AUDIT AND ACCOUNTING QUARTERLY UPDATE – QUARTER 1

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1 Covid-19 update for charities (Lecture A732 – 11.28 minutes)

In January 2021, the Charity Commission for England and Wales (CCEW) issued further guidance for charities in respect of the Covid-19 pandemic. At the time of writing these notes, the UK was still in its third lockdown with the Government aiming to announce a 'roadmap' out of lockdown restrictions on or around 22 February 2021.

The effect of the pandemic has been significant on businesses up and down the country and charities have also been adversely affected. To assist charities, the various regulators have provided timely guidance to enable trustees to discharge their responsibilities properly while the effects of Covid-19 are still being dealt with.

The financial position of a charity must be looked at closely. Keep in mind that some charities rely on fundraising activities – most of which have not been able to go ahead due to the Covid-19 pandemic. This is likely to lead to significant financial difficulties for the charity and invariably going concern issues will need to be carefully considered as well. The adequacy of any going concern disclosures must be considered by the independent examiner or auditor.

1.1 AGMs and other meetings

The guidance issued by the CCEW confirms that charitable companies and Charitable Incorporated Organisations (CIOs) can hold AGMs and other members' meetings online. This was made possible through provisions in the Corporate Insolvency and Governance Act 2020 which applies until 30 March 2021. Obviously this Act may have its deadline extended depending on what the Government do in respect of Covid-19.

In respect of other types of meetings (or for other types of charity other than charitable companies and CIOs), the trustees will need to check if their governing documents allow them to hold meetings online or by telephone. If the governing documents do not allow virtual meetings or meetings by telephone, it is possible to amend them so as to allow meetings to be held in this way. A lot of charities have amended their governing documents accordingly to allow for virtual meetings to be held given the fact that we are already into year 1 of the disruption caused by the pandemic.

However, Covid-19 has posed significant difficulties and, for some charities, virtual meetings are not a viable solution; nor are socially-distanced face-to-face meetings. Where charities are faced with these difficulties, they may have no choice but to cancel or postpone their AGMs and other critical meetings. It is advisable to have adequate documentation in place where this happens which clearly states the circumstances faced by the charity and why it is not viable to have virtual/telephonic/socially distanced face-to-face meeting. Adequate documentation is advised by the CCEW even if there are no such rules as this demonstrates good governance of the charity. **This is also particularly important if it is not possible for the charity to hold its AGM causing difficulties in finalising the annual report and accounts**.

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The CCEW still ask that, where possible, the charity submits its annual reports to them on time. However, where the situation impacts on the completion of annual return and accounts, charities with an imminent filing date can email the CCEW to ask for a filing extension (filingextension@charitycommission.gov.uk).

1.2 Virtual and telephonic meetings

It is fair to say that face-to-face meetings of any kind have been avoided for the last year or so, where possible, due to the pandemic. Some charities have clauses in their governing documents which allow them to meet virtually or by telephone and so the CCEW advises trustees to check their governing documents to see if this is possible.

Where there are no such clauses in governing documents and the trustees do decide it appropriate to hold meetings virtually or by telephone, the CCEW have said they will understand. However, trustees should be advised to document these decisions to demonstrate good governance of their charity.

1.3 Charitable companies or CIOs

The CCEW guidance confirms that in the specific case of members' meetings (not trustee/director meetings) of charitable companies or CIOs held between 26 March 2020 and 30 March 2021:

- They may be held by telephone/video or other electronic means, even if the governing document requires them to be held physically face-to-face.
- Members still have the right to vote, but the charity can require this to be done electronically, or by other means (such as by post).
- Members will not have the right to attend a meeting in person or participating in meetings other than to vote.

Where reliance is placed on these provisions, that decision must be documented in the minutes. All other meeting requirements must also be met. The CCEW require that all charitable companies and CIOs have a robust system in place which ensures only those eligible to vote can do so and that a record is maintained of who has voted and the percentage of votes cast.

Trustees and directors of charitable companies or CIOs must bear in mind that these are temporary provisions arising from the Corporate Insolvency and Governance Act 2020. It also applies to exempt charities that are community benefit or friendly societies and will (currently) end on 30 March 2021 (previously it was due to end on 30 December 2020). This date could be extended further depending on how the Government's route of lockdown works but at the time of writing these notes, there was no indication by the regulators that this date is going to be extended further.

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1.4 Mergers and collaborative working

The CCEW acknowledges that charities are facing immense challenges due to Covid-19. Many charities have had to reassess how they operate in order to avoid reducing services or, in worse cases, closing down. Some charities have entered into collaborative working arrangements with other charities or merged in order to make better use of charitable funds and property and provide better services for beneficiaries.

To help charities in this specific area, the CCEW have issued a checklist that can be used that can be obtained from www.gov.uk/guidance/how-to-merge-charities.

Charities which are in search of partners for collaboration or merger can check the register of charities to find potential partners.

1.5 Use of reserves and restricted funds

Many charities have found themselves in a financially precarious position since the pandemic and government-imposed restrictions started. Trustees have become very concerned about their financial position and, in the first instance, trustees will need to consider what the charity's short-, medium- and longer-term priorities are in order to see if their financial planning needs to change.

Since March 2020, the impact of Covid-19 has been very much 'up and down'. Non-essential businesses have been forced to close, then open (with restrictions), then close again. Some charities have simply remained closed since the first lockdown given the burdens involved in becoming Covid-19-compliant. Charities have also faced significant disruption as they have been unable to carry out certain fundraising activities due to the lockdown rules and ban on gatherings.

Trustees are encouraged to think about whether certain projects can be paused in order to focus on essential spending. Trustees must also identify which funds or assets have limits on their use. Certain funds (such as 'designated' funds) or funds which the charity has earmarked for a particular purpose may be re-prioritised.

Restricted funds can prove to be more difficult because of the restrictions imposed by the donor. Restricted funds cannot be spent at the discretion of the trustees – they may only be used for a particular and defined purpose.

If there are restrictions on funds, there could be ways around amending these restrictions. However, this should not be a decision taken lightly by the trustees. Accessing or releasing restricted funds should only be considered if other options, such as use of reserves, are not possible. In some cases, professional advice should be sought to ensure the trustees make the right decisions. The CCEW have confirmed in their guidance that they will be as helpful as possible in this respect, but it is always advisable to seek professional advice as well where restricted funds are concerned.

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In any event, all decisions on financial matters should normally be taken collectively. Significant decisions and action points must be recorded in writing.

1.6 Insolvency assistance for charitable companies and CIOs

New provisions have been included in the Corporate Insolvency and Governance Act 2020 which help businesses to continue operating and avoid insolvency during the Covid-19 crisis. These new provisions also apply to charitable companies with the majority of the provisions also applying to CIOs.

The provisions cover the following:

- Moratoriums, offering companies and CIOs breathing space from debt enforcement action so they have the chance to explore options for rescue or restructure.

- Limitation termination clauses in supply contracts, to provide for continuity of supplies so companies and CIOs can carry on operating.

- Temporary suspension of wrongful trading provisions, allowing company directors and trustees of CIOs to continue operating a charity through the emergency without the threat of personal liability. These provisions, which applied between 1 March and 30 September 2020, have been reinstated, so that it won't be possible to bring wrongful trading claims in relation to losses caused by trading between 26 November 2020 and 30 April 2021. Again, there is the possibility that the 30 April 2021 deadline may be extended depending on the Government's plan in tackling Covid-19 going forward.

- Temporary suspension of the use of statutory demands and a restriction on winding-up petitions, where a company or CIO cannot pay its bills due to the Covid-19 emergency. These provisions currently apply until 30 March 2021 (but could be extended depending on the Government's plan).

- Support for viable companies struggling with debt to restructure under a new procedure – these procedures do not apply to CIOs.

1.7 Trading subsidiaries – financial support from charitable parents

Trading subsidiaries of charitable parents can be a vital source of income for the charitable parent (e.g. through the 'gifting' of profits up to the charitable parent via the gift aid scheme). For many trading subsidiaries, the impact of Covid-19 has been serious. In some cases, the trading subsidiary may no longer be financially viable and the charity trustees will need to decide if their charity can temporarily support the subsidiary to assist through these difficult economic times. Trading subsidiaries could look at the various loan schemes in place to see if they may be able to take advantage of those (e.g. the Coronavirus Business Interruption Loan Scheme or the Bounce Back Loan Scheme).

Trustees must keep in mind that they have a duty to put the interests of their charity first and to carefully consider whether financial support of the trading subsidiary can be justified as an investment.

Before deciding to make an investment in a trading subsidiary, the trustees must consider whether there is a likelihood that the trading subsidiary will become profitable within a reasonable timescale and that it can sustain the loss of income in the meantime. The objective here is for the trustees to form a conclusion as to whether, or not, a cash injection from the charitable parent is justified to manage cash flow. Other options available to trustees are deferment of loan or rent payments. Trustees must also be satisfied that the charity can afford to provide the support and that its assets will not be placed at undue risk. To this end, it is important to advise trustees to ensure that any decisions made in this regard are carefully documented.

Where support for a trading subsidiary cannot be justified, other options may include:

- restructuring the subsidiary;
- redesigning its purpose, role and activities; or
- closure.

In most cases, trustees won't need to contact the CCEW concerning this decision. However, they will need to carefully consider the immediate and long-term situation, the charity's finances and the likely future prospects for the subsidiary.

Professional advice will also invariably need to be sought by trustees. Trustees must also have regard to the CCEW decision-making guidance (*It's your decision: charity trustees and decision making* (CC27)) and keep a record of how the trustees have made their decision and that the annual report and return provides clear and transparent information concerning any support for the subsidiary.

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2 UK GAAP update (Lecture A731 – 10.17 minutes)

2.1 EU-exit amendments

In December 2020, the Financial Reporting Council (FRC) issued *Amendments to UK and Republic of Ireland accounting standards – UK exit from the European Union.* The amendments update UK GAAP to reflect changes in company law arising from Brexit which came into effect at 11pm on 31 December 2020.

The amendments are limited to those which are necessary to ensure consistency with company law and generally update legal references and terminology used in the standards (for example, changing references to 'EU-adopted IFRS' to 'adopted IFRS').

The amendments are not expected to have any significant impact on entities which apply UK GAAP in the preparation of their financial statements. For entities that prepare their financial statements under FRS 101 *Reduced Disclosure Framework*, all extant EU-adopted as at 31 December 2020 has been transposed into UK company law as at that date. For accounting periods commencing on or after 1 January 2021, UK adopted IFRS will apply. Transitional provisions will apply where the accounting period spans 1 January 2021 as illustrated in the following example:

Example – FRS 101 reporter whose reporting date spans 1 January 2021

Sunnie Ltd prepares its financial statements under FRS 101 (it is a subsidiary that applies IFRS in the preparation of its financial statements) but is registered in the UK and hence prepares Companies Act accounts.

Sunnie has an accounting reference date of 31 March.

The financial statements for the year ending 31 March 2021 will be prepared using EU-adopted IFRS as this financial year starts on 1 April 2020.

The financial statements for the year ending 31 March 2022 will be prepared using UK-adopted IFRS as this financial year starts on 1 April 2021 (ie the year starts on/after 1 January 2021).

2.2 IBOR Phase 2

In December 2020, the FRC also issued *Amendments to FRS 102 – Interest rate benchmark reform (Phase 2).* IBOR Phase 1 amendments were issued by the FRC in December 2019.

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These second round of amendments cater for financial reporting issues that have arisen because of the interest rate benchmark reform (Inter-bank Offering Rate (IBOR) is being phased out by the end of 2021). The amendments to FRS 102 aim to simplify the accounting requirements and provide disclosure of the nature and extent of the risks arising, hence minimising reporting costs for entities applying FRS 102 thus enabling them to provide useful information to the users of the accounts.

It is expected that these amendments will largely affect entities that apply hedge accounting under FRS 102. In practice, it appears uncommon for many entities which prepare their financial statements under UK GAAP to apply hedge accounting.

The issues concerning IBOR are contained in a specialist webinar provided by Mercia and hence are not discussed further in this session.

The amendments in respect of IBOR Phase 2 are effective for accounting periods commencing on or after 1 January 2021. Early application is permitted.

2.3 UK Endorsement Board

In January 2021, the FRC announced that the UK Endorsement Board (UKEB) had launched their website (www.endorsement-board.uk). The UKEB will be responsible for influencing the development, and subsequent endorsing and adopting, new or amended international accounting standards which are issued by the International Accounting Standards Board for use by UK companies. This will take effect from 1 January 2021 following Brexit. EU-adopted IFRS can no longer be used in the UK for accounting periods commencing on or after 1 January 2021.

The UKEB's website will provide access to all key developments relating to its work, including:

- UK-adopted international accounting standards
- UKEB adoption status report
- UKEB appointments and meetings agendas and minutes, etc
- The UKEB work plan

A review of the UKEB's website indicates the following adoption projects:

UKEB work plan – adoption projects	Issued / Effective
Major – endorsement and adoption project IFRS 17 *Insurance Contracts*	May 2017

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Amendments to IFRS 17	June 2020
Narrow-scope amendments – endorsement and adoption project	
Annual Improvements to IFRS 2018-2020	May 2020 – Effective 1 January 2022
Onerous Contracts – Costs of Fulfilling a Contract (Amendments to IAS 37)	May 2020 – Effective 1 January 2022
Property, Plant and Equipment: Proceeds before Intended Use (Amendments to IAS 16)	May 2020 – Effective 1 January 2022
Reference to the Conceptual Framework (Amendments to IFRS 3)	May 2020 – Effective 1 January 2022
Classification of Liabilities as Current or Non-Current (Amendments to IAS 1)	January 2020 – Effective 1 January 2023
Accounting Policies and Accounting Estimates (Amendments to IAS 8)	Expected February 2021 – Effective date is expected to be 1 January 2023
Disclosure Initiative – Accounting Policies (Amendments to IAS 1)	Amendment expected February 2021 – Effective date expected 1 January 2023
Deferred Tax Related to Assets and Liabilities Arising from a Single Transaction (Amendments to IAS 12)	Amendment expected Q2/2021 – Effective date expected 1 January 2023

It is not expected that the means by which UK GAAP is maintained will change. The UKEB's remit will only be in respect of UK-adopted IFRS. UK GAAP will continue to be maintained by the FRC and the same protocol will continue to be followed in respect of any planned amendments, for example Discussion Papers, Exposure Drafts and such like.

2.4 New editions of UK GAAP expected

Given the changes that have arisen to UK GAAP since the triennial review in 2018, the FRC have said that they may issue new editions of FRSs 100 to 105 in the Spring of 2021. These new editions will consolidate all changes made to UK GAAP since 2018 as currently all amendments are included on the FRC's website which can make accessing the standards quite difficult – especially given the number of amendments that have taken place.

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3 Companies House reforms (Lecture A733 – 22.26 minutes)

On 9 December 2020, the Government launched three consultations in respect of Companies House and the register of companies. These consultations aim to support reforms to clamp down on fraud and give businesses greater confidence in transactions.

This part of the course will examine some of the most notable aspects of the reforms.

Many practitioners have complained about the information lodged at Companies House and the way in which the organisation handles various information/requests. These reforms aim to improve the service stakeholders will receive as well as ensuring that the information in the public domain will be credible.

Under the proposals, directors will not be able to be appointed until their identity has been verified and the registrar's powers will be increased so that they can query, investigate and remove false or inaccurate information. The proposals aim to crack down on fraud and money laundering and provide businesses with increased confidence.

The three consultations are in respect of:

- Improving the quality and value of financial information on the UK companies register
- Powers of the registrar
- Implementing the ban on corporate directors

Comments on the proposals closed on 3 February 2021. As and when these proposals are developed, further updates will be provided.

3.1 Improving the quality and value of financial information

The first consultation sets out planned reforms of Companies House to ensure that it is fit for the future and continues to make a valuable contribution to the UK's business environment. These reforms will give Companies House a more effective role in assisting the government's wider efforts to tackle economic crime by improving the integrity of the information made publicly available about companies and other business entities.

This consultation sets out proposals under three themes:

- How information is submitted to Companies House
- What information should be filed at Companies House
- What Companies House does with this information

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Part A of the consultation focuses on how information is delivered to Companies House. It proposes to require financial statements to be delivered digitally and to introduce full tagging of accounts. It also seeks views on reducing the filing deadline for accounts. The proposed filing deadline reduction is an issue that is expected to be of interest to many practitioners.

The approach that is proposed by the Government is a 'file once with government' approach. This approach aims to reduce the burdens on companies and increase the efficiency and effectiveness of government agencies in regulating, monitoring and preventing fraudulent activity. Suggestions on the 'file once with government' approach include adopting a centralised accounts submission standard which would ensure that all government bodies receive identical information through the use of one portal. The consultation also looks at certain options that may include:

- enabling companies to file their accounts in one central place and for all government bodies to extract the information they need from that central source; or
- developing technology that would send the relevant information to each government organisation at the relevant time.

Digital filing

Section 2 of Part A focuses on mandating digital filing of the financial statements. The consultation acknowledges that requiring all financial information to be delivered in a digital format is a critical step towards companies being able to file their financial information once across government and is also important in ensuring proposals referenced elsewhere in the consultation can be achieved.

Companies House confirmed that in 2019/20 they received just under 7,000kg of paper each month. The consultation therefore acknowledges that digital filing will reduce the volume of paper used by both Companies House and the preparer. As entities' 'carbon footprints' move up the ranks of importance, it is expected that this will be given prominence.

Tagging of financial information

Fully tagged financial reporting in iXBRL format has been mandatory for filing accounts with HMRC since 2016. The consultation proposes to mandate financial information to be fully tagged for filing at Companies House and states that this is an important first step towards any future plans for companies to be able to file once with government.

Companies House also plan to validate more tags than it currently does which means that more checks will be performed on financial statements when they are filed. The consultation proposes that if they do not meet the required standard, the accounts will be rejected and the checks carried out will be aligned as far as possible with HMRC.

Reducing the filing deadline

As noted above, for practitioners, this is probably one of the most controversial aspects of the consultation.

The consultation acknowledges that most companies file their accounts digitally anyway and, in future, Companies House wants all companies to file digitally. In light of this, Companies House are proposing to reduce the filing deadline. At the present time, due to Covid-19, filing deadlines have been temporarily increased up until 5 April 2021 but in a non-Covid-19 environment the filing deadline for public companies is six months from the reporting date and for private companies is nine months from the reporting date.

A penalty regime is in place for companies that miss their filing deadline and the penalty is doubled if the filing deadline is missed again in the next year. It is expected that this penalty regime will remain in place.

Suggestions to reduce the filing deadline ranged from three to six months from the end of the reporting period. The consultation was seeking views on shortening the time allowed to submit accounts to Companies House – in particular it wanted views on what the impact would be if the filing deadline were shortened to three months for public companies and six months for private companies from the end of the reporting year.

We expect there to be mixed views on this, but it would enable more timely information to be submitted to Companies House as the accounts would have been prepared three months earlier than they may otherwise have been. Preparing accounts for the company earlier may also be beneficial to the company itself.

What is to be filed at Companies House?

Part B of the consultation asks whether further information may improve the value of the register. The government proposes that company directors should confirm the company's eligibility to file certain types of accounts and is seeking views on revising the small company accounts filing options as this appears to be causing confusion among preparers.

The consultation acknowledges that the company directors are ultimately responsible for ensuring the financial information lodged at Companies House gives a true and fair view of the financial position of the entity (although currently for small entities filing 'filleted' or 'filleted abridged' accounts (see **3.6** below), these types of accounts are not aimed at giving a true and fair view so there is a disconnect with the true and fair concept in this regard). The government therefore proposes to implement a requirement for accounts to include a declaration of eligibility which is signed by the director(s).

This declaration will require all three threshold conditions (turnover, balance sheet total and employee numbers) to be disclosed by all companies (although the government are

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still considering whether these thresholds disclosed in the company's declaration should be made available on the public register and they were seeking views on the publication of this information). The director(s) will also confirm that the company meets the threshold conditions to file under the filing regime adopted.

In the case of dormant accounts, the declaration will include confirmation that the company is not trading and meets the criteria to file dormant accounts (i.e. it has no significant accounting transactions).

The proposal is that the declaration need only be signed by one director. However, all directors will be liable in the case of a false statement. Sanctions for false declarations may include fines and/or criminal sanctions or director disqualification. It should be noted that the registrar's powers are also being increased within the consultations and these proposals are examined in **3.2** below. However, there will no longer be an obligation on the part of the registrar to accept documents that, on the face of it, *appear* to be compliant with the requirements of the law.

Companies House plan to introduce validation checks to ensure the threshold conditions match the requirements for the filing regime used.

It would appear, therefore, that the proposals mean that more checks will be being carried out at Companies House. Many accountants will welcome this as there are frequent complaints about how Companies House merely 'accept anything that is lodged with them'.

Small companies filing options

Since the abolition of the 'abbreviated accounts' regime in 2015, small companies have had some degree of flexibility afforded to them in terms of what they can currently file at Companies House. They can file the full accounts, 'filleted' accounts or 'filleted abridged' accounts. The two most commonly filed accounts for companies at the smaller end of the scale are filleted and filleted abridged accounts because these contain the minimum amount of information required for Companies House purposes. In practice, most directors wish to place the least amount of information on the public record as possible and so filleted abridged accounts have, to some extent, met that requirement. Do keep in mind that there is strict protocol in company law that has to be followed before abridged accounts are prepared in the form of an annual agreement by **all** shareholders for the company to prepare abridged accounts and a statement on the face of the balance sheet that all the members have consented to abridged accounts being drawn up.

Many respondents to previous consultations have argued that the information lodged by companies at the smaller end of the scale, including micro-entities, provides little value and have questioned whether it is right for a company to obtain limited liability protection while providing such minimum financial information. Some respondents have

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argued that all companies should file a profit and loss account. This will probably not bode well with many directors of small entities and their advisers.

There have also been suggestions that as more detailed financial information is supplied by small entities to HMRC and banks, that same level of information should also be made available on the public register. This could generate a lot of debate because, of course, information supplied to the bank or HMRC is not publicly available and never has been.

Since its introduction, the micro-entities regime has been taken up by many micro-entities, especially since the introduction of FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* in 2015. The information on the register for micro-entities is very limited (as micro-entity financial statements contain little in the way of information). The consultation suggests that the level of information provided in a micro-entity's financial statements lodged with Companies House potentially deters lenders and credit agencies from agreeing finance for companies that file such accounts. The consultation confirms that a study published by Cardiff University concludes that *'… there is systemic evidence that the credit scorer penalises companies which file micro-entity abbreviated accounts.'*[1] This will clearly be a concern for most micro-entities.

Companies House have also stated that they have evidence that the micro-entities regime introduced in 2013 is not being applied correctly. Some entities are reporting as a micro-entity when they are not entitled to do so. Companies House suggest that this may be because companies do not understand the eligibility criteria or are confused by the range of filing options available. In addition, Companies House also suggest that fraud investigation bodies have reported that micro-entity accounts are often used by companies that are investigated in money laundering cases.

The government is therefore proposing to review the filing options that are made available for small entities with a view to reducing the number of options and making the filing process easier while, at the same time, increasing the value of the register. This may prove to be a welcome move by many in the accountancy profession given that there was widespread criticism of the abolition of the abbreviated accounts regime, which appeared to be working fine before it was abolished.

3.2 Powers of the registrar

This second consultation also relates to the government's proposals to reform Companies House to help combat economic crime and make the register more useful. One of the proposals includes reforming the powers of the Registrar of Companies ('the registrar').

[1] See http://orca.cf.ac.uk/111660/3/PEELABRPAPER.pdf

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The consultation introduces the proposals by confirming they are looking at amending the registrar's powers so that the registrar is no longer obliged to accept documents where there is a reason to query any information contained in them. The proposal cites an example of where the registrar has reason to believe that the use of a registered office may be fraudulent.

The proposals in respect of the registrar's powers are set out in three chapters:

- **Chapter 1** *Introducing a new power to query information*
- **Chapter 2** *Reform of the registrar's existing powers*
- **Chapter 3** *Rules governing company registers*

This consultation closed on 3 February 2021 and, as above, any developments in this area will be covered as they arise.

Introducing a new power to query information

Respondents to the 2019 consultation agreed that Companies House should have more discretion to query information before placing it on the register, and to ask for evidence where it is considered appropriate.

To this end, the government have adopted two basic assumptions:

- the registrar should have the power to query any information supplied, and any information held on the register; and
- that it would be disproportionate to propose that the registrar queries every error, anomaly or inaccuracy that is brought to their attention.

The government intends to provide the registrar with querying power using a risk-based approach. This is on the basis of the sheer amount of information held and the fact that it would not be possible for the registrar to act on every error, inaccuracy or anomaly and it would be inappropriate to expect that.

The general principle proposed is that the registrar will use their querying power where they identify an error, inaccuracy or an anomaly which appears to be fraudulent, suspicious or may impact significantly on the integrity of the register and the UK's business environment.

The government suggests that the use of a risk-based approach will ensure that resources are used in an efficient, targeted and proportionate way. Information which Companies House generates or receives will be assessed and those cases which, in the registrar's view, present the biggest risks to the integrity of the register and the quality of information it holds will be prioritised.

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The consultation clarifies that this risk-based approach will not just be confined to errors, anomalies or inaccuracies; rather, it will also include circumstances where there is evidence that the information on the register (or submitted to the registrar) may pose a risk to the UK's reputation as a good place to do business, including the facilitation of crime.

The consultation provides the following example:

> Information is received about two companies, 'A' and 'B', that suggests that both of their records contain inaccurate information. The registrar has received other information about company A that suggests it may be being used to commit fraud, and that this crime is being facilitated by the inaccurate information. There is no other information available about company B to use in a prioritisation decision. In this case, priority will be given to raising a query with company A because (a) there may be inaccurate information on its record and (b) there is evidence that this inaccurate information may lead to public harm.

There are a number of sources which may help Companies House inform querying decisions, including:

- The registrar's own knowledge, including information and intelligence derived from proactive analysis by Companies House to identify anomalies, patterns and trends in information.
- Anomalous information submitted to Companies House, such as those submitted under duties set out in the Fifth Money Laundering Directive.
- Information supplies by others including law enforcement, government partners and civil society.
- Data derived from data sharing with other government departments and agencies.
- Monitoring of current affairs.
- Information supplied via direct customer contact with Companies House.

Inevitably, if the registrar raises a query, they will receive additional evidence to satisfy that query. The consultation proposes that this evidence will not be published on the public register but will be held securely and stored by Companies House in line with relevant data protection legislation. However, information may be made available in certain circumstances to law enforcement and other bodies through appropriate data gateways. Such sharing of data will be done in accordance with these gateways and with the relevant data protection legislation.

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Reforming the registrar's existing powers

At the present time, the registrar has the power to remove only limited categories of information from the register. Generally, this relates to officer appointments for which there is a formal process which the registrar must follow before information can be removed. The registrar cannot, however, remove false information about people with significant control and this requires the individual to seek a court order for its removal, which can prove arduous. This narrow-scope power creates a lot of complaints from stakeholders, including members of the public.

The government proposes to extend the registrar's powers so they cover any non-legal effect document and some legal-effect filings. The process to be followed before information is removed should be reviewed and updated in order to make it more responsive to individual circumstances. The government is therefore seeking views on whether the registrar should have greater powers to remove information together with suggestions for other approaches they could take.

Registered office address

The registrar can, on application, change a company's registered office address to a default address. There have been instances where a company then reverts to the previous address and current restrictions prevent the registrar from tackling such abuse (even though this sort of abuse is not considered to be widespread). The government proposes to allow the registrar to ask for appropriate evidence when a company subsequently seeks to change its registered office.

In addition, the registrar currently has no power to change an address to the default address without an application (even if the address supplied by the company does not exist). The government proposes to provide the registrar with the power to move a company to the default address where there is evidence that to do so is proportionate and appropriate. There is also a proposal for a 12-month timescale for which a company can remain at the Companies House default address. The government are also considering making it a criminal offence if a company (or other entity) remains at the Companies House default address for longer than 12 months (punishable by imprisonment and/or a fine, a civil penalty, or both).

Removal of director's details

Sometimes directors have been appointed to companies fraudulently and the individuals have applied to Companies House to have their details removed – only to find that the offending company re-appoints them. The government intends to close this loophole so that if the company attempts to re-appoint the individual, the company will need to provide evidence that the person has consented to act in that capacity. This is also an example of a circumstance in which the registrar may share information with law enforcement.

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Speeding up processes

The registrar's current powers were created at a time when paper filing was primarily the only means by which information could be lodged at Companies House. At present, a company is given 28 days to raise an objection or provide evidence concerning an application for the removal of information. Stakeholders suggest this timescale is now too long given that most documents are filed electronically and an individual's details may still remain in the public domain until the 28-day timescale has elapsed. The government therefore proposes to reduce this to 14 days in light of the fact that most information is now provided electronically.

Delivery by electronic means

S1068 of Companies Act 2006 *Registrar's requirements as to form, authentication and manner of delivery* enables the registrar to require delivery of some specific documents by electronic means only. The power to require documents to be delivered electronically only rests with the secretary of state and section 1069 of Companies Act 2006 requires them to make regulations to enact the power.

The government intends to transfer the power to mandate electronic filing from the secretary of state to the registrar as currently the secretary of state is the only person that can draw up the relevant regulations. It is hoped that this change will lead to a proportionate approach in dealing with electronic filing and also recognises the fact that the registrar's role is evolving due to emerging trends.

Rules governing company registers

Companies are legally required to keep and maintain their own records of certain categories of information. For example:

- Register of directors
- Register of members
- Register of secretaries
- Register of People with Significant Control (PSC register)
- Register of directors' usual residential addresses
- Register of charges (only those created prior to 6 April 2013)

Company law requires information to be entered into these registers within a set timeframe and then file a notification of a change at Companies House.

As noted in **3** above, under the reforms, it is proposed that a director becomes a director in law only once their identity has been verified and their information has been added

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on the register. This will have an impact on the practicability of a company maintaining its own statutory register. If the reforms are actioned as proposed, then the 'flow-through' of the legislation (i.e. appointment as a director, entry into the company register and subsequent notification to Companies House) will be broken. This will lead to discrepancies between the company register and the information held at Companies House which could end up being widespread and this is an issue the government do not want to result.

The government therefore intends to remove the requirement for companies to maintain a register of directors. Not only will this save a burden on the company, but it will also prevent discrepancies between the register of directors and Companies House from arising.

The register of directors can currently be inspected by members of the company (free of charge) or by the public (for a fee). The government are considering the impact on members' rights to inspect information within the register of directors in the development of their proposals. The government will also consider their approach to information which is included in the register of directors but is not on the public record.

The government were also interested in receiving views on the requirement to keep:

- Register of secretaries
- Register of directors' usual addresses
- Register of members
- Register of People with Significant Control
- Register of charges

3.3 Implementing the ban on corporate directors

The ban on corporate directors is not anything 'new' as provisions were put in place in the Small Business, Enterprise and Employment Act 2015 (SBEEA 2015). The SBEEA 2015 made provisions for a transitional phase of 12 months (on commencement of the provisions) to enable companies to achieve compliance. However, these provisions have yet to be implemented and the government have suggested that this should be done in conjunction with the Corporate Transparency and Register Reform.

The closing date for comments was 3 February 2021.

In July 2013, the government asked for views on measures they could implement to ensure they know who really owns and controls companies in the UK. One of the proposals was that all company directors should be natural persons. Currently, the law only requires one director on the board to be a natural person and any number can be corporate directors (companies or other types of legal entity).

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The government is uncomfortable with having corporate directors in place and wanted to consider whether UK companies should be prohibited from appointing corporate directors to the board. This is the case in other countries such as Germany and the US.

One of the government's main concerns is that the use of corporate directors can 'muddy' the waters around ownership. In addition, there are also concerns that the use of corporate directors can provide a 'screen' behind which illicit activity can be conducted.

Of course, not every company that has a corporate director appointed will be committing illegal activity and it would be wrong to suggest that is the case. However, there are some entities that do manipulate the use of corporate directors which can prevent individual accountability.

Conversely, the government also acknowledge that there are legitimate uses for corporate directors within corporate governance arrangements. The Consultation Document cites an example of appointing a corporate director of a subsidiary in order to be able to have a number of individuals of varying professions representing that directorship in the boardroom, according to the agenda under discussion. It also suggests that corporate directors can be used as a means of facilitating joint ventures or reducing administrative costs.

The SBEEA 2015 does provide the scope for the government to define exceptions to the ban on corporate directors. This would allow companies, in prescribed circumstances, to continue to appoint corporate directors.

Companies that could be exempt from the ban on corporate directors

In 2014, the previous Department for Business, Innovation and Skills (BIS) carried out an initial consultation and identified certain entities that could potentially be exempt from the ban on corporate directors as follows:

Type of company	Why they should be exempt from the ban
Companies with shares admitted to trade on a regulated and prescribed market.	Respondents supported an exemption for these types of entities on the basis that they are subject to high standards of transparency in order to trade on these markets. Respondents also argued that the exception should also apply to subsidiaries, including where the listed company only holds a minority interest.
Large public companies in group structures and large private companies in	Mixed views were received in this respect. Many respondents suggested that neither

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group structures.	of these characteristics implied greater transparency. Respondents did highlight the administrative benefit of using corporate directors in these structures (e.g. reducing registering of new directors' details at Companies House each time the relevant post in the parent company was changed).
Charitable companies.	Most respondents highlighted additional benefits of corporate directors to charities. This included facilitating joint ventures between charities and enabling multiple experts to sit on the board within a single corporate director role. Questions were raised about the transparency requirements on charities and proposed that an exception would only be justified after approval by the charities regulator.
Trustee companies of pension funds.	All respondents supported an exception for these types of entity. Respondents cited the benefits of using corporate directors on pension funds to reduce administrative costs and reducing liability exposure for experts that provide advice to pension funds and employer involvement in the funds.

Proposed plans

As a starting point, the government is proposing to create a principles-based exception alongside the ban on corporate directors. The principles suggested are that a company can be appointed as a director, if:

- all of its directors are, in turn, natural persons; and
- those natural person directors are, prior to the corporate director appointment, subject to the Companies House identity verification process.

The government are also considering the range of corporate entities which may be permitted to be in scope of the exception. They do not want the range of corporate entities eligible for the exception to be so wide that it undermines the purposes of the general prohibition. As part of the wider reforms, the government are planning to

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introduce ID verification for general partners of limited partnerships and for 'designated members' of LLPs. The government suggest that this may be an appropriate basis for permitting appointments where the corporate director is one or other of those partnership forms.

In respect of overseas entities, the starting point would be to enable constructive cross-border relationships where appropriate. ID verification is expected to deliver a marked improvement in terms of transparency. Hence, the government proposes not to differentiate between corporate directors by reference to their place of origin to enable UK and overseas entities to be subject to the same treatment.

Compliance and reporting

The Consultation Document suggests that the regulations will be structured in such a way that they will safeguard the integrity of the natural person principle from the perspective of the potential appointor company and the appointee at least insofar as both are UK registered companies. The Consultation Document provides an example as follows:

> If UK Company C appoints UK Company D as director, any attempt by D to appoint a corporate director would be unlawful and, therefore, ineffective. This works both up and down the chain of directorships: C cannot validly be appointed as another UK company's director while it has D as its director.
>
> As a further safeguard, and to cater for relationships involving non-UK companies, the government envisages overlaying a requirement for Company C to take all reasonable steps to assure itself that D has (and continues to have) no corporate directors. In its annual confirmation statement to Companies House, Company C must confirm that it believes this to be the position.

Section 167 of the Companies Act 2006 also requires the company to notify Companies House of any changes to its directors. Provision is made in the Act for companies to notify the registrar when a director ceases to be a director at the end of the transitional period because it does not meet the conditions for remaining as a director. The existing offences of s167 will continue to apply in this respect.

The government's impact assessment suggests that around 33,000 companies currently have a corporate director on their board but that at least two-thirds of those companies would be compliant with the principles-based approach that has been suggested.

In addition, the provisions of SBEEA 2015 apply to companies incorporated under the Companies Act 2006. The government is, however, thinking about applying the principles of this consultation to other forms (limited partnerships and limited liability partnerships). Hence, where either a general partner or designated member is another

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corporate entity, they ought also to comprise all natural person directors who will be required to undertake ID verification.

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4 Intangible assets: Problem areas (Lecture A734 – 23.54 minutes)

Intangible assets (including the concept of goodwill) can prove to be complex issues to account for. FRS 102 *The Financial Reporting Standard appliable in the UK and Republic of Ireland* deals with intangible assets in Section 18 *Intangible Assets other than Goodwill*. Goodwill is dealt with in FRS 102, Section 19 *Business Combinations and Goodwill*.

An 'intangible asset' is defined as:

> *An identifiable non-monetary asset without physical substance. Such an* ***asset*** *is identifiable when:*
>
> *(a) it 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****; or*
>
> *(b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.*

FRS 102 Glossary ***intangible asset***

The Glossary to FRS 102 refers to intangible assets being 'identifiable' and 'separable'. The two terms are inter-related in that identifiability is achieved when it is:

- separable; or
- arises from contractual or other legal rights.

Separability

An asset is said to be separable if it is capable of being disposed of by the entity. Alternatively, an asset is also separable if the benefits attached to the asset can be transferred to another entity – for example, through a leasing agreement. In other words, the asset is capable of being extracted from the business on its own without having to dispose of the underlying business to which it relates. This means that the asset is also capable of being distinguished from goodwill.

An important point to note where separability is concerned is that the requirement is not that the entity has to have the *intention* of selling or leasing the asset to a third party. The test is whether the entity has the option to do so if it wished.

Contractual or legal rights

Contractual or legal rights is the other criterion mentioned in the definition of an intangible asset according to the Glossary. For example, a legal right could arise where a taxi business is concerned. In the UK, a taxi cab cannot be operated without a licence issued by the relevant authority. The licence, therefore, will give rise to future economic

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benefits which are identifiable (as the taxi business will be able to generate revenues from taxi fares once it has the licence to operate). In contrast to the separability test, the taxi licence may not be separable since it is unlikely that the taxi licence could be sold without having to dispose of the underlying business to which it relates.

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At the outset it is important that preparers clearly understand the definition of an intangible asset in order to ensure that such assets are recognised correctly in accordance with the standard. Keep in mind that intangible assets can often be subjective, so care needs to be taken to ensure they are recognised on the balance sheet appropriately and in accordance with the applicable financial reporting framework.

4.1 Internally generated intangible assets

Sometimes an entity may embark on a project to develop an intangible asset (for example, computer software or a website). Care needs to be taken in this respect because whether expenditure qualifies for recognition on the balance sheet as an intangible asset will depend on:

- the stage in the project at which the expenditure was incurred; and
- whether the recognition criteria in the applicable financial reporting framework can be met.

It should be emphasised that micro-entities choosing to report under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* must write all expenditure incurred in developing an internally generated intangible asset off to the profit and loss account. There is no option available under FRS 105 to capitalise costs such as development costs. If the micro-entity wishes to have this option, they must transition to FRS 102.

FRS 102, para 18.8A requires an entity that has embarked on an internal project to develop an internally generated intangible asset to classify expenditure incurred in the generation of the asset into two phases:

- the research phase; and
- the development phase.

In practice, deciding on whether expenditure has been incurred in the research or the development phase can often be unclear, particularly if the entity has not kept a sufficient track of the expenditure and the stage in the development at which it has been incurred. When the entity is unable to distinguish expenditure between the research or the development phase FRS 102, para 18.8B requires the expenditure on the project to be treated as if it had arisen in the research phase, hence it is written off to profit or loss as incurred (see below).

In addition, FRS 102 precludes certain types of expenditure from being capitalised as follows:

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(a) *Internally generated brands, logos, publishing titles, customer lists and items similar in substance.*

FRS 102 para 18.8C

(b) *Start-up activities (ie start-up costs), which include establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie pre-opening costs) and expenditure for starting new operations or launching new products or processes (ie pre-opening costs).*

(c) *Training activities.*

(d) *Advertising and promotional activities (unless it meets the definition of* ***inventories held for distribution at no or nominal consideration*** *(see paragraph 13.4A)).*

(e) *Relocating or reorganising part or all of an entity.*

(f) *Internally generated goodwill.*

Research expenditure

All research expenditure is written off to profit or loss as incurred. This is because in the research phase of an internal project, the entity is unable to demonstrate that an intangible asset will exist that will generate economic benefits for the entity.

FRS 102, para 18.8G provides some useful examples of what it considers to be expenditure incurred in the research phase of an internal project as follows:

(a) *Activities aimed at obtaining new knowledge.*

FRS 102, para 18.8G

(b) *The search for, evaluation and final selection of, applications of research findings and other knowledge.*

(c) *The search for alternatives for materials, devices, products, processes, systems or services.*

(d) *The formulation, design, evaluation and final selection of possible alternatives for new or improved material, devices, projects, processes, systems or services.*

Development expenditure

FRS 102 provides an accounting policy choice for entities in respect of development expenditure (unlike IAS 38 *Intangible Assets* which requires all development costs to be capitalised once the recognition criteria are met). Under FRS 102, Section 18, an entity can either write off development costs to profit or loss as they are incurred, or they can be capitalised as an intangible asset. Whichever accounting policy choice is selected by the entity, it is important that it is consistently applied.

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Strict criteria have to be met before expenditure on an internal project can qualify to be treated as development costs. FRS 102, para 18.8H states that an entity can capitalise development expenditure if, and only if, an entity can demonstrate **all** of the following:

FRS 102, para 18.8H

(a) The technical feasibility of completing the intangible asset so that it will be available or use or sale.

(b) Its intention to complete the intangible asset and use or sell it.

(c) Its ability to use or sell the intangible asset.

(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Where an entity incurs a significant amount of development costs, they will need to be able to clearly demonstrate that they can meet all of the above. Difficulties can arise where systems are unable to correctly distinguish expenditure between research and development and there is a higher risk that costs can be capitalised incorrectly or written off to profit or loss incorrectly.

Example – Research and development expenditure

Dexter Ltd started developing a new drug for dogs aimed at managing certain illnesses without the use of aggressive drugs. This project commenced on 6 January 2020. During the year to 31 December 2020, Dexter spent £2m on researching and developing the new drug and this has been recognised as an intangible asset on the company's balance sheet. A breakdown of this expenditure is as follows:

	£m
Research into ingredients and product materials	0.5
Market research	0.2
Training activities for staff	0.4
Development activities	0.9

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	2.0

The company reports under full FRS 102 and has an accounting policy choice of capitalising all development expenditure.

The production director has produced a schedule of activity of this project which confirms that market research indicated on 1 August 2020 that the product was likely to be profitable and cash flows were able to be produced. Development expenditure started to be incurred at the start of April 2020. At the reporting date the product's development had not been completed.

The question has arisen as to whether the full £2m qualifies for capitalisation on the balance sheet as development expenditure or whether this is overstated resulting in expenditure in profit or loss being understated.

Solution

Expenditure on research activities (including market research and employee training) do not qualify for recognition as an intangible asset and hence must be written off to profit or loss.

In relation to development costs, £0.4m (£0.9m x 4 months / 9 months) was incurred before the drug was known to be commercially viable (the commercially viable test was passed on 1 August 2020). Hence, the expenditure from 1 April 2020 to 31 July 2020 (4 months) needs to be written off to profit or loss as this would be classed as research expenditure.

Therefore, of the £2m costs incurred, £1.5m (£0.5m + £0.2m + £0.4m + £0.4m) must be written off to profit or loss. The intangible asset recognised on the balance sheet as at 31 December 2020 will be £0.5m. There will be no amortisation charge recognised in respect of these capitalised costs because the development process had not been completed.

There are many pitfalls that can be fallen into where research and development is concerned and it's important that preparers fully understand the requirements when an entity has a policy of capitalising development costs. The above example of Dexter Ltd highlights the importance of correctly identifying development activities because costs which did not qualify for recognition had been recognised within intangible assets, therefore causing intangible assets to be overstated and expenditure understated.

For auditors, the challenge will be ensuring correct capitalisation at an appropriate time (particularly where records are quite sparse). It has not been unknown for auditors to issue a modified audit opinion due to insufficient evidence concerning the capitalisation of development costs so this must be built into any audit risk assessment.

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To assist preparers with development costs, FRS 102, para 18.8J provides examples of what it considers to be development activities as follows (note the list below should not be viewed as being comprehensive):

(a) The design, construction and testing of pre-production or pre-use prototypes and models.

FRS 102 para 18.8J

(b) The design of tools, jigs, moulds and dies involving new technology.

(c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.

(d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

4.2 Initial recognition

Intangible assets are always initially recognised at cost (FRS 102, para 18.9). Elements of cost will all depend on how the intangible asset has been acquired in the first place. The table below determines the elements of the cost of an intangible asset depending on the circumstances in which it has been acquired:

Method of acquiring the intangible asset	Elements of cost
Separately acquired	• Purchase price, including import duties and non-refundable purchase taxes, net of trade discounts and rebates; and • Any directly attributable costs of preparing the asset for its intended use.
Internally generated	• The sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria. • This includes all directly attributable costs such as costs of materials and services, employee benefits, fees to register a legal right and the amortisation of patents and licences used to generate the intangible asset. • Eligible borrowing costs are dealt with under FRS 102, Section 25 *Borrowing Costs*.

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Acquired through a business combination	• Cost is the intangible asset's fair value at the date of acquisition.
Acquired via a grant	• Cost is the fair value at the date the grant is received or receivable. • For public benefit entities, FRS 102, Section 34 *Specialised Activities* will apply.
Exchanges of assets	• Cost is fair value unless the: – exchange transaction lacks commercial substance; or – fair value of neither the asset received nor the asset given up is reliably measurable. In such cases, cost is measured at the carrying amount of the asset given up.

Past expenditure written off to profit or loss

An important point to emphasise relates to past expenditure on an intangible asset that have been written off to profit or loss. FRS 102, para 18.17 prohibits these from being recognised at a subsequent date as part of the cost of the intangible asset.

4.3 Residual values

Residual values are used in the calculation of depreciable amount (i.e. cost less residual value equals depreciable amount). The depreciable amount of an asset is then written off on a systematic basis over the asset's useful economic life.

The Glossary to FRS 102 defines 'residual value (of an asset)' as:

> *The estimated amount that an entity would currently obtain from disposal of an* ***asset****, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its* ***useful life****.*

FRS 102 Glossary ***residual value (of an asset)***

The key points to be aware of where residual values and intangible assets are concerned is that FRS 102, para 18.23 assumes a residual value of £nil. In other words, the cost of the intangible asset will be written off over its useful life in its entirety. There are, however, two exceptions where a residual for an intangible asset may be appropriate:

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1. *there is a commitment by a third party to purchase the asset at the end of its useful life; or*

2. *there is an active market for the asset and:*

   (i) *residual value can be determined by reference to that market; and*

   (ii) *it is probable that such a market will exist at the end of the asset's useful life.*

FRS 102, para 18.23 (a) and (b)

In practice, residual values for intangible assets are rare. However, where they do exist, preparers must keep in mind the definition (cited above) says that it is the amount the entity would **currently** obtain from disposal of an asset, after deducting costs of disposal, if the asset were **already** of the age and condition expected at the end of its useful life. Therefore, residual values are based on current amounts (not historic values) and if there is any material change in the residual value for an intangible asset it will affect the current year's amortisation charge.

4.4 Amortisation

Confusion often surrounds the amortisation policy for an entity that has intangible assets on the balance sheet. FRS 102 does not specify an amortisation method but in practice the straight-line method is usually used.

Intangible assets are amortised on a systematic basis over their useful economic lives. FRS 102, para 18.19 states that the useful life of an intangible asset which arises from contractual or other legal rights must not exceed the period of the contractual or other legal rights (it can be shorter depending on the length of time the entity expects to use the asset).

FRS 102, para 18.20 places a 'cap' on amortisation of 10 years and it is important that this cap is only applied in very rare circumstances. This 10-year cap only applies when management are unable to assign a reliable useful economic life to the intangible asset. This is expected to be quite rare in practice as management should be able to reliably estimate the useful life of an intangible asset with reasonable certainty. However, if it cannot, then the amortisation period **cannot** exceed 10 years; it can be shorter but cannot be longer. Care needs to be taken to ensure a sound understanding of this requirement because it has been misinterpreted by many entities that think the maximum all intangible assets can be amortised over is 10 years.

Example – Intangible asset written off over 10 years

Morley Ltd acquired an intangible asset for £100,000 in respect of a REACH licence which it has capitalised on the balance sheet on 4 March 2019. This licence allows the

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company to manufacture a chemical known as E2371.

Morley has an accounting reference date of 31 January. In the financial statements for the year ended 31 January 2020 it amortised the cost of the licence over 10 years as the directors could not reliably measure the life of the licence as there are no restrictions in the licence as to how long the company is eligible to manufacture E2371.

In the board meeting on 6 January 2021, the production director informed the board that he received notification on 20 December 2020 that E2371 will be outlawed by the Government in five years time as it contains certain ingredients that will become illegal for use. The finance director has asked whether the company needs to retrospectively change the amortisation for the year ended 31 January 2020 or whether it can change the amortisation charge in 2021 to cater for the newly established useful economic life of the licence.

A change in amortisation method (or rate) is a change in accounting estimate according to FRS 102, Section 10 *Accounting Policies, Estimates and Errors*. A change in an accounting estimate is accounted for prospectively (i.e. in the current year and going forward). Hence, the finance director does not retrospectively change the prior year's amortisation charge. The prior year's charge was not an error because, at the time, management could not reliably estimate the useful economic life of the licence. However, as they now can, the amortisation charge for the year ended 31 January 2021 reflects a useful economic life remaining of five years.

4.5 Revaluation model for intangible assets

In practice most intangible assets are measured under the cost model (cost less amortisation less any accumulated impairment losses). The revaluation model is available under FRS 102, Section 18 but is rarely used in practice.

Under the revaluation model, an intangible asset is carried at a revalued amount which is its fair value at the date of revaluation less any subsequent accumulated amortisation and accumulated impairment losses.

It is rare for a fair value to be available for an intangible asset because this has to be derived from an 'active market'. The Glossary to FRS 102 defines an 'active market' as:

FRS 102 Glossary ***active market***

A market in which all the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

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Prior to adopting the revaluation model for intangible assets, an entity must be sure that there is an active market from which to derive a fair value. Professional valuations of assets would not be acceptable.

If an active market does exist for the intangible asset, revaluations must be carried out on a **sufficiently regular** basis to ensure that the carrying amount of the intangible asset does not differ materially from its fair value at the balance sheet date. Active markets are likely to exist for certain intangible assets such as taxi licences, production and milk quotas and airport landing rights.

The revaluation model in FRS 102, Section 18 works in the same way as the revaluation model in FRS 102, Section 17 *Property, Plant and Equipment*. Revaluation gains are recorded in the revaluation reserve (unless some, or all, of the gain reverses a previously recognised revaluation loss in respect of that intangible asset in which case it is recognised in profit or loss).

Revaluation losses are recorded in the revaluation reserve to the extent of a revaluation surplus in respect of that intangible asset. Any surplus revaluation loss is the recorded in profit or loss.

4.6 Goodwill

Goodwill is dealt with in FRS 102, Section 19 *Business Combinations and Goodwill*. The amortisation rules for goodwill are contained in Section 18 (paras 18.19 to 18.24) and the 10-year cap also applies to goodwill (where management cannot reliably estimate the useful economic life of goodwill).

The key point to emphasise where goodwill is concerned is that internally generated goodwill cannot be recognised on the balance sheet. This has been a rule recognised in UK GAAP for many years but there are still some entities that have recognised internally generated goodwill (with the credit going to the director's current account). This does not comply with UK GAAP requirements and would need to be corrected by way of a prior period adjustment if material (which it almost certainly would be). This would apply even if the goodwill had been professionally valued. Keep in mind that only **purchased** goodwill can be recognised on the balance sheet.

It has also not been unknown for HMRC to challenge the value of goodwill recognised on a newly incorporated entity (for example where a sole trader may incorporate and the limited company acquires goodwill from the trader). Care needs to be taken with valuations of goodwill because HMRC will be quick to disallow any excessive valuations and this is where the valuer needs to ensure they keep an adequate record of all assumptions used in the valuation in the event it is challenged by HMRC.

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5 Deferred tax: Problem areas (Lecture A735 – 18.13 minutes)

Reviews of files often indicate problems around the tax aspects of the client's financial statements. Usually this is in respect of the deferred tax calculation and/or the specific treatment of deferred tax in relation to its underlying transaction.

It should be noted that for micro-entities choosing to report under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, there are never any problems where deferred tax is concerned because deferred tax is prohibited. Under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, deferred tax is dealt with in Section 29 *Income Tax* and there are often errors noted during file reviews or during a desktop review of financial statements.

5.1 Rate of tax used in the calculation of deferred tax

One of the most common errors in the calculation of deferred tax is the rate of tax used. FRS 102, para 29.12 states:

> *An entity shall measure a deferred tax liability (asset) using the tax rates and laws that have been enacted or substantively enacted by the reporting date that are expected to apply to the reversal of the timing difference.*

FRS 102, para 29.12

Prior to the Chancellor's March 2020 Budget, it was expected that the rate of corporation tax in the UK would reduce from 19% to 17% from 1 April 2020. In his March 2020 Budget, the Chancellor confirmed that the rate of corporation tax would remain at 19%.

FRS 102, para 29.12 refers to tax rates and laws that have been '… enacted or substantively enacted by the reporting date …'. The term 'substantively enacted' is defined (in quite a lot of detail) in the Glossary to FRS 102 as follows:

> *Tax rates shall be regarded as substantively enacted when the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so.*
>
> *A UK tax rate shall be regarded as having been substantively enacted if it is included in either:*
>
> *(a) a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent; or*
>
> *(b) a resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968. (Such a resolution could be used to collect taxes at a new rate before that rate has been enacted. In practice, corporation tax rates are now set a year ahead to avoid having to invoke the Provisional Collection of Taxes Act for the quarterly payment system).*

FRS 102 Glossary ***substantively enacted***

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A Republic of Ireland tax rate can be regarded as having been substantively enacted if it is included in a Bill that has been passed by the Dail.

For balance sheet dates ending on or after 17 July 2020, the rate of tax to be used in the calculation of deferred tax is 19%. For balance sheet dates prior to 17 July 2020 the rate of tax should have been 17%. This is because the 19% tax rate became substantively enacted on 17 July 2020 and then became enacted (i.e. it was included in the Finance Act 2020) on 22 July 2020.

Example – Change of rate of deferred tax

Ranger Ltd is preparing its financial statements for the year ended 31 October 2020. The finance director has amended the 31 October 2019 financial statements so that deferred tax represents 19% of all timing differences. She informed you that she has done this on the grounds that the rate of corporation tax was changed in the last Budget so she felt a prior year adjustment was necessary.

The finance director should not restate the prior year's financial statements for the changes to the tax rate. This is because the financial statements for the year ended 31 October 2019 would have already reflected the correct rates of tax for deferred tax as they were at that point in time. The fact that the rate of tax was confirmed as remaining at 19% in March 2020 does not apply retrospectively.

Only the financial statements for the year ended 31 October 2020 should reflect the deferred tax at the rate of 19%.

5.2 Deferred tax on revalued assets

Deferred tax on revalued assets continues to present challenges to preparers. The most common types of assets to be revalued are properties. At the outset it is worth noting:

- Investment properties experience **fair value gains and losses**; and
- Revalued property, plant and equipment experiences **revaluation gains and losses**.

Properties that are classified as investment properties are accounted for under FRS 102, Section 16 *Investment Properties* and must be remeasured to fair value at each reporting date. Fair value gains and losses on investment property are taken to the profit and loss account due to the application of the Fair Value Accounting Rules in FRS 102, Section 16.

Revaluation gains and losses in respect of properties measured under the revaluation model in FRS 102, Section 17 *Property, Plant and Equipment* are taken to a revaluation

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reserve and reported as other comprehensive income. Gains are only taken to profit or loss if they reverse a previously recognised revaluation loss in respect of that asset with any surplus gain credited to the revaluation reserve. Losses are taken to the revaluation reserve to the extent of a surplus on the revaluation reserve in respect of that asset with any excess loss taken to the profit and loss account.

Non-monetary assets such as properties attract deferred tax consequences which must follow their underlying transaction in the financial statements as follows:

- **Investment property fair value gains and losses:** Deferred tax is taken to profit or loss as the underlying fair value gain or loss is also recorded in profit or loss.

- **Revaluation gains and losses on property, plant and equipment:** Deferred tax is taken to profit or loss or other comprehensive income as appropriate. If part of the revaluation gain or loss is recorded in other comprehensive and part of it is recorded in profit or loss, the deferred tax must be split accordingly.

Example – Deferred tax on revalued assets

Weaver Ltd has three properties on its balance sheet as at 31 December 2020 as follows:

	Investment property	**Owner-occupied property 1**	**Owner-occupied property 2**
	£	£	£
Value at 1 January 2020	185,000	270,000	350,000
Increase in value in the year	17,200	12,500	-
Decrease in value in the year	-	-	(38,200)
Opening revaluation reserve	-	24,200	31,450

Investment property

The increase in fair value of the investment property is taken to the profit and loss account as follows:

Dr Investment property	17,200
Cr Fair value adjustments (P&L)	17,200

Deferred tax on the increase will arise of £3,268 (£17,200 x 19%) which is recorded in the financial statements as:

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Dr Deferred tax expense (P&L)	3,268
Cr Deferred tax provision	3,268

The company may choose to ring-fence the fair value gains (net of deferred tax) into a separate component of equity to keep a track of them if the company wishes, but there is nothing in company law that requires this. For simplicity, this example has deliberately not done this.

Owner-occupied property 1

The increase in value in the year is recorded in the revaluation reserve and reported as other comprehensive income as follows:

Dr Property, plant and equipment	12,500
Cr Revaluation reserve	12,500

The revaluation gain gives rise to an increase in the deferred tax liability of £2,375 (£12,500 x 19%) and is also recorded in the revaluation reserve as follows:

Dr Revaluation reserve	2,375
Cr Deferred tax provision	2,375

The balance on the revaluation reserve in respect of that property is £34,325 reconciled as follows:

Opening balance b/f	24,200
Plus revaluation gain in the year	12,500
Less deferred tax on revaluation	(2,375)
Closing balance c/f	34,325

Owner-occupied property 2

The decrease in value in the year is £38,200. The surplus on the revaluation reserve in respect of this property is £31,450 so we can use up this balance first and then take the excess to profit or loss (do not send the whole loss to profit or loss which is what some companies have inadvertently done in these situations), i.e.:

Dr Revaluation reserve	31,450
Dr Loss on revaluation (P&L)	6,750
Cr Property, plant and equipment	38,200

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The revaluation loss gives rise to a decrease of the deferred tax liability in respect of this property of £7,258 (£38,200 x 19%). Part of the deferred tax will be recorded in other comprehensive income and part of it will be recorded in profit or loss as follows:

Dr Deferred tax provision	7,258
Cr Revaluation reserve	5,976
Cr Deferred tax provision (P&L)	1,282

As £31,450 of the revaluation loss has been recorded in other comprehensive income, the deferred tax which is taken to other comprehensive income is £7,258 being £31,450 x 19%. As £6,750 of the revaluation loss has been recorded in profit or loss, 19% of this loss is also taken to profit or loss as well.

In respect of owner-occupied property 2, there will be no revaluation surplus left once this revaluation loss has been recorded. If, in subsequent years, the property increases in value, the increase in value is taken to profit or loss to the extent of the loss reported (£6,750) with any remaining revaluation gain taken to the revaluation reserve. The associated deferred tax liability will also be split between the profit and loss account and revaluation reserve at the tax rate enacted, or substantively enacted, by the reporting date. This tax rate may also be different than the 19% tax rate at the time the revaluation gain is accounted for depending on what the tax is rate that has been enacted or substantively enacted by that balance sheet date.

You can see from the above example that deferred tax on revalued assets can become complex – particularly where there are several assets that have been revalued in the year all of which have experienced revaluation gains and losses. A methodical approach in these situations is important to ensure that the correct deferred tax balances are recorded in the financial statements correctly.

5.3 Refundable Research and Development (R&D) Expenditure Credits

Finance Act 2013 introduced the R&D Expenditure Credit (referred to as RDEC). Under this regime, an entity can receive a taxable credit which is based on qualifying R&D expenditure.

On the face of it, the scheme appears to have the characteristics of a government grant and debates have been ongoing as to whether such credits are to be treated as government grants or not. The regime is administered via the entity's corporation tax return, but it enables an entity to monetise the credit without a corporation tax liability. Companies that do have a corporation tax liability can use the credit to offset against corporation tax payable. Conversely, where the entity does not have a corporation tax

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liability (or a very small liability), the entity may receive a refund subject to certain restrictions.

The credit will, therefore, be of monetary to value to claimants regardless of their tax position. As a consequence, it is seen as appropriate to account for the RDEC under FRS 102, Section 24 *Government Grants*.

Hence, where the entity enters into the RDEC scheme, the tax credit is recognised within pre-tax income. For entities that apply the accounting policy choice of writing development expenditure off to profit or loss, FRS 102, Section 24 would require the entity to record the 'grant' as a separate income item (offsetting against R&D expenditure would go against the offsetting provisions in FRS 102, para 2.52 and company law).

For entities that capitalise development expenditure as intangible assets, the R&D credit should be recorded as deferred income. It is not possible under FRS 102 (or company law) to offset the R&D credit against the intangible asset and recognise it via reduced amortisation charges – it must be presented separately as deferred income and, of course, presented as current/non-current as appropriate to comply with the statutory formats of the balance sheet.

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6 Covid-19 and fraud (Lecture A736 – 18.106 minutes)

The effects of Covid-19 are still causing huge levels of disruption across the country. At the time of writing these notes, the country was awaiting details of how the Government intends to loosen the restrictions imposed in January 2021 to enable the economy to start to recover. The prime minister is due to make an announcement about this on or around 22 February 2021.

The CJRS has been extended until the end of April 2021 (this could also be extended further depending on the future strategy of the government going forward). The various loan schemes are also extended until 31 March 2021 – but, again, there is always the possibility that this deadline could be extended as well.

The past year has been stressful for both clients and accountants. Accountants have had a raft of new schemes and grants to grapple with and to advise clients as to their eligibility for such grants and schemes.

6.1 Anti-money laundering considerations

When the Chancellor announced details of the Self-Employed Income Support Scheme (SEISS) and the various loan schemes, it soon became clear that agents could not apply for grants such as the SEISS on behalf of clients. To a certain extent, this made life easier for the agent – not only in terms of workload, but also the fact that the client was wholly responsible for applying for the scheme which lessens the potential recourse on the accountant.

Nearly a year later, and it transpires that some clients have done things that they really should not have done. For example, claiming the CJRS for staff who have not been furloughed; or deliberately inflating turnover levels to enable them to obtain the maximum £50,000 Bounce Back Loan. Some accountants have also said they have seen clients ‘boasting’ on social media that they have received a CBILS or a Bounce Back Loan and have no intention of paying it back – they’ll simply close the company down when it comes to making repayments and form another one.

All of these situations point to fraudulent claims and this is where the accountant cannot forget their anti-money laundering obligations.

In addition, professional accountants are bound by the Code of Ethics and Conduct issued by their relevant professional body. The various professional bodies have published a lot of guidance for advisers on the Covid-19 measures. In addition, there is also primary guidance in the form of *Professional Conduct in Relation to Taxation* (PCRT). The PCRT sets out the principles and standards which all members (including students) of the sponsoring bodies must follow in their tax work.

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Furloughed employees who are asked to continue to work

The PCRT FAQs were updated last year to advise on handling clients which have instructed their employees to continue working while on furlough. Where an employer does this, they run the risk of being committed for an act of fraud.

Where a professional accountant becomes aware that their client has asked a staff member(s) to continue working while on furlough, they should advise the client that this contravenes the terms of the CJRS. Where the client refuses to tell their employee to stop working, the PCRT requires the accountant to cease acting for the client.

The accountant must also consider their anti-money laundering reporting obligations. These will depend on whether there are proceeds of crime involved. Where the professional accountant believes their client has made an innocent mistake and puts right the mistake as soon as they had been advised to do so, it is unlikely that there are proceeds of crime and hence an anti-money laundering report would not be necessary.

However, if the professional accountant believes that the client was fully aware of the restrictions on employees working while furloughed, then the matter should be reported to the firm's Money Laundering Reporting Officer (MLRO). A report would be necessary in these circumstances because the client has knowingly claimed government funds to which they are not entitled. Monies received under the scheme would constitute proceeds of crime. The MLRO/sole practitioner must then submit a Suspicious Activity Report (SAR) to the National Crime Agency.

Example – Sole practitioner

Jeanette is a sole practitioner acting for a client, Bamber Ltd. The director of Bamber Ltd has asked Jeanette to prepare a furlough claim for one of its employees. Jeanette is aware that the employee concerned is still working for Bamber.

In this example, Jeanette must refuse to submit such a claim and explain the reason to the director of Bamber (i.e. it contravenes the CJRS). It may well be that the client has misunderstood the rules or is just simply not aware of the rules.

There would be no need for Jeanette to make a SAR at this point in time because there is not yet a crime with proceeds as no CJRS claim has been submitted.

If it is assumed that Bamber Ltd instructs a new firm of accountants because of the disagreement, the professional inquiry letter may make reference to a disagreement of the company's eligibility for the CJRS grant. If Jeanette subsequently becomes aware that the company has submitted a fraudulent claim, then Jeanette would need

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to make a SAR.

Clients who are struggling

Many clients have been experiencing cash flow difficulties during the Covid-19 crisis – especially when lockdown measures are implemented. In some cases, the client may be tempted to take advantage of government support measures to which they are not entitled.

The PCRT FAQ on this issue is clear. No tax adviser must engage in assisting a client to abuse any of the support schemes. This extends to the 'Time to Pay' arrangements. Where a client is struggling the advisers should explore what other support may be available to assist their clients.

Advisers must act within the requirements of the PCRT when handling the tripartite relationship between themselves, their clients and HMRC. The FAQ goes on to clarify that the adviser must ensure that:

(a) All planning advice is based on a realistic view of the facts and credible interpretation of the law.

(b) The adviser does not create, promote or encourage arrangements which seek to achieve results contrary to the clear intention of Parliament in enacting the legislation, or that are highly artificial or highly contrived and seek to exploit shortcomings in the legislation.

(c) They document any difficult judgements that they make in interpreting the rules.

Where an adviser becomes aware of an issue which provides them with reasonable grounds on which to suspect there has been a financial crime, they need to consider making a SAR to the firm's MLRO or, in the case of the MLRO or sole practitioner, to the NCA.

Tax advisers must also keep in mind the requirements of s328 of the Proceeds of Crime Act when assisting a client which says:

> *A person commits an offence if he enters into or becomes concerned in an arrangement which he knows or suspects facilitates (by whatever means) the acquisition, retention, use or control of criminal property by or on behalf of another person.*

S328 Proceeds of Crime Act

The penalty for such an offence is a fine or a prison sentence of up to 14 years or both.

Example – SEISS grant

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Mathew is a sole practitioner acting for a self-employed individual, Robyn. Robyn wishes to claim the most recent SEISS grant. As Mathew cannot make the claim on behalf of Robyn, she will have to do this herself. Mathew has concluded that Robyn would not be entitled to the grant as she has worked full-time since the last SEISS grant and has not been adversely affected due to the pandemic.

Mathew will not be preparing the claim as the grant has to be applied for by the taxpayer themselves. However, Mathew may become aware that Robyn has claimed the SEISS grant fraudulently and hence Mathew may need to make a SAR to the NCA.

VAT deferral scheme

The portal for the VAT deferral scheme opens on 23 February 2021. One of the PCRT's FAQs relates to an adviser who wishes to maximise the amount of VAT which can be deferred by recognising more output VAT in the relevant quarter.

It should be noted that agents cannot apply for the VAT deferral scheme on behalf of their clients. Only clients themselves can deal with the application.

The FAQ confirms that there are detailed VAT rules which constitute a VATable supply and the time at which it is deemed to occur. Deliberately inflating the amount of output VAT which should be recognised may constitute fraud or other financial crime. Professional advisers must not create, promote or encourage arrangements which are contrary to the clear intention of Parliament in enacting the legislation, or are highly artificial, or highly contrived, and seek to exploit shortcomings in the legislation.

Bounce Back loans

As is clearly understood, Bounce Back loans can only be used for business purposes. They cannot be used for personal purposes, such as paying off a personal credit card debt. The bank may also refuse an application where they believe the loan is going to be used for personal purposes.

Example – Bounce Back loan

Miller LLP acts for Osbourne Ltd which is a small business. Osbourne Ltd has applied for a Bounce Back loan which has been successful. The director of Osbourne Ltd has posted on social media that he has bought his daughter a new car and is planning a loft conversion in his new house now that he has received the loan.

Professional accountants do not have a responsibility in tracking what the loan

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proceeds were used for. However, in this example, Miller LLP have come into receipt of information suggesting that the loan was not used for the purposes intended and will have an obligation to file a SAR with the NCA where they suspect fraudulent activity.

Example – Transfer of loan proceeds to director's bank account

Emery LLP acts for Holmes Ltd which is a small business. The director of Holmes Ltd applied for a Bounce Back loan which was successful and the company received £50,000 into the business bank account. The loan proceeds were immediately transferred into the personal bank account of the director.

The fact that the loan proceeds have been immediately transferred into the personal account of the director is a 'red flag' which may be a cause for a SAR if Emery LLP suspects that the loan has been obtained fraudulently.

6.2 Code of ethics

Professional accountants must bear in mind that they have a Code of Ethics and Conduct (the Code) to follow from their professional body. Breaches of the Code will invariably involve sanctions being imposed such as a fine or even expulsion from the professional body.

Each professional body's Code usually adopts a principles-based threats and safeguards approach. The five fundamental principles are:

- **Integrity** – all professional accountants must be straightforward and honest in all professional and business relationships.
- **Objectivity** – a professional accountant must not compromise professional or business judgement because of bias, conflict of interest or the undue influence of others.
- **Professional competence and due care** – a professional accountant must maintain professional knowledge and skill (in practice, legislation and techniques) to ensure that a client or employer receives competent professional service.
- **Confidentiality** – a professional accountant must not disclose confidential or business information or use it to their personal advantage unless they have

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explicit permission to disclose it, or a legal or professional right or duty to disclose it.

- **Professional behaviour** – a professional accountant must comply with relevant laws and regulations, and avoid any action that may bring disrepute to the profession.

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7 ISA (UK) 540, ISA (UK) 570 and ISA (UK) 700 (Lecture A737 – 23.51 minutes)

Auditors will be starting to think about the audit of December year ends (if they have not already started to plan these assignments).

For audits of financial statements of 31 December 2020 year ends onwards, ISA (UK) 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* will apply as well as ISA (UK) 570 (Revised September 2019) *Going Concern* and ISA (UK) 700 (Revised January 2020) *Forming an Opinion and Reporting on Financial Statements*. Auditors must, therefore, ensure that their procedures sufficiently cater for these revised ISAs as they are notably different than their predecessors.

7.1 ISA (UK) 540 – Overview of the key changes

The table below provides a high-level overview of the key changes which auditors need to have an awareness of:

Issue to be aware of	Point to note
Spectrum of inherent risk	A separate assessment of inherent risk is required for the purposes of assessing the risks of material misstatement at the assertion level for accounting estimates.
Inherent risk factors	These include: • Complexity; • Subjectivity; • Estimation uncertainty; and • Others (such as the extent to which estimates have been subject to issues such as management bias, fraud or changes in accounting requirements).
Enhanced risk assessment procedures	Specific procedures are now required when the auditor is obtaining an understanding of the entity in order to provide an appropriate basis for the identification and assessment of the risks of material misstatement at BOTH the financial statement and assertion level. Separate assessments of inherent risks

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	and control risks are also required.
Auditor's decisions about controls	More emphasis is placed on the importance of the auditor's decisions concerning controls over accounting estimates and there is overlap with other standards in this respect, such as ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* and ISA (UK) 330 *The Auditor's Responses to Assessed Risks*.
Objectives-based work effort	Further audit procedures (including tests of controls, where applicable) must be responsible to the assessed levels of risk of material misstatement at the assertion level. This has to take into account the effect of one, or more, inherent risk factors and the auditor's assessment of control risk. In addition, the auditor is required to test how management have arrived at the accounting estimate by: • testing the methods used; • testing the significant assumptions; • testing the data.
Professional scepticism	The revised ISA (UK) recognises that the importance of professional scepticism increases when accounting estimates are affected by a greater degree of inherent risk factors, or where there is a higher risk of material misstatement due to management bias or fraud. Enhanced risk assessment requirements will be needed in respect of professional scepticism.
'Stand-back' requirement	This relates to professional scepticism. Auditors must evaluate the audit evidence obtained to determine whether the accounting estimates (and related disclosures) are reasonable in the context of the financial reporting framework, or if

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	they are misstated. This includes an evaluation of both corroborative and contradictive audit evidence.
Disclosure requirements	The auditor is required to obtain sufficient and appropriate audit evidence that the disclosures in respect of accounting estimates are adequate in the context of the financial reporting framework. The auditor must also confirm that the disclosures included are those necessary in order to give a true and fair view.
Communication with those charged with governance	The auditor must communicate whether the accounting estimates and their related disclosures are impacted by key factors including complexity, subjectivity or other inherent risk factors.
Written representations	There are enhanced requirements to request written representations from management and, where appropriate, those charged with governance, about whether the methods, significant assumptions and the data used in making the accounting estimates and related disclosures are appropriate to comply with the financial reporting framework. Note, this requirement differs from the previous ISA (UK) 540 which only required a representation confirming that the significant assumptions used in making the accounting estimates are reasonable.

7.2 ISA (UK) 570 – Overview of the key changes

Going concern has always been important, but it has certainly been given more prominence since the outbreak of Covid-19. It is also an area that is of particular focus by file reviewers.

ISA (UK) 570 (Revised September 2019) is also effective for audits with a 31 December 2020 year end onwards. It is expected that work effort will be increased where ISA (UK) 570 (Revised September 2019) is concerned.

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It is also worthwhile noting that going concern is very much a key focus at the present time in the Covid-19-related climate.

The auditor is still required to obtain sufficient and appropriate audit evidence to identify whether events or conditions exist which may cast significant doubt on the entity's ability to continue as a going concern and identify whether, or not, a material uncertainty exists. The auditor is also still required to obtain sufficient and appropriate audit evidence concerning the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

Extended auditor's responsibilities

The auditor's responsibilities are extended further in ISA (UK) 570 (Revised September 2019). These extended responsibilities require the auditor to:

- Evaluate the method used by management in assessing the entity's ability to continue as a going concern, including determining if:
    - the method selected is appropriate in the context of both the financial reporting framework and the auditor's understanding of the entity;
    - changes from the method used in prior periods are appropriate; and
    - whether the calculations are applied in accordance with the method and are mathematically accurate.
- Evaluate the relevance and reliability of the underlying data used to make the assessment.
- Evaluate the assumptions on which management's assessment is based which requires the auditor to determine whether there is adequate support for the assumptions underlying management's assessment which includes determining:
    - whether the assumptions are appropriate in the context of the applicable financial reporting framework and, where applicable, changes from the prior period are appropriate; and
    - whether the assumptions are consistent with each other and with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit.
- Evaluate management's plans for future actions in respect of going concern, including evaluating whether the outcome of these plans is likely to improve the situation and whether they are feasible.
- Consider whether any additional facts or information have become available since the date on which management made its assessment.

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- Request written representations from management and, where appropriate, those charged with governance, concerning their plans for future actions and the feasibility of those plans.

To all intents and purposes, where an audit firm was already doing going concern work adequately, the above changes can simply be seen as codifications or clarifications of the auditor's responsibilities. In this situation, there should not be anything too arduous for the auditor to do to achieve compliance with the ISA (UK) 570 (Revised September 2019). Audit procedures and programmes will need to be checked to ensure they comply with ISA (UK) 570 (Revised September 2019) so that the audit team discharge the responsibilities correctly.

However, where there have been deficiencies noted in an audit firm's going concern procedures, then the above may require a review of the procedures BEFORE the audit takes place to ensure those procedures achieve the revised standard's objectives.

7.3 Auditor's reports and irregularities

The Quarter 4 Audit and Accounting Update examined the new requirement in ISA (UK) 700 (Revised January 2020) *Forming an Opinion and Reporting on Financial Statements*.

For 31 December 2020 year ends onwards, there is now a requirement for the auditor to include an explanation of the extent to which the audit was capable of detecting irregularities, including fraud. This requirement applies to **all** auditor's reports and not just those for Public Interest Entities. This requirement must not be forgotten about.

The FRC's Compendium of Illustrative Auditor's Reports (issued in March 2020) places the auditor's explanation of the extent to which the audit was capable of detecting irregularities, including fraud, within the 'Auditor's Responsibilities for the audit of the financial statements' paragraph.

Professional bodies are expected to issue guidance on this area of the auditor's report in due course.

8 Audits of less complex entities (Lecture A738 – 6.10 minutes)

It is fair to say that many auditors of companies which are considered to be less complex do sometimes become exasperated at the lengths they have to go to in order to comply with the International Standards on Auditing (ISAs (UK)). Over the last couple of years revisions to ISAs (UK) include a three-fold increase to ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* (although this revised ISA (UK) does not come into mandatory effect until December 2021 year ends onwards so there is a little bit of breathing space for now). There have also been significant changes to ISA (UK) 540 and 570 (as discussed earlier). In addition, there may also be some quality management standards coming in which will need to comply with (a consultation and impact assessment was issued in December 2020 and comments on this close on Friday 19 March 2021).

To certain extent, the changes made to the ISAs (UK) are in response to either changes in company law requirements, or they are changes made by the FRC in response to the Brydon review of auditing or the Competition and Markets Authority's review. The aim of the revised ISAs (UK) is to strengthen the work carried out by auditors in an attempt, to a certain extent, to reduce the 'expectations gap' (i.e. the gap that exists between what the auditor actually does and what the general public think they do).

In 2019, the International Auditing and Assurance Standards Board (IAASB) issued a Discussion Paper (DP) *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs*. The title of this DP will bring a somewhat hopeful sense of relief to many auditors that have less complex audits – but what is a 'less complex entity' in the context of the DP?

The DP uses the term 'less complex entities' rather than 'small and medium-sized entity' because the IAASB suggest that this matter is not about the size of the entity, as even a small audit can be complex; hence it is more appropriate for the focus to be on the complexity of the audit rather than on the size of the entity.

Professional bodies have welcomed the suggestion for a separate standard for less complex entities citing lengthier revised standards and lack of flexibility as some of the reasons why a standard for a less complex entity would help. ICAEW, for example, is calling for such a standard to happen as quickly as possible. Ideally, ICAEW would like a wholesale re-write of the ISAs which would start from simple universal principles that apply to all audits. However, in recognition of the time this would take, ICAEW suggests that a separate standard for less complex entities would be seen as a practical solution which would be achievable in a much shorter length of time.

In practice, it may also be the case that audits of less complex entities may be more compliant with a simpler and easier to use standard than is currently the case with the very detailed and lengthy ISAs.

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8.1 Project update

The IAASB is currently developing a standard for less complex entities. The standard will not be available for use by listed entities as they must continue to use the current ISAs.

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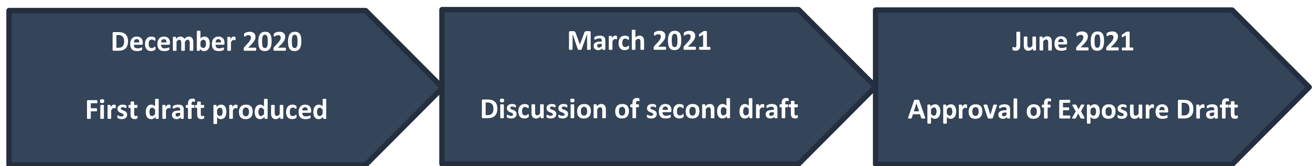
The targeted timeline for the development of the standard is as follows:



8.2 Will the standard be available for use in the UK?

The FRC have not yet made any announcement as to whether an auditing standard for less complex entities will be available for use in the UK. In any event, it is unlikely to be available in the immediate future. Some of the professional bodies are pushing for such a standard and so it may well be available and any developments in this area will be covered in future update courses.

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9 Common audit issues (Lecture A739 – 20.19 minutes)

With audits for December year ends onwards pretty much in progress, the focus of this section is to address some of the more common audit issues that have been flagged up during file reviews and by professional bodies.

As addressed in section 7, ISA (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures* and ISA (UK) 570 (Revised September 2019) *Going Concern* are two of the 'big' issues that will kick in mandatorily from 31 December 2020 year ends onwards so auditors need to make sure they have a sound awareness of the provisions of those standards in order to achieve compliance.

Professional bodies often cite a lack of audit evidence for material areas of the financial statements as being one of their main concerns. A lack of audit evidence will contravene the requirements of ISA (UK) 500 *Audit Evidence*. ISA (UK) 500 requires the auditor to obtain **sufficient** and **appropriate** audit evidence to support the amounts and disclosures in the financial statements. But what is 'sufficient' and 'appropriate' audit evidence and how do auditors know they have such evidence?

- **Sufficiency** relates to the *quantity* of audit evidence
- **Appropriateness** relates to the *quality* of audit evidence

When considering the sufficiency of audit evidence, the auditor must consider:

- the risk of material misstatement;
- the materiality of the item(s) in question;
- the nature of the accounting system and the entity's system of internal control;
- the results of tests of control (sometimes called 'compliance tests');
- the auditor's knowledge and experience of the entity;
- the size of the population being tested;
- the size of the sample to be selected; and
- the overall reliability of the audit evidence obtained.

'Appropriateness' is broken down into two sub-concepts:

- reliability; and
- relevance.

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Reliable audit evidence

Audit evidence should be obtained from the most trustworthy and dependable sources possible.

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Audit evidence is considered to be more reliable when it is:

- obtained from an independent external source;
- obtained internally from the entity but has been subject to effective controls;
- obtained directly by the auditor;
- is in documentary form; and
- the documents are original (not scanned copies or photocopies as these may have been 'doctored').

If the evidence is unreliable it will not be appropriate for the audit, regardless of how much the auditor obtains. Hence an auditor could obtain 'sufficient' audit evidence which is not 'appropriate' meaning the objectives of ISA (UK) 500 has not been achieved.

Relevant audit evidence

In order to be relevant audit evidence, the evidence has to meet the objective of the audit procedure. This is best illustrated using an example:

Example – Reliance on a trade debtors circularisation letter

The audit file of Sky Ltd for the year ended 31 July 2019 is being reviewed post-issuance (i.e. a 'cold' review). During the cold review the reviewer noted that the auditor had relied on debtors' circularisation letters to confirm the valuation assertion of year end debtor balances. The audit engagement partner has responded stating that, in his opinion, this is relevant audit evidence because the debtor has acknowledged the debt and has agreed the balance back to their purchase ledger. In light of this, the audit team performed no other audit procedures on the sample of year end debtor balances tested.

One of the primary tests for debtors is to verify the valuation assertion (i.e. that the debtor balance is recoverable and does not need to be written down by way of a bad debt provision). A debtors' circularisation letter is not relevant audit evidence to corroborate the valuation assertion. Such a letter would only confirm the rights and obligations and existence assertions. A debtor may agree the balance outstanding on their purchase ledger to the positive circularisation letter but that does not mean they intend to pay the debt, or even have the resources available to pay as they could be experiencing cash flow difficulties.

Alternative audit procedures must be applied by the auditor to corroborate the valuation assertion, such as extended post year end cash receipts testing and

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discussing the need for any specific bad debt provisions with the credit controller or finance director which will specifically cover the valuation assertion.

Example – Attendance at inventory count

It is 4 March 2021. The audit manager and audit senior are planning the audit of Whittaker Enterprises Ltd for the year ending 31 March 2021. The company will have a material amount of stock and work-in-progress and hence the audit firm is planning on attending the year end stock count.

Attendance at the client's stock count is primarily an observation test to ensure that management's instructions are being adhered to and that the procedures adopted in the stock count will reduce the risk of material misstatement in the year end stock valuation.

During the stock count attendance, the auditor will carry out test counts on the stock as follows:

- Select a sample of items from the physical inventory and agree them back to inventory records. This confirms the **completeness** of the accounting records.
- Select a sample of items from the inventory records and agree them back to the physical inventory. This confirms the **existence** of inventory.

The two tests above, at first glance, appear to be very similar. However, they are **relevant** procedures to undertake at the inventory count because they test different assertions about the inventory balance.

The above examples focus on the relevant **assertions** in the financial statements, all of which must be addressed appropriately during the course of the audit. As a recap, ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatements Through Understanding of the Entity and Its Environments* deals with assertions in paragraphs A129 and A130, a summary of which is as follows:

Assertions about classes of transactions and events and related disclosures	
Occurrence	Transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the

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	entity.
Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
Cut-off	Transactions and events have been recorded in the correct accounting period.
Classification	Transactions and events have been recorded in the proper accounts.
Presentation	Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about account balances, and related disclosures	
Existence	Assets, liabilities and equity interests exist.
Rights and obligations	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
Completeness	All assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
Accuracy, valuation and	Assets, liabilities, and equity interests have been

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allocation	included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Classification	Assets, liabilities, and equity interests have been recorded in the proper accounts.
Presentation	Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

The assertions above may also be adapted, as appropriate, in considering the different types of potential misstatements which may occur in disclosures not directly related to recorded classes of transactions, events or account balances. ISA (UK) 315 (Revised June 2016), para A130 provides an example of an entity which may be required to describe its exposure to risks arising from financial instrument, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

9.1 Generating sufficient and appropriate audit evidence

Quite often there is a general misunderstanding among audit teams as to the types of audit procedures to be adopted. While many audit software programs or 'off-the-shelf' working papers provide guidance to auditors on the procedures to adopt, the risk is that these are sometimes used as a 'tick box' exercise and in some cases specific audit procedures, which are client-specific and responsive to the assessed levels of risk, may need to be adopted to address the relevant assertion being tested. Therefore, it is often useful to go 'back to basics' and recap on the primary methods of obtaining audit evidence.

Tests of control

Tests of control are designed to test the operating effectiveness of controls in preventing or detecting and correcting a material misstatement. Tests of control do not focus on a specific monetary amount in the financial statements; rather they provide evidence of whether an entity's internal control system has operated effectively during

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the year. During file reviews, there is often confusion about whether a test of control has been undertaken. Documenting how a system works (or is meant to work) is not a test of control; nor is just discussing how a procedure works with a staff member of the audit client. The auditor must physically observe the control in operation and assess its operating effectiveness.

Examples of tests of control are shown in the table below:

Control in place	Test of control
Production staff are paid overtime on a regular basis to ensure customer orders are fulfilled on time. This overtime is reviewed by the production director prior to being processed in the company's payroll system.	Review the overtime sheets and ensure these have been authorised by a responsible official prior to the overtime being paid.
Customer credit limits have to be authorised by the finance director before the credit account is opened.	Review a sample of new credit accounts opened during the year and confirm the credit limits have been reviewed by the finance director prior to the account being opened (the finance director should evidence his/her review with a signature).
Staff who are paid in cash have to produce ID before collecting their pay packets from the payroll department.	Attend a cash wages payout and observe the staff producing their ID prior to being given their pay packet.
The client prepares an annual capital expenditure budget for each department at the start of every financial year.	Inspect the annual budget to ensure it is prepared and confirm, through reading board minutes, that the budget has been approved by the board.
The company maintains a fixed asset register that details cost, depreciation, asset number and location.	Inspect the fixed asset register to ensure details expected to be recorded have been recorded to ensure proper controls are exercised over the company's assets.
The company obtains several quotations	Inspect the purchase order for the

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from approved suppliers before acquiring certain goods (for example items of capital).	quotations to ensure they have been obtained.
The company carries out a regular review of expense accounts in profit or loss to ensure that capital items have not been incorrectly written off in error.	Discuss with management as to how discrepancies are dealt with and then inspect management accounts and revenue expenditure reconciliations for evidence of this review.

The above table shows some typical tests of control. As you can see, the focus is not on any monetary amount in the financial statements; instead, it is on the operating effectiveness of the controls.

If the entity's controls are weak (or non-existent), the auditor would be wasting their time in testing the entity's controls and a more substantive approach would need to be taken. Conversely, if controls are deemed to be effective, the auditor may decide to place reliance on these controls which could enable the auditor to carry out less substantive procedures. The auditor would clearly document this conclusion (together with reasons for placing reliance on the controls) in the audit file.

Substantive procedures

Substantive procedures are sub-divided into two further procedures:

- Tests of detail; and
- Analytical procedures.

Unlike tests of control, substantive procedures do focus on monetary amounts in the financial statements as they aim to test for material misstatement at the assertion level.

Tests of detail verify individual transactions and balances. Hence, they look at the supporting evidence for an individual transaction, such as looking at a purchase invoice for a fixed asset or verifying the year end cash book balance to the bank reconciliation/bank statement.

Substantive analytical procedures would be used to assess the reasonableness of an amount in the financial statements. For example, calculating the percentage change of purchases from last year and comparing it to the percentage change in sales to see if they move in line with each other as expected. Other forms of substantive analytical procedures include ratio analysis, trend analysis and proof in total tests.

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Care needs to be taken with substantive analytical procedures because – as in the example of comparison of % change in purchases and sales above – the procedure itself is not looking at any of the individual purchases, but at the total figure. Therefore, it is entirely possible that there are a number of misstatements within the purchases figure which would only be discovered by carrying out tests of detail. Analytical procedures on their own would not detect these misstatements, but they may indicate a source of misstatement.

Professional bodies and file reviewers have frequently criticised audit files for over-reliance on substantive analytical procedures – particularly for companies where either no tests of control have been carried out, or there is evidence on the audit file that controls are weak at the audit client. Keep in mind that analytical procedures should only be used as the main source of substantive evidence where the client's system of internal control has been assessed as being reliable. This is because in a reliable system of internal control there is less chance of misstatements being present as the system would have detected and corrected them.

9.2 Revenue recognition (income completeness) testing

Revenue will usually always be a material figure in the accounts. The primary test for revenue is that of understatement. Hence, in directional testing, if we test revenue directly for understatement, we are testing debtors indirectly for understatement also due to the concept of double-entry.

Substantive procedures for income completeness must always start from 'outside' of the accounting system. The idea of the income completeness test is to ensure that all orders received by the business have been invoiced and that the sale has been correctly recorded in the accounting system, hence we are testing revenue for understatement.

Example – Incorrect starting point for income completeness

The auditor of Wolves Ltd is carrying out income completeness tests on the company's revenue figure in the financial statements for the year ended 31 January 2021.

The company maintains an automated sales order processing module.

The income completeness test has been undertaken as follows:

For a sample of sales invoices:

- Step 1: Agree the casts on the sales invoice
- Step 2: Agree the sales invoice to the customer's individual sales ledger

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account

- Step 3: Agree the value of the sale to the debtors control account
- Step 4: Agree the value of the sale to the sales nominal
- Step 5: Agree the VAT element has been posted to the output VAT control

This test has started from the incorrect point and is essentially an irrelevant test and a waste of audit time.

The objective of the income completeness test is to ensure that orders received by the company have been invoiced. If the starting point is the sales invoice itself, then the test becomes irrelevant because you will not find any orders received not yet invoiced. If the auditor is testing a lot of sales invoices, a long time could be wasted on a test that will not achieve anything.

The starting point in income completeness testing should be the customer's order as this originates from outside of the accounting system. Hence, the audit procedures should start from the order to the invoice then through the various ledgers.

Also, be careful when it comes to rebutting the presumption that fraud in relation to revenue recognition exists. Lots of audit firms tend to assume that no fraud in respect of revenue recognition will arise because it has never happened in the past. Issues such as management override of controls and the ease of revenue manipulation are key fraud risk factors that must be considered in every audit.

If the presumption that fraud in relation to revenue recognition has been rebutted, then there must be adequate documentation on the audit file to justify the reasons for the rebuttal.

9.3 Cash flow statement

For some reason, audit work on cash flow statements appears to be weak in many reviews that are carried out. It may be that audit firms consider the cash flow statement to be a 'bridge' between the profit and loss account and balance sheet and as audit work is done on those primary statements, no further audit work needs to be done on the cash flow statement.

Keep in mind that the cash flow statement is one of the primary financial statements and is a statement that must be audited properly. The audit procedures should focus on verifying the accuracy, completeness and classification of the figures in the cash flow

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statement. For example, classification of debt and treatment of non-cash movements has led to files being criticised when such items are material.

Frauds at the assertion level are usually associated with the profit and loss account and balance sheet; however, fraud within the cash flow statement can exist and is potentially significant. For example, if the entity boosts operating cash flows by shifting cash inflows from financing activities into it or shifting operating cash outflows into financing or investing activities.

The audit of cash and cash transactions is critical because cash is the primary target of employee and management fraud.

Typical audit procedures which should be carried out over the cash flow statement include the following (note the list below is not comprehensive and additional entity-specific procedures may also be necessary):

- Agree and reconcile all amounts in the cash flow statement to amounts that appear elsewhere or to the auditor's working papers (such as tax paid and interest paid amounts to bank statements).
- Agree the reconciliation of profit or loss to net cash flow from operating activities to other areas of the financial statements, such as:
    - the measure of profit (loss) to the profit and loss account;
    - depreciation charge to the fixed asset lead schedule;
    - gain or loss on disposal of fixed assets to the reperformance of the disposal account; and
    - movements in working capital to the balance sheet items.
- Reperform the cash flow statement from the audited profit and loss account, balance sheet and statement of changes in equity.
- Cast the cash flow statement for mathematical accuracy.
- Confirm the amounts reported in investing and financing activities have been correctly classified and that the amounts are reasonable.
- For foreign currency cash flows, ensure these have been translated using the exchange rate at the date of the cash flow (or an average exchange rate if exchange rates have not fluctuated significantly during the reporting period) – where average rates are used, recalculate the average rate and agree this to the one used.

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- For unrealised gains and losses arising from changes in exchange rates, recalculate the effect of the exchange rate change on cash and cash equivalents held in a foreign currency and ensure this has been presented separately from cash flows from operating, investing and financing activities.

- Agree non-cash transactions to supporting documentation and ensure they have been excluded from the cash flow statement (e.g. conversion of debt to equity).

- Review the disclosures for non-cash transactions for adequacy.

- Agree the components of cash and cash equivalents to the balance sheet, including the components of the reconciliation of amounts presented in the cash flow statement to the equivalent items presented in the balance sheet.

- Agree the analysis of changes in net debt to supporting information and ensure sufficient detail has been shown to enable users to identify balances where several balances (or parts thereof) in the balance sheet have been used.

9.4 Recoverability of debtors

One area of concern where recoverability of debtors is concerned has been addressed earlier which is reliance on a debtors' circularisation letter for the valuation assertion. As noted above, circularisation letters do not verify the valuation assertion and hence should not be used as audit evidence to support the valuation assertion.

Debtors (whether trade or other debtors) must be assessed for recoverability (i.e. the valuation assertion). In directional testing, assets in the balance sheet are tested primarily for overstatement.

Work on trade debtors often focuses on balances that are overdue. This is an important test because there is a much higher risk of irrecoverable debtors when they are overdue than there is when the debtor is within credit terms. However, what is often apparent is that debtors which are within credit terms are then ignored because the focus has been on overdue debts.

Audit work must also be carried out on debtors which are within credit terms at the balance sheet date to ensure recoverability. Often, where these are missed due to the focus being on overdue debts, the balance which is within credit terms is also material.

Samples should be designed in such a way that the focus of the test achieves a broad coverage of both overdue and non-overdue items.

Also, keep in mind that the procedures for recoverability should include extended post-year end cash receipts testing, discussions with relevant individuals about specific bad debt provisions and reviews of correspondence post-year end to ascertain whether any balances at the year end are in dispute (which could give rise to a further write-down of

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a debtor's balance). In addition, the auditor should check if confirmation has been received post-year end that a balance outstanding at the reporting date will not be paid as this could indicate an adjusting post balance sheet event.

Another area of concern is that some financial statements prepared under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* seem to include general bad debt provisions. These are provisions which are merely a certain percentage of debtors (e.g. 5% of total trade debtors) that might not pay. Such general provisions are not allowed under FRS 102 – only specific bad debts may be provided for so do watch out for audit clients with these as sometimes they can be material (either individually or when aggregated).

Another issue is that of a loss incurred by an LLP. Depending on the partnership agreement, losses may be allocated to the partners in the same way as profits. Where this is the case, the capital accounts may then become overdrawn and would be presented within debtors.

The recoverability of these overdrawn capital accounts should be given careful consideration where the client is audited because the auditor will need to obtain sufficient appropriate audit evidence that the overdrawn capital accounts can be recouped. In the event of a loss-making LLP, there could be going concern issues so this needs to be carefully looked at also.

9.5 'Comfort' letters

Letters of comfort (or 'support letters') are often used by auditors as audit evidence to confirm support will be made available to an entity. For example, it is often the case that a support letter will be provided by a parent entity to the subsidiary's auditor that says the parent will be willing to provide financial support if, and when, necessary.

The problem with support letters is that they are internally generated. A support letter is a weak form of audit evidence – especially where it is serving to corroborate the going concern basis of accounting.

While comfort letters are a form of audit evidence, they should complement other evidence obtained from the auditor. If support is going to be offered by the parent (or another entity), the auditor must obtain sufficient and appropriate audit evidence that the parent/other entity is in a sustainable position to be able to offer that support. If the parent/other entity themselves are going through a turbulent financial crisis, little comfort can be gained from a letter saying they'll offer the support as the question that the auditor must ask in these situations is 'how?'.

The auditor will need to satisfy themselves that the parent/other entity is in a sufficiently adequate financial position to be able to support the audit client when necessary by looking at audited financial statements, cash flow forecasts and budgets. Additional work should also be performed on these to ensure they are reasonable and

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the procedures applied will complement existing audit work which the auditor has performed on the audit client's going concern status.

9.6 Provisions and contingencies

Provisions and contingencies have moved up the ranks of importance since the Covid-19 pandemic has hit businesses and so care needs to be taken with these issues – especially where contracts have become onerous due to the pandemic. Care also needs to be taken with issues such as reimbursement assets, which are discussed later.

A 'provision' is defined as a liability of uncertain timing or amount. The fact that a provision is uncertain in terms of its timing and amount is what distinguishes it from a normal creditor. In order to recognise a provision in the financial statements, three criteria have to be met:

- The entity has an obligation at the balance sheet date as a result of a past event.
- It is probable (i.e. more likely than not) that the entity will be required to transfer economic resources in settlement.
- The amount of the obligation can be reliably estimated.

If any of the above three criteria cannot be met, a provision is not recognised and a contingent liability is disclosed instead (if the contingent liability is material).

For example, if payment is only possible, not probable, then no provision is recognised but a contingent liability is disclosed.

In practice it can often be difficult in establishing whether a provision should be recognised, or a contingent liability disclosed. The audit risk where provisions and contingencies are concerned is that either liabilities are understated (and the resulting profit overstated) or disclosures are incomplete. If this audit risk is not addressed properly, there is a chance the auditor could express an incorrect opinion on the financial statements.

The focus of the audit testing should be on whether an obligation exists at the reporting date and, if so, whether the provision is valued correctly. Keep in mind, there may be some interaction with ISA (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures* where provisions are concerned.

Again, it is important that all the relevant assertions are tested where provisions and contingencies are concerned. These are:

- Accuracy
- Presentation

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- Rights and obligations
- Existence
- Completeness
- Valuation

Typical procedures that should be applied over provisions and contingencies include the following:

Audit procedure	Relevant assertion that will be addressed
Discuss with the directors, or inspect relevant documentation, to confirm that a present obligation exists at the year end.	Rights and obligations
Inspect relevant board minutes to ascertain whether payment is probable (i.e. more likely than not).	Existence
Obtain a breakdown of the provision, cast it and agree the figure to the nominal ledger, trial balance and financial statements.	Accuracy and presentation
Recalculate the provision and agree components of the calculation to supporting documentation.	Completeness
Inspect the post-year end cash book/bank statements to identify if any payments have been made and compare any payments made to the amount provided for in the accounts to ascertain whether the provision is reasonable.	Valuation
With the client's permission, obtain confirmation from the lawyer about the	Existence and rights and obligations

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likely outcome of any legal case and the chances of payment.	
Inspect correspondence from the lawyer concerning the legal case to assess whether a provision should be recognised and, if so, whether the amount of the provision is adequate.	Valuation and completeness
Review the financial statement disclosures concerning the provision or contingent liability to ascertain compliance with FRS 102 (or the relevant financial reporting framework).	Presentation
Obtain a written representation from management that they believe the provision has been valued appropriately and is complete.	Valuation and completeness

Also, auditors must keep in mind the requirements of ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items* which deals with litigation and claims at paragraphs 9-12 and A17-A25 and have regard to those provisions where they apply.

Reimbursement assets

In some cases, a provision for a liability will be needed in the financial statements because the recognition criteria have been met. The entity may be able to recoup some of this liability back from a third party (e.g. an insurer).

There are some important considerations for the auditor where reimbursement assets are concerned as the recognition criteria for a reimbursement asset is not the same as that for a provision for a liability.

- In order to qualify for recognition on the balance sheet, the receipt of a reimbursement asset must be **virtually certain**. The virtually certain test is a higher hurdle to pass than the probability test for a provision for a liability. The virtually certain test would essentially require written confirmation from the third party that they will pay and/or the auditor can verify receipt of the reimbursement asset to a post-year end bank statement.

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If receipt is not virtually certain, a reimbursement asset does not exist and a contingent asset is disclosed instead if material.

- Reimbursement assets cannot be offset against their related provision for liability in the balance sheet. The expense in profit or loss can be reported net, but the balance sheet must show the reimbursement asset and the provision for liability gross. Auditors must therefore carry out procedures to ensure the presentation assertion is appropriately addressed.

In the current economic climate, it is important that auditors carry out adequate procedures to ensure that the relevant assertions for provisions and contingencies are addressed properly. This is because more entities are making additional provisions due to the Covid-19 pandemic (such as onerous contract provisions and restructuring provisions) or disclosing contingent liabilities due to being unable to fulfil contracts because of lockdown restrictions.

9.7 Written representations

Written representations are dealt with in ISA (UK) 580 *Written Representations*. While written representations are a form of audit evidence, they are a weak form and care needs to be taken with them. Indeed ISA (UK) 580, para 4 states:

> *Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities, or about specific assertions.*

ISA (UK) 580, para 4

Auditors must not, therefore, rely solely on written representations as audit evidence. The reason ISA (UK) 580 takes this particular stance is because a written representation letter is internally generated by the entity and so should only be used to complement other forms of audit evidence to which the representations relate.

Some professional bodies have criticised audit firms for failing to have the written representation produced on the client's letterhead. Therefore, auditors must ensure that they arrange for the written representation to be produced on the letterhead of the audit client.

ISA (UK) 580 also contains Appendix 1 *List of ISAs (UK) Containing Requirements for Written Representations*. Audit firms must ensure that the written representation they obtain from their client contains the specific representations, where applicable, that is required by ISA (UK) 580.

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Appendix 1 as follows:

- ISA (UK) 240 (Revised June 2016), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraph 39
- ISA (UK) 250 (Revised November 2019), *Section A – Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 17
- ISA (UK) 450 (Revised June 2016), *Evaluation of Misstatements Identified During the Audit* – paragraph 14
- ISA (UK) 501, *Audit Evidence – Specific Considerations for Selected Items* – paragraph 12
- ISA (UK) 450 (Revised December 2018), *Auditing Accounting Estimates and Related Disclosures* – paragraph 37
- ISA (UK) 550, *Related Parties* – paragraph 26
- ISA (UK) 560, *Subsequent Events* – paragraph 9
- ISA (UK) 570 (Revised September 2019), *Going Concern* – paragraph 12-2(f)
- ISA (UK) 710, *Comparative Information – Corresponding Figures and Comparative Financial Statements* – paragraph 9
- ISA (UK) 720 (Revised November 2019), *The Auditor's Responsibilities Relating to Other Information* – paragraph 13(c)

9.8 Intimidation threats

Auditors have to be seen to be independent. In today's modern auditing profession, the Ethical Standard issued by the FRC makes various provisions to enable auditors to remain independent. One of the threats to independence and objectivity is an intimidation threat. This is where the client may place undue pressure on the auditor to achieve a desired outcome (usually an unqualified audit opinion when a qualified opinion would be more appropriate or trying to persuade the auditor not to include a matter within their auditor's report, such as a Material Uncertainty Related to Going Concern paragraph or an Emphasis of Matter paragraph).

With Covid-19 still causing significant amounts of disruption up and down the country, there is a higher risk of an intimidation threat from an audit client and care must be taken by the auditor to deal with such threats accordingly whilst maintaining independence and objectivity. It would be reckless for an auditor to 'give in' to an audit client and issue, for example, an unqualified audit opinion when a qualified opinion is necessary in the circumstances.

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Example – Intimidation threat

The audit of Slevin Industries Ltd for the year ended 31 December 2020 is currently underway. The financial statements recognise profit before tax of £317,500 and total assets of £6.25m.

During the audit of trade debtors, the audit senior noted a large balance of £490,000 owing from a company which is wholly owned by the brother of the chief executive. This amount is shown as more than 120 days overdue. The brother does not own any shares in Slevin Industries, nor is he a director of the business.

The credit control clerk has informed the audit senior that she does not think this company will pay this balance as they have been struggling financially for a while. In addition, it would seem that the brother has been doing ad-hoc work within Slevin Industries for which he is paid a nominal sum via the payroll.

A review of the records at Companies House shows that the accounts for the brother's company are overdue for filing, as is the annual confirmation statement and there is a proposal to strike the company off which has currently not been objected to.

A further discussion with the finance director indicated that the company is unlikely to receive payment from the brother's company. The finance director has said that he is unwilling to write this debt off for two reasons:

- First, there is no evidence that payment will not be received – the brother may be able to access finance in the future.
- Second, no liquidator has been appointed to the brother's company even though it is not currently trading.

The auditor has concluded that the balance owed by the brother's company is irrecoverable. The balance is material in monetary terms because it represents 7.8% of total assets (£490k / £6.25m). It is also both material in monetary terms and material in nature to profit before tax because if the £490,000 debt is written off, it will turn the £317,500 profit into a £172,500 loss.

The audit engagement partner has informed the finance director that if this amount is not written off, it will cause a qualified audit opinion. The finance director has said that he will arrange for a 'comfort letter' to be sent to the auditor confirming that the balance is recoverable if the auditor does not issue a qualified opinion, or if that is not enough, he will write the debt off, but in the next accounting period. The finance director has also informed the audit engagement partner that the company's borrowings are due to be renewed shortly and a qualified opinion would have a

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detrimental impact on the bank's decision as well as on the credit-rating.

This is an example of an intimidation threat. The auditor has come across a situation that could mean the issuance of a qualified auditor's report. The client does not want to write the debt off and if the auditor does 'give in' to the client and issue an unqualified opinion, they will have expressed the wrong opinion.

The auditor must maintain their stance. If the client does not write the balance owing from the brother's company off, they must express a qualified opinion. The auditor may also then need to consider whether, or not, they wish to continue acting for the client given the intimidation threat that has arisen in the current year's audit.

Intimidation threats in a Covid-19 climate are appearing to become more common. Auditors cannot simply 'turn a blind eye' to issues such as irrecoverable balances remaining as assets on the balance sheet, or inadequate going concern disclosures. If an issue is material (either in combination or in aggregate) and it is not addressed by the client, there will be a corresponding effect on the auditor's opinion.

In the event of doubt, it is always advisable for the auditor to seek independent advice from their professional body's technical advisory department or from.

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