Retention of accounting records

Accounting records have to be kept either at the company's registered office or at an alternative location as the directors think fit. Wherever these accounting records are held, provisions exist in the Companies Act 2006 at section 388(b), which says that these records must be open to inspection by the company's officers. If such accounting records are retained at a place that is outside the United Kingdom, it is mandatory under legislation for accounts and returns in relation to the business dealt with in those accounting records to be sent to, and kept at, a place in the United Kingdom and for such information to be available for inspection. This requirement is embellished in section 388(3) (a) and (b), which says that the accounts and returns to be sent to the United Kingdom must be such as to:

- Disclose with reasonable accuracy the financial position of the business in question at intervals of not more than six months and
- Enable the directors to ensure that the accounts required to be prepared under this Part comply with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).

Accounting records in respect of a private company are to be retained for a period of three years from the date on which they are made. For public companies, accounting records must be retained for a period of six years from the date on which they are made.

The officers of a company will be committing a criminal offence if they fail to maintain adequate accounting records for the prescribed levels of time and in a place required under the Companies Act 2006. An offence is committed by an officer if he:

- Fails to take all reasonable steps for securing compliance by the company with subsection (4) of that section (period for which records to be preserved) or
- Intentionally causes any default by the company under that subsection.

Section 389(4) outlines the punishments to be levied by the courts in the event that a person is found guilty:

- On conviction on indictment, to imprisonment for a term not exceeding two years or a fine (or both);
- On summary conviction:
  - In England and Wales, to imprisonment for a term not exceeding twelve months or to a fine not exceeding the statutory maximum (or both);
  - In Scotland and Northern Ireland, to imprisonment for a term not exceeding six months or to a fine not exceeding the statutory maximum (or both).

An important point to emphasise is that where a company has not kept adequate accounting records, ALL officers of the company will be guilty of an offence under the Companies Act 2006. Adequate accounting records are also required to be kept for the purposes of taxation and auditors of companies must also report by exception if, in the auditor's opinion, adequate accounting records have not been kept or returns adequate for the audit have not been received from branches that have not been visited by the auditor.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

International financial reporting standards (IFRS) have become more widespread over recent years. Many countries have chosen to adopt IFRS as their financial reporting framework on the grounds that such standards offer consistency in financial reporting for reporting entities. Many commentators also believe that the adoption of IFRS opens up wider potential to access more capital markets. The International Accounting Standards Board (IASB) is very keen to promote the adoption of IFRS across the globe and their stated goal is to develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles.

IFRS began to gather pace in 2005 as 27 European Union member states and many other countries adopted the use of IFRS. Countries such as Argentina, Brazil and Canada have since followed suit and adopted IFRS as their financial reporting framework.

In the United Kingdom, listed companies were mandated to present their financial statements under EU-adopted IFRS for accounting periods commencing on or after 1 January 2005. This was closely followed by companies listed on the Alternative Investment Market (AIM) in 2007.

The adoption of IFRS around the world has not been without controversy. Indeed, in the UK, the legality of IFRS in the UK was brought into question and a legal opinion was given by George Bompas QC on 8 April 2013 who concluded that since the true and fair view is paramount, company directors have a duty to override IFRS in order to comply with it. In his opinion, Bompas took issue with an earlier legal opinion on the same issue, which was commissioned by the Financial Reporting Council (FRC), and this opinion was provided by Martin Moore QC. This acknowledged the FRC's approach, which is that the true and fair requirement is integral to the preparation of financial statements in the UK, whether they are prepared under UK GAAP or IFRS. Moore also said that companies could depart from the relevant standard but only in 'extremely rare' or 'exceptional' circumstances.

On 3 October 2013, the Department for Business Innovation and Skills released a government response to the concerns raised in which it states:

> *'The Department for Business has given serious consideration to concerns raised by some stakeholders that accounts prepared over the past 30 years, in accordance with UK or international financial reporting standards, have not been properly prepared under UK and EU law.*
>
> *However, it is entirely satisfied that the concerns expressed are misconceived and that the existing legal framework, including international financial reporting standards, is binding under European law.'*

On the same day as the Department for Business issued this response, the FRC issued a press release confirming that it shared the view of the Department for Business.

Smaller companies and IFRS

In the UK, listed companies are required to report under EU-endorsed IFRS and it is rare to find any smaller companies (other than listed companies) reporting under the IFRS framework. This is due, in large part, to the significant disclosure requirements that IFRS mandates and such disclosure requirements are not considered to be 'fit for purpose' for companies at the smaller end of the scale.

In July 2009, the IASB issued the *IFRS for SMEs*. The overall objective of the *IFRS for SMEs* is essentially to provide a framework under IFRS, but with a much less burdensome disclosure regime. The standard itself is a stand-alone document, which only contains one optional cross-reference to mainstream IFRS in relation to financial instruments (which provides a choice concerning the treatment of financial instruments). The IASB issued *IFRS for SMEs* for those entities that do not have 'public accountability'. The concept of public accountability has been extremely difficult to define in the UK and Republic of Ireland and the concept was withdrawn in the second round of Exposure Drafts that the FRC issued to explain their intention to replace UK GAAP. The *IFRS for SMEs* was not compatible with UK companies' legislation and this is the reason why it was never adopted in its entirety in the UK. Notwithstanding its incompatibility with UK company law, FRS 102 is based on *IFRS for SMEs*, which has been amended to be compatible with UK legislation and EU Directives.

List of current IFRS and IAS in extant

At the time of writing, the following international accounting standards (IAS) and international financial reporting standards (IFRS) and interpretations (SIC/IFRIC) were in issue:

IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Separate Financial Statements
IAS 28	Investments in Associates and Joint Ventures
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement (superseded by IFRS 9: Financial Instruments where IFRS 9 is applied)
IAS 40	Investment Property
IAS 41	Agriculture
IFRS 1	First-time Adoption of IFRS
IFRS 2	Share-based Payment
IFRS 3	Business Combination
IFRS 4	Insurance Contracts

IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Assets
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interests in Other Entities
IFRS 13	Fair Value Measurement
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 4	Determining Whether an Arrangement Contains a Lease
IFRIC 5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programmes
IFRIC 14	IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 16	Hedges of a Net Investment in a Foreign Operation
IFRIC 17	Distributions of Non-cash Assets to Owners
IFRIC 18	Transfers of Assets from Customers
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine
IFRIC 21	Levies
SIC-7	Introduction of the Euro
SIC-10	Government Assistance – No Specific Relation to Operating Activities
SIC-15	Operating Leases – Incentives
SIC-25	Income Taxes – Changes in the Tax Status of an Enterprise or its Shareholders

SIC-27	Evaluating the Substance of Transactions in the Legal Form of a Lease
SIC-29	Disclosure – Service Concession Arrangements
SIC-31	Revenue – Barter Transactions Involving Advertising Services
SIC-32	Intangible Assets – Web Site Costs

GENERALLY ACCEPTED ACCOUNTING PRACTICE

The way in which company accounts are prepared is governed by the requirements of generally accepted accounting practice (GAAP). UK GAAP includes accounting standards and companies legislation and is also frequently cited in tax legislation because HM Revenue and Customs require financial statements used in the calculation of taxable profit or loss to be prepared under GAAP.

The prescribed GAAP in the UK is as follows:

- EU-endorsed IFRS,
- UK GAAP (FRSs 100, 101, 102 and 103),
- Financial Reporting Standard for Smaller Entities (note the planned changes above and in Chapter 4) and
- Micro-entities legislation.

Statements of Recommended Practice (SORPs) are publications issued to certain industries or sectors, which recommend accounting practices and go to supplement accounting standards and other legal and regulatory requirements; for example, Limited Liability Partnerships have a SORP titled *Accounting by Limited Liability Partnerships*. SORPs are not issued by the Financial Reporting Council, but are instead issued by a SORP-making body. At the time of writing, seven out of the eight SORPs were being updated as a result of the new UK GAAP. The remaining SORP not being updated was that of the insurance sector SORP, which is expected to be withdrawn because of the introduction of FRS 103 *Insurance Contracts* (issued by the FRC on 20 March 2014), which specifies the accounting and disclosure requirements for entities dealing with such contracts.

To achieve a true and fair view, financial statements must comply with UK GAAP. Auditors are also specifically required to report in their auditors' report if the financial statements comply with UK GAAP (or not).

SUBSTANCE OF TRANSACTIONS

Financial statements prepared under UK GAAP must report the 'substance' of transactions and not merely the legal form. The term 'substance of a transaction' is taken to mean the commercial reality of a transaction and the section in FRS 102 that can illustrate this concept extremely well is that of Section 20 *Leases*. In a leasing transaction, the lessor may continue to hold the legal ownership of an asset subject to a finance lease; however, the characteristics of the transaction are such that the lessee enjoys the rights to use the asset in order to generate economic benefits for the entity

leasing the asset. This, in substance, gives rise to an asset. This concept can also be accentuated when it can be demonstrated that the 'risks and rewards' of ownership of the asset have substantially been transferred from lessor to lessee (for example, where the lessee is required to carry out maintenance of the asset at its own cost or where the lessee is required to pay early termination fees in the event the lease is cancelled before its maturity date).

Paragraph 2.8 to FRS 102 refers specifically to substance over form and says that transactions as well as other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. When a company applies this concept, the reliability of their financial statements is enhanced.

The concept of substance over form was initially identified back in the early 1980s and emerged due to the ways in which entities were financing their operations. It became apparent that financing transactions were becoming more complex and this complexity often led to a separation of the legal title to an asset from access to its economic benefits and risk. Certain financing arrangements were being entered into which, in some instances, were deliberately engineered to achieve a desired outcome (which was to keep financing arrangements off the balance sheet). This practice was coined 'off balance sheet finance' and the concept is still as much a problem today as it was back in the early 1980s. At the time of writing, standard-setters across the world (in particular the IASB and the US Financial Accounting Standards Board) are trying to overhaul the ways in which certain financing arrangements (namely leases) are accounted for so as to reduce the instances where entities achieve off balance sheet finance.

The problem with off balance sheet finance, and the non-reporting of the substance of a transaction, is the fact that not only can it have a significant effect on the balance sheet of a company but it can also have a significant effect on a company's reported profit (or loss). This is particularly the case in a sale and leaseback arrangement, which may not have been accounted for as such; the arrangement could have been reported as a fixed asset disposal, and hence a profit could be recorded, when, in fact, the transaction was (in substance) a financing arrangement (a secured loan).

In determining the substance of a transaction and when an asset or a liability should be recognised on the balance sheet, it is necessary to determine whether an asset or a liability has, in fact, been created. Entities falling under the scope of FRS 102 will be pointed to the *Concepts and Pervasive Principles* in Section 2 of FRS 102. An asset is a resource that is controlled by the reporting entity that derives economic benefit for the entity itself. The point to emphasise where assets are concerned is the concept of 'control'. To meet the definition of an asset, an entity must have control over that asset.

Conversely, a liability is an obligation on the part of the entity that creates an expectation that the entity will experience an outflow of funds (or depletions of other assets) in order to settle the obligation.

In assessing whether an asset or a liability has been created, the characteristics of the transaction should be scrutinised and not simply the legal form. The term 'risks

and rewards' is often cited when determining the substance of transactions and some factors that may be considered are as follows.

Risks

- Which party to the transaction will bear the risks of unfavourable (or favourable) changes to the value of the asset?
- Who will bear the risk of obsolescence of the asset?
- Who will bear the risk that the asset may be damaged or lost?

Rewards

- Who benefits from any increases in the fair value of the asset?
- Who will benefit from the income streams associated with the asset?
- Who will benefit from the use of the asset?

The above lists are not exhaustive and there are many other factors that may need consideration when determining the substance of a transaction. The important aspect where substance over form is concerned is not to merely rely on the legalities of the transaction – the commercial reality of the transaction will determine whether an asset or a liability has been created, which will then determine the relevant accounting treatment.

DIRECTORS' REPORTS

In addition to preparing financial statements, the directors of a company are also required under the Companies Act 2006 to prepare a directors' report. Where the company is the parent of a group and the directors prepare consolidated financial statements, the directors must prepare a group directors' report. The group directors' report will cover all the undertakings that have been dealt with in the consolidation process.

Small companies are permitted to prepare a directors' report, although the content of these directors' reports are very minimal and merely outline the principal activity of the company during the year and the names of the directors who served on the board during the year. There is also reference to the fact that the directors' report of a small company has been prepared in accordance with the small companies regime in the Companies Act 2006.

Companies that will not be eligible to apply the FRSSE (or other small companies regime, which may come into effect following the EU Accounting Directive) and who must report under FRS 102 are required to prepare a directors' report that complies with the following requirements in the Companies Act 2006:

- General matters (section 416) including SI 2008/410 disclosures;
- Matters relating to the company and subsidiaries (SI 2008/410) (relating to a parent company preparing consolidated financial statements);
- A statement as to disclosure of information to auditors as per section 418.

Strategic reports

For financial years ending on or after 30 September 2013, the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 will apply. Companies should review the guidance that has been issued by the FRC, although the majority of the FRC's guidance relates to quoted companies, other public companies, large companies and medium-sized companies. Companies that qualify as small or that would also qualify as small except for being, or having been, a member of an ineligible group are exempted from the requirement to prepare a strategic report. Parent companies that prepare consolidated financial statements must also prepare a 'group strategic report', which relates to all the undertakings that have been included in the consolidation.

For financial years ending on or after 30 September 2013, the directors of a company that qualifies as large or medium-sized must prepare a strategic report in addition to the directors' report and this requirement has been introduced by new sections 414(A) to 414(D) to the Companies Act 2006. At the same time as introducing these new sections, section 417 of the Companies Act 2006, which required a directors' report to include a business review of the company, was repealed. The consequence for unquoted companies is that the strategic report will essentially mirror the requirements of the business review.

The main difference between the strategic report and the business review is that the strategic report must be presented separately in the financial statements from the directors' report. In addition, section 414(D) to the Companies Act 2006 requires the strategic report to be separately approved by the board of directors and signed on behalf of the board by a director or the company secretary.

Content of the strategic report

The overarching objective of the strategic report is to inform the shareholders and help them to assess how the directors have discharged their duty to promote the success of the company. To achieve this objective, the strategic report must:

- Contain a fair review of the company's business, that is, a balanced and comprehensive analysis of the development and performance of the company's business in the period and of its position at the end of it.
- Contain a description of the principal risks and uncertainties facing the company.
- To the extent necessary for an understanding of the development, performance or position of the company's business include analysis using key financial performance indicators and, where appropriate, analysis using other key performance indicators, including information relating to environmental and employee matters. 'Key performance indicators' are factors by reference to which the development, performance or position of the company's business can be measured effectively. A company qualifying as medium-sized for a financial year does not need to include non-financial information.

- Where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.
- Contain matters otherwise required by Regulations, like the Large and Medium-sized Companies and Group Accounting Regulations (SI 2008/410), to be disclosed in the directors' report, that the directors consider to be of strategic importance to the company. However, when a company chooses to disclose in the strategic report information that is required to be included in the directors' report, it should state in the directors' report that it has done so and so should indicate which information has been disclosed elsewhere.

For quoted companies, the strategic report must contain additional information as follows:

- The main trends and factors likely to affect the future development, performance and position of the company's business and information about environmental matters (including the impact of the company's business on the environment), the company's employees, social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies. If the report does not contain the information on environmental matters, employees and social, community and human rights issues, it must state which of those kinds of information it does not contain.
- A description of the company's strategy and the company's business model.
- A breakdown showing at the end of the financial year the number of persons of each sex who were directors of the company, the number of persons of each sex who were senior managers of the company (other than those who were directors) and the number of each person of each sex who were employees of the company.
- A company is not required to disclose information in the strategic report about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

The amendments to the Companies Act 2006 have resulted in some disclosures no longer being required in the directors' report, in particular:

- A description of the principal activities of the company during the year,
- Details of charitable donations,
- Policy and practice on payment of creditors and
- The acquisition of own shares by private companies.

GROUP ACCOUNTS

Under the Companies Act 2006, the parent of a group (other than a small group) is required to prepare consolidated financial statements (with certain exceptions). The objective of such financial statements is to show the results of the group as if the group structure did not exist, that is, the trading results of all companies within the group

with the outside world. To achieve this objective, the following accounting is required for consolidated financial statements:

- Elimination of intra-group balances and transactions,
- Provisions for acquisitions and merger accounting,
- The treatment and disclosure of non-controlling interests (minority interests),
- Non-consolidated subsidiary undertakings,
- Associates and joint ventures and
- The preparation of the financial statements as if the group structure did not exist.

Group financial statements are considered in more detail in Chapter 6.

APPROVAL OF FINANCIAL STATEMENTS

Before their issuance, the directors' report, financial statements and auditor's report all need to be approved and signed off. The board of directors are required to approve the financial statements (usually, but not always, in a general meeting). The company secretary *or* a director is required to sign the directors' report and at least one director is required to sign the balance sheet and the name of the signatory must be stated.

The report of the auditors must state the names of the auditor(s) and be signed and dated. Where the auditor is an individual, section 503 of the Companies Act 2006 says the report must be signed by the individual. Where the auditor is a firm, the report of the auditors must be signed by the senior statutory auditor in his/her own name, for and on behalf of the firm of auditors.

For small companies that are subject to the small companies regime, a statement must be made (in a prominent position) that the financial statements have been prepared in accordance with the special provisions for companies subject to the small companies regime above the signature. In addition, the balance sheet must contain a statement to that effect in a prominent position above the signature.

INTERACTION OF FRS 102 TERMINOLOGY WITH COMPANIES ACT 2006 TERMINOLOGY

As mentioned earlier in this chapter, IFRS has gathered faster pace around the globe and the use of international terminology has also gathered faster pace. FRS 102 is based on *IFRS for SMEs* (with certain amendments to *IFRS for SMEs*, which are outlined in Chapter 5).

The following table outlines the key terminology differences in FRS 102 as compared to the Companies Act 2006:

Company law terminology	***FRS 102 terminology***
Accounting reference date	Reporting date
Accounts	Financial statements
Associated undertaking	Associate
Balance sheet	Statement of financial position
Capital and reserves	Equity
Cash at bank and in hand	Cash
Debtors	Trade receivables
Diminution in value [of assets]	Impairment
Financial year	Reporting period
Group [accounts]	Consolidated [financial statements]
IAS	EU-adopted IFRS
Individual [accounts]	Individual [financial statements]
Interest payable and similar charges	Finance costs
Interest receivable and similar income	Finance income/investment income
Minority interests	Non-controlling interest
Net realisable value [of any current asset]	Estimated selling price less costs to complete and sell
Parent undertaking	Parent
Profit and loss account	Income statement (under the two-statement approach)
	Part of the statement of comprehensive income (under the single-statement approach)
Related undertakings	Subsidiaries, associates and joint ventures
Stocks	Inventories
Subsidiary undertaking	Subsidiary
Tangible assets	Includes: property, plant and equipment; investment property
Trade creditors	Trade payables

A point worth noting is that as entities will be complying with the company law formats (even under the FRS 102 regime), a reporting entity may select to use the same terminology throughout their financial statements as under the previous UK GAAP (hence ‘debtors’ rather than ‘receivables’ and ‘stocks’ rather than ‘inventories’).

For Limited Liability Partnerships (LLPs), the Statement of Recommended Practice (SORP) that gives guidance on the accounting and disclosure requirements for LLPs has also been updated to reflect the new financial reporting regime under FRS 102.

MICRO-ENTITIES LEGISLATION

This section of the chapter examines the new micro-entities legislation and Chapter 4 also considers the issue concerning micro-entities in more detail.

On 1 December 2013, legislation was introduced in the form of SI 2013/3008, the Small Companies (Micro-Entities' Accounts) Regulations 2013, which was brought in by the European Union with the objective of reducing costs for small and medium-sized entities. The legislation is effective for financial years ending on or after 30 September 2013 and where the company's financial statements are filed with the Registrar of Companies (Companies House) on or after 1 December 2013.

Under SI 2013/3008, a company qualifies as a micro-entity if it meets at least two of the following three conditions:

- Turnover of not more than £632,000;
- Gross assets (balance sheet total) of not more than £316,000;
- Average number of employees not exceeding ten.

Where a company has a short accounting period, then the turnover figure must be adjusted proportionately to decipher if the company does qualify as a micro-entity.

Example – Company with a short period-end

A company with a year-end date of 31 December 2016 has been trading since 1 April 2016 (a nine-month accounting period).

Where an accounting period is not one year, the turnover figure must be adjusted proportionately. In this case, the company will use 9/12 × £632,000 to determine whether the entity qualifies as a micro-entity.

For companies that are parent companies, the company will qualify as a micro-entity in the year only if:

- The company qualifies as a micro-entity in that year,
- The group headed up by the company qualifies as a small group (as defined in the Companies Act 2006 section 383(2) to (7)) and
- The company has not voluntarily elected to prepare consolidated accounts.

A key point to emphasise where groups are concerned is that care must be taken in assessing whether each company within the group qualifies as a micro-entity. The exemptions available under the micro-entities regime will not be available for subsidiary companies that are included in consolidated financial statements for the year. In addition, the micro-entities regime is not applicable to:

- Investment undertakings,
- Financial holding undertakings,
- Credit institutions,
- Insurance undertakings and
- Charities.

At the time of writing, there were also no plans to allow Limited Liability Partnerships (LLPs) to take advantage of the micro-entity exemptions. In addition, at the time

of writing, there was no legislation in place in the Republic of Ireland in respect of micro-entities, although the legislation was in the consultation stage.

Financial statements prepared under the Companies Act 2006 must give a true and fair view and this concept has been enshrined in companies legislation for many years. Under the micro-entities regime, such entities will only be required to disclose minimal amounts of information at the foot of the balance sheet and additional disclosures will not be required; hence the financial statements are therefore presumed to give a true and fair view as per the legislation applied to micro-entities (known as the 'deeming provisions'). The amounts in the financial statements themselves will continue to be prepared to UK GAAP and hence recognition and measurement issues are not affected; it is only the additional disclosures that will not be required.

In addition, a micro-entity will not be able to:

- Use the revaluation model for tangible fixed assets.
- Measure fixed asset investments at market value.
- Account for investment properties using the fair value model in the small companies regime. Therefore, a micro-entity applying the small companies regime will account for such property under the normal fixed asset rules as opposed to fair value.

The reason for the prohibitions above is that the legislation does not recognise any provisions of the alternative accounting rules. It will also not be possible, for example, to use a previous GAAP revaluation amount as deemed cost for assets that have been subjected to the revaluation model under GAAP (for example, investment property).

The profit and loss account under the micro-entities legislation will be prepared under Format 2 as follows:

(a) Turnover
(b) Other income
(c) Cost of raw materials and consumables
(d) Staff costs
(e) Depreciation and other amounts written off assets
(f) Other charges
(g) Tax
(h) Profit or loss

The balance sheet will be prepared using either Format 1 or Format 2 as follows:

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 2

Assets

(a) Called up share capital not paid
(b) Fixed assets
(c) Current assets
(d) Prepayments and accrued income

Liabilities

(a) Capital and reserves
(b) Provisions for liabilities
(c) Creditors
(d) Accruals and deferred income

It is to be noted that under Format 2, aggregated amounts of creditors and accruals and deferred income that fall due within one year and after more than one year must be shown separately.

The balance sheet must also contain, in a prominent position above the signature, a statement that the accounts are prepared in accordance with the micro-entity provisions.

Notes to the financial statements

Under the micro-entities legislation, limited notes are required to be made underneath the balance sheet, which contain disclosures relating to:

(a) Guarantees and other financial commitments and
(b) Any directors' benefits: advances, credits and guarantees.

Illustrative financial statements prepared under the micro-entities legislation are shown in Chapter 4.