Audit and Accounting Update Quarter 1

CONTENTS

		Page
1	Triennial review refresher (Lectures A694/ 695 – 22.47/ 21.55 minutes)	1
2	New anti-money laundering regulations published (Lecture A 696 – 12.17 minutes)	18
3	Recent amendments to UK GAAP (Lecture A697 – 7.43 minutes)	24
4	Impairment of assets (Lecture A698 – 23.08 minutes)	29
5	Financial reporting and Brexit (Lecture A699 – 11.33 minutes)	43
6	Amendments to the Charities SORP (FRS 102) (Lecture A700 – 21.23 minutes)	45
7	Brydon review of audit (Lecture A701 – 18.10 minutes)	48
8	Revised Ethical Standard issued (Lecture A702 – 37.51 minutes)	52
9	Charities: independent examiners and auditors (Lecture A703 – 17.53 minutes)	62
10	Charities: Matters of material significance (Lecture A704 – 5.19 minutes)	89

Publication date: **March 2020**

1 Triennial review refresher (Lectures A694/ 695 – 22.47/ 21.55 minutes)

UK GAAP was amended in December 2017 for the effects of the Financial Reporting Council (FRC) triennial review. This resulted in the FRC issuing revised versions of all FRSs in the suite of UK GAAP in March 2018.

The triennial review amendments come into mandatory effect for accounting periods commencing on or after 1 January 2019. Therefore, 31 December 2019 year ends will be the first ones affected by the amendments where an entity has not early adopted them.

It is important at the outset to clarify that the amendments are not be viewed as 'wholesale' changes. Rather than 'reinventing the wheel', the FRC have made incremental improvements and clarifications to UK GAAP through the triennial review. The result is a suite of standards which should be easier to work with and which reflects most of the implementation feedback from commentators received during the Exposure Draft comment period.

Future reviews of UK GAAP are not going to be undertaken on a three-year cycle, hence this is the first and last triennial review which the FRC will undertake. The Basis for Conclusions in FRS 102 (March 2018) confirms that future periodic reviews will take place every four or five years to allow time for experience of the most recent edition of FRS 102 to develop before seeking stakeholder feedback. However, if an emerging issue proves to be of an urgent nature, the FRC have said that they will deal with it as an ad-hoc amendment to FRS 102 (or other FRS as applicable).

The majority of the amendments are editorial in nature. However, there are some amendments which will have a direct impact on the financial statements and practitioners must have a sound understanding of them. These amendments are discussed below:

1.1 Removal of the undue cost or effort exemptions

The FRC have removed the undue cost or effort exemptions in FRS 102. This has been done because some entities were applying the undue cost or effort exemptions as accounting policy choices, which they were never intended to be. This is probably down to the fact that the term 'undue cost or effort' was not a defined term in UK GAAP (although it is defined in *IFRS for SMEs*).

The removal of the undue cost or effort exemptions will probably affect some entities more than others; for example, those entities with an investment property on the balance sheet where the undue cost or effort from obtaining a fair value at the reporting date has been exercised. This means that all investment property which is rented to a third party will need to be measured at fair value. The Appendix to FRS 102, Section 2 *Concepts and Pervasive Principles* does allow for situations when a reliable fair value cannot be determined. However, the FRC expect these situations to be extremely rare for investment property.

Areas of FRS 102 where the undue cost or effort exemptions have been removed are:

- Section 14 *Investment in Associates* – para 14.10
- Section 15 *Investments in Joint Ventures* – para 15.15
- Section 16 *Investment Property* – paras 16.1, 16.3, 16.4 and 16.10
- Section 17 *Property, Plant and Equipment* – para 17.1(a)

1.2 Intra-group investment property

As noted in 1.1 above, the removal of the undue cost or effort exemptions means that all investment property rented to a third party must be remeasured to fair value at each balance sheet date.

In order to address implementation issues, the FRC introduced an accounting policy choice for groups which rent out property to other group members. FRS 102, para 16.4A states:

FRS 102, para 16.4A

> *An entity that rents investment property to another group entity shall account for those properties either:*
>
> *(a) at fair value with changes in fair value recognised in* ***profit or loss*** *in accordance with this section (the Appendix to Section 2 provides guidance on determining fair value); or*
>
> *(b) by transferring them to property, plant and equipment and applying the cost model in accordance with Section 17.*
>
> *An entity choosing to apply (b) above shall provide all the disclosures required by Section 17, other than those related to fair value measurement.*

It must be emphasised that the above accounting policy only relates to **investment property rented to another group entity**. This option does not apply to non-group investment property which must be remeasured to fair value through profit or loss at each balance sheet date (even for small entities). Micro-entities applying FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* can only measure investment property under the cost model (cost less depreciation less impairment).

Where a group decides to apply the provisions in FRS 102, para 16.4A(b), it must apply this accounting policy change as far back as its date of transition. The date of transition is the start date of the comparative period reported in the financial statements. Hence, for a 31 December 2019 year end, the date of transition is 1 January 2018.

On transition, an entity is permitted to use the fair value of such an investment property as its deemed cost at the date of transition to the triennial review amendments. Alternatively, it can use the historical cost of the property and depreciate/impair the asset as if it had always been carried at cost.

Example – Intra-group investment property measured under the cost model

Topco Ltd is preparing its financial statements to 31 December 2019. It has an investment property that it rents out to its subsidiary and wishes to apply the accounting policy choice in FRS 102, paragraph 16.4A(b) and use the cost model in Section 17 to measure the property. Extracts from the working papers of Topco Ltd for the investment property are as follows (note for the purposes of this example it has been assumed that the company has maintained a separate component of equity in which to segregate the fair value gains on the property):

Cost/valuation	**31.12.2018**	**31.12.2017**
	£	£
Cost/fair value	430,000	400,000
Fair value increase	40,000	30,000
Closing fair value	470,000	430,000

	31.12.2018	**31.12.2017**
Deferred tax	£	£
Deferred tax @ 17%	(6,800)	(5,100)
Fair value/non-distributable reserve		
Opening reserve	24,900	-
Gain net of deferred tax	33,200	24,900
Closing reserve	58,100	24,900

Step 1 – Transitional adjustments

The date of transition to the triennial review amendments in this example is 1 January 2018 (being the start date of the comparative period reported in the financial statements). The fair value of the property at this date is £430,000. The entries in Topco's books to record the change in accounting policy are as follows:

	£
Dr Property, plant and equipment	430,000
Cr Investment property	430,000

Being transfer to PPE per FRS 102, para 16.4A(b)

(Note this assumes the company presents investment property separately on the face of the balance sheet).

	£
Dr Fair value/non-distributable reserve	24,900
Cr Revaluation reserve (equity)	24,900

Being transfer of fair value gains net of deferred tax

If Topco had not maintained a separate component of equity, the debit would be to retained earnings (profit and loss reserves).

Step 2 – Restate the comparative year

The 31 December 2018 financial statements showed a further fair value increase of £40,000 and an increase in the deferred tax provision of £6,800. These were recorded in the financial statements as follows:

	£
Dr Investment property	40,000
Cr Fair value adjustments (P&L)	40,000
Dr Tax expense	6,800
Cr Deferred tax provision	6,800

Being adjustments to fair value of investment property

at 31 December 2018

The financial statements need to be restated by reversing these adjustments because the property has been transferred to Section 17 from the date of transition. We then need to bring in the depreciation charge on the property (because it is now being measured at cost less depreciation less impairment). Assuming the directors have assessed a useful economic life of 40 years (and the value of the land is immaterial), the depreciation charge for 31 December 2018 will be £10,750 and also in the current year 31 December 2019.

Step 3 – Consider transferring the excess depreciation from the revaluation reserve

The annual depreciation charge if the property was stated at cost would be £10,000 (£400,000 / 40 years). However, it is being measured using a revalued amount of £430,000 resulting in a depreciation charge of £10,750 (£430,000 / 40 years).

The accounting regulations state that an amount may be transferred from the revaluation reserve to retained earnings if the amount was previously charged to that account or represents realised profit. Therefore, Topco may choose to transfer £750 from the revaluation reserve to retained earnings to avoid distributable profit from being understated.

While there would be no corporate tax implications, it should be noted that the above change in accounting policy would reduce pre-tax profit in the comparative year in Topco's individual financial statements by £50,750, being the reversal of the £40,000 fair value gain plus the depreciation charge of £10,750.

1.3 Financial instruments

The wording in FRS 102, Section 11 *Basic Financial Instruments* is anything but 'basic'. Financial instruments are probably one of the most complex areas of UK GAAP and the FRC made significant amendments to Section 11 through the triennial review. Prior to the amendments, a financial instrument had to meet the detailed conditions in para 11.9 if the instrument were to be classed as basic.

The FRC have now included para 11.9A which provides a description of a basic financial instrument. Therefore, if the financial instrument does not meet the detailed conditions in para 11.9, but meets the description, the financial instrument can still be classed as basic and accounted for under Section 11. This will mean that for a relatively small number of financial instruments, they can be treated as basic (and accounted for at amortised cost) rather than non-basic (and accounted for at fair value).

FRS 102, para 11.9A describes a basic financial instrument as follows:

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

FRS 102, para 11.9A

1.3.1 Accounting policy choice to apply IAS 39

The option has been retained in Section 11 and Section 12 to apply the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement.* This option is available until the impairment requirements in FRS 102 (Section 27 *Impairment of Assets*) are amended to reflect IFRS 9 *Financial Instruments*, or the FRC decide not to amend FRS 102 any further in respect of IFRS 9. The IAS 39 so called 'EU carve-out' option also continues to be available.

In addition, para 11.42 also requires an entity to disclose information which enables the users to evaluate the significance of financial instruments on the entity's financial position and performance. Hence, an entity which has taken the accounting policy option to apply the recognition and measurement requirements of IAS 39 or IFRS 9 (which is uncommon in the UK) may need to consider additional disclosures based on IFRS 7 *Financial Instruments: Disclosure*.

1.3.2 Investments in shares

There was an anomaly in FRS 102 prior to the amendments. FRS 102 (September 2015) requires investments in non-convertible preference shares and non-puttable ordinary shares or preference shares to be measured at fair value, unless fair value cannot be measured reliably.

Certain preference shares which are liabilities of the issuer (and measured at amortised cost) are treated differently by the holder.

Reference to such investments in shares in FRS 102 has been amended to non-derivative instruments which are equity of the issuer. This improves the accounting for those instruments which are liabilities of the issuer as they are measured at amortised cost if the instrument is accounted for under Section 11 (i.e. it is basic).

1.3.3 Loans with two-way compensation clauses

The FRC issued commentary in June 2016 concerning the accounting for social housing loans; notably the classification of loans with two-way compensation clauses. Respondents did not agree that the inclusion of a description of a basic financial instrument (which has been included in paragraph 11.9A) sufficiently addressed the issue. To alleviate concerns in this respect, paragraph 11.9(c) has been amended which confirms that compensation could be paid by either the holder (the lender) or the issuer (the borrower).

1.3.4 Macro hedging

Fair value hedge accounting for a portfolio of financial instruments was not included in FRS 102 and therefore entities wishing to apply macro hedging applied the provisions in paragraph 11.2 (and 12.2) and used the recognition and measurement provisions in IAS 39/IFRS 9.

FRS 102 has been amended to cross-refer to the IAS 39 requirements for macro hedging.

1.4 Directors' loans

The way that an off-market rate loan is accounted for under FRS 102 has not been without controversy. Many practitioners have expressed their disapproval of having to discount off-rate loans using a market rate of interest for a similar loan. There are 'workarounds' where discounting is concerned; for example, if there are no terms in place, FRS 102 would regard the loan as being repayable on demand and hence will be measured as a current asset or current liability at the undiscounted amount of cash payable. In practice, most off-rate loans are unstructured (e.g. directors' loans and intra-group loans) and therefore discounting may be avoidable.

The FRC recognised that using the amortised cost method (which uses an effective rate of interest) in Section 11 for loans which are provided by a director-shareholder, or close family member of that director-shareholder does prove arduous, with costs outweighing benefits. The amendments to FRS 102 now mean that such loans can be measured at transaction price (i.e. at cost) without having to impute a market rate of interest for a similar debt instrument.

Paragraph 11.13A states:

FRS 102, para 11.13A

> *As an exception to paragraph 11.13, the following financing transactions may be measured initially at transaction price:*
>
> *(a) a basic financial liability of a **small entity** that is a loan from a person who is within a director's group of close family members[1], when that group contains at least one shareholder[2] in the entity; and*
>
> *(b) a public benefit entity concessionary loan (see paragraph PBE11.1A).*

The definition of 'close members of the family of a person' per the Glossary to FRS 102 is as follows:

*FRS 102 Glossary **close members of the family of a person***

> *Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:*
>
> *(a) that person's children and spouse or domestic partner;*
>
> *(b) children of that person's spouse or domestic partner; and*
>
> *(c) dependants of that person or that person's spouse or domestic partner.*

Therefore, loans to small entities from a director who is not a shareholder, and has no close family members that are shareholders, will not qualify for the exemption. Loans to small entities from a directors' group of close family members (including the director) will qualify when that group also includes a shareholder in the small entity.

[1] In this context, a director's group of close family members shall be the director and the close members of the family of that director (see glossary definition of **close members of the family of a person**). This includes a person who is the sole director-shareholder of an entity.

[2] For small LLPs this shall be read as a member who is a person.

The relief is also available to small LLPs.

It is important to emphasise that the relief does not apply to loans to a director from a company, nor does it apply to intra-group loans. Where such loans are concerned, if there are no workarounds to discounting the loan (e.g. if the loan is unstructured or if it is not a 53-week loan), the loan must be discounted to present value using a market rate of interest.

It should be noted that where a director-shareholder, or close family member of that director-shareholder, provides a loan to the small entity at below market rates of interest or at zero rates of interest, the loan will be caught by the related party disclosure requirements in paragraph 1AC.35 of Section 1A *Small Entities*; hence the loan must be disclosed as a related party transaction as it has not been concluded under normal market conditions.

1.5 Intangible assets

The FRC amended Section 18 *Intangible Assets other than Goodwill* so as to provide entities with an accounting policy choice of either separately recognising intangible assets acquired in a business combination or including them within goodwill. If the entity chooses to separately recognise intangible assets, they must apply this policy to **all intangible assets in the same class and on a consistent basis**.

Following the triennial review amendments, FRS 102, para 18.8 states:

> *Intangible assets acquired in a **business combination** shall be recognised separately from goodwill when all the following three conditions are satisfied:* *FRS 102, para 18.8*
>
> *(a) the recognition criteria set out in paragraph 18.4 are met;*
>
> *(b) the intangible asset arises from contractual or other legal rights; and*
>
> *(c) the intangible asset is separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or **liability**).*

> *An entity may additionally choose to recognise intangible assets separately from goodwill for which condition (a) and only one of (b) or (c) above is met. When an entity chooses to recognise such additional intangible assets, this policy shall be applied to all intangible assets in the same class (ie having a similar nature, function or use in the business), and must be applied consistently to all business combinations. Licences are an example of a category of intangible asset that may be treated as a separate class, however, further subdivision may be appropriate, for example, where different types of licences have different functions within the business.*

1.6 Financial institutions

The definition of a financial institution in the Glossary to FRS 102 has been amended to remove references to '… generate wealth or manage risk through financial instruments.' The removal of this phrase means there should be less uncertainty about how the definition should be applied and hence fewer entities will fall under the definition of a financial institution.

The Glossary provides a list of institutions that fall under the definition of a financial institution. The FRC have also removed 'retirement benefit plans' and 'stockbrokers' from the list, which will be a welcome change as they are not similar to the rest of the entities within the Glossary's definition. In addition, retirement benefit plans are also subject to their own disclosure requirements in Section 34 *Specialised Activities*.

1.7 Key management personnel compensation

The requirement to disclose key management personnel compensation in totality is contained in paragraph 33.7 of FRS 102. Paragraph 33.7A has been inserted by the FRC which states that when an entity is required to disclose directors' remuneration (or equivalent) under law or regulation, it is exempt from the requirement of paragraph 33.7 provided that key management personnel and the directors are the same.

Care needs to be taken where this is concerned, because the definition of 'key management personnel' is quite broad and includes all individuals who have the authority and responsibility for planning, directing and controlling the entity, whether directly or indirectly. The definition includes directors (whether executive or otherwise) and so it may not necessarily be the case that key management personnel and the directors are the same body of individuals; although in a smaller entity, this could well be the case.

1.8 Net debt reconciliation

For those entities which are required to prepare a cash flow statement, the net debt reconciliation is brought into FRS 102. This has been done on the grounds that the FRC consider the reconciliation provides useful information to users. As preparers will already be familiar with the net debt reconciliation (from the old FRS 1 *Cash flow statements (Revised 1996)* days), the costs of compliance will be negligible and software providers will usually include this reconciliation within their accounts production software systems in any event.

1.9 Small entities

FRS 102, Section 1A *Small Entities* was extensively amended as part of the triennial review due to small entities in the Republic of Ireland being brought within the scope of Section 1A due to the enactment of the Companies (Accounting) Act 2017. The small companies' regime for entities in the Republic of Ireland is available for periods starting on or after 1 January 2017. However, entities in the Republic of Ireland can early adopt the requirements as far back as periods beginning on or after 1 January 2015 provided that the financial statements have not yet been approved.

It should be emphasised that Section 1A only sets out the **presentation** and **disclosure** requirements for a small entity and reflects the requirements of company law. **Recognition** and **measurement** is still based on full FRS 102. This was done intentionally by the FRC so that if a small entity outgrows Section 1A (and hence becomes a medium-sized or large entity), the accounting treatments remain the same; but the disclosure requirements will be based on full FRS 102 and not Section 1A.

The disclosure requirements for small entities in the UK are set out in Appendix C of Section 1A *Disclosure requirements for small entities in the UK* (as was the case in the September 2015 edition of FRS 102). The disclosure requirements which a small entity in the Republic of Ireland is legally required to make are contained in Appendix D *Disclosure requirements for small entities in the Republic of Ireland*. The five encouraged disclosures that were contained in Appendix D in the September 2015 edition of FRS 102 have been moved into Appendix E *Additional disclosures encouraged for small entities*. An additional paragraph has been inserted into Appendix E encouraging small entities in the Republic of Ireland to provide the disclosures in paragraphs 1AE.1(b), (c) and (e).

These relate to the fact that an entity is a public benefit entity (if applicable), going concern disclosures and transitional disclosures on first-time adoption of FRS 102.

1.10 Gift aid

There were divergent practices emerging where gift aid payments are concerned which were brought to the FRC's attention. For accounting purposes, gift aid payments are a distribution, but for tax purposes they are a donation. A legal opinion obtained by the ICAEW confirmed that gift aid payments are a distribution and hence should be treated in much the same way as a dividend. There is an ICAEW technical release available (TECH 16/14BL REVISED *Guidance on donations by a company to its parent charity*).

This issue affects charitable parents which have trading subsidiaries that are within the scope of corporation tax. A gift aid payment is made to the parent to 'gift' the profits made by the trading subsidiary to the parent and corporation tax relief is granted on the gift aid payment. This often results in a corporation tax liability of £nil for the trading subsidiary.

Prior to the triennial review amendments, divergent practices arose in respect of when the liability to make the gift aid payment arose and hence when it was recognised in the financial statements and also where the gift aid payment was presented.

The amendments to FRS 102 clarify that gift aid payments can only be accrued in the financial statements when a legal obligation exists at the balance sheet date for the entity (not a constructive obligation). This can often be resolved by having a Deed of Covenant in place because this satisfies the recognition of a gift aid payment as a liability where payment is made by the subsidiary to the charitable parent after the year-end. Where a Deed of Covenant is not in place, it is unlikely the trading subsidiary will have a legal obligation at the balance sheet date and hence it must not recognise the gift aid payment.

Paragraph B29.13 of the Basis for Conclusions of FRS 102 confirms that gift aid payments are to be recognised as a distribution to owners as they are similar to dividends (i.e. they are recognised within equity). Paragraph B29.13 of the Basis for Conclusions also cross-refers to paragraph 32.8 of FRS 102 which specifically deals with dividends and states that where an entity declares a dividend **after** the balance sheet date, that dividend is not to be recognised as a liability. The same principles must be applied to gift aid payments and an expected gift aid payment must not be accrued unless a legal obligation to make the payment exists at the balance sheet date. Paragraph B29.13 of the Basis for Conclusions confirms that a board decision to make a gift aid payment to a charitable parent, which has been taken prior to the reporting date, is not sufficient to create a legal obligation.

Keep in mind also that, unlike a dividend, it will usually not be possible to **quantify** the amount of the gift aid payment at the balance sheet date because the accounts will not have been finalised. A dividend, however, can be declared of Xp or £X per share provided there are sufficient distributable profits available.

More than half of the respondents to FRED 68 stated that, in their opinion, a liability should be recognised for an expected gift aid payment if, for example, there is a past practice of making such payments. The FRC concluded that this is inconsistent with the requirements of FRS 102 (i.e. paragraph 32.8 and dividends) and they did not agree that this reflects the substance of the transaction which is that of a distribution to owners and hence no amendment was made to FRS 102 in this respect.

As noted above, gift aid payments are distributions for accounting purposes and donations for tax purposes. When a subsidiary does not have a legal obligation to make a distribution of its profits to its owners at the balance sheet date, it will have taxable profits and hence will need to recognise a tax expense. This is because paragraph 29.14 of FRS 102 prohibits the tax effects of dividends being recognised before the dividend itself has been recognised.

The amendments to FRS 102 (in the form of paragraph 29.14A) state that when it is **probable** (i.e. more likely than not) that a gift aid payment will be made within nine months of the reporting date to the same charitable group, or charitable venturer, and the payment will qualify to be set against profits for corporation tax purposes, the **tax effects** of the gift aid payment can be accrued (but not the gift aid payment itself because there is no legal obligation at the balance sheet date).

The gift aid payment is recognised as a distribution to owners and the tax effects are recognised in profit and loss.

1.11 Fair value guidance

The fair value guidance which was included in paragraphs 11.27 to 11.32 of FRS 102 (September 2015) has now been moved into the Appendix to Section 2 *Concepts and Pervasive Principles*. This was done on the grounds that the FRC acknowledged that the fair value guidance is applied generally, rather than confined to financial instruments and illustrates a measurement basis described in Section 2.

1.12 Debt for equity swaps

Paragraph 22.8A has been inserted to address concerns by stakeholders that FRS 102 was silent on the accounting for debt for equity swaps because, in some cases, such transactions can be significant.

Paragraph 22.8A states that no gain or loss is recognised in profit or loss as a result of a debt for equity swap if:

- the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder;
- the creditor and the entity are controlled by the same party/parties both before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity; or
- the extinguishment is in accordance with the original terms of the financial liability.

1.13 Business combinations

When a parent entity acquires a subsidiary, it is required to use the purchase method to account for the acquisition. The purchase method uses fair values to account for the assets acquired, liabilities and contingent liabilities assumed.

The purchase method outlined in paragraph 19.7 of FRS 102 has been amended to include more steps as a means of clarifying exactly what must happen for the purchase method to be applied correctly. In practice, the amendments are not expected to have any significant effects, but the amendments also mean that paragraph 19.7 is now consistent with the steps in IFRS 3 *Business Combinations*.

The definition of a group reconstruction has also been amended to incorporate, in certain circumstances, the transfer of a business in addition to the transfer of equity holdings.

1.14 Comparatives for disclosure only required by a SORP

The FRC have confirmed that when a disclosure is not required by FRS 102, but is required by a SORP, comparatives should be provided.

1.15 Effects of 'major' IFRSs on FRS 102

The following 'major' IFRSs have been issued by the IASB:

- IFRS 9 *Financial Instruments*. This uses an 'expected credit loss' model approach which is more forward-looking and hence recognises impairment losses on financial assets much sooner than the 'incurred credit loss' model which FRS 102 currently uses.

- IFRS 15 *Revenue from Contracts with Customers*. This requires a much more rigorous approach to revenue recognition using a five-step model and more comprehensive disclosures.

- IFRS 16 *Leases*. This standard does not distinguish between an operating and a finance lease. For lessees, the vast majority of (what would have been classed as) operating leases are now recognised on the balance sheet as 'right-to-use' assets. Leases can only be treated as 'operating' if they are low-value or the lease has a short-life.

The FRC are currently waiting on implementation feedback from IFRS preparers to assess whether, or not, to reflect some, or all, of the provisions of these major IFRSs into UK GAAP. The FRC will need at least two years worth of implementation feedback on which to base any decisions.

For UK GAAP reporters, it is safe to say that there is no need to have any concerns about these major IFRSs having an impact on FRS 102 (or any other FRS in the suite of UK GAAP) for the time being. It could also be the case that the FRC do not implement any of the provisions of the major IFRSs into UK GAAP on the grounds of a cost-benefit analysis but time will eventually tell.

2 New anti-money laundering regulations published (Lecture A 696 – 12.17 minutes)

On 10 January 2020, The Money Laundering and Terrorist Financing (Amendment) Regulations 2019 (SI 2019/1511) came into effect. The Regulations amend, rather than replace, the existing 2017 Regulations. A link to the Regulations is here. Unfortunately, the timing of the issuance of SI 2019/1511 is not ideal because (at the time of writing), CCAB guidance has not yet been updated.

The government did consult on transposition of the EU's Fifth Anti-Money Laundering Directive ('the Directive') in the first half of 2019, but other governmental matters (Brexit and related issues) took prominence and it was only on 20 December 2019 that the SI was laid before Parliament. The EU's deadline for transposition into national law was 10 January 2020, hence the reason for the short timescale between issuance and implementation.

The changes themselves are not wide-reaching, but they do have implications in that they extend the regulated sector and situations in which enhanced due diligence must be carried out. A notable feature of the Regulations is that they do acknowledge that electronic identification is a suitable means of confirming identity in a majority of situations. However, it is worth noting that the Regulations do not mandate the use of electronic identification.

An important point to emphasise is that firms which fail to comply with the new Regulations can face a significant fine so if you are not up to speed with the amendments, then now is the time to do so!

2.1 Extension of the regulated sector

The Regulations extend the regulated sector to the following:

- Cryptoasset exchange providers: where 'cryptoasset' means a cryptographically secured digital representation of value or contractual rights that uses a form of distributed ledger technology and can be transferred, stored or traded electronically.

- Custodian wallet providers: these are services which are designed to safeguard or administer cryptoassets.

- Letting agents: where a property is let for one more, or more, and the monthly rent during at least part of the term is equivalent to €10,000 or more. Regulation will be by HMRC or the relevant professional body. An online registration system will open in May 2020 for lettings agents who rent out commercial or residential property valued at €10,000 or more for a minimum of one calendar month.

- Art market participants (either storing, trading in or acting as an intermediary in the sale or purchase of works of art): where the value of a transaction, or series of transactions, is €10,000 or more. Regulation will be by HMRC or the relevant professional body. An online registration system is now open for those in the art market who deal in sales, purchases and storage of works of art with a value of €10,000 or more, whether for a single transaction or series of linked transactions, regardless of the payment method used.

2.2 Enhanced due diligence

The 2019 Regulations acknowledge that electronic identification is permissible (provided certain conditions are met), but they do mandate such identification. However, in practice, electronic identification can be a more efficient means of completing this important part of the identification process.

An area to watch out for where enhanced due diligence is concerned is the requirement to obtain **information on the source of funds and source of wealth of the customer and of the customer’s beneficial owner**.

Many firms will probably want to switch to electronic identification and where this is the case, the firm must ensure that the service meets the requirements for reliability. It will still be necessary to obtain copies of a passport or driving licence to ensure that the name you are checking electronically is the name of the person you are dealing with.

In addition, enhanced due diligence procedures have been broadened in the 2019 Regulations. Enhanced due diligence will be required in respect of certain risk factors, other than geographical location, including transactions relating to:

- precious metals;

- oil;
- arms;
- tobacco;
- ivory;
- protected species; and
- complex **and/or** unusually large transactions[3].

The Regulations outline the work that must be carried out as follows:

- Obtain additional information on the customer and their beneficial owner.
- Obtain additional information on the intended nature of the business relationship.
- Obtain information on the source of funds and wealth of the customer and their beneficial owner.
- Obtain information on the reasons for the transactions.
- Obtain the approval of senior management for establishing or continuing with the business relationship.
- Conduct enhanced monitoring of the business relationship by increasing the number and timing of controls and selecting patterns of transactions which need further examination.

If you cannot identify the beneficial owner and have tried everything possible to identify the beneficial owner, you must take reasonable measures to verify the identity of the senior managing official in the business. The Regulations require strict record-keeping requirements to be met so that you are able to demonstrate the work done to attempt to verify the beneficial owner(s) or the managing official responsible for managing the business.

2.3 Discrepancies regarding persons of significant control

The 5MLD includes a requirement to report discrepancies that are found in the Persons of Significant Control (PSC) register. The objective of this requirement is so that the register is kept as accurate as possible because any discrepancies found must be reported to Companies House.

[3] The 2017 Regulations only required enhanced due diligence when **both** these factors were present.

Companies House has issued guidance on how to report a discrepancy. It has also confirmed that the term 'discrepancy' is not defined in the 5MLD, but that the government's intention is that only *material* discrepancies are reported to them. Therefore, a spelling mistake or other such minor errors would not warrant a report to Companies House (the entity should make such corrections themselves). The focus of a report should be on clear factual errors, including a discrepancy with:

- persons listed as a PSC;
- a missing PSC;
- PSC exemption;
- PSC type;
- address;
- place of registration;
- date of birth;
- legal form; and
- company statement.

Reporting a discrepancy involves completing the online form. Companies House will not inform the company that such a report has been made, but they will let the obliged entity know the outcome of their investigation.

2.4 Other notable changes

Other notable changes which are of direct relevance to an accountancy firm include the following:

- The definition of 'tax adviser' has been extended so that includes material aid, or assistance or advice, in connection with the tax affairs of other persons, whether provided directly or via a third party. The impact of this amendment will be felt by those firms who work closely with third parties such as a solicitor or an IFA.

- Firms must amend their policies where new products, new business practices (including new delivery mechanisms) or new technology are adopted.

- Relevant employees must be trained properly in the requirements of the Regulations and this is now extended to any agents, such as sub-contractors, which are used by the firm.

- Customer due diligence must be updated where the firm has a legal duty to contact a client for the purpose of reviving information relevant to the risk assessment or that relates to beneficial ownership or control.

- Where the client is an entity, there is now an explicit requirement to understand the ownership and control structure. While this was already a requirement of the 2017 Regulations, it has now been explicitly stated as a requirement.

- There is a more specific approach to high-risk countries with the enhanced due diligence procedures being set out in more detail.

- The registration requirements for trusts without tax consequences will be set out in separate regulations.

2.5 Important points for practitioners

Professional bodies do undertake anti-money laundering monitoring visits to ensure that firms are applying the Regulations properly. You should ensure that you can evidence that all staff are adequately trained (on a regular basis) on anti-money laundering regulations and that you have appropriate policies, procedures and controls in place (including firm-wide risk assessments). Failure to have adequate procedures in place will result in disciplinary action and can lead to hefty fines and other sanctions being imposed.

3 Recent amendments to UK GAAP (Lecture A697 – 7.43 minutes)

The FRC have stated that they intend to periodically review UK GAAP every four or five years rather than carry out ‘triennial reviews’. The idea behind this is so that the latest editions of the standards have time to become established and it should also allow the FRC to receive more constructive and useful feedback on implementation issues.

However, the FRC have also stated that if an issue emerges which they consider to be important, they will deal with it outside of the periodic review cycle as an ad-hoc project so standard-setting activity is unlikely to remain silent over the four/five-year period and this has already been evidenced by amendments being made to UK GAAP. The last triennial review only takes mandatory effect for accounting periods commencing on or after 1 January 2019 (see section 1 of these notes). However, the FRC is likely to start requesting informal feedback for the next periodic review in 2021.

It should be noted that FRS 101 *Reduced Disclosure Framework* is subjected to annual reviews to provide additional disclosure exemptions as IFRS evolves and to respond to stakeholder feedback concerning other possible improvements.

3.1 FRS 102 amendments for interest rate benchmark reform

On 17 December 2019, the FRC issued amendments to FRS 102 in respect of the interest rate benchmark reform. This amendment is unlikely to have a wide-reaching impact.

It is expected that the London Inter Bank Offering Rate (LIBOR) will not be available after 2021. This gives rise to increasing uncertainty concerning the long-term viability of some interest rate benchmarks creating issues affecting financial reporting in the period prior to the reform, especially in respect of hedge accounting.

The amendments to FRS 102 are in respect of specific hedge accounting requirements in Section 12 *Other Financial Instruments Issues*. They provide relief which will avoid unnecessary discontinuation of hedge accounting during the period of uncertainty. Reporting entities will apply specific hedge accounting requirements assuming that the interest rate benchmark relevant to the hedge accounting remains unaltered as a result of the interest rate benchmark reform.

Paragraph 1.22 is inserted into FRS 102 as follows:

In December 2019 amendments were made to this FRS to insert paragraphs 12.25B to 12.25H and 12.30, and make other minor consequential amendments. These amendments are effective for accounting periods beginning on or after 1 January 2020. Early application is permitted. If an entity applies these amendments to an accounting period beginning before 1 January 2020 it shall disclose that fact, unless it is a small entity, in which case it is encouraged to disclose that fact. *Amendments to FRS 102, para 3*

Entities shall apply paragraphs 12.25B to 12.25H to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies these amendments, or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies these amendments.

In the reporting period in which an entity first applies these amendments, in relation to these amendments only, an entity is not required to disclose the information required by paragraphs 10.13(b) to (d).

The FRC have included specific paragraphs in Section 12 (paras 12.25B to 12.25H) which rovides relief as follows:

Temporary amendments to specific hedge accounting requirements

Paragraphs 12.25C to 12.25H only apply to hedging relationships directly affected by interest rate benchmark reform. A hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about: *Amendments to FRS 102 new para 12.25B*

(a) the interest rate benchmark designated as a hedge risk; and/or

(b) the timing and/or the amount of the interest rate benchmark-based cash flows of the hedged item and/or the hedging instrument.

In determining whether a forecast transaction (or a component thereof) is highly probable, an entity shall assume that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform. *Amendments to FRS 102 new para 12.25C*

Amendments to FRS 102 new para 12.25D

In applying the requirement in paragraph 12.25A, in order to determine whether the hedged future cash flows are expected to occur, an entity shall assume that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform.

Amendments to FRS 102 new para 12.25E

In applying the requirement in paragraph 12.18A, an entity shall assume that the interest rate benchmark on which the hedged cash flows and/or the hedged risk are based or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of interest rate benchmark reform.

Amendments to FRS 102 new para 12.25F

For a hedge of a non-contractually specified benchmark component of interest rate risk, an entity shall apply the requirement in paragraph 12.16C(a) – that the changes, in the cash flows or fair value attributable, are a separately identifiable and reliably measurable specific risk or risks – only at the inception of the hedging relationship.

Amendments to FRS 102 new para 12.25G

An entity shall cease applying paragraphs 12.25C to 12.25E at the earlier of:

(a) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the relevant interest rate benchmark-based cash flows; or

(b) when the entire amount accumulated in the cash flow hedge reserve with respect to that hedging relationship is classified to profit or loss.

If the hedging relationship is discontinued at an earlier date, an entity shall prospectively cease applying paragraph 12.25E to that hedging relationship at the date of discontinuation.

Amendments to FRS 102 new para 12.25H

When designating a group of items as the hedged item, or a combination of financial instruments as the hedging instrument, an entity shall cease applying paragraphs 12.12C to 12.25E to an individual item or financial instrument as relevant in accordance with paragraph 12.25G, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to that item or financial instrument.

The FRC has also included an additional paragraph 12.30 as follows:

Amendments to FRS 102 new para 12.30

> *When an entity has taken advantage of the temporary amendments to specific hedge accounting requirements in paragraphs 12.25C to 12.25F, it shall disclose:*
>
> *(a) that fact; and*
>
> *(b) the significant interest rate benchmarks to which the entity's hedging relationships are exposed.*
>
> *It shall also consider whether any further disclosure is necessary, for example in accordance with paragraphs 8.6 and 8.7.*

These amendments to FRS 102 are effective for accounting periods commencing on or after 1 January 2020. Early adoption is permitted.

3.2 Annual review of FRS 101

On 18 December 2019 the FRC issued FRED 73 *Draft amendments to FRS 101 – 2019/20 cycle*.

There is nothing of major significance in this FRED. It proposes to amend FRS 101 to provide an exemption from the disclosure of cash flows required by paragraph 24(b) of IFRS 6 *Exploration for and Evaluation of Mineral Resources* together with a corresponding amendment to FRS 102 in respect of qualifying entities.

FRED 73 also proposes to amend the exemption from paragraph 33(c) of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* by removing the condition that this exemption is only available when equivalent disclosures are made in the relevant consolidated financial statements of the group in which the entity is consolidated. This amendment is being proposed for consistency with the exemption from the presentation of a statement of cash flows.

4 Impairment of assets (Lecture A698 – 23.08 minutes)

An overarching principle in financial reporting is that assets should not be carried in the balance sheet in excess of their recoverable amount. To that end, it is important that at every balance sheet date an entity considers whether assets are showing indicators of impairment. If they are, an impairment test is necessary. Note, accounting standards do not require an impairment test to be carried out at each balance sheet date; instead they require an entity to assess whether assets are showing **indicators** of impairment **first** and **then** do an impairment test (which involves calculating 'recoverable amount') if there are indicators that an asset (or a group of assets) is/are impaired.

FRS 102 deals with the impairment of assets in Section 27 *Impairment of Assets*. For micro-entities choosing to report under FRS 105, that standard deals with impairment of assets in Section 22 *Impairment of Assets*. These notes will deal with the requirements of FRS 102, although the impairment requirements of FRS 105 are broadly similar.

4.1 What does Section 27 not cover?

FRS 102, Section 27 does not deal with the following issues:

Issue	Relevant section of FRS 102 which deals with the issue
Assets arising from construction contracts	Section 23 *Revenue*
Deferred tax assets	Section 29 *Income Tax*
Assets arising from employee benefits	Section 28 *Employee Benefits*
Investment property measured at fair value	Section 16 *Investment Property*
Biological assets related to agricultural activity measured at fair value less estimated costs to sell	Section 34 *Specialised Activities*
Deferred acquisition costs and intangible assets arising from insurance contracts	FRS 103 *Insurance Contracts*

4.2 Impairment of inventory

Inventory (stock) is dealt with in Section 13 *Inventories*; however, there are specific impairment requirements relating to inventory in paragraphs 27.2 to 27.4.

Of course, inventory is a particularly sensitive area of the financial statements, impacting on both the profit and loss account and balance sheet. FRS 102 requires inventory to be measured at the lower of cost and estimated selling price less costs to complete and sell.

Hence, if inventory is impaired and is not written down to net realisable value (which may be £nil), this will result in inventory being overstated and presenting a misleading picture in the financial statements.

FRS 102 requires management to make an assessment at each balance sheet date of the entity's inventory and consider whether any items are impaired. If these items are impaired, they should be written down to recoverable amount (net realisable value) with the write-down being recorded in profit or loss for the period.

Ideally, estimated selling price less costs to complete and sell should be done on a line-by-line basis. However, where this is impracticable[4] FRS 102, para 27.3 allows an entity to group items of inventory relating to the same product line which have similar purposes or end uses and are produced and marketed in the same geographical area for the purpose of assessing impairment.

Example – Inventory valuation

On 31 December 2019 a company undertakes an inventory count. Details of the following products have been extracted from the inventory system:

Item ref	**Cost**	**Estimated selling price**	**Valuation**	
VR4522	200.00	450.00	270.00	See note 1
VR4523	150.00	340.00	150.00	See note 2
VR4524	200.00	120.00	200.00	See note 3

Note 1

The finance director has included advertising costs of £70 as this is a new product and he feels such costs should be included as they are directly attributable to this product.

Note 2

This item has been used for several years in the company's manufacturing process and there are no additional issues with the valuation of this product.

Note 3

The company has just received notification from the supplier of this product that it is seriously defective and contains highly corrosive chemicals and they are advising to

[4] Defined in the Glossary to FRS 102 as *Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.*

destroy this product immediately.

Based on the above three issues, the revised inventory valuation is as follows:

Item ref	Cost	Estimated selling price	Valuation	
VR4522	200.00	450.00	200.00	See note 1
VR4523	150.00	340.00	150.00	
VR4524	200.00	-	-	See note 2

Note 1

Advertising expenditure must not be included within the inventory valuation as this would be considered a selling cost. Selling costs are prohibited to be recognised directly in inventory per FRS 102, para 13.13(d).

Note 2

As this product is seriously defective and cannot be used in the production process (nor sold), the estimated selling price is assumed to be nil and hence the cost of this product has been written down accordingly.

Reversals of inventory impairment

There may be situations where an entity has recognised an impairment loss for its inventories but then carries out a subsequent assessment of selling price less costs to complete and sell which may give clear evidence that there has been an increase in such an estimate because of changed economic circumstances. In such cases, the entity reverses the amount of the impairment but this reversal is limited to the amount of the **original** impairment loss so that the new carrying amount of inventory is the lower of cost and revised selling price less costs to complete and sell.

Example – Reversal of a previously recognised impairment loss

A company carries out an impairment test on its inventories for the third quarter-ended 30 September 2019. During that assessment there was evidence of impairment in a batch of chemicals where it was alleged that the chemical mix was unsuitable for the purposes which it was originally intended. The company had recognised a write-down of this inventory by way of an impairment loss of £2,000 for the quarter-ended 30 September 2019.

At the year-end 31 December 2019, the company still had this batch of chemicals in its inventory. However, on 1 November 2019, the supplier's quality control director issued a statement confirming that investigations had taken place concerning this incorrect mix and the conclusion was that there were, in fact, no issues at all with the mix and they were still suitable for the purposes originally intended. The company has been informed that the same batch of chemicals has increased in price and will now cost £3,000.

The company can still reverse its original impairment of £2,000. However, despite the increase in price, the amount of the reversal is limited to the amount of the original impairment loss. The fact that the supplier has increased its price by £1,000 is irrelevant for the purposes of this impairment reversal.

4.3 Impairment of assets other than inventory

An asset is impaired when its **recoverable amount** is lower than its carrying amount. Recoverable amount is the *higher* of 'value in use' and 'fair value less costs to sell and its value in use'.

Indicators that an asset may be suffering impairment include:

- physical damage to the asset has occurred;
- the asset is (or has become) technically obsolete; and
- management have announced plans to close an operation.

'Fair value less costs to sell' is defined as:

> *The amount obtainable from the sale of an **asset** or **cash-generating unit** in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.*

*FRS 102 Glossary **fair value less costs to sell***

The standard recognises that the best evidence of such a valuation is in a binding sale agreement where the price will be agreed upon by the parties in the sale, or market price in an 'active market'. An 'active market' is one where such transactions are regularly traded an prices can be obtained reliably.

Value in use requires more consideration and is usually the most complex value to arrive at. It is the present value of the future cash flows which are expected to be derived from an asset. In practice, it is more likely that fair value less costs to sell will be used.

FRS 102, para 27.16 requires the following elements to be used in the calculation of an asset's value in use:

FRS 102, para 27.16 (a) to (e)

(a) an estimate of the future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those future cash flows;

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Estimates of future cash flows

These must include:

- projected cash inflows arising from continued use of the asset;
- projected cash outflows necessary to generate the cash inflows and which are directly attributable, or allocated on both a reasonable and consistent basis; and
- net cash flows expected to be received or paid on disposal of the asset.

An entity should estimate future cash flows for the asset in its current condition. Estimates of future cash flows which are expected to arise from a future restructuring which the entity is not yet committed must be excluded. In addition, cash flows for improving or enhancing the asset's performance.

Discount rate

The value in use calculation requires the entity to discount future cash flows using an appropriate discount rate. When deciding on the rate(s) to be used to discount such cash flows, it must be a pre-tax rate(s) which reflects current market assessments of:

- the time value of money; and
- the risks specific to the asset for which the future cash flow estimates have not been adjusted.

In addition, the discount rate(s) used by an entity to measure an asset's value in use must not reflect risks for which future cash flows estimates have been adjusted to avoid double-counting.

Example – Calculation of recoverable amount

Gleaming Garments Ltd manufacturers four brands of washing powder: GleamClothes, Britewash, Ecowash and Kiddykind. Each brand itself is considered a cash-generating unit for the purposes of impairment testing. The company acquired the Ecowash brand through the acquisition of a small entity several years ago. At the year-end 31 December 2019, the goodwill attributable to this brand was in the balance sheet at a value of £140,000.

Demand for the Ecowash brand has declined over recent months due to adverse publicity, whereas demand for the other three brands has increased.

The directors have undertaken an exercise relating to the expected cash flows as follows:

	Cash inflows	**Cash outflows**
Year	**£**	**£**
2020	70,000	27,000
2021	75,000	45,000
2022	85,000	65,000
2023	30,000	20,000

The company's external accountancy firm has carried out a valuation of the goodwill using the 'whole company approach' and this valuation shows the goodwill to have a value of £83,000. In addition, the accountants have undertaken a further exercise to calculate value in use using an assumed interest rate of 5% as follows:

	Cash flows	**PV factor**	**Present value**
Year	**£**		**£**
2020	43,000	0.952	40,936
2021	30,000	0.907	27,210
2022	20,000	0.864	17,280
2023	10,000	0.823	8,230
Value in use			93,656

Value in use exceeds the whole company approach valuation of £83,000 hence value in use becomes recoverable amount.

An impairment loss has arisen on the goodwill of £46,344 (£140,000 less £93,656) which is recognised in profit or loss.

4.4 Cash-generating units

A cash generating unit is defined as:

> *The smallest identifiable group of **assets** that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.*

FRS 102 Glossary ***cash-generating unit***

Examples of cash-generating units include:

- each individual hotel in a large hotel chain;

- books published in both paper form and electronic form for a book publisher;
- individual branches of a large clothing retailer; and
- individual restaurants in a large restaurant chain.

In respect of impairment losses in a cash-generating unit, FRS 102, para 27.21 states that the impairment loss is allocated as follows:

FRS 102, para 27.21 (a) and (b)

(a) *first, to reduce the carrying amount of any* ***goodwill*** *allocated to the cash-generating unit; and*

(b) *then, to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the cash-generating unit.*

Care must be taken with this because the carrying amount of any asset in the cash-generating unit cannot be reduced below the highest of:

FRS 102, para 27.22 (a) to (c)

(a) *its fair value less costs to sell (if determinable);*

(b) *its value in use (if determinable); and*

(c) *zero.*

Example – Allocation of an impairment loss

A company has carried out an impairment test on one of its groups of assets which is considered to be a cash-generating unit. Financial statement extracts for the year-ended 31 December 2019 are as follows:

	£
Goodwill	130,000
Plant and machinery	200,000

The cash-generating unit has suffered an impairment loss of £150,000 during the year. The directors have undertaken an exercise to calculate fair value less costs to sell and the value in use of goodwill. They have determined that the fair value less costs to sell is £60,000 and the value in use is £50,000. The directors have concluded that it is not practicable to arrive at a figure for fair value less costs to sell or value in use for plant and machinery.

The impairment loss of £150,000 is first allocated to goodwill with the remainder being applied to the plant and machinery. However, neither the goodwill nor any asset within a cash-generating unit can be reduced below the highest of:

- fair value less costs to sell (if determinable);
- value in use (if determinable); or
- zero.

As fair value less costs to sell is higher than value in use, goodwill is to be carried at £60,000, so of the £150,000 impairment, £70,000 (£130,000 less £60,000) is allocated to goodwill. The remaining £80,000 is charged against plant and machinery. The financial statement extracts will then be as follows:

	£
Goodwill	60,000
Plant and machinery	120,000

4.5 Other considerations for goodwill

FRS 102 provides additional considerations for goodwill in paragraphs 27.24 to 27.27. FRS 102, para 27.24 recognises that goodwill in isolation cannot be sold or generate cash flows which are independent of the cash flows of other assets, hence the fair value of goodwill cannot be measured directly.

When an entity does not wholly-own a subsidiary, there are non-controlling interests (NCI) which need to be considered when it comes to impairment testing. This is because part of the recoverable amount of the cash-generating unit belongs to the NCI in goodwill. The carrying amount of that unit has to be notionally adjusted before being compared with recoverable amount.

This is done by grossing up the carrying amount of goodwill allocated to the unit which belongs to the NCI and using the notionally adjusted amount to compare against recoverable amount to determine whether, or not, the cash-generating unit is impaired.

Example – Apportioning an impairment loss

Topco Ltd acquired 80% of Subco Ltd on 1 January 2019 for £340m. At the date of acquisition, the fair value of Subco's net assets and contingent liabilities is £300m. Goodwill arose on the acquisition as follows:

	£m
Fair value of net assets and contingent liabilities	300
Goodwill*	100
Non-controlling interest (£300m x 20%)	60
Goodwill calculation:	
Cost of investment	340
Net assets acquired	(240)
Goodwill	100

The assets in the subsidiary were showing indicators of impairment and at the year-end 31 December 2019 the finance director calculated a recoverable amount of £200m. Subco's assets are being depreciated over their useful economic lives of ten years and the residual value is expected to be £nil at the end of this life. Goodwill is being amortised over five years.

Part of the £200m recoverable amount belongs to the NCI's share of goodwill which has not been recognised. FRS 102, para 27.26 requires the carrying value of Subco to be notionally adjusted by the goodwill attributable to the NCI. This grossed-up value is then compared to recoverable amount:

	£m	£m
Goodwill (£100m x 4/5)		80
Unrecognised NCI in goodwill**		20
Gross carrying value of identifiable net assets	300	
Accumulated depreciation	(30)	
		270
Notionally adjusted carrying vallue		370
Recoverable amount		(200)
Impairment loss		170

**Goodwill attributable the parent's interest of 80% was £100m hence goodwill attributable to the NCI is ¼ of the 80%, i.e. £25m. At the end of 2019 it is £20m (£25m x 4/5).

The impairment loss is then allocated first to goodwill of £80m and the remaining £20m belongs to the NCI.

	Carrying value of CGU		**Impairment**	**Post--impairment**
	£m	£m	£m	
Goodwill attributable to Topco		80	(80)	
Gross value of identifiable assets	300			
Accumulated depreciation	(30)			
Carrying amount of identifiable assets		270	(70)	200
Carrying value		350		
Recoverable amount		200		
Impairment loss in Topco		150	(150)	

Reconciled as:

	£m
Total impairment loss for notional purposes	170
Unrecognised goodwill belonging to NCI	(20)
Impairment loss recognised in Topco	150

4.6 Reversals of impairment losses

It is possible to reverse a previously recognised impairment loss that has been previously charged to profit or loss. However, this reversal can only be done where the reasons for the impairment loss no longer apply. This means that an entity not only needs to assess whether assets are impaired at each balance sheet date, but also needs to assess whether previous impairment losses may no longer exist, or have decreased.

Impairment losses in respect of goodwill can **never** be reversed in a subsequent accounting period. This was due to amendment to company law in 2015 that applies mandatorily for periods commencing on or after 1 January 2016 (unless early adopted). It was not necessary to restate goodwill for impairments which had been reversed prior to this date.

When circumstances suggest that a previously recognised impairment loss no longer applies, the entity must consider whether all, or part, of the previously recognised impairment loss should be reversed in the current period. FRS 102, para 27.29 (a) and (b) outline two situations which will determine the procedure for reversing the prior period impairment loss and it will depend on whether the prior period impairment loss on the asset concerned was based on:

- the recoverable amount of that individual asset; or
- the recoverable amount of the cash-generating unit to which that asset belongs.

Where a previously recognised impairment loss reverses in respect of a cash-generating unit, the reversal must not increase the carrying amount of any asset above the *lower* of:

(a) recoverable amount; and

(b) the carrying amount which would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.

Example - Prior period impairment loss based on recoverable amount of the individual asset

On 31 December 2018, an asset with a net book value of £70,000 was impaired. The value of the impairment loss was £35,000. Had the asset not suffered impairment it would have had a carrying amount of £60,000 (depreciation of the asset is being charged over its useful life of ten years on a straight-line basis). The directors have now obtained evidence that the impairment loss charged in 2018 no longer applies. The finance director has reversed the entire £35,000 back to profit and loss for the year ended 31 December 2019.

Had the asset not been impaired in 2018, the carrying amount would have been £60,000 and in 2019 £50,000. On the basis that the carrying amount of the asset is still £35,000, the maximum amount of the impairment reversal in 2019 can only be £15,000 (£50,000 less £35,000). This is because FRS 102, para 27.30(c) states that the reversal of an impairment loss should not increase the carrying amount of the asset above the carrying amount which would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

The finance director can only debit the carrying amount with £15,000 and credit the profit and loss account with the same. This will bring the asset up to its carrying amount of £50,000. Following the reversal of the impairment loss, the company will adjust the depreciation charge for the asset in future periods to allocate the asset's depreciable amount over its remaining useful life.

5 Financial reporting and Brexit (Lecture A699 – 11.33 minutes)

At present there are still many uncertainties relating to Brexit and how the profession will be affected. For UK GAAP reporters, the impact of Brexit is unlikely to have a significant impact. Questions have been asked as to whether the current suite of UK GAAP will be scrapped and see a return of the FRSSE – the answer to this is 'no'.

In terms of IFRS, Britain cannot use EU-adopted IFRS after exit day because it is no longer part of the EU. All extant EU-adopted IFRS up to the and including exit day are still in use but the FRC now have a UK IFRS endorsement body which will deal with adopting IFRS in the UK.

Legislation is in place to protect small company qualification as well as filing exemptions for companies and LLPs to ensure compliance with Companies Act 2006.

Company law has been amended by no longer referring to the European Economic Area (EEA) as this has been replaced with references to the UK throughout the Companies Act 2006 and other supporting regulations. Section 384 of the Companies Act 2006 was amended so that an entity can only qualify as a small entity if they are not admitted to trading on a UK regulated market rather than an EEA market.

For intermediate parent entities, the exemption from preparing consolidated financial statements is only available where the immediate parent which prepares group accounts is based in the UK rather than being an EEA parent. The similar exemption contained in section 401, which was available where there is a non-EEA parent preparing 'equivalent' group accounts is expanded to include groups with an EEA parent.

Under section 394A, a dormant company is only exempt from preparing and filing financial statements if it has a guarantee from a UK parent. Prior to Brexit, this exemption was wider as it included EEA parents.

6 Amendments to the Charities SORP (FRS 102) (Lecture A700 – 21.23 minutes)

The Charity Commission made amendments to the Charities SORP (FRS 102) to reflect the amendments to UK GAAP arising from the Financial Reporting Council's triennial review amendments. Changes arising from the triennial review are applicable for accounting periods commencing on or after 1 January 2019 with early adoption permissible (see below). Clarification amendments to the Charities SORP (FRS 102) are applicable to periods commencing on or after 5 October 2018.

In October 2019, a second edition of the Charities SORP (FRS 102) was released which applies to charities preparing their financial statements in accordance with FRS 102. This second edition is effective for accounting periods commencing on or after 1 January 2019.

Early adoption

The early adoption of changes to the Charities SORP (FRS 102) arising from the triennial review are permissible except where prohibited by regulator or charity or company law, provided **all** of the changes are implemented at the same time. For charities registered in Scotland with OSCR, including cross-border charities, early adoption is not permitted (see Charities Accounts (Scotland) Amendment Regulations 2018 (SSI 344/2018)).

6.1 Clarifying amendments

Clarifying amendments which apply to accounting periods commencing on or after 5 October 2018 are as follows:

Module 3: Accounting standards, policies, concepts and principles, including adjustment of estimates and errors

Clarification of the existing requirement to provide comparative information.

Module 5: Recognition of income, including legacies, grants and contract income

Clarification concerning when payments by subsidiaries to their charitable parents that qualify for gift aid should be accrued in the individual accounts of the charitable parent.

Module 10: Balance sheet

The undue cost or effort exemption for depreciating assets comprising of two or more major components which have substantially different useful economic lives is removed.

Module 13: Events after the end of the reporting period

Clarification has been provided as to when payments by subsidiaries to their charitable parents that qualify for gift aid are adjusting events occurring after the end of the reporting period.

6.2 Significant amendments

Significant amendments arising from the FRC's triennial review which apply mandatorily for accounting periods commencing on or after 1 January 2019 (with early adoption permissible in certain cases) are as follows:

Accounting and Reporting by Charities: The Statement of Recommended Practice (SORP) – Scope and Application module.

The date from when the amendments arising from the FRC's triennial review are effective is inserted.

Module 10: Balance sheet

The amendments to Module 10 permit charities which rent investment property to another group entity to measure the investment property under the cost model (cost less depreciation less impairment) or at fair value.

The amendments also remove the undue cost or effort exemptions for the investment property portion of mixed-use property to require measurement at fair value.

The amendments also remove the disclosure requirement of stocks recognised as an expense from the notes to the financial statements.

Module 14: Statement of cash flows

Amendments have been made to Module 14 which now requires charities to prepare a reconciliation of net debt as a note to the statement of cash flows.

Module 27: Charity mergers

The transfer of activities to a subsidiary undertaking are included as an example of a charity reconstruction that should be accounted for as a merger.

Appendix 1: Glossary

The definition of the term ‘service potential’ has been included

A further section on more minor amendments arising from the triennial review has been included.

7 Brydon review of audit (Lecture A701 – 18.10 minutes)

In December 2018, Sir Donald Brydon issued his report into the quality and effectiveness of audit. This report was commissioned given the high-profile corporate collapses over the last couple of years and attempts to address how the 'expectations gap' can be bridged. The 'expectations gap' is the difference between what an auditor does and what the general public perceive the auditor does.

The recommendations themselves are collectively aimed at improving audit and assurance in respect of public interest entities (PIEs), although any changes to the auditing profession are likely to have an impact on non-PIEs.

The report makes 64 recommendations and we won't be looking at all of his recommendations but have picked out some of the more significant ones. Perhaps the most significant recommendation is the development of a new auditing profession. The report states that auditing is too important to be left to an adjunct of another profession and should be an independent profession in its own right, with its own governing principles, qualifications and standards rather than being an extension of the accounting profession. Brydon has recommended that:

> *ARGA[5] should facilitate the establishment of a corporate auditing profession based on a core set of principles. ARGA should be the statutory regulator of that profession. In doing so, I recommend that ARGA develops a coherent framework for corporate audit that includes but is not limited to the statutory audit of financial statements.*

Whether this will, or will not, transpire only time will tell. Currently there are hundreds of thousands of trainee accountants coming through the accountancy profession. For many an audit route is simply a non-starter, preferring tax, management accounting or another direction. This, of course, would limit the number of entrants into a new auditing profession. Some commentators do not think having a separate audit profession in its own right is the answer with some suggesting that the starting point may be making the UK auditing standards more accessible.

The report agrees with the *Netherlands Commission on the Future of the Accountancy Sector* which states that:

[5] The Audit, Reporting and Governance Authority which will be the successor body to the FRC.

> *The profession of auditor must become more attractive. Breaking the negative spiral into which the profession seems to have fallen is necessary. The profession itself is primarily responsible for providing an attractive environment for potential new auditors, and must address such crucial factors as work pressure, work-life balance and culture.*

Brydon report, para 6.0.7

Again, these are only suggestions at the time of writing and any changes will, of course, be dealt with by the FRC/ARGA in due course.

7.1 True and fair concept

Auditors in the UK currently express an opinion as to whether the financial statements give a true and fair view. An immediate problem with this concept is that it has never actually been legally defined. The most authoritative statements as to the meaning of true and fair are legal opinions written by Lord Hoffman and Dame Mary Arden in 1983 and 1984 and again by Dame Mary Arden in 1993.

A significant amount of time has elapsed since Lord Hoffman's and Dame Mary Arden's opinions were expressed and, during that time, there have been significant changes to accounting standards and company law.

The Brydon review recognises that there is a growing challenge in using 'true and fair' as a descriptor of financial reporting. This is on the basis that invariably financial statements will contain estimates and judgements. Auditors also only consider material issues within the financial statements and hence express an opinion on whether, or not, the accounts are free of material misstatement. The Brydon report states that it is difficult to see how either directors or the auditor can communicate effectively that modern company accounts are 'true'.

The report recommends that 'true and fair' be replaced in company law with the term 'present fairly, in all material respects'. Sir Donald Brydon considers that this will not actually weaken the auditor's opinion on the financial statements; he considers that this more accurate statement will strengthen the value of that opinion.

7.2 Fraud

Possibly one of the main contentious areas of the expectations gap. Members of the general public who are not accountants or auditors, or have had any experience of accounting or audit, expect the auditor to detect all types of fraud in the financial statements. Indeed, when a major corporate collapse takes place, one of the first questions is 'why didn't the auditors spot that?'.

Currently, ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* only requires an auditor to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. Indeed, ISA (UK) 240, para 5 states that:

> *… Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs (UK).*

ISA (UK) 240, para 5 (extract)

The Brydon report recommends that the auditor's duty in respect of fraud be extended so that the auditor effectively has a duty to detect fraud. The report recommends:

> *A new reporting duty on directors to set out the actions they have taken each year to prevent and detect material fraud.*

Brydon report, para 2.7.1

> *A corresponding new duty on the auditor to state in their report how they have assured the directors' statement on material fraud, and what additional steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.*

The report also recommends that auditors undergo initial and ongoing period training in forensic accounting and fraud awareness, and that ARGA maintains an open access case study register detailing corporate frauds.

7.3 Auditor transparency

The report recommends increased auditor transparency as follows:

- Audit firms to ensure that there is a clear separation between the team which negotiates the audit fee and the team which carries out the audit.

- Audit firms to publish the profitability of their work from audit, and also the remuneration of their senior statutory auditors and the attendant performance measures around that remuneration.

- The auditor's report to disclose the hours spent on each audit by each grade within the audit team.

- Clear reasons be provided for any resignation, dismissal or decision not to participate in a retender for an audit. In addition, auditors and companies should answer relevant questions in a general meeting.

7.4 Initial 'feelings' on the report

Some commentators suggest that some of the recommendations might be a step too far, for example a recommendation that the audit profession be split from accountancy and hence be a profession in its own right. The report acknowledges that audit itself is not 'broken', but has lost its way. Of course, good audits are responsive to areas such as fraud risk factors and challenging assumptions and judgements within the financial statements. It would be grossly unfair to tarnish all audits with criticism because feedback on many audits is good.

Conversely, some commentators suggest that the report also contains some very valid recommendations. For example, the suggestion to replace the true and fair concept and the recommendation to provide clear reasons for any resignation, dismissal or decision not to participate in a retender.

8 Revised Ethical Standard issued (Lecture A702 – 37.51 minutes)

In December 2019, the FRC issued a revised Ethical Standard (ES) which aims to strengthen auditor independence and prevent conflicts of interest following the collapse of high-profile entities such as Patisserie Valerie and Carillion. This revised ES was issued a day before the Brydon report and so a decision on expanding which entities will follow the revised ES will follow this year to ensure a consistent approach.

The effective date of the revised ES is now for periods beginning from 15 March 2020 (except paragraph 5.42 which applies to accounting periods commencing on or after 15 December 2020 and which caps non-audit services to 'other entities of public interest'). This was a move from the original date of 15 December 2019 following a number of concerns raised by respondents to the Exposure Draft. The FRC have included transitional provisions in the revised ES and the effective date for changes to ISAs (UK) remains at 15 December 2019.

An overview of some of the key changes is shown below:

8.1 Contingent fees

A 'contingent fee basis' is defined in the Glossary of Terms (Auditing and Ethics) as:

Glossary of Terms (Auditing and Ethics)

> *Any arrangement made under which a fee is calculated on a pre-determined basis relating to the outcome or result of a transaction, or other event, or the result of the work performed. A fee that is established by a court, competent authority or other public authority is not a contingent fee.*
>
> *Differential hourly fee rates, or arrangements under which the fee payable will be negotiated after the completion of the engagement, or increased to cover additional work identified as necessary during the engagement, do not constitute contingent fee arrangements.*

Example – Contingent fee

ABC LLP are a firm of auditors planning the audit of its new client, Sunlight Ltd, for the year ended 31 December 2019. Prior to the audit planning commencing, the finance director has asked the audit engagement partner if a fee, equivalent to 2% of pre-tax profit per the final audited financial statements, could be proposed.

This would give rise to a contingent fee arrangement because it is based on a percentage of pre-tax profit. This would not be permitted under the Ethical Standard.

A contingent fee arrangement creates a self-interest threat and the ES recognises that such threats are so significant that they cannot be eliminated or reduced to a level where independence would not be compromised.

Fees in respect of audit engagements must be calculated to reflect the time spent and the skills and experience of the personnel performing the engagement in accordance with all relevant requirements (e.g. ISAs (UK) and company law).

Example – Fees agreed with potential flexibility

ABC LLP has won a new audit client and has agreed a fee of £25,000 plus VAT. There is a clause in the engagement terms which states that if additional works are necessary additional fees will be agreed with management prior to the work being carried out.

Under the ES, arrangements whereby estimated fees are agreed with the entity on terms where the fees may be varied based on the level of audit work required do not constitute contingent fee arrangements, so including such terms in the engagement letter would be permissible.

Example – Non-audit services offered to an audit client on a contingent fee basis

ABC LLP is tendering for new audit for a potential client that is not a public interest entity. In addition, the finance director has requested the tender includes a quote for additional non-audit services such as tax advisory work. In the meeting to discuss the tender, the finance director stated that the company was looking to engage the firm to advise on tax planning opportunities and asked if the firm would agree to a fee being based on the company's overall tax savings.

The ES states at paragraph 4.10 that the firm (including any of its network firms) shall not provide any non-audit or additional services, to or in respect of an entity relevant to an engagement, wholly or partly on a contingent fee basis. This is because providing such non-audit services on a contingent fee basis can create the perception that the firm's interests are so closely aligned with the entity that the integrity, objectivity or independence of the firm and covered persons could be, or be seen to be, comprised.

It is crucial that auditors do not enter into contingent fee arrangements. This would not only be in breach of the ES, but it would also result in sanctions being brought against the firm by either the FRC/ARGA and/or the firm's professional body.

8.2 Third-party test

Throughout the ES, it refers to an 'objective, reasonable and informed third-party' (the 'ORITP' test). This test has been redefined in the revised ES.

This test should **not** be the perspective of another practitioner. The third party is informed about the respective roles and responsibilities of an auditor, or reporting accountant as applicable, those charged with governance and management of an entity. The ES states that the assessment which a firm makes when applying third-party test is:

- principles-based, covering both the spirit and the letter of the requirements of the ES;
- carried out using both qualitative and quantitative factors, and includes issues arising on an engagement or issue-specific basis, and in the context of wider publicly available information that an informed person would be aware of and would bring to bear on their assessment – it is based on the information available at the time and not through use of hindsight;
- an overarching assessment of risks that the third party may consider would have an impact on the audit firm's independence and not a narrow or formulaic assessment. Such an assessment might include the factors the shareholders use when assessing the independence of an auditor proposed for appointment; and

- alive to the risks that arrangements, policies or procedures implemented by a firm to address any threat to independence may be construed as a way to circumvent the overarching principles and supporting ethical provisions of the ES.

The definition of ‘independence’ makes reference to the third-party test as follows:

Glossary of Terms – Ethics and Auditing

> *Independence—*
>
> *Freedom from conditions and relationships which, in the context of an engagement, would compromise the integrity or objectivity of the firm or covered persons.*
>
> *Integrity or objectivity (and therefore independence) would be compromised if it is probable (more likely than not) that an objective, reasonable and informed third party would conclude that the threats, arising from any conditions or relationships that exist (taking into account any conflicts of interest that they may cause, or generally be perceived to cause, or otherwise, and having regard to any safeguards implemented), would impair integrity or objectivity to such an extent that it would be inappropriate for the firm to accept or continue to perform the audit or other public interest assurance engagement unless the threats were eliminated or further reduced or unless more, or more effective, safeguards were implemented.*

The important message here is that the audit firm **cannot** be seen to be breaching the third-party test.

8.3 Ethics partner

The role of the ethics partner has also been revised in the ES to enhance their authority. There is also a new requirement for PIEs to report to the FRC (or relevant supervisory body) where an audit firm chooses to override the advice of the ethics partner.

8.4 Fee levels

There is a cap on the total fees for non-audit services provided to an audit client that is a PIE and its controlled undertakings. This is limited to no more than 70% of the average of the audit fees paid in the last three consecutive financial years. This requirement does not apply retrospectively. The cap is based on average audit fees for the three consecutive financial periods following the appointment of a new auditor for periods commencing on or after 17 June 2016, the cap will apply from the fourth financial period of that engagement.

In exceptional circumstances, the FRC may allow an audit firm to be exempt from this cap in respect of a PIE but only for a period not exceeding two financial years.

Auditors will not be allowed to perform an audit where it is expected that the total fees for services receivable from a PIE or other listed entities and its subsidiaries relevant to a recurring engagement by the firm will regularly exceed 10% of the annual fee income of the firm, or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the engagement partner's profit share is calculated.

For non-listed and non-PIEs, where it is expected that the total fees for services receivable by such entities and its subsidiaries relevant to a recurring engagement will regularly exceed 15% of the annual fee income of the firm, or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the engagement partner's profit share is calculated, the ES prohibits the auditor from performing the engagement so must resign or not stand for reappointment, as appropriate.

8.5 Audit-related services

Section 5 *Non-audit/Additional Services* in the revised ES sets out a list of activities which are audit-related services for the purposes of the ES as follows:

- reporting required by law or regulation to be provided by an auditor;
- reviews of interim financial information;
- reporting on regulatory returns;
- reporting to a regulator on client assets;
- reporting on government grants;
- reporting on internal financial controls when required by law or regulation;
- extended audit work that is authorised by those charged with governance performed on financial information[6]and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions.

[6] This does not include accounting services.

8.6 Permitted non-audit/additional services

The approach taken by the revised ES has changed from the 2016 ES. The revised ES provides a 'permitted' list of non-audit/additional services which an audit firm can provide to a PIE, subject to the approval of the audit committee after the audit firm has properly assessed threats to independence and the safeguards applied in accordance with the ES. The list of permitted services is in paragraph 5.40 of the revised ES.

Auditors of PIEs will only be able to provide non-audit services which are closely linked to the audit itself or which are required by law or regulation. The idea behind this approach is to reduce the risk of a damaging conflict of interest where the commercial interests of an auditor are perceived to be the most important factor in an audit relationship, rather than a focus on performing a high-quality audit.

Examples of permitted services included in the revised ES include:

- reporting on internal financial controls when required by law or regulation;
- reporting on the iXBRL tagging of financial statements in accordance with the European Single Electronic Format for annual financial reports; and
- services which support the entity in fulfilling an obligation required by UK law or regulation, including listing requirements where:
    - the provision of such services is time critical;
    - the subject matter of the engagement is price sensitive; and
    - it is probable that an objective, reasonable and informed third party would conclude that the understanding of the entity obtained by the auditor for the audit of the financial statements is relevant to the service, and where the nature of the service would not compromise independence.

It is important that where you are acting for a PIE that you properly understand the range of non-audit/additional services because the revised approach from a 'forbidden' list to a 'permitted' list may significantly restrict the range of services which audit firms can provide to these sorts of clients.

8.7 Amendments to ISAs (UK)

The FRC have issued revisions to eight ISAs (UK) as follows:

- ISQC (UK) 1 (Revised November 2019) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements*
- ISA (UK) 200 (Updated January 2020) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*
- ISA (UK) 220 (Revised November 2019) *Quality Control for an Audit of Financial Statements*
- ISA (UK) 230 (Updated January 2020) *Audit Documentation*
- ISA (UK) 240 Revised June 2016 (Updated January 2020) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
- ISA (UK) 250 Section A (Revised November 2019) *Section A – Consideration of Laws and Regulations in an Audit of Financial Statements*
- ISA (UK) 250 Section B (Revised November 2019) *Section B – The Auditor's Statutory Right and Duty to Report to Regulators of Public Interest Entities and Regulators of Other Entities in the Financial Sector*
- ISA (UK) 260 Revised November 2019 (Updated January 2020) *Communication With Those Charged With Governance*
- ISA (UK) 500 (Updated January 2020) *Audit Evidence*

- ISA (UK) 580 (Updated January 2020) *Written Representations*

- ISA (UK) 600 (Revised November 2019) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

- ISA (UK) 620 (Revised November 2019) *Using the Work of an Auditor's Expert*

- ISA (UK) 700 (Revised January 2020) *Forming an Opinion and Reporting on Financial Statements*
- ISA (UK) 701 (Revised January 2020) *Communicating Key Audit Matters in the Independent Auditor's Report*

- ISA (UK) 720 (Revised November 2019) *The Auditor's Responsibilities Relating to Other Information*

Revisions to the above include additional application guidance to make it clear how auditors should respond to requirements.

Although the changes affect a broad selection of the ISAs (UK), the main changes focus on four principal areas:

Laws and regulations

There is a greater consideration of whether there are any indications of non-compliance with the legal and regulatory framework in which the audit client operates. The auditor must consider this at the risk assessment stage of the audit and there is improved guidance on circumstances which may indicate that non-compliance has arisen. The amendments also emphasise the importance of qualitative factors when considering whether any non-compliance is material and hence may require disclosure in the financial statements.

Groups

Audits of group financial statements has been frequently cited as being poor by regulators and hence the FRC have improved the guidance to clarify the level of work which is expected when considering the work performed by component auditors. There was already published guidance on this via a Staff Guidance Note and this has now been elevated into the main body of ISA (UK) 600 to give it extra prominence and emphasises the importance of getting it right. There is also guidance included on how the group auditor responds when they are unable to gain access to the component auditor's working papers.

Reporting

There are enhancements to the auditor's report which provide greater clarity on the auditor's capability for detecting irregularities, including fraud, in an effort to reduce the 'expectation gap'. The additional reporting requirements which exist for PIE audits are to be extended so auditors must specify the level of materiality they have worked with and provide additional information on the application of this materiality level and the significant judgements made by the auditor during the course of their work.

Other information

Enhancements to the auditor's report are introduced which clearly present the auditor's responsibilities for the other information required by law which is presented alongside the financial statements (e.g. the strategic report and the directors' report). More significant changes are also made for the audits of entities that report on how they have applied the provisions in the UK Corporate Governance Code.

8.8 Conclusion

Auditors must keep abreast of developments in the area of audit because they are coming through 'thick and fast' at the present time. It is likely that further changes will be made by the FRC to incorporate recommendations in the Brydon review.

9 Charities: independent examiners and auditors (Lecture A703 – 17.53 minutes)

Charity law sets out the reporting, filing and external scrutiny obligations which trustees are required to follow. Charity law states that a charity with a gross income exceeding £25,000 is required to have some form of external scrutiny of their accounts and the trustees may decide that an independent examination is appropriate (provided that an audit is not required by charity law or any other reason).

9.1 Audit or independent examination?

A charity is required to have an audit for financial years ending on or after 31 March 2015 if either its gross income exceeds £1 million, or its gross income exceeds £250,000 and the gross assets (not net assets) exceeds £3.26 million.

An audit may also be required by virtue of the governing document or other reason so the examiner needs to check other available information where the charity's gross income and gross assets are below the above thresholds because an audit may be required due to other reasons.

If the gross income for the year is £25,000 or less, an independent examination is not required but the trustees may decide to have one if they wish.

9.2 Who can carry out an independent examination?

An independent examination can be carried out by any person that is independent, has the necessary knowledge and experience and provided that the gross income of the charity is £250,000 or less. The independent examiner will also need to understand what accounts are, what they are intended to do and possess some analytical skills.

In order for an examiner to be independent, they must have no connection with the charity's trustees which may impact on impartiality. This does not mean that the examiner cannot be a member or sponsor of the charity, but they should not be a material donor.

The *Independent examination of charity accounts: Directions and guidance for examiners (CC32)* states that the term 'independence' means that the examiner is not influenced, or perceived to be influenced, by either close personal relationships with the trustees or by a day-to-day involvement in the administration of the charity being examined. Whether a connection with the charity amounts to a close personal relationship with the trustees which will have an impact on independence must be judged in light of the particular circumstances.

Examiners cannot independently review their own work; hence this will preclude the charity's bookkeeper from being the examiner. In practice, many charities appoint the services of a professional accountancy firm to carry out the independent examination and the person carrying out the examination must have a sound awareness of the provisions in CC32.

9.3 Relevant professional bodies

Once a charity's gross income exceeds £250,000, the examiner has to be a person who is a member of one of the following bodies. The examiner must also ensure that they comply with their professional body's rules when undertaking the role of examiner. The listed bodies are:

- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants in Scotland
- Institute of Chartered Accountants in Ireland
- Association of Chartered Certified Accountants
- Association of Authorised Public Accountants
- Association of Accounting Technicians
- Association of International Accountants
- Chartered Institute of Management Accountants
- Institute of Chartered Secretaries and Administrators
- Chartered Institute of Public Finance and Accountancy
- Fellow of the Association of Charity Independent Examiners
- Institute of Financial Accountants
- Certified Public Accountants Association

9.4 CC32 December 2017

The Charity Commission for England and Wales has issued guidance in the form of CC32 *Independent examination of charity accounts: Directions and guidance for examiners (CC32)*. The latest edition of CC32 is the December 2017 edition which applies mandatorily for independent examiner's reports signed by the examiner and dated on or after 1 December 2017.

The December 2017 edition of CC32 included three additional directions concerning conflicts of interest, related parties and the charity's financial circumstances as follows:

- **Direction 2:** Check for any conflict of interest that prevents the examiner from carrying out their independent examination.
- **Direction 7:** If the accounts are prepared on an accruals basis and one, or more, related party transactions have taken place, the examiner must check if these were properly disclosed in the accounts.
- **Direction 9:** The examiner must check whether the trustees have considered the financial circumstances of the charity at the end of the reporting period and, if the accounts are prepared on an accruals basis, check whether the trustees have made an assessment of the charity's position as a going concern when approving the charity's financial statements.

CC32 incorporates terminology such as 'must', 'should', 'recommend' and 'may', which in these circumstances have the following definitions attached:

- The word 'must' in the guidance means that something is a legal or regulatory requirement or duty which the independent examiner must comply with or follow when carrying out their independent examination.
- The word 'should' means that guidance is best practice which the Charity Commission expects the independent examiner to consider when undertaking their examination.
- 'Recommend' and 'may' are used where the Charity Commission believes that the independent examiner will find useful when carrying out their work. The independent examiner will have to exercise their own judgement where a recommendation or practice is concerned.

It is important to emphasise that if the independent examiner has not followed the new directions and guidance from 1 December 2017, the Charity Commission states that the examiner will not have carried out their independent examination properly so it is important that independent examiners fully understand the guidance in CC32 (December 2017).

1.4.4 Schedule of directions in CC32

The examiner is required to follow all the Directions which apply. However, CC32 confirms that in the case of receipts and payments accounts, Direction 7 does not apply and Directions 8 and 9 only apply in part. The purpose of the Directions are to provide the procedural basis for an independent examination. Examiners should note that a charitable incorporated organisation (CIO) is not a company and hence independent examiners of CIOs should always follow the guidance in CC32 for non-company charities.

The Directions contained in CC32 are as follows:

Direction	Direction heading (first line of the Direction)	Applicable to receipts and payments	Applicable to accruals accounts
1	Check whether the charity is eligible to have an independent examination	✓	✓
2	Check for any conflict of interest that prevents the examiner from carrying out their independent examination	✓	✓
3	Record your independent examination	✓	✓
4	Plan the independent examination	✓	✓
5	Check that accounting records are kept to the required standard	✓	✓
6	Check that the accounts are consistent with the accounting records	✓	✓
7	If the accounts are prepared on an accruals basis and one or more related party transactions took place the examiner must check if these were properly disclosed in the notes to the accounts	-	✓
8	Check the reasonableness of the significant estimates and judgements and accounting policies used in accounting for the types of fund held and in the preparation of the accounts	Part	✓
9	The examiner must check whether the trustees have considered the financial circumstances of the charity at the end of the reporting period	Part	✓

	and, if the accounts are prepared on an accruals basis, check whether the trustees have made an assessment of the charity's position as a going concern when approving the accounts		
10	Check the form and content of the accounts	✓	✓
11	Identify items from the analytical review of the accounts that need to be followed up for further explanation or evidence	✓	✓
12	Compare the trustees' annual report with the accounts	✓	✓
13	Write and sign the independent examination report	✓	✓
-	Statutory duty to report matters of material significance to the Commission	✓	✓
-	Examiner's discretion to report relevant matters to the Commission	✓	✓

9.5 Reporting

Appendix 4 in CC32 contains 12 illustrative examiner's reports. There are two kinds of examiner's report: one for non-company charities and another for charitable companies.

Most charities are non-company charities, but where a charity is set up under the Companies Act 2006, these are regarded as charitable companies. The wording of an unqualified auditor's report for a non-company charity preparing accruals accounts, with a gross income of £250,000 or less is as follows:

Independent examiner's report to the trustees of XYZ Charity

I report to the trustees on my examination of the accounts of XYZ Charity (the Charity) for the year ended 30 November 2017.

Responsibilities and basis of report

As the charity trustees of the Trust you are responsible for the preparation of the accounts in accordance with the requirements of the Charities Act 2011 (‘the Act’).

I report in respect of my examination of the Trust’s accounts carried out under section 145 of the 2011 Act and in carrying out my examination I have followed all the applicable Directions given by the Charity Commission under section 145(5)(b) of the Act.

Independent examiner’s statement

I have completed my examination. I confirm that no material matters have come to my attention in connection with the examination giving me cause to believe that in any material respect:

1. accounting records were not kept in respect of the Trust as required by section 130 of the Act; or
2. the accounts do not accord with those notes; or
3. the accounts do not comply with the applicable requirements concerning the form and content of accounts set out in the Charities (Accounts and Reports) Regulations 2008 other than any requirement that the accounts give a true and fair view which is not a matter considered as part of an independent examination.

I have no concerns and have come across no other matters in connection with the examination to which attention should be drawn in this report in order to enable a proper understanding of the accounts to be reached.

Signed:

Name:

Relevant professional qualification or membership of professional bodies (if any):

Date:

9.6 Key points of focus

Independent examiners and auditors need to ascertain the relevant requirements at the outset; i.e. is an audit required or is an independent examination required. Once this has been established, the independent examiner or auditor must gain a sound understanding of the relevant guidance in order to ensure that the examination/audit is carried out in accordance with the relevant guidance or International Standards on Auditing (UK). Independent examiners must ensure that they understand the provisions in CC32 and that their work could stand up to scrutiny.

9.7 Auditors and independent examiners responsibilities

The Charity Commission for England and Wales carries out reviews of the work of auditors and independent examiners to ensure compliance with their responsibilities. This is because the Charity Commission views auditors and independent examiners as their 'second line of defence', after the trustees, against mismanagement in charities. The Charity Commission relies on auditors and independent examiners to scrutinise the accounts which the trustees prepare and to report to the Charity Commission any significant concerns which the independent examiner or the auditor identifies during the course of their work.

Unfortunately, the Charity Commission have identified significant failings in the accounts which independent examiners and auditors are reviewing which they have failed to identify.

In August 2019, the Charity Commission published a benchmark of the minimum standards which it expects in an external scrutiny of the accounts of a charity.

9.8 The Charity Commission's benchmark

The Charity Commission's latest benchmark became effective by the Accountancy Services Team from 1 September 2019. It comprises 15 criteria, nine of which apply regardless of whether the external scrutiny is of receipts and payments or accruals accounts. The other six criteria only apply to the external scrutiny of accruals accounts.

The benchmark is as follows:

Criteria that apply to the external scrutiny of receipts and payments and accruals accounts:

Trustees’ annual report
For registered charities, there is a trustees’ annual report or, if a company, a combined trustees’ annual report and directors’ report
External scrutiny report
There is an independent examination report or audit report
There is an audit report if an audit is required by the charity’s size
The external scrutiny report is worded correctly with reference made to the correct legislation
The accounts
There is a receipts and payments account or a statement of financial activities
There is a statement of assets and liabilities or a balance sheet
The accounts are internally consistent, i.e. the closing funds balance within the receipts and payments accounts or statement of financial activities is consistent with the statement of assets and liabilities or balance sheet
The accounts add up correctly
Unrestricted and restricted funds are clearly identified

Criteria that apply to the external scrutiny of accruals accounts only

The accounts
The accounts have been prepared on an accruals basis, if required by the charity's size or because it is a company
The accounting policies note states that the accounts have been prepared under the correct Charities SORP
The notes disclose all of the required related party transactions as required by the Charities SORP
The statement of financial activities either incorporates an income and expenditure account or there is a separate income and expenditure account, if the charity is a company
Consolidated accounts have been prepared if applicable and required by the charity's size
There is a cash flow statement, if required by the charity's size

9.9 Findings of the Charity Commission

The Charity Commission reviewed 296 sets of accounts for 2017 drawn from three random samples (chosen to reflect the different accounting and scrutiny requirements that apply) to assess whether they meet the benchmark.

Three quarters of charities with incomes over £1 million met the external scrutiny benchmark but this fell to half or less of the charities in the two lower income samples.

Charity income	% of accounts meeting the external scrutiny benchmark
£25,000 - £250,000	37% (of 100 charities)
£250,000 - £1 million	51% (of 100 charities)
£1 million and greater	76% (of 96 charities)

A concern of the Charity Commission is the number of accounts submissions which do not meet the benchmark. The Charity Commission acknowledge that the responsibility for the charity's financial statements rests with the trustees; however, they are concerned about the work done by auditors and examiners who have scrutinised these accounts.

The Charity Commission looked in further detail at the results for each of the three documents which make up a set of financial statements for a charity. All of the charities in the two largest income samples provided a trustees' annual report and nearly all of them filed an audit or independent examiner's report with the required wording (as did the vast majority of charities in the lowest income sample). The Charity Commission did notice that compliance with the accounts criteria was much lower in all three samples. The benchmark focuses on the content of the accounts, since this reflects the scope of an audit or examination.

The table below breaks down the Charity Commission's findings:

Income/% of accounts meeting criteria	Trustees' annual report	External scrutiny report	Accounts	All three documents
£25,000 - £250,000	90%	74%	44%	37%
£250,000 - £1 million	100%	96%	51%	51%
£1 million and greater	100%	99%	76%	76%

8.9.1 Trustees' annual report

The Charity Commission confirmed that of the two largest income samples, all of the charities provided a trustees' annual report. One charity in the lowest income sample did not file a narrative report and another 9% provided notes of an annual general meeting or a Chair's report instead of a trustees' annual report despite the fact that the Charity Commission gave the trustees the opportunity to make good the incomplete submission.

8.9.2 External scrutiny report

The Charity Commission reports that there was a high level of compliance from the charities in the two largest income samples. However, one charity did not file a scrutiny report and another filed an independent examination report when an audit was required. Four charities in the lowest income sample did not file a scrutiny report despite being given the opportunity by the Charity Commission to make good an incomplete submission.

The main failing noted by the Charity Commission was that the external scrutiny report did not have the correct wording (e.g. referring to the repealed Charities Act 1993).

Therefore, where reliance on accounts production software is being placed, the examiner/auditor is strongly advised to check that the relevant report is correctly worded rather than just placing reliance on the software.

8.9.3 The accounts

The Charity Commission noted two main reasons why charities in the two largest income samples failed to meet the benchmark:

- incomplete reporting of related party transactions. The Charity Commission noted that 34% of the accounts in the £250,000 - £1 million income sample and 14% of the accounts in the over £1 million income sample did not meet this requirement; and

- not providing a separate income and expenditure account, or not stating that it was included in the SOFA. This criteria only applies to charitable companies, but approximately 70% of the charities in each of the two larger income samples are companies. 21% of the companies in the £250,000 - £1 million income sample and 12% of the accounts in the over £1 million income sample did not meet this requirement.

The Charity Commission noted that charities in the lowest income sample performed even more poorly than those in the larger income samples. However, the Charity Commission did note that the criteria are less relevant because 34 of the charities opted to prepare receipts and payments accounts, where there is no requirement to disclose related party transactions and only 30 of the charities in this sample were companies.

The Charity Commission also noted that while all the charities within the sample filed accounts, 28% of them did not meet a basic integrity standard, with incorrectly labelled or missing statements and no information concerning the types of funds held.

2.1.4 Relative performance of auditors/independent examiners

The section of the Charity Commission's samples with the highest percentage of charities meeting the benchmark is those with an income of over £1 million (these must be audited). The audited charities in the other two samples did not reach the same standard, but the Charity Commission confirmed that a higher percentage met the benchmark than the accounts which had been independently examined.

Charity income/type of scrutiny	% of accounts meeting the external scrutiny benchmark	
	Independent examination	**Audit**
£25,000 - £250,000	38% (of 92 charities)	50% (of 4 charities)
£250,000 - £1 million	48% (of 67 charities)	59% (of 32 charities)
£1 million and greater	0% (of 1 charity)	77% (of 95 charities)

Trustees of charities with an income of less than £250,000 and who opt for independent examination are not required to appoint a person who is a member of a recognised accountancy body. The Charity Commission confirmed that the trustees of 70 of the 92 charities in their sample which opted for independent examination appointed qualified examiners. The Charity Commission also confirmed that the qualified examiners performed significantly better than the unqualified examiners, with 44% of the financial statements which they reviewed meeting the benchmark, compared with only 18% for the unqualified examiners.

9.10 Action taken by the Charity Commission

The Charity Commission is taking action by working with the accountancy profession – primarily to raise the standard of work done by independent examiners and auditors. For each charity within the Charity Commission's sample, they recorded the accountancy body, if any, which the charity's auditor/independent examiner belonged. Firms or individuals regulated by the Institute of Chartered Accountants in England and Wales and ACCA issued the vast majority of audit or independent examination reports.

The findings from the Charity Commission are shown in the table below:

Body/report	Number of external scrutiny reports	Number of accounts not meeting the criteria
ICAEW	203	69
ACCA	47	30
Other Charities Act 2011 listed body	18	12
No qualification stated	23	19
No scrutiny report file	5	5
Total	296	135

The Charity Commission have confirmed that they are working with ICAEW and ACCA to improve their members' awareness of charity reporting and accounting requirements as well as to identify the necessary improvements to the learning and resources available to their students and members.

The Charity Commission have also provided details of members who had audited or examined sets of accounts which did not meet the benchmark.

9.11 Updated guidance

The Charity Commission have updated *Independent examination of charity accounts: guidance for trustees (CC31)* which provides trustees with the information which they need to:

a) check whether their charity can have its accounts independently examined instead of audited;
b) appoint a suitable person to carry out the independent examination; and
c) prepare for the independent examination.

The Charity Commission have also contacted the trustees of the 135 charities which filed trustees' annual reports, external scrutiny reports and/or accounts which failed the benchmark. They have provided guidance to them which aims to help improve the quality of their future trustees' annual reports and accounts. The Charity Commission have also required the trustees of 10 of these charities to address additional specific concerns which were identified as follows:

- one charity which did not file any form of trustees' annual report;
- five charities which did not file any form of external scrutiny report;
- three charities which did not comply with one of the accounting or external scrutiny thresholds, including one charity that had appointed an examiner who did not hold the required professional qualifications; and
- one charity that had appointed one of the trustees as its independent examiner, in clear breach of both the trustees' and the examiner's duty to ensure that the person carrying out the examination is independent of the charity.

9.12 Small charities: charity commission's review

The Charity Commission has also undertaken an exercise in which they have reviewed the accounts of smaller charities. This has been done because the Charity Commission view the accounts of small charities as the prime means by which the trustees are publicly accountable to donors, beneficiaries and the wider public for the charity's activities and how they have used the charity's money.

Charities with an income of less than £25,000 are not required to file their annual report and accounts with the Commission (except for Charitable Incorporated Organisations) or to arrange for an independent scrutiny of their accounts. While small charities only account for around 1% of the sector's income, they represent nearly 62% of the charities on the Commission's register.

9.13 Focus of the Commission's review

The focus of the Commission's review was on whether each set of accounts met the basic requirements of the users of those accounts rather than on strict technical compliance with reporting standards. The Commission based their view of the user's requirements on the Populus survey of public trust and confidence (June 2016) (superseded by the June 2018 version). In both surveys, Populus found that 'ensuring that a reasonable proportion of donations make it to the end cause' and 'make a positive difference to the cause they work for' remain the most important factors driving public trust and confidence in charities.

To that end, the Commission focussed their review on the following criteria:

- have the trustees produced both of the required documents that make up a set of small charity accounts (the annual report and the accounts)?
- does the annual report explain what activities the charity had carried out during the year to achieve its purposes (the Commission assessed the content of the document provided, rather than what it was called)?
- do the accounts contain both an analysis of receipts and payments and a statement of assets and liabilities and are these consistent with each other (or the equivalent if the accounts were prepared on an accruals basis)?

9.14 Results of the review

In 2017, the Commission reviewed a sample of 110 charities which had reported income less than £25,000 covering the accounting years ending during the 12 months to 31 December 2015. This was done because the Commission base their published information concerning charities and accounts on the annual return cycle and AR 2015 was the most recent complete cycle at the time.

The Commission contacted the charities in the sample to obtain a copy of their annual report and accounts. The Commission needed to send reminders and further guidance on the requirements in many cases and the Commission excluded documents prepared after they had contacted the trustees to ask for them. The sample size meant that the Commission's findings are statistically representative of the annual report and accounts filed with them by small charities for the period.

8.14.1 What did the Commission find?

64% of the charities in the sample provided sets of accounts which were of an acceptable quality (i.e. they had met the basic standard set by the Commission). The Commission concluded that the quality of reporting has improved in both of their most recent surveys.

The 36% which did not meet the basic standard can be split into three equal groups as follows:

- Both of the required documents were provided in some form but one, usually the accounts, or both of them were inadequate. The main flaws in the accounts were the lack of any information on the charity's assets and liabilities or the accounts covering a different year end to the annual return.
- Only one of the required documents was provided – usually the accounts.
- Neither of the required documents were provided.

The responses received by the Commission indicated that some trustees believed that the annual return and the accounts are the same thing and others believed that they only had to complete the annual return to meet their public reporting responsibilities. In more worrying instances, some trustees believed that they did not need to produce an annual report and/or accounts because their charity did not carry out much activity. This demonstrates a lack of even the basic level of knowledge about a charity's reporting requirements.

8.14.2 Action taken by the Commission

The Commission has provided guidance to the trustees of the charities which did not submit sets of accounts of an acceptable quality. The Commission has also provided guidance on closing a charity to those charities which stated that they are no longer active.

The Commission has also reminded trustees that **all** registered charities must prepare an annual report and accounts and make them publicly available, even if they are not required to file them with the Commission.

9.15 Other charities

Following on from above which examined the Charity Commission's findings in respect of small charities, the Commission has also reviewed other charities with income over £25,000.

Such registered charities are required to file the following documents with the Commission within 10 months of their financial year end:

- the trustees' annual report;
- the accounts; and
- the report of an independent scrutiny of the accounts.

The Commission reported that approximately 38% (64,000) of the charities on their register have incomes over £25,000 and they account for 99% of the sector's income.

9.16 Focus of the Commission's review

As with small charities, the focus of the Commission's review for other charities was whether each set of accounts reviewed met the basic requirements of the users of those accounts rather than on strict technical compliance with reporting requirements (SORP and FRS 102).

This led the Commission to focus on the following criteria:

- have the trustees filed all of the required documents that make up a set of accounts (the annual report, the independent scrutiny report and the accounts) and do they provide a consistent picture of the charity's activities?

- does the annual report explain what activities the charity had carried out during the year to achieve its purposes?

- have the accounts been prepared on the correct basis depending on the charity's income and type, either receipts and payments or accruals accounts (also known as SORP accounts)? Also, do the accounts contain both a statement of financial activities (SOFA), which analyses the charity's expenditure, and a balance sheet that are consistent with each other (or the equivalent if receipts and payments accounts were prepared)?
- have the accounts been subject to the required level of independent scrutiny depending on the charity's income and gross assets, either an audit or an independent examination?

9.17 Results of the review

The Commission found that 74% of the accounts they reviewed were of an acceptable quality, i.e. they met the basic standard that had been set. The reasons why the remaining 26% failed to meet the basic standard are as follows:

- one of the required documents was missing (5% of charities);

- the annual report was inadequate, mainly because it provided little or no information of the charitable activities carried out (11% of charities);

- the independent scrutiny report was inadequate, mainly because the wording of the report demonstrated that the person carrying out the scrutiny was not familiar with the independent examination requirements (5% of charities); and

- the accounts were inadequate, mainly because they were incomplete or did not balance (5% of charities).

The Commission acknowledge that the inadequacies may, in some instances, have been the result of an incomplete submission (for example where the was a contents page which listed documents or pages which were not present).

9.18 Action taken by the Commission

The Commission reviewed the accounts of the following year for 26 of the 28 charities which did not submit accounts of acceptable quality. Of the other two charities, one no longer needs to file their accounts because its income is now less than £25,000 and the other is now in default of its filing duties. The following action has been taken:

- no further action is required (nine charities), usually because more recent accounts submitted are of an acceptable quality;
- providing guidance to the trustees (17 charities), where the areas for improvement are such that the guidance should enable the trustees to be able to prepare future sets of accounts to an acceptable standard; and
- requiring action from the trustees (two charities), where the most recent accounts contain serious deficiencies and need to be corrected and resubmitted. This includes the charity that is in default.

9.19 Related party transactions

Related party transactions lend themselves to a host of issues where charities are concerned. The Charity Commission require trustees to always act in the best interest of the charity and not for private benefit.

In 2017/18, the Commission opened 335 regulatory compliance and inquiry cases into 'trustee pay, and concerns about trustee or other private benefits or trustee decision making'. The Commission has reminded trustees of the importance of the trustees identifying all related party transactions and to handle conflicts of interest properly (this is important to good governance).

Charities applying the SORP in the preparation of their financial statements must be transparent about their transactions with persons and entities closely connected to the charity or its trustees. **The Commission requires the auditor or independent examiner to report to them if related party transactions are not fully disclosed in the accounts which they have scrutinised**. The focus of the Commission's review was therefore to check whether charities are providing the disclosures required by the SORP in respect of related party transactions.

9.20 Reporting requirement for related parties

Where the charity prepares accruals accounts, it must disclose:

- trustees' remuneration and benefits;
- trustees' expenses; and
- transactions with those persons and entities that are closely connected to the charity or its trustees, referred to as related parties.

Where there has been no transactions of each type listed above, that fact must be stated.

9.21 What the Commission reviewed

The Commission reviewed the 2017 accounts filed by 262 charities which had prepared SORP accruals accounts. The aim of this review was to assess whether the charity had provided the required related party disclosures. The Commission drew charities from three random samples, chosen to reflect the different accounting and scrutiny requirements which apply.

9.22 The Commission's findings

The Commission has reported that disclosure of related party transactions has improved significantly as the income of the charity increased. Having said that, less than two-thirds of the charities in the Commission's two lower income samples fully complied with the SORP's transparency requirements. The table below outlines the overall findings of the Commission:

Charity income	% of accounts fully disclosing related party transactions
£25,000 - £250,000	55% (of 66 charities)

£250,000 - £1 million	66% (of 100 charities)
£1 million and greater	86% (of 96 charities)

The Commission is concerned that a significant proportion of charities are not fully reporting their related party transactions properly. Therefore, the Commission looked in more detail at the completeness of reporting of each of the three types of related party transaction. They found that the vast majority of charities disclosed trustees' remuneration and, to a lesser extent, trustees' expenses in the notes to the financial statements. It was the disclosure of transactions with persons and entities closely connected to the charity or its trustees which was significantly less complete.

The table below outlines the Commission's findings in this respect:

Income/% of accounts including	Remuneration	Expenses	Transactions	All three aspects
£25,000 - £250,000	85%	74%	55%	55%
£250,000 - £1 million	91%	84%	71%	66%
£1 million and greater	98%	95%	89%	86%

The Commission acknowledge that some of the lack of disclosure may be because some practitioners have not picked up on a change of disclosure requirement from the previous edition of the SORP (Charities SORP 2005). This required a statement that there had been no trustees' remuneration or expenses where this was the case. Even though this requirement has been carried over into the Charities SORP (FRS 102), this edition of the SORP also requires a similar statement where there had been no related party transactions during the accounting period.

The Commission found that most of the charities in the sample which provided all three of the required disclosures provided clear statements about each. The Commission states that where disclosures were less clear, they tried to give trustees the benefit of the doubt. For example, if a note's heading referred to trustees' remuneration and expenses, but there was no information within the note itself on expenses, the

Commission assumed that this meant that there were no expenses to disclose. Where any disclosures were missing, the Commission checked the trustees' annual report in case the information had been included there.

In some cases, the Commission suggest that the disclosures made by some charities indicate that their trustees were not fully aware of the scope of related party transactions. For example:

- disclosing the transactions in which the trustees themselves were directly involved, but not those involving persons or entities connected with them; and
- disclosing the remuneration paid to the trustees and persons connected with them, but not any other transactions they were involved in.

The Commission's scope of this study was to check whether the required disclosures had been included rather than to check whether the information disclosed was consistent with the information in the trustees' annual report and in other areas of the accounts. This check should be carried out by the charity's independent examiner or auditor.

9.23 Completeness of examiner/auditor reporting to the Commission

The Commission rely on each charity's auditor or examiner to report to them where trustees have not fully disclosed related party transactions in their accounts. Of the 77 sets of accounts across the three samples that failed to do so, 74 had been reviewed by an independent examiner or auditor. The Commission found that none had reported this to them.

The Commission acknowledge that whilst this is disappointing, it is not surprising. The Commission acknowledge that where the auditor or examiner identifies a deficiency in the disclosure of related party transactions, the Commission would expect that they recommend to the trustees that the deficiency is corrected before the accounts are finalised. It is only when the trustees are unwilling to do so should the auditor or examiner be in the position of having to report a matter of material significance. The Commission suspects that, in a number of cases, the requisite nil disclosure has simply been omitted and if this deficiency had been spotted, it would have been corrected.

The Commission state that the change to the SORP was intended to provide greater assurance on the full disclosure of related party transactions. The Commission state that the absence of the reporting of incomplete disclosure to the them by the auditor or examiner could be taken as evidence that the auditor or examiner may have been complicit in the trustees' failure to provide complete disclosure. This is quite a worrying statement and one which auditors and examiners need to keep at the forefront of their minds when dealing with sensitive areas such as related party disclosures.

In addition, the Commission also state that this may indicate that significant conflicts of interest have not been managed appropriately by trustees and this must be carefully considered by auditors and examiners. If incomplete or non-disclosure of related party transactions is not being reported, the Commission has concerns that the failure to manage conflicts of interests by trustees is also being under-reported.

9.24 Action taken by the Commission

The Commission have contacted the trustees of the 74 charities which had been independently examined or audited and which did not fully disclose related party transactions in their accounts. The Commission have provided guidance on the SORP's disclosure requirements and have required them to provide the missing disclosures to them and to their auditor or examiner.

The Commission have also contacted the trustees of another four charities which did not file any external scrutiny report and have advised them of their duty to appoint an auditor or independent examiner.

The Commission has also recorded the accountancy body, if any, that the charity's auditor or independent examiner stated that they were a member of. The Commission then provided details to ACCA and ICAEW of their members who had audited or independently examined sets of accounts which did not fully disclose related party transactions. Both ACCA and ICAEW have agreed to write to the members concerned and remind them of their obligation to check compliance with the SORP. In addition, they will also ask each member to:

(a) confirm whether there are in fact any trustee remuneration/expenses and/or related party transactions that should have been disclosed in the accounts; and

(b) report any omissions to the Commission as a matter of material significance, indicating if in their view this was a deliberate omission by the trustees.

The table below provides details of the Commission's findings:

Body/report	Number of external scrutiny reports	Number of accounts not disclosing related party transactions
ICAEW	194	41
ACCA	41	17
Other Charities Act 2011 listed body	12	9
No qualification stated	11	7
No scrutiny report filed	4	3
Total	262	77

The Commission has asked ACCA and ICAEW to ensure that all of the members concerned have responded to them, indicating which (if any) should have also reported to the Commission.

9.25 Lessons to be learnt

The Commission has concerns that the trustees of a significant number of charities preparing accruals (SORP) accounts are failing to be transparent about related party transactions, those in which they are persons and entities closely connected to them have an interest. The Commission have emphasised that a lack of transparency is damaging to public confidence and goes to cast doubt on the integrity of the governance arrangements at the charity.

Even where the trustees delegate aspects of accounts preparation to the examiner or auditor, the trustees remain responsible for approving the trustees' annual report and accounts. The trustees must co-operate with the auditor or examiner because they cannot be expected to know all of the related parties who are involved with the charity so co-operation is key to ensuring that adequate disclosure is made in the accounts.

Trustees also have a duty to act in the charity's best interest. This includes:

(a) avoiding putting themselves in a position where their duty to the charity conflicts with their personal interests or loyalty to any other person or body; and

(b) not receiving any benefit from the charity unless it is properly authorised and is clearly in the charity's interests; this includes anyone who is financially connected to the trustee (e.g. a partner, dependent child or business partner).

Auditors and examiners have a duty to carefully check that the required disclosures concerning related party transactions have been made in the financial statements and to report to the Commission if they have not. Auditors and examiners must also bear in mind that they have a duty to report to the Commission if any significant conflicts of interest have not been managed appropriately by the trustees.

9.26 Public interest reporting by charities

All registered charities must publish a trustees' annual report. The aim of public benefit reporting is to show that the charity is being true to their own purposes and demonstrating the difference which they are making. The Charity Commission therefore view public benefit as being at the heart of what charities are about.

9.27 Focus of the Commission's review

The focus of the Commission's review was on whether each trustees' annual report demonstrated a clear understanding of the public benefit reporting requirement. The assessments were based on the Commission's guidance *Public benefit reporting (PB3)*.

The Commission assessed whether the trustees' annual report contained:

(a) an explanation of the activities undertaken by the charity to further its purposes for public benefit; and

(b) a statement by the trustees as to whether they have had due regard to the Commission's guidance on public benefit, known as 'the public benefit statement'.

The review was based on a random sample of 105 trustees' annual reports from the register of charities, covering accounting years ending during the 12 months to 31

December 2016. The sample comprised charities reporting incomes over the main filing threshold of £25,000.

9.28 Findings by the Commission

The Commission found that 52% of the trustees' annual reports demonstrated a clear understanding of the public benefit reporting requirement (this was 51% in the previous year). The Commission is, however, disappointed that many charities do not explain the activities which they undertake to improve the lives of their beneficiaries and make a difference.

The Commission found that the majority of trustees' annual reports met at least one of two aspects of public benefit reporting as follows:

- 66% explained the activities undertaken by the charity to further its purposes for the public benefit, compared with 71% in the previous year; and
- 66% included a public benefit statement, compared with 62% in the previous year.

The Commission noted that the trustees' reports which met the public benefit reporting requirement were those where the trustees' had appreciated that public benefit reporting is more than just including a standard statement. What the Commission is looking for, in addition to the public benefit statement, is evidence of some reflection on the difference which the charity's activities had made. The main examples of approaches taken by trustees to meet this requirement were:

(a) expanding the public benefit statement to explain why the trustees believed that the charity's activities provided public benefit;

(b) explaining who had benefitted from what the charity had done, whether a particular group of beneficiaries or the wider public; and

(c) explaining the impact of what the charity had done, such as examples of how the charity's services had led to improvement in people's lives.

9.29 Action taken by the Commission

The Commission has provided guidance to the trustees of all charities in their sample whose 2016 trustees' annual reports did not meet the public benefit reporting requirement, taking account of the content of more recent trustees' annual reports where these had been filed.

9.30 Important points to note

The Commission has stated that the trustees' annual report is the key means by which the trustees of a charity are publicly accountable for the work which they have done to make a difference to the charity's beneficiaries. Public benefit reporting encourages trustees to reflect on how well they are doing and to communicate this to their supporters, potential funders an the wider public.

10 Charities: Matters of material significance (Lecture A704 – 5.19 minutes)

In November 2017, the Charity Commission issued updated guidance in the form of *Matters of Material Significance reportable to UK charity regulators – A guide for auditors and independent examiners*. This guidance applies to both independent examiners and auditors, both of whom have a duty to report matters of material significance to the relevant charity regulator who are as follows:

- The Charity Commission for Northern Ireland
- The Office of the Scottish Charity Regulator
- The Charity Commission for England and Wales

At the outset it is important to note that auditors or examiners are only expected to report matters which they identify during the normal course of their work. This means that there are no additional requirements for auditors or examiners to carry out additional work aimed at identifying matters of material significance which are reportable. This will, of course, involve professional judgement being exercised by auditors and examiners.

In addition, even if the charity's trustees have reported a matter to the charity regulator, the auditor or examiner will have some additional information or perspective which the regulator needs in order to reach a fully informed assessment of the matter. Hence, the auditor or examiner is also expected to make a report to the charity regulator.

10.1 Material significance

Charity law refers to the term 'material significance' to determine which matters are to be reported to the regulator. The term 'must' means that the charity regulator is referring to a specific legal or regulatory requirement and auditors and examiners must report any matters of material significance that they encounter during their appointment.

Auditors and examiners will be familiar with the term 'material' but this has a slightly different meaning to which auditors and examiners will be familiar because it is wider than financial materiality.

The general mantra of the regulator is:

When in doubt, report it

This is the default preference for auditors and examiners. Hence, always err on the side of caution and if any doubts exist concerning a matter, simply report it to the regulator to ensure that legislative requirements are discharged appropriately.

10.2 Reportable matters

There are nine reportable matters in the Charity Commission's list. The guidance states that a matter becomes reportable as soon as:

- the auditor or independent examiner becomes aware of it; or
- the auditor or independent examiner intends to offer a modified audit opinion, an audit opinion with an emphasise of matter or material uncertainty related to going concern; or
- a qualified independent examination report identifies one or more concerns about the charity's accounts.

The nine reportable matters of material significance are as follows:

1. Dishonesty and fraud
2. Internal controls and governance
3. Money laundering and criminal activity
4. Support of terrorism
5. Risk to charity's beneficiaries
6. Breaches of law or the charity's trusts
7. Breach of an order or direction made by a charity regulator
8. Modified audit opinion or qualified independent examiner's report

9. Conflicts of interest and related party transactions

10.3 Failure to report

Auditors and independent examiners who fail to report matters of material significance to the relevant charity regulator will be breaking the law. The charity regulators will take very seriously any discovery that an auditor or independent examiner has failed in their legal obligation to report relevant matters. The charity regulators reserve the right to take further action. In addition, ACCA will also sanction auditors and independent examiners if they fail to report matters of material significance in contravention of legislation.