Audit and Accounting Quarterly Update – April 2022

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1 Periodic review update (Lecture A774 – 12.42 minutes)

In March 2021, the Financial Reporting Council (FRC) announced the start of the periodic review of UK GAAP. The last major change to UK accounting standards was in respect of the triennial review amendments which were finalised in December 2017. Since then, the FRC have stated that they no longer intend to carry out triennial reviews of UK GAAP. Instead, they will carry out periodic reviews every four or five years as this will enable the most recent editions of the standards to become established. In turn, this should allow the FRC to receive more constructive feedback once the next periodic review starts.

The FRC invited comments from stakeholders on areas that they may wish to consider reviewing as part of the forthcoming periodic review. This comment period closed in October 2021 and the FRC have received a lot of feedback.

1.1 Next steps

The FRC are currently working their way through the suggestions received as part of the initial comment period. Discussions with the FRC indicate that there are some areas which may see some significant change, some where there may be moderate change and other areas which will see very light changes.

An Exposure Draft of the proposed amendments is not expected until the second half of 2022. Once the Exposure Draft is issued, it is expected that there will be a standard comment period of three months and practitioners of all sizes are encouraged to make comments on areas that they feel are of importance.

The FRC's planned 'effective from' date for the amendments was previously planned for accounting periods commencing on or after 1 January 2024. However, the FRC have deferred the proposed effective date of the amendments that will be set out in the forthcoming Exposure Draft until no earlier than 1 January 2025. Delaying the effective from date for a year will give practitioners and clients time to digest the changes and consider the impact the changes will have on the financial statements.

1.2 Will the new IFRS®s be included in this review?

The 'new' IFRSs referred to are in respect of:

- IFRS 9 *Financial Instruments*

- IFRS 15 *Revenue from Contracts with Customers*
- IFRS 16 *Leases*

There has been much speculation about the FRC aligning FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (and, to a certain extent, FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*) to the above IFRSs. There is currently no definitive answer to this. However, the FRC have been analysing implementation feedback from IFRS preparers to assess the cost/benefit of potentially aligning UK accounting standards, so they are more consistent with the requirements of the above IFRS.

A summary of the main issues relating to the above IFRSs is as follows:

IFRS 9

IFRS 9 uses an 'expected credit loss' (ECL) model which is more forward looking and requires the preparer to recognise impairment losses on financial assets when full recoverability is not expected. UK GAAP does not use the ECL model; instead it uses an incurred credit loss model which means that financial assets, such as trade debtors and loans receivable, are written down to recoverable amount when a loss has been incurred rather than when a loss is expected.

Some commentators are of the opinion that the ECL model would be inappropriate for UK GAAP reporters because it is complex to apply in practice. It would also appear that there has been little in the way of criticism of the incurred credit model which appears to be working fine in practice. Therefore, we expect some 'pushback' if the FRC propose to move UK GAAP reporters onto an ECL model.

IFRS 15

IFRS 15 is a rigorous standard which prescribes a five-step model approach to recognising revenue and requires far more extensive disclosures than UK GAAP, which is expected because IFRS is used for public interest entities. The way in which IFRS 15 is drafted would mean that it would be disproportionate to UK GAAP reporters so it is expected that if the FRC do propose to align FRS 102, Section 23 *Revenue* with IFRS 15, there would have to be simplifications included in any potential amendments.

IFRS 16

This is probably the most contentious of the standards and the one which appears to be causing the most concern among practitioners, especially those whose client portfolio is wholly made up of SME clients.

IFRS 16 essentially requires all leases for lessees to be recognised on the balance sheet. There are some limited exceptions for short-life and low-value leases which can be treated in much the same way as operating leases currently are.

This is where the FRC will need to tread carefully because it is expected that there will be a lot of pushback if it is proposed to align FRS 102, Section 20 *Leases* (and potentially FRS 105, Section 15 *Leases*) to the requirements of IFRS 16.

Concerns raised by practitioners currently include proportionality of the potential requirements; in other words, what are the benefits to private entities of reporting all leases on balance sheet? The costs involved in restating financial statements to comply with any new lease accounting requirements and the impact on any covenants.

Interestingly, the International Accounting Standards Board (IASB) are currently carrying out their comprehensive review of the *IFRS® for SMEs* standard. The IASB have confirmed that they do not intend to change the way in which leases are accounted for under *IFRS for SMEs* hence the concept of a finance and operating lease for lessees will remain.

The FRC were planning to wait and see how the IASB would incorporate any changes to lease accounting in *IFRS for SMEs* to see if it would provide them with a useful starting point. However, as this is not going to be the case, the FRC will have carefully think about how any planned changes to the lease accounting requirements in UK GAAP will work.

Opinion on this issue is divided. Some in the profession welcome changes to lease accounting on the grounds that the concept of operating versus finance lease for lessees has become outdated as leasing arrangements have evolved over the years. Others are against the idea of reporting all leases on the balance sheet for reasons cited earlier (cost versus benefit being the main one).

An issue which could prove problematic for the FRC is how a private entity derives the discount rate to discount the cash flows in the lease to present value to be able to recognise the right-of-use asset and the corresponding lease obligation. The FRC will then need to carefully consider any transitional provisions or exemptions that they may make available to private entities in transitioning to any new lease accounting requirements.

At this stage, any proposals for change would only be proposals. This is an area which is expected to generate a lot of debate once the Exposure Draft is issued and so any proposals could well either end up not being actioned or be significantly changed once the final standard is developed.

Practitioners of all sizes are strongly encouraged to respond to the potential changes, particularly once the Exposure Draft is issued. The email address to provide constructive feedback to the FRC is ukfrsperiodicreview@frc.org.uk.

2 New editions of UK GAAP issued

In January 2022, the FRC issued new editions of:

- Foreword to Accounting Standards
- Overview of the financial reporting framework
- FRS 101 Reduced Disclosure Framework
- FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland
- FRS 103 Insurance Contracts
- Implementation Guidance to accompany FRS 103 Insurance Contracts
- FRS 104 Interim Financial Reporting
- FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime

The FRC have not reissued FRS 100 *Application of Financial Reporting Requirements* as there are some additional changes needed to that standard which will be actioned later in 2022.

2.1 Why have the FRC reissued these standards?

As noted in the previous section of these notes, the FRC are currently underway with their periodic review of UK GAAP so it begs the question as to why the FRC would need to reissue latest editions of the standards if they are going to change in the short-term.

Since the March 2018 editions of the standards were issued, there have been some changes made to them, such as:

- Amendment in respect of multi-employer defined benefit plans
- Amendments in respect of the interest rate benchmark reforms
- Amendments in respect of Britain's exit from the EU
- Amendments in respect of Covid-19-related rent concessions

The January 2022 editions of the standards consolidate all the amendments made since the last triennial review (note FRS 101 is reviewed on an annual basis). Whilst there are no changes to be aware of where the new editions are concerned, it is better to have new editions of the standards which incorporate all the changes made since the last editions were published.

In addition, the latest editions of the standards will provide the basis for the FRC's periodic review. The *Foreword to Accounting Standards* and *Overview of the financial reporting framework* have been reissued to reflect developments in accounting standards, legislation and regulation.

3 FRS 102, Section 1A *Small Entities* (Lecture A775 – 13.30 minutes)

FRS 102, Section 1A outlines the presentation and disclosure requirements for small entities (including small LLPs). FRS 102, Section 1A was first introduced in the September 2015 edition of FRS 102 following transposition of the EU Accounting Directive into UK company law.

Most small entities prepare their financial statements in accordance with FRS 102, Section 1A. However, it should be noted that Section 1A is optional and hence a small company need not report under Section 1A if it does not wish to.

The structure of Section 1A per the January 2022 edition of FRS 102 is as follows:

Section	Paragraphs
Scope of this section	1A.1 to 1A.4
True and fair view	1A.5 to 1A.6
Statement of compliance	1A.6A
Complete set of financial statements of a small entity	1A.7 to 1A.11
Information to be presented in the statement of financial position	1A.12 to 1A.13
Information to be presented in the income statement	1A.14 to 1A.15
Information to be presented in the notes to the financial statements	1A.16 to 1A.20
Voluntary preparation of consolidated financial statements	1A.21 to 1A.22

There are five appendices attached to Section 1A as follows:

- Appendix A Guidance on adapting the balance sheet formats
- Appendix B Guidance on adapting the profit and loss account formats
- Appendix C Disclosure requirements for small entities in the UK

- Appendix D Disclosure requirements for small entities in the Republic of Ireland
- Appendix E Additional disclosures encouraged for small entities

Appendix C outlines the disclosures for small entities which are required by law as follows:

Disclosure requirements	Paragraphs
Accounting policies	1AC.3 to 1AC.6
Changes in presentation and accounting policies and corrections of prior period errors	1AC.7 to 1AC.9
True and fair override	1AC.10
Notes supporting the statement of financial position	1AC.11
Fixed assets	1AC.12 to 1AC.19
Impairment of assets	1AC.20 to 1AC.21
Fair value measurement	1AC.22 to 1AC.26
Indebtedness, guarantees and financial commitments	1AC.27 to 1AC.31
Notes supporting the income statement	1AC.32
Information about employee numbers	1AC.33
Related party disclosures	1AC.34 to 1AC.36
Other	1AC.37 to 1AC.39

3.1 True and fair requirements

The requirement to prepare financial statements that give a true and fair view is enshrined in company law. Section 393 of Companies Act 2006 prohibits the directors from approving financial statements unless they are satisfied that they give a true and fair view.

Unlike the micro-entities' legislation, there are no 'deeming' provisions in company law for small companies (i.e. a *presumption* that the financial statements give a true and fair view if they have been prepared in accordance with the relevant requirements). The directors of a small company still have a legal duty to ensure the entity's financial statements give a true and fair view and a criminal offence will be committed where the directors knowingly approve financial statements which do not give a true and fair view.

Merely applying the minimum legal requirements in FRS 102, Section 1A may sometimes be insufficient to enable a true and fair view to be presented. In this respect, additional disclosures beyond the requirements of Section 1A will be needed.

To assist preparers, the FRC has included Appendix E to Section 1A which provides five **encouraged** disclosures that small entities (including micro-entities that apply FRS 102, Section 1A) should consider as follows:

When relevant to its transactions, other events and conditions, a ***small entity*** *in the UK is encouraged to provide the following disclosures:* *FRS 102, para 1AE.1*

(a) a statement of compliance with this FRS as set out in paragraph 3.3, adapted to refer to Section 1A;

(b) a statement that it is a ***public benefit entity*** *as set out in paragraph PBE3.3A;*

(c) the disclosures relating to ***material*** *uncertainties related to events or conditions that cast significant doubt upon the small entity's ability to continue as a* ***going concern*** *as set out in paragraph 3.9;*

(d) dividends declared and paid or payable during the period (for example, as set out in paragraph 6.5(b)); and

(e) on first-time adoption of this FRS an explanation of how the transition has affected its ***financial position*** *and financial performance as set out in paragraph 35.13.*

When relevant to its transactions, other events and conditions, a small entity in the Republic of Ireland is encouraged to provide the disclosures in paragraph 1AE.1(b), (c) and (e). *FRS 102, para 1AE.2*

While the above disclosures are encouraged, as opposed to mandatory, small entities should consider them. Over the last couple of years, material uncertainties relating to going concern have moved up the ranks of importance because of the Covid-19 pandemic and many small entities have made disclosures in respect of material uncertainties related to going concern. However, some have not even though it is clear that there are material uncertainties related to going concern.

Important point

Where a small entity does not make disclosures in respect of material uncertainties relating to going concern, it would be difficult to justify that the financial statements give a true and fair view. The fact that they are **material** uncertainties that have not been disclosed means that the financial statements would likely be misleading. Keep in mind that professional bodies do not allow members to have their names associated with financial statements that are misleading. Hence, it may be the case that the practitioner needs to consider resigning if the directors refuse to provide disclosures in respect of material uncertainties related to going concern.

ACCA's Technical Factsheet on Covid-19 issues acknowledges that ACCA member firms cannot have their names associated with financial statements that are misleading. ICAEW Code of Ethics also takes the same stance in prohibiting members from having their names associated with misleading information (see paragraph R111.2).

Where the small entity is audited and the directors refuse to include adequate disclosures relating to material uncertainties in respect of going concern, the auditor will modify their opinion accordingly.

Example

The financial statements of Sunnie Limited for the year ended 31 December 2021 show a healthy profit has been sustained, despite the challenges faced by the pandemic. The balance sheet is showing a large amount of net current assets and the entity is cash rich. The company prepares its financial statements in accordance with FRS 102, including Section 1A.

Note 20 to the financial statements states:

Material uncertainties related to going concern

The directors are of the opinion that there are no material uncertainties related to going concern that require disclosure. In arriving at this conclusion, the directors have had regard to the working capital requirements for at least 12 months from the date of approval of the financial statements and the company's cash flow forecast budgets.

In this scenario, there are no material uncertainties related to going concern and therefore this disclosure is superfluous. Where there are no material uncertainties related to going concern, there would be no need to make such a disclosure.

3.2 From small to medium-sized or large

A company may expand and grow into a medium-sized or large company. When this happens, the entity will not be able to apply the presentation and disclosure requirements of Section 1A and must therefore report under the provisions of full FRS 102.

One of the distinct advantages of having Section 1A dealing with presentation and disclosure only is that a transition need not be carried out when the entity grows into a medium-sized or large entity. This is because recognition and measurement of amounts will still be based on full FRS 102. So while the amounts that would be recognised in the entity's financial statements would not change, the disclosure requirements would become more comprehensive because they would be based on full FRS 102 rather than Section 1A.

In addition, the entity would also need to consider whether they have applied the simplification in FRS 102, para 11.13A(a) and measured a loan received from a director-shareholder/member of the group of close family members of the director which contains a shareholder at face value. If this is the case, the loan will need to be restated. FRS 102, para 11.1B states:

> *An entity taking advantage of the exemption in paragraph 11.13A(a) that subsequently ceases to be a small entity may, when remeasuring the financial liability to present value* ***prospectively*** *from the first* ***reporting date*** *after it ceases to be a small entity, determine the present value on the basis of the facts and circumstances existing at that time or at the date the financing arrangement was entered into.*

FRS 102, para 11.13B

3.3 From large or medium-sized to small

An entity that has contracted to become small and which is eligible to apply Section 1A for the first time will be able to take advantage of reduced disclosures in its financial statements. Again, the recognition and measurement requirements would not change as these would be based on full FRS 102, but the disclosure requirements would become less comprehensive.

The newly small entity may also wish to take advantage of the simplification in FRS 102, para 11.13A(a) in respect of a loan received from a director-shareholder/member of the group of close family members of the director which contains a shareholder and remeasure the loan at face value. In this respect, FRS 102, para 11.13C states:

An entity that subsequently becomes eligible to take advantage of the exemption in paragraph 11.13A(a) and chooses to do so shall apply the exemption retrospectively.

In practice, there would be little benefit in remeasuring the loan to face value as the calculations will already have been carried out when the loan was first received (i.e. imputing a market rate of interest and discounting the loan). It would therefore be advisable to continue measuring the loan at amortised cost using the imputed market rate of interest until the loan is repaid.

3.4 Referencing Section 1A in the accounting policies

When a small entity prepares its financial statements using Section 1A, it is best practice to correctly refer to the section in the basis of preparation of the financial statements.

There is, however, a requirement to state that the financial statements are prepared in accordance with the provisions applicable to companies subject to the small companies regime.

4 Goodwill and intangible assets (Lecture A776 – 17.43 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*.

During reviews of financial statements and audit files, common issues are frequently found relating to goodwill and intangible assets, so it is worthwhile addressing these areas to recap on the core accounting issues.

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 either:

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

Separability

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

In addition, the separability criterion is met when the asset is also capable of being distinguished from goodwill.

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 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.

At the outset it is important that preparers clearly understand the definition of an intangible asset 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 as it is incurred. 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. Nowadays, however, sophisticated software can be purchased which keeps a track of such projects.

However, 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 overleaf).

Expenditure which must not be capitalised

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

FRS 102 para 18.8C

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

(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.*

4.2 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:

FRS 102, para 18.8G

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

(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.*

4.3 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 the policy selected is consistently applied and adequately disclosed.

Strict criteria must 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:

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

FRS 102, para 18.8H

(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 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
Greaves Ltd started developing a new drug for dogs aimed at managing

certain illnesses without the use of aggressive drugs which can cause other side effects. This project commenced on 6 January 2021. During the year to 31 December 2021, Greaves 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
	2.0

The company reports under full FRS 102 and has an accounting policy 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 2021 that the product was likely to be profitable and cash flows were able to be generated. Development expenditure started to be incurred at the start of April 2021 and the company had incurred £0.4m worth of development expenditure up to 1 August 2021. 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.

<u>Solution</u>

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 was incurred before the drug was known to be commercially viable (the commercially viable test was passed on 1 August 2021). Hence, this expenditure 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 2021 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 Greaves 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. If this is not corrected, the financial statements will be misleading.

For auditors, the challenge will be ensuring correct capitalisation has taken place 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.

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):

FRS 102 para 18.8J

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

(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.

4.4 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*.
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 • the 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.

4.5 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:

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

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) 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.

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. No prior year restatement would be needed in respect of a change in residual value because this would be treated as a change in estimate per FRS 102, Section 10 *Accounting Policies, Estimates and Errors*. Changes in accounting estimates are accounted for prospectively.

4.6 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.

The concept of amortisation has been the subject of much debate over the years – most notably with international accounting standard-setters. Currently, goodwill under the IFRS regime is not amortised but is subject to annual impairment tests. UK GAAP mandates amortisation and prohibits indefinite useful lives being assigned to goodwill and intangible assets.

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 ten years and it is important that this cap is only applied in **exceptional** cases. This ten-year cap only applies when management are unable to assign a reliable useful economic life to the intangible asset. This is 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 ten 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 some preparers who think the maximum all intangible assets can be amortised over is ten 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 2020. This licence allows the 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 2021 it amortised the cost of the licence over ten 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 2022, the production director informed the board that he received notification on 20 December 2021 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 2021 or whether it can change the amortisation charge in 2022 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. 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 2022 reflects a useful economic life remaining of five years.

4.7 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 must be derived from an 'active market'. The Glossary to FRS 102 defines an 'active market' as:

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.

FRS 102 Glossary ***active market***

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 on their own 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.

4.8 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 ten-year cap also applies to goodwill (only in the exceptional cases 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) with tax consequences. 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.

This is consistent with the requirements in *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), Sch 1, Part 1, Section B, Note 3 which only permits goodwill to be recognised when it has been acquired for valuable consideration (see Note 2 in *The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* (SI 2008/409, Sch 1, Part 1, Section B).

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.

5 Provisions and contingencies (Lecture A777 – 9.07 minutes)

We are aware of a third-party consultancy firm ('the firm') that is 'cold-calling' clients in connection with potential breaches of GDPR.

The firm is approaching clients enquiring as to whether they think they may have breached GDPR and, if so, recommending that they make a provision in the financial statements for potential sanctions from the Information Commissioner's Office.

In the material that we have seen, the firm refers to the directors' duties under company law to prepare financial statements which give a true and fair view, which is correct. However, nowhere in the material are any references to UK accounting standards which essentially govern the recognition and measurement of any provision.

Professional bodies have been made aware of this firm and the implications that incorrectly recognising provisions may have on the client concerned. We understand that ACCA will be issuing a Technical Factsheet concerning this issue in due course which will advise its member firms to advise their clients to approach such schemes with caution.

In some cases, claims for provisions are applied for retrospectively. In other words, the tax computation for a previous period is amended which will trigger a refund of corporation tax. A commission is then paid to the firm for securing the corporation tax refund. There is a heavy disclaimer in the material we have seen which states that the firm does not act in the capacity as tax adviser or accountant – thus the onus is on the client to deal with any challenge from HM Revenue and Customs (HMRC).

HMRC have opened compliance checks on some clients that have been advised by the firm to make a provision in their financial statements, and of course there are costs associated with dealing with this compliance check on behalf of the client. Ultimately, HMRC will be keen to ensure that the provisions in UK accounting standards have been correctly applied. In some isolated cases, it would appear that the value of the provision has been excessive and has had a detrimental impact on the level of distributable profit that is available to the shareholders.

5.1 Correct recognition of a provision

Provisions and contingencies are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 21 *Provisions and Contingencies* (FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with them in Section 16).

FRS 102, para 21.4 states that an entity must recognise a provision only when:

(a) *the entity has an obligation at the **reporting date** as a result of a past event;*

(b) *it is **probable** (ie more likely than not) that the entity will be required to transfer economic benefits in settlement; and*

FRS 102, para 21.4

(c) *the amount of the obligation can be estimated reliably.*

All three of the above criteria must be met at the balance sheet date in order for a provision to be recognised. If any one of the above criteria cannot be met, a provision cannot be recognised.

5.2 Contingent liabilities

FRS 102, para 21.12 states:

*A contingent liability is either a possible but uncertain obligation or a present obligation that is not recognised because it fails to meet one or both of the conditions (b) and (c) in paragraph 21.4. An entity shall not recognise a contingent liability as a liability, except for provisions for contingent liabilities of an acquiree in a **business combination** (see paragraphs 19.20 and 19.21). Disclosure of a contingent liability is required by paragraph 21.15 unless the possibility of an outflow of resources is remote. When an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.*

FRS 102, para 21.12

Therefore, where the recognition criteria for a provision cannot be met, the entity may need to disclose a contingent liability but only if that contingent liability is material and the condition in FRS 102, para 21.4(a) is met. If the possibility of an outflow of resources is remote, no disclosure is required. FRS 102 does not define 'remote' but it should be taken to mean that something is not expected to happen, although it cannot be ruled out completely.

5.3 Impact of incorrectly recognising a provision in respect of GDPR breaches

If HMRC open a compliance check into the company's tax return where a provision has been made that has triggered a tax refund, HMRC will be interested to see that the requirements of accounting standards have been correctly applied. As noted above, the material which we have seen by the firm approaching clients does not appear to make any reference to accounting standards.

Where HMRC is satisfied that the provision has been incorrectly claimed for, or they are satisfied that the provision does not meet the recognition criteria in FRS 102 or FRS 105, they will disallow the claim. This will result in the tax relief being repayable to HMRC together with potential penalties and interest. This can prove costly to the client and given the challenges that businesses have been faced with over the last couple of years due to Covid-19, any large cash outflows which can be avoided should be.

Clients should be advised to contact their accountant if approached by any firms claiming to be able to obtain a tax refund on their behalf through the recognition of a provision for (potential) breaches of law or regulation. Technical advice should be sought by the practitioner in the event or difficult or contentious issues either through the relevant professional body's technical advisory department or by speaking to a member of staff at Mercia for technical input.

6 Government grants (Lecture A778 – 10.41 minutes)

Over the last couple of years, government grants have become common transactions in financial statements. For example, grants in respect of Covid-19 such as the Coronavirus Job Retention Scheme grant.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with government grants in Section 24 *Government Grants*. FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with the issue in Section 19 *Government Grants*.

While government grants have become common during the pandemic, they are also received by entities for other reasons, such as for setting up operations in a deprived area of the country to encourage employment opportunities. New start-up businesses can also receive government grants to assist them with the initial day-to-day running costs of the business, or to fund certain fixed assets.

The term 'government grant' is defined as:

> *Assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the* ***operating activities*** *of the entity.*
>
> *Government refers to government, government agencies and similar bodies whether local, national or international.*

FRS 102 Glossary ***government grant***

6.1 Scope

FRS 102, Section 24 deals with the accounting for all government grants and recognises that a government grant is assistance provided by government in the form of a transfer of resources to an entity in return for past or future compliance with specific conditions relating to the operating activities of the entity.

The scope of FRS 105, Section 19 is shorter and paragraph 19.1 states that Section 19 applies to all government grants for micro-entities. FRS 105, para 19.2 confirms that government grants exclude those forms of government assistance which cannot reasonably have a value placed on them (for example, services provided by government for free) and transactions with government that cannot be distinguished from the normal trading transactions of the micro-entity.

FRS 102, Section 24 does not deal with:

- forms of government assistance which cannot reasonably have a value placed upon them;
- transactions with government that cannot be distinguished from normal trading transactions of the entity; and
- government assistance provided to an entity in the form of benefits which determine taxable profit or loss, or are determined or limited on the basis of the entity's tax liability.

Forms of government assistance which cannot reasonably have a value placed upon them would include free advice provided to the entity. Therefore, anything which is specific to the reporting entity (i.e. where a value cannot realistically be placed) would be regarded as being unable to have a value placed upon them.

Transactions with government that cannot be distinguished from normal trading transactions of the entity would include examples such as contracts to supply local government where the supply terms are negotiated in advance and a grant is offered in exchange for terms which would be regarded as favourable when compared with other suppliers.

Government assistance provided to an entity in the form of benefits which determine taxable profit or loss or are determined or limited on the basis of the entity's tax liability would include examples such as income tax holidays, investment tax credits, accelerated capital allowances (e.g. first year allowances or the annual investment allowance) and reduced tax rates.

6.2 Recognition and measurement

Recognition and measurement principles are dealt with in FRS 102. paras 24.3A to 24.5G and in FRS 105, paras 19.3 to 19.10.

FRS 102, para 24.3A and FRS 105, para 19.3 both acknowledge that government grants, including non-monetary grants, shall not be recognised in the financial statements until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received.

The term 'reasonable assurance' is not a defined term in either standard. However, the term 'probable' is a defined term and means 'more likely than not', hence reasonable assurance should be interpreted in the same way as probable. In other words, it is more likely than not that the entity will comply with the conditions attaching to the grant and the grant will be received.

Once the recognition criteria have been met, the entity recognises the grant as follows:

- FRS 102: performance model or accrual model
- FRS 105: accrual model only

Both the accrual model and performance model are discussed below. However, where an entity is reporting under FRS 102, a choice between both models is offered. Whichever choice is applied by an entity, it must be applied on a class-by-class basis and should be applied consistently. In practice, the performance model is usually applied to revenue-based grants, whereas the accrual model is applied to capital-based grants because the latter achieves the 'matching' concept (although the matching concept no longer exists).

In all cases, grants should be measured at the fair value of the asset received or receivable.

Performance model

FRS 102, para 24.5B states that the performance model is a model which imposes three specific methods of grant recognition:

FRS 102, para 24.5B(a) – (c)

(a) *A grant that does not impose specified future* ***performance-related conditions*** *on the recipient is recognised in income when the grant proceeds are received or receivable.*

(b) *A grant that imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.*

(c) *Grants received before the* ***revenue recognition*** *criteria are satisfied are recognised as a liability.*

The term 'performance-related conditions' is defined in FRS 102 as follows:

> *A condition that requires the performance of a particular level of service or units of output to be delivered, with payment of, or entitlement to, the resources conditional on that performance.*

FRS 102 Glossary ***performance-related condition***

Under the performance model, grants are recognised in profit and loss at the date the performance-related conditions are met. This could be at one specific point in time, or it could be over a period of time. If there are no performance-related conditions attached to the grant, it is recognised in income when the grant is receivable (which may, of course, be a different date than when the grant is actually received by the reporting entity).

Grants received before the revenue recognition criteria are met would be recognised as deferred income in the financial statements (i.e. as a current or long-term liability) as appropriate.

It should be noted that micro-entities reporting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* are not permitted to use the performance model. Only the accrual model is permissible under FRS 105 as this is deemed to be the simplest method for micro-entities to apply. However, the lack of disclosure requirements under FRS 105 will mean that the value of any unamortised grant is subsumed within creditors and no related disclosure will be made in the micro-entity's financial statements.

Practical consideration of impact on profit

Some commentators express concern about the performance method, particularly in the case of capital-based grants as in the year of acquisition of an asset, if all the performance-related conditions of the grant have been fulfilled, the grant effectively qualifies for immediate recognition in the profit and loss account under the performance model. Thus, in the year of receipt, the profit and loss account may contain a large credit representing the value of the grant, whereas the associated costs will only be recognised in the profit and loss account as depreciation over the life of the asset or impairment is charged.

The concern expressed by some commentators does warrant further consideration as to the appropriateness of a grant which relates to an asset where the performance-related conditions have been met. In practice, it is likely that the accrual model will be the most common due to it being familiar by preparers and it eliminates the occurrence of a large credit being recognised in profit and loss as the grant is received.

6.3 Accrual model

FRS 102, para 24.5C requires that an entity applying the accrual model to a government grant must class the grant as either revenue-based or capital-based.

Revenue-based grants are typically those which relate to expenses already incurred by the reporting entity which are being reimbursed by way of a government grant (such as the CJRS grant). Such grants would be recognised directly in profit and loss as they become receivable.

FRS 102 does not provide any guidance on distinguishing between revenue-based and capital-based grants. In practice, grants received towards the cost of a tangible fixed asset would be capital-based; whereas grants received to reimburse the entity for costs already incurred would be revenue-based.

In most cases it will be clear from the terms of the grant whether it is a revenue-based or capital-based grant. In all cases, however, it is important to scrutinise the terms of the grant to ensure these are, or will be, met, to ensure correct accounting treatment.

Revenue-based grants

FRS 102, para 24.5D states that grants which relate to revenue are recognised in income on a systematic basis over the periods in which the entity recognises the related costs for which the grant is intended to compensate.

Grants which are revenue-based must be shown as income in the profit and loss account; **they cannot be offset against the expenses to which they relate**, as not only would this contravene the principle of a minimum of netting off but would also contravene company law. In addition, FRS 102, para 2.52 prohibits income and expenses being offset, unless permitted by an FRS. FRS 102 does not permit grant income being offset against the expense headings to which it relates. This would also apply to a micro-entity reporting under FRS 105 which would show the grant income as 'Other income' in its Format 2 profit and loss account.

The Companies Act 2006 also prohibits such offsetting. Para 8 of Schedule 1 to *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410) says:

> *Amounts in respect of items representing assets or income may not be offset against amounts in respect of items representing liabilities or expenditure (as the case may be), or vice versa.*

Sch 1, SI 2008/410, para 8

An equivalent prohibition is found in *The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* (SI 2008/409), Sch 1, para 8.

Capital-based grants

FRS 102, para 24.5F states that grants which relate to assets (i.e. capital-based grants) are recognised in income on a systematic basis over the expected useful life of the asset.

The grant income is released to the profit and loss account to match the depreciation charge so that when the asset is fully depreciated, the grant is fully amortised at the same time see.

It might be tempting to consider deducting a grant received for a capital asset against the cost of the asset, but this method is not permissible under FRS 102. Company law prohibits such netting off and the FRC made the decision that all entities should follow the same requirements. Therefore, a capital grant being accounted for under the accrual model is always dealt with as deferred income with a release to profit or loss over the life of the asset to which it relates. This prohibition is dealt with in FRS 102 para 24.5G which confirms that capital-based grants are not deducted from the carrying amount of the asset to which they relate.

Capital-based grants are recognised in the financial statements as deferred income. The unamortised balance of the grant is shown within creditors: amounts falling due within one year and, where appropriate, creditors: amounts falling due after more than one year.

Example – Capital-based grant

Caspian Concrete Ltd acquires an asset for use in its business costing £100,000. It receives a government grant towards 50% of the cost of the asset.

The company's depreciation policy is to write this asset off on a straight-line basis over its useful economic life of five years, at the end of which the residual value is expected to be £nil. The depreciation charges and the grant are recognised in the profit and loss account as follows:

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Asset	£	£	£	£	£
Cost	100	80	60	40	20
Depreciation	(20)	(20)	(20)	(20)	(20)
Net book value	80	60	40	20	-
Grant					
Unamortised balance	50	40	30	20	10
Released to profit and loss	(10)	(10)	(10)	(10)	(10)
Balance c/fwd	40	30	20	10	-

At the end of year 1, the asset has a net book value of £80,000 and the value of the unamortised grant is £40,000. The unamortised grant is split between current and non-current liabilities to comply with the statutory formats as follows:

- Creditor falling due within one year £10,000
- Creditor falling due after more than one year £30,000

An entity may receive a government grant in respect of an asset which does not depreciate; for example, land. FRS 102 does not provide guidance in respect of non-depreciable assets where a grant may be received and merely states at para 24.5F that capital-based grants are recognised on a systematic basis over the useful life of the asset. IAS® 20 *Accounting for Government Grants and Disclosure of Government Assistance*, para 18 does provide some guidance where non-depreciable assets are concerned (although entities reporting under FRS 102 do not need to consult the guidance in IFRS if they do not wish to, but it can provide a useful starting point for developing an accounting policy). This paragraph cites an example of a grant being awarded to an entity which is conditional upon the erection of a building on the site. Land generally does not depreciate and hence where an entity may receive a grant towards the cost of land, it would be appropriate to recognise the grant in profit or loss over the life of the building.

An entity may receive a grant towards an asset whose residual value increases over time. Under FRS 102, residual values are based on current, rather than historic, values and hence this will have an impact on the depreciation charged in the period. FRS 102 is silent on how grants received in respect of assets whose residual values have increased should be treated so management would have to develop an accounting policy in line with FRS 102, para 10.4. Under FRS 102, para 10.4 management would have to develop an accounting policy that results in information that is both relevant and reliable having regard to the following sources in descending order in FRS 102, para 10.5:

(a) *the requirements and guidance in an FRS dealing with similar and related issues;*

FRS 102, para 10.5

(b) *where an entity's financial statements are within the scope of a* ***Statement of Recommended Practice (SORP)*** *the requirements and guidance in that SORP dealing with similar and related issues; and*

(c) *the definitions,* ***recognition*** *criteria and* ***measurement*** *concepts for* ***assets***, ***liabilities***, ***income*** *and* ***expenses*** *and the pervasive principles in Section 2 Concepts and Pervasive Principles.*

An entity may choose to match the grant to the initial cost of the asset to which it relates so that some of the grant is matched with the depreciation expense and the unamortised grant balance is recognised on disposal of the asset. Other entities may choose to release a proportion of the grant each year so that the remaining balances reflects the amount of the asset yet to be depreciated/amortised. The grant will be wholly released to the profit and loss account once depreciation ceases due to residual values exceeding the asset's carrying amount.

There are a variety of entity-specific circumstances which may be present that would perhaps warrant a different treatment of the grant where residual values of the asset appreciate, and it is important to carefully consider these circumstances and apply the most appropriate accounting treatment.

Some entities may choose to continue to write-off the unamortised balance of the grant to profit and loss regardless of the fact that the asset's carrying amount is lower than residual value as this would be the simplest and most cost-effective method. Such a treatment may be challenged by auditors who would possibly view this as an inappropriate method on the basis that the income is not being matched by an associated expense. While not specifically prohibited, it would be crucial to assess the appropriateness of such a treatment in light of the entity-specific circumstances. Another approach would be to consider whether the performance method of recognition is more appropriate, but this needs to be applied to all grants in the same class.

6.4 Repayment of grants

FRS 102, para 24.5A states that where a grant becomes repayable, it is to be recognised as a liability.

Grants will invariably become repayable when the conditions attached to the grant have not been complied with or events occur meaning that some, or all, of the grant becomes repayable (for example if an illegal act is performed). A liability is recognised when it is probable (i.e. more likely than not) that an outflow of economic benefit will be required to settle the liability (in other words, the entity will have to repay the grant to the donor). If the liability is not probable it is a contingent liability and hence is not recognised in the financial statements but will instead be disclosed in accordance with FRS 102, Section 21 *Provisions and Contingencies*, FRS 105, Section 16 *Provisions and Contingencies* if material.

Presenting the liability in the financial statements

The means by which a liability is presented in the balance sheet for a repayable grant is not specifically covered by FRS 102. IAS 20, para 32 says that a government grant which becomes repayable is to be accounted for as a change in accounting estimate. Changes in accounting estimates are accounted for prospectively (i.e. in the current and subsequent years with no retrospective restatement needed). IAS 20 then sets out a hierarchical approach to accounting for the repayment as follows:

- First, take the repayment to any unamortised balance held in the balance sheet in respect of the grant.
- Secondly, take any excess of the payment over the unamortised balance to the profit and loss account.
- Thirdly, if no unamortised deferred credit exists, the whole repayment is taken to the profit and loss account.

Whilst there is no requirement to consider IFRS in developing an accounting policy when FRS 102 does not set one out, the above treatment seems a logical treatment under FRS 102.

Example – Grant becomes repayable

On 1 March 2020, Cooper Enterprises Ltd received a local government grant of £250,000 to assist with the refurbishment of their existing building. The terms of the grant are that 50% relates to the refurbishment costs and the remaining grant can be retained by the business if they employ an additional 300 individuals from the local community in the next 12 months. If they fail to employ at least 300 individuals, the remaining 50% of the grant must be repaid and an additional 10% of the building grant. The company has an accounting reference date of 31 March.

The refurbishment completed on 30 September 2020 and the directors recognised 50% of the grant in the profit and loss account correctly.

On 31 March 2021, the company had failed to employ an additional 300 people. On this date £125,000 of the grant was unamortised (£250,000 less 50% in respect of the building refurbishment) but £137,500 ((£125,000 x 10%) + £125,000) must be repaid to the local council. The entries in respect of this repayment are:

	£
Dr Deferred income	125,000
Dr Profit and loss	12,500
Cr Cash at bank	137,500

6.5 Government loans

FRS 102, para 24.6(d) requires an entity to disclose an indication of other forms of government assistance which the entity may have benefited from. The term 'government assistance' is not defined in the Glossary to FRS 102 but is mentioned in para 24.3 in the context of benefits available to entities in determining taxable profit or loss (e.g. income tax holidays, enhanced capital allowances and such like).

Para 24.7 elaborates further in respect of the disclosure requirements for government assistance and says:

> *… government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under specified criteria.*

FRS 102, para 24.7 (excerpt)

Examples cited by FRS 102, para 24.7 are free technical or marketing advice and the provision of guarantees.

A government loan will not be regarded as a grant. However, if the loan attracts an interest rate of 0% or is charging interest at a rate which is below market rates, this will give rise to a financing transaction to which the provisions of FRS 102, Section 11 *Basic Financial Instruments* will apply.

Where the initial carrying amount of the loan differs from the cash received, for example due to the use of the effective interest method, the difference (i.e. the measurement difference) would be regarded as a government grant as shown in the example below. The measurement difference represents the value of the benefit which an entity has received by being provided with a loan from the government at a rate of interest which is below market rate. Hence, in substance, the recipient of the loan will have implicitly received a grant in the form of the reduced interest rate.

Example – Loan from local government

Williams Windows Ltd receives a loan from the local council of £50,000 as it is a new start-up company. The loan attracts interest at 0%, but if the company were to take out a similar loan with its bank, the bank would charge interest at 7%.

The loan is for two years and is repayable in equal instalment of £25,000 per annum.

As the loan is below market rate, it must be discounted to present value using market rates (i.e. 7%) as follows:

	Cash flow	PV factor	Present value
Year 1	25,000	0.935	23,375
Year 2	25,000	0.873	21,825
			45,200

The loan is profiled as follows:

	Bal b/f	Interest @ 7%	Cash flow	Bal c/f
	£	£	£	£
Year 1	45,200	3,164	(25,000)	23,364
Year 2	23,364	1,636	(25,000)	-

On initial recognition, the loan is recorded as follows:

	£
Dr Cash at bank	50,000
Cr Loan payable	45,200
Cr Profit and loss	4,800

Being initial recognition of government loan at below market rate

7 Deferred tax update (Lecture A779 – 12.24 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with deferred tax in Section 29 *Income Tax*. Micro-entities choosing to prepare their financial statements under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* are prohibited from accounting for deferred tax.

FRS 102 requires deferred tax to be recognised on all timing differences that have originated, but not reversed, at the balance sheet date (with limited exceptions). FRS 102, para 29.6 confirms that timing differences are differences between taxable profits and total comprehensive income as stated in the financial statements that have arisen from the inclusion of income and expenses that have been assessed to tax in different periods to which they are recognised in the financial statements. One of the most common types of timing difference is the difference between the net book value of a fixed asset versus its tax written down value where accelerated capital allowances (e.g. the *Annual Investment Allowance*) has been claimed.

Deferred tax is not recognised on permanent differences (except in limited circumstances where a business combination is concerned). FRS 102, para 29.10 confirms that a permanent difference arises because certain types of income and expenses are non-taxable or disallowable, or because certain tax charges or allowances are greater or smaller than the corresponding income or expense in the accounts.

There is an added complexity at the present time for preparers of financial statements under FRS 102 because of the increase in corporation tax rate from 19% to 25% from 1 April 2023 and the resurrection of marginal rates of tax. This section of the notes examines the provisions in Finance Act 2021 which affects the calculation of deferred tax under FRS 102.

7.1 Rate of tax to be used in calculating deferred tax

FRS 102, para 29.12 requires an entity to measure deferred tax using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date and which are expected to the reversal of the timing difference.

The term 'substantively enacted' is defined 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.

FRS 102 Glossary ***substantively enacted***

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).

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.

Finance Act 2021 makes provision for the rate of corporation tax in the UK to increase (from 1 April 2023) from 19% to 25% where a company has taxable profits in excess of £250,000. In addition, there is also a small profits rate of tax of 19% where taxable profits are £50,000 or less. Marginal relief is brought back to provide a gradual increase in the tax rate of companies where taxable profits lie between £50,000 and £250,000. These limits are effectively pro-rated where a company is associated with other companies. Therefore, for example, if a company had two associated companies, the upper limit would be £83,333 (£250,000 / 3 – [number of associated companies + 1]).

Finance (No. 2) Bill became substantively enacted on 24 May 2021. Consequently, there are impacts on deferred tax accounting depending on whether the accounting period ends before or after 24 May 2021.

Accounting period ends prior to 24 May 2021

For accounting periods which end before 24 May 2021 (i.e. 30 April 2021 year ends and prior), but where the financial statements are approved post 3 March 2021 (the date of the spring budget), deferred tax would continue to be calculated at a rate of 19% because this was the rate that was enacted or substantively enacted by the reporting date.

The entity may need to make additional disclosures as to the effect of the increased tax rate on current and deferred taxes, particularly where the effect of the change in tax rate is material.

Accounting period ends on or after 24 May 2021

For accounting periods ending on or after 24 May 2021, deferred taxes in respect of timing differences which are expected to reverse on or after 1 April 2023 will need to be remeasured at 25% where profits are expected to exceed £250,000; or at the marginal rate if profits are expected to fall between £50,000 and £250,000.

Example – Deferred tax with marginal rate calculations

Zico Ltd acquires a machine on 1 April 2021 at a cost of £75,000. The company's depreciation policy for this machine is to depreciate it on a five-year straight-line basis. The directors anticipate a £nil residual value at the end of this five-year life. The company has taken advantage of HMRC's *Annual Investment Allowance* and has claimed 100% relief on the cost of the machine.

The company's taxable profit for the year ended 31 March 2022 is £50,000. It has no associated companies.

Corporation tax provision for the year	£
£50,000 x 19%	9,500

Net book value of new machine	
Cost	75,000
Depreciation (£75k / 5 years)	(15,000)
Net book value at 31 March 2022	60,000

Deferred tax calculation	
Timing difference	60,000
Tax rate enacted at the year end	19%
Deferred tax liability	11,400

For the year ended 31 March 2023, taxable profit is £150,000 and forecasts indicate that this level of profit is expected for the next five years. The calculations are now as follows:

Corporation tax provision for the year	£
£150,000 x 25%	37,500
Less marginal relief:	

3/200 x (£250k - £150k)		(1,500)
Tax provision		36,000
Effective tax rate (£36k / £150k)		24%
<u>Net book value of new machine</u>		
Net book value b/f		60,000
Depreciation (£75k / 5 years)		(15,000)
Net book value at 31 March 2023		45,000
<u>Deferred tax calculation</u>		
Timing difference		45,000
Tax rate (use marginal rate per above)		24%
Deferred tax liability at 31 March 2023		10,800
Deferred tax liability b/f		11,400
Unwinding of timing difference		600
Dr Deferred tax provision	600	
Cr Deferred tax expense		600

It is important to keep in mind the requirements of FRS 102 which is to measure deferred tax using the tax rates and laws that have been enacted or substantively enacted by the reporting date <u>that are expected to apply to the reversal of the timing differences</u>. This requirement means that in some cases the rate of tax used in the year end tax computation will be different than the rates used in the calculation of deferred tax because you are using the future rate for deferred tax purposes.

7.2 The 'super deduction' and deferred tax

In his spring 2021 Budget, the chancellor announced a temporary 130% deduction for qualifying expenditure on new plant and machinery. This expenditure will result in a 130% first year allowance. Where a qualifying asset is sold in a period that commences prior to 1 April 2023, the sales proceeds are deemed to be up to 130% of the actual proceeds.

For UK GAAP purposes, the super deduction will comprise a 100% allowance for the cost of the asset and an additional 30% that is considered an investment tax credit on the grounds that there are no additional related conditions that need to be fulfilled relating to this investment.

Therefore, if the qualifying asset is sold prior to 1 April 2023, a balancing charge will be calculated equating to 1.3 times the sales proceeds.

For the purposes of FRS 102, the 100% allowance will be dealt with in the normal way (i.e. as a deferred tax liability). FRS 102 does not contain any guidance in respect of the super deduction. IAS 12 *Income Taxes* at paragraph 51 states:

> *The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.*

IAS 12, para 51

FRS 102 does not go into this level of detail in respect of the way in which the entity expects to recover the asset or settle a liability. However, a similar approach can be taken under UK GAAP, hence:

(a) If the entity does not expect to sell the plant and machinery subject to the super deduction prior to 1 April 2023, the additional 30% would be regarded as a permanent difference. Deferred tax is not recognised in respect of permanent differences.

(b) If the company does expect to sell the plant and machinery subject to the super deduction prior to 1 April 2023, the super deduction would be regarded as a timing difference as the tax benefit is expected to reverse in future tax periods, hence a deferred tax liability would need to be recognised in respect of this timing difference.

8 The use of 'directional testing' in audit

Nowadays, most audit programmes are automated and set out various procedures to cover the relevant assertions (i.e. rights and obligations, completeness, occurrence etc). The concept of directional testing was an audit methodology which was developed in the late 1980's to provide a framework for the conduct of the individual audit assignment and all audits.

The term 'directional testing' is frequently used in the wrong context because the majority of audit tests (tests of controls and substantive procedures) necessarily have a 'direction' which is determined by the purpose of the test. Simply testing for, say, completeness and existence of certain transactions and balances without considering the other financial statement assertions does not constitute directional testing as either an audit methodology or an audit strategy.

Directional testing is of particular interest because it is a good example of an auditing methodology; it is conceptually straightforward because it is based on basic bookkeeping principles (debits and credits) and is still consistent with current 'best practice' which is reflected in the ISAs (UK), such as:

- ISA (UK) 300 *Planning an Audit of Financial Statements* which requires the auditor to plan and perform the audit in an effective manner.
- ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* (to become ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement* for audits of financial statements for periods beginning on or after 15 December 2021, with earlier adoption permitted). This requires the auditor to gain an understanding of transactions pertinent to the entity.
- ISA (UK) 320 *Materiality in Planning and Performing an Audit* which requires the auditor to consider materiality (e.g. in determining the extent of audit procedures).
- ISA (UK) 330 *The Auditor's Responses to Assessed Risk* which requires an assessment of inherent risk relating to financial statement assertions about transactions and balances.

8.1 The use of directional testing

The concept of directional testing has its roots placed in the basic bookkeeping principle that every debit has a corresponding credit. If the trial balance balances (which invariably it does nowadays due to computerised bookkeeping) then there can still be a second misstatement.

Example – Misstatement within the trial balance

The auditor discovers that the client's trade debtors are overstated by £19,000. As a consequence of this misstatement:

- another asset is understated by £19,000 (i.e. if cash received has not been recorded); or
- liabilities are overstated by £19,000 (i.e. if the bank account is overdrawn and cash is not recorded); or
- revenue is overstated by £19,000 (for example due to incorrect cut-off procedures or invalid or incorrect invoices being processed via the sales ledger); or
- some other combination amounting to £19,000.

Directional testing works by testing debits in the trial balance for **overstatement** and credits in the trial balance for **understatement**. Therefore, by testing debits for overstatement, the matching credits will be tested indirectly for overstatement. By testing credits for understatement, the matching debits will be tested indirectly for understatement. Direct and indirect tests are often referred to as *primary* and *corollary* tests respectively. The primary tests interlock so as to give complete audit coverage.

Some auditors may ask if it is possible to use directional testing the other way around – i.e. test debits for understatement and credits for overstatement. This is permissible but the 'rule of thumb' is that it is applied in the former – i.e. debits are tested for overstatement and credits for understatement for the reasons outlined below:

- it addresses some of the more common errors which may arise in the balance sheet such as understating a liability due to oversight or deliberately and overstating an asset such as failing to recognise a bad debt provision;
- it helps to identify irregularities because a theft will often result in an overstatement of an asset or an expense – e.g. the theft of cash may be accounted for by writing it off to an expense account (or other asset account);
- it is more difficult for revenue/income to be overstated and it will be detected, where material, indirectly. For example, if a sales ledger clerk

has overstated revenue by raising fictitious sales invoices, the debit (e.g. cash or a debtor) will be overstated which will be tested directly;

- a primary test for overstatement starts with the end result, i.e. the monetary amount stated in the accounts. The direction of testing is backwards to its source to confirm the occurrence and valuation of recorded transactions and the existence, valuation and rights to the asset; and

- the primary test for understatement starts at the source of the transaction (e.g. goods despatched notes) and traces transactions forward to the financial statements. These tests are aimed at ensuring the completeness and valuation of recorded transactions and balances.

Example – Trade debtors

The audit objective for trade debtors is to ensure that they are not overstated. Amounts due from customers will be overstated if, for example:

- cash received has not been posted to the customer's account; or
- a sales invoice is overstated or posted twice or raised incorrectly; or
- a credit note due has not been raised; or
- a bad debt has not been written off.

The auditor will direct their substantive procedures towards ensuring such errors have not happened. Therefore, a sample of customers are selected from the debtors list and are asked to confirm their balances through a debtors circularisation and all discrepancies are investigated. For any non-responses, the auditor will test the make-up of the balance to supporting invoices, goods despatched notes and/or customer orders. After date cash received is matched against amounts due at the year end to verify valuation of debtors.

Example – Revenue and liabilities

The audit objective for revenue (sales) is to ensure that it is not understated. Revenue could be understatement if, for example:

- goods have been despatched but not invoiced; or
- receipts from cash sales have not been recorded; or
- sales invoices are under-valued; or
- sales invoices raised have not been recorded in the sales

ledger/revenue nominal.

When starting at goods despatched notes as the source of a sale the auditor should ensure (through tests of control) that goods cannot be despatched without a document being raised (i.e. a sales invoice or at least a goods despatched note). This is to establish the completeness of the population from which a sample of documents can be selected to trace through the accounting system.

It is also possible to start the substantive tests over income from the customer's order.

The audit objective for liabilities is to ensure that they are not understated. For trade creditors, testing from the source document (the document which creates the liability) means starting with goods received. However, if this is not documented, for example on goods received notes, purchase invoices can provide the most complete population from which transactions can be tested. When a sample is selected from the other side of the entry (in this example purchases are debits but the actual test is a test for understated creditors), it is called the 'reciprocal population'.

For trade creditors, material understatement is usually likely to arise in respect of the largest suppliers who will have been identified in the testing of purchases for overstatement.

8.2 Stock (inventory)

Stock appears in both the balance sheet and the profit and loss account and hence is tested for both overstatement and understatement. When the auditor attends the year end stock count, they will test stock from the count sheets to the physical stock (which tests for **existence**) and from physical stock to count sheets (which tests for **completeness**). For directional testing purposes testing from the physical stock to the count sheets also tests that the amounts are recorded.

8.3 Testing the balance sheet in both directions

By conducting direct tests on assets and liabilities in both directions, complete audit coverage can be achieved (although careful consideration must be given to audit-related costs by doing this). Testing liabilities for overstatement is straightforward because suppliers' accounts can be selected from the trade creditors list and traced back to supporting invoices, goods received notes etc. When the auditor considers testing assets for understatement, they should consider how this could arise. For example, trade debtors will be understated if cash credited to a sales ledger account has not been received; or, if a credit note has been incorrectly raised. It will therefore be the credit entries in the asset accounts which are tested for their validity.

8.4 Testing the profit and loss account in both directions

Again, testing the profit and loss account in both directions will achieve complete audit coverage (again, consideration must be given to audit-related costs by doing this).

To test income for overstatement requires that recorded sales are substantively tested for occurrence. To test an expense for understatement will involve identification of its source and verification of its completeness.

For purchases, this will usually involve tracing goods received notes through the accounting system. However, for many expenses such as rent, rate, depreciation and wages, completeness may be established through analytical procedures (e.g. a proof in total test).

9 Auditing the cash flow statement

The cash flow statement (or 'statement of cash flows' as it is referred to in FRS 102) is one of the primary financial statements. This means that it is given no more, or no less, prominence than the other primary statements (the profit and loss account, balance sheet, other comprehensive income statement and statement of changes in equity).

However, it is concerning that some audit files which have been reviewed reveals that no audit work has been carried out on the cash flow statement despite it being a primary financial statement. For example, classification of debt and treatment of non-cash movements has led to files being failed when such items are material.

Generally, the cash flow statement provides an insight as to how an entity has generated and spent cash. However, it is also used to:

- assess the entity's ability to generate future cash flows;
- assess the entity's ability to pay dividends and to meet obligations (e.g. payment of interest and capital to lenders);
- understand the differences between the measure of profit used and the net cash flow from operating activities; and
- assess the cash and non-cash investing and financing activities during the period.

Whilst fraud at the financial statement level is usually associated with profit and loss account and balance sheet accounts, fraud in the cash flow statement can exist and is potentially significant. This could happen, 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.

9.1 Audit procedures for the cash flow statement

For the majority of audited entities, the cash flow statement will be automatically calculated – usually from movements between the current year and prior year trial balance. However, it is important that the auditor exercises professional scepticism throughout the audit and, where the cash flow statement is concerned, keeps in mind that there could be manipulation of the figures presented in the cash flow statement (e.g. to boost net cash inflows from operating activities or even to turn net cash outflows from operating activities into net cash inflows from operating activities).

Typical audit procedures for the cash flow statement include:

- agree and reconcile all amounts in the cash flow statement to amounts that appear elsewhere or to the auditor's working papers (e.g. tax paid and interest paid amounts to bank statements);
- agree the reconciliation of profit (loss) to net cash flow from operating activities to other areas of the financial statements, e.g.:
    - the measure of profit (loss) to the profit and loss account;
    - depreciation charge to the fixed assets 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 that 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;
- 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 equivalents items presented in the balance sheet; and

- for accounting periods commencing on or after 1 January 2019, 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 therefore) in the balance sheet have been used.

Auditors should bear in mind that the cash flow statement is a primary financial statement and hence should have audit procedures applied over it in the same way that the other primary financial statements do. Remember, the auditor's report lists the cash flow statement as one of the statements that has been subject to audit and therefore it is important that adequate audit procedures are performed over it.

10 ISQM 1 – Part 3

In July 2021, the FRC issued two new quality management standards:

- ISQM (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements;*
- ISQM (UK) 2 *Engagement quality reviews*.

As we explained in quarter 3 and 4 of 2021, it is important that firms do start to consider the impact these ISQMs will have. ISQM (UK) 1 requires the system of quality management to be designed and implemented by 15 December 2022, with an evaluation of this within one year following this date.

According to ISQM (UK) 1, there are eight components of a system of quality management as follows:

- The firm's risk assessment process (see quarter 3 2021 notes)
- Governance and leadership (see quarter 4 2021 notes)
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Engagement performance
- Resources
- Information and communication
- The monitoring and remediation process

In this quarter, we will examine relevant ethical requirements.

10.1 Relevant ethical requirements

There are some changes that firms need an awareness of that are incorporated within ISQM (UK) 1 as follows:

- ISQM (UK) 1 takes a principles-based approach to establish quality objectives to address certain responsibilities in accordance with relevant ethical requirements, especially those related to independence.

- There is an increased focus on all relevant ethical requirements as opposed to just independence.
- There is added clarity concerning the extent to which the firm's system of quality management must address the relevant ethical requirements which also apply to others outside of the firm, such as networks, network firms and service providers.
- There is improved clarity concerning the scoping of the relevant ethical requirements in the context of the system of quality management.

Some aspects of outgoing ISQC (UK) 1 have been retained in ISQM (UK) 1 as follows:

- ISQC (UK) 1 includes specific requirements concerning information and communication relating to independence, such as personnel notifying the firm of threats to independence and breaches of independence. The firm's system of quality management under ISQM (UK) 1 will still need to address the information and communication related to independence, but this is dealt with in the information and communication component of ISQM (UK) 1.
- ISQC (UK) 1 includes requirements to have specific policies and procedures where long association is concerned. This has not been retained in ISQM (UK) 1, but the firm's system of quality management would still need to address the long association of personnel engaged on the audit to take into account the provisions of the relevant ethical requirements. This is necessary because the quality objectives of ISQM (UK) 1 deal with the fulfilment of relevant ethical requirements.

10.2 Relevant ethical requirements

ISQM (UK) 1, para 29 states:

The firm shall establish the following quality objectives that address the fulfilment of responsibilities in accordance with relevant ethical requirements, including those related to independence: *ISQM (UK) 1, para 29*

(a) The firm and its personnel:

(i) Understand the relevant ethical requirements to which the firm and the firm's engagements are subject; and

(ii) Fulfil their responsibilities in relation to the relevant ethical requirements to which the firm and the firm's engagements are subject.

(b) Others, including the network, network firms, individuals in the network or network firms, or service providers, who are subject to the relevant ethical requirements to which the firm and the firm's engagements are subject:

(i) Understand the relevant ethical requirements that apply to them; and

(ii) Fulfil their responsibilities in relation to the relevant ethical requirements that apply to them.

Delegates will note that (b) refers to the firm's responsibility concerning the relevant ethical requirements which apply to others (i.e. network, network firms or service providers). This is because ISQM (UK) 1 recognises that others who are external to the audit firm may be involved in the performance of engagements or various activities in the system of quality management. Consequently, the firm has a responsibility to address relevant ethical requirements which apply to others.

The firm is only responsible for the relevant ethical requirements which apply to others in the context of the firm and the firm's engagements. Other professionals (such as valuation agents) may be subject to other ethical requirements which do not relate to the firm.

Example – Relevant ethical requirements

Toulouse & Co is a firm of chartered accountants based in the UK and is subject to the ICAEW *Code of Ethics*.

The firm is carrying out the audit of one of its clients, Carcassonne Investments Ltd and has engaged the services of an auditor's expert to carry out work to corroborate the valuation of certain complex financial instruments. The expert is provided access to highly sensitive information in order to carry out their work. In addition, the expert is regulated by its own professional body and is subject to their own ethical requirements.

- Toulouse & Co are not responsible for the expert's fulfilment of the ethical requirements of its own professional body. This is the responsibility of the expert themselves.
- Toulouse & Co is, however, responsible for ensuring that the auditor's expert understands the confidentiality provisions in the ICAEW *Code of Ethics*. The expert must treat the client's information as confidential.

Best practice

It would be best practice for the firm to consider who is involved in the firm's engagements and carrying out activities for the firm's system of quality management. This will lead the firm onto then considering how relevant ethical requirements may affect them.

When considering responses to address others' fulfilment of relevant ethical requirements, the firm may find that the responses differ from the responses designed and implemented by the firm which address the firm's staff members' fulfilment of relevant ethical requirements. For example:

- Staff members of the audit firm will be subject to regular training on relevant ethical requirements.
- In respect of service providers, the firm may include the specific relevant ethical requirements in the engagement terms.
- When component auditors are involved (either inside or outside of the network), the relevant ethical requirements may be included in the group audit instructions. In some situations, however, the group auditor may determine it appropriate to provide additional training to component auditors.

11 QAD audit monitoring 2020/21 (Lecture A780 – 21.26 minutes)

It is fair to say that auditing over the last couple of years has proved challenging, particularly during the height of the pandemic. Audit firms have had to adapt considerably, and this has presented additional risks.

One of the main areas that auditors have had to carefully consider is that of going concern. Indeed, what may have been a profitable and lucrative business pre-pandemic, may not be the case during the pandemic given the significant and detrimental impact the pandemic has had on businesses. To that end, going concern has been one of the main focuses of file reviews and examining how auditors have challenged management's conclusions concerning going concern.

Each audit file reviewed by QAD is placed into one of the following categories:

- **Satisfactory**: no concerns about audit quality although QAD may identify some minor improvement points.
- **Generally acceptable**: limited concerns in relatively isolated areas.
- **Improvement required**: more gaps or weaknesses in evidence or more widespread weaknesses in documentation.
- **Significant improvement required**: significant concerns over the adequacy or appropriateness of audit evidence or judgements in one key area or multiple issues across several different areas.

11.1 Common issues

The 2020/21 monitoring report states that the most common weaknesses remain unchanged from the previous year and are:

- Audit evidence
- Audit documentation
- Identification and assessment of risk

The report confirms that the underlying issues behind many audits which are graded as 'require improvement' or 'significant improvement required' relate to professional scepticism and challenge of management.

Root cause analysis is gathering pace where audit deficiencies are concerned and involves asking 'why' questions. Root cause analysis involves identifying the cause of problems or events to prevent them from happening again. It should be noted that root cause analysis will also feature as a component of all firm's implementation of ISQM (UK) 1.

ICAEW have reviewed a sample of root cause analysis carried out by firms. The analysis focussed on audits which required improvement or significant improvement in 2020 in the following areas:

- risk assessment at the planning stage of the audit;
- the extent of audit evidence obtained and the level of documentation;
- the degree of disclosure within the financial statements.

The QAD monitoring reports confirms that firms cite similar root causes for the above failings. The most common reason was a lack of understanding of the ISAs (UK) or accounting standards. Other reasons cited were flaws in the design of audit tests and inadequate review by a senior member of the audit team (e.g. the audit manager or the audit engagement partner). Firms have also acknowledged that client familiarity tends to lead to poorer documentation.

Disclosure errors

As part of a file review, the financial statements will be examined for technical accuracy. A concern (not only of ICAEW but also of Mercia) is the number of disclosure errors that are noted when financial statements are reviewed. This is due to a lack of knowledge of FRS 102 or by failing to use disclosure checklists regularly.

While automated accounts production software systems have become a critical feature of accountancy practices, over-reliance on them is a reason for technical deficiencies in the financial statements. In some cases, the accounts production software system will generate disclosure notes that are either 'boiler-plate' or superfluous; in other cases the disclosures generated will be inadequate or incomplete.

Lack of knowledge of the audit team

QAD carried out a review of a group audit by a firm with three audit partners. During that review, QAD identified significant weaknesses in the application of ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements*

(Including the Work of Component Auditors). QAD noted there was no overall group audit planning or strategy. The file included various client schedules and financial information relating to the non-UK components and while these had been reviewed by the group audit team, no clear audit testing had been undertaken.

The firm's root cause analysis indicated that training courses had not included enough content on group audits and there had been a misunderstanding about the scope of work conducted on subsidiaries by an overseas accountancy firm. The overseas accountancy firm had not actually carried out an audit in accordance with ISAs but had produced detailed financial statements for tax purposes.

The firm responded by ensuring that courses are tailored to include more group audit requirements and that discussions with the client start with the scope of the work to be performed on subsidiaries by non-UK accountancy firms. The firm had also undertaken to arrange a hot file review of the next audit to ensure that all weaknesses were fully addressed.

Flawed design of audit tests

QAD had reviewed the work in progress (WIP) section of the audit by a firm with one audit partner. QAD concluded that the level of detail on the file concerning the audit team's challenge of the stage of completion of contracts and expected costs and margins did not show enough audit evidence to conclude on the balance in the statutory financial statements.

The firm agreed that although it had identified appropriate risks to address for WIP, the work was not documented in a coherent way. The firm undertook to carrying out additional work during the next audit to review the outcome of previous completed projects to assess the accuracy of management estimations.

Inadequate review

QAD reviewed the audit of another firm with one audit partner. During a review of revenue testing, QAD noted that the audit test for **completeness** of revenue was to check a sample of transactions from the sales ledger system. This test is incorrect for completeness because it provides evidence of the **existence** assertion.

The firm had concluded that this was an error that could be traced back to the planning stage of the audit because the planning had been undertaken without sufficient partner involvement. The audit partner had not conducted a detailed review of the audit work and acknowledged over-reliance on audit staff. The firm has undertaken to ensure more partner involvement in the review process of every audit file.

Knowledge of accounting standards

QAD reviewed the audits of a firm with two audit partners and identified significant gaps in financial statement disclosures for an audit client that had made a material acquisition during the year. None of the required disclosures for business combinations had been made and there were no related party disclosures despite the existence of material related party transactions.

The firm had carried out a root cause analysis and found that there was no disclosure checklist used by the audit team during that year's audit. The firm's policy was to use a checklist once every three years. While this is not an unreasonable general policy, such a policy had not been effective in this case because there had been a significant change to the client during the year meaning additional disclosures would be required and hence a disclosure checklist would have been particularly important in this year.

The firm has now changed its policy so that all audit teams will now consider whether changes at the client will require use of a disclosure checklist every year. In addition, a disclosure checklist will be completed annually for all large clients as a mandatory requirement.

12 Revised ISA (UK) 315 (Lecture A781 – 28.21 minutes)

In July 2020, the FRC issued a revised ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement* which becomes effective for audits of financial statements for periods commencing on or after 15 December 2021. One of the most notable changes at the outset is the shorter name (from ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding of the Entity and Its Environment*).

The revised ISA (UK) 315 is more than three times the content of its predecessor so there is a lot of information that auditors will need to get to grips with and reflect in their audit methodologies.

ISA (UK) 315 is considered to be a 'foundational' standard because it contains the requirements for identifying and assessing the risks of material misstatement at the planning stage of the audit. Carrying out a thorough risk assessment at the planning stage will enable the auditor to design and perform further audit procedures to address the risk.

The IAASB (who triggered the changes to ISA 315) wanted a standard which reflected a more robust risk identification and assessment process. In turn this will enable the auditor to undertake a more effective response to the identified risks.

The revised ISA is structured in such a way that it addresses **what** the auditor needs to do. The application material (which has been enhanced) then sets out **why** and **how** the auditor carries out the procedures.

12.1 What do the changes seek to achieve?

The changes to ISA (UK) 315 are extensive and they aim to:

- Promote consistency in the application of procedures for risk identification and assessment.
- Make the standard more scalable through revised principles-based requirements.
- Reduce the complexity of the standard and make it more usable by auditors of all entities, regardless of nature or complexity.
- Encourage a more robust risk assessment hence more focus is devoted to responses to identified risks.

- Support auditors using the standard by incorporating guidance material which recognises the evolving environment, including IT aspects.

12.2 Summary of the changes

A high-level summary of the changes brought in by ISA (UK) 315 (Revised July 2020) are as follows:

- Five new inherent risk factors (subjectivity, complexity, uncertainty, change and susceptibility to misstatement due to management bias or fraud).
- A new concept of 'spectrum of risk' which is the degree to which inherent risk varies.
- Requiring the auditor to obtain sufficient and appropriate audit evidence from risk assessment procedures.
- Significantly more requirements on IT, including general IT controls.
- Distinguishing between 'direct and 'indirect' controls.
- Requiring inherent risk and control risk to be assessed separately.
- A new 'stand-back' provision when material classes of transactions, account balances and disclosures are not considered as significant.

We will examine some of the main changes in this session to enable auditors to plan for changes to their audit methodologies in good time before the revised ISA (UK) comes into mandatory effect.

12.3 Summarising 'what' the auditor needs to do (the 'what' bit)

At the outset it is worth noting that the revised ISA (UK) 315 is iterative in nature. This means that many of the standard's requirements are interrelated and therefore are not performed in a linear manner. It should also be kept in mind that the auditor is required to exercise professional judgement in determining the nature and extent of the work that is to be carried out (i.e. conclusive procedures are not contained in the standard that will apply to all audits).

At the planning stage of the audit, the auditor is required to obtain an understanding of the client's business, especially in relation to:

- the client's system of internal control;
- the entity itself and the environment in which it operates; and

- the application of the relevant financial reporting framework (e.g. FRS 102 or IFRS).

The requirements to obtain an understanding of the entity have been enhanced to ensure that the auditor carries out a thorough risk assessment. One of the changes to ISA (UK) 315 is escalating the requirements to obtain an understanding of the applicable financial reporting framework out of the understanding the entity and its environment in order to encourage an increased focus on the entity's financial reporting requirement (ISA (UK) 315.19(b)).

Once this understanding has been obtained, the auditor must then identify and assess the risk of material misstatement at both the financial statement and assertion level. In doing this, the auditor must identify the relevant assertions (e.g. completeness, accuracy, rights and obligations etc) and the related significant classes of transactions, account balances and disclosures. This requires the auditor to understand what is meant by a 'relevant assertion' and 'significant class of transactions, account balance and disclosure'.

Example

Taylor Ltd has prepared its draft financial statements for the year ended 31 March 20X3. During discussions with the finance director it became apparent that a large customer has gone into liquidation after the balance sheet date but owes Taylor Ltd a large sum of money that is unlikely to be recovered.

The relevant assertion in this instance is 'valuation'. The significant account balance is trade receivables/debtors. This is because if the debtor balance is not written off, trade receivables and profit before tax could both be materially overstated.

Also keep in mind that the determination of a relevant assertion is made **before** the auditor considers any related controls the client has in place which could minimise the risk (i.e. 'inherent risk').

12.4 Risk of material misstatement

Audit risk (the risk that the auditor expresses an inappropriate opinion on the financial statements) is made up of three components: **inherent risk**, **control risk** and **detection risk**). Out of all three risks, detection risk is the only risk under the control of the auditor. This 'model' has not been changed in the revised ISA (UK) 315).

Inherent risk assessment

The auditor must assess inherent risk at the assertion level by assessing the likelihood and size of misstatements. ISA (UK) 315 (Revised July 2020), para 31 says that in doing this the auditor must take into account how, and the degree to which:

ISA (UK) 315 (Revised July 2020), para 31 (a) and (b)

(a) Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and

(b) The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level.

To help auditors do this, the revised ISA (UK) 315 contains the concept of the 'spectrum of inherent risk'. This is a new concept which requires the auditor to understand what is meant by an 'inherent risk factor'.

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to misstatement that could be material **before** the auditor considers any related controls. Inherent risk factors (individually or in aggregate) increase the inherent risk by varying degrees. ISA (UK) 315 (Revised July 2020), para 5 requires that for the identified risks of material misstatement at the assertion level, a separate assessment of both inherent risk and control risk (see below) be carried out. The paragraph then goes on to clarify that inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Hence, the degree to which inherent risk varies is referred to as the *spectrum of inherent risk*.

The higher the combination of likelihood and magnitude, the higher the inherent risk and vice versa. It is also possible for a higher risk assessment to arise from different combinations of likelihood and magnitude. For example, a higher risk assessment may result from a lower likelihood, but higher magnitude.

ISA (UK) 315 (Revised July 2020), para 32 also requires the auditor to determine whether any of the assessed risks of material misstatement are significant risks. In addition, para 33 also requires the auditor to determine whether substantive procedures (i.e. the audit procedures which aim to detect misstatement at the assertion level) alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level.

Control risk assessment

ISA (UK) 315 (Revised July 2020), para 34 only requires the auditor to carry out an assessment of control risk if they plan to test the operating effectiveness of controls. Where tests of controls are not planned, the assessment of control risk is such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.

The drafting of ISA (UK) 315 (Revised July 2020), para 34 seems a little odd. On the one hand the paragraph is initially saying that no assessment of control risk is required and then it goes on to set control risk at a specific level (i.e. the same as inherent risk).

Example

The auditor of Miller Ltd is not planning on testing the operating effectiveness of internal controls this year and has said there is no need to assess control risk per ISA (UK) 315 (Revised July 2020), para 34.

This is not true. The correct application of paragraph 34 would mean that when control risk is not assessed, the level of risk assessment which is assigned to control risk cannot be lower than that assigned to the level of inherent risk.

12.5 'Stand-back' provision

Once the auditor has obtained the required understanding and identified the significant classes of transactions, account balances and disclosures, ISA (UK) 315 (Revised July 2020), para 35 requires the auditor to evaluate the audit evidence arising from the risk assessment procedures. This has been coined the 'stand-back' provision and has been introduced to prompt the auditor to confirm the completeness of the identified risks. In other words, focussing their attention on material classes of transactions, account balances and disclosures that have not been determined as significant.

The stand-back provision aims to require the auditor to make sure that the audit evidence they have obtained at the risk assessment stage confirms that there are no risks of material misstatement relating to material classes of transactions, account balances and disclosures which should have been identified at the risk assessment stage.

13 Companies House reforms (Lecture A782 – 19.04 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.

13.1 Corporate transparency and register reform – February 2022

Subsequent to the above white papers, BEIS has responded with a further white paper redefining the Companies House reform proposals.

Accounts filing

In this the government has set out further plans to reform governance at Companies House to stop manipulation of the service, particularly in the use of anonymous or fraudulent shell companies and partnerships.

Going forward Companies House will 'change its statutory role from being a largely passive recipient of information to a much more active gatekeeper over company creation and custodian of more reliable data', said Lord Callanan, the minister for business.

It will also change the accounts filing requirements for small and micro companies.

As yet, there is no timetable for introduction of the new rules which will be brought in through statutory instrument. However, this is a priority for government and will be part of the Economic Crime Bill.

As part of the consultation, the government reviewed the type of accounts being filed by small and micro companies and plans to simplify the framework by reducing the filing options to just two: micro-entities and small companies. It will remove the abridged and filleted accounts options to make the system easier to understand, reduce fraud and error, and increase transparency.

All small companies will then be required to file a profit and loss account, and a balance statement. This will ensure that key information such as turnover and profit or loss is available on the public register to help creditors and consumers make informed decisions. Small companies will also have to file a directors report.

The current filing periods of nine months after the end of the reporting year for a private company and six months for a public company will not be changed, with the government stating that it could review this in the future once the impact of the pandemic has waned.

There will also be a requirement to use full iXRBL tagging of accounts information on the register and Companies House will reject accounts that do not meet the required tagging standard.

It has also clarified the requirement for a company to prepare and deliver one set of accounts. This proposal closes the loophole where a company can file multiple accounts with different government departments.

In terms of simplification, the government is considering a File Once with Government approach so that accounts only need to be filed once with government. This would enable companies to file accounts in one central place and for government bodies to extract the information they need.

More powers

Companies House will be given more powers to questions suspicious director appointments or filings and, in some cases, request further evidence or reject the filing. It will also have more extensive legal gateways for data sharing with law enforcement, other government bodies and the private sector. This will mean more efficient sharing of suspicious activity with law enforcement and establishment of feedback loops with other government bodies and the private sector.

To make anonymous filings harder, those setting up, managing, and controlling companies and other registrable entities will have a verified identity with Companies House, or have registered and verified their identity via an anti-money laundering supervised third-party agent.

Currently the identity verification service is envisaged to be carried out by one or more third party identity service providers.

Individuals who fail to verify their identity or comply with new requirements under these reforms will be subject to new criminal and civil sanctions. The government is still considering the level of penalties, which could include director bans for breaking rules on company registration and misuse of registered addresses.

Companies House will have a more powerful analytical capability to spot suspicious behaviour and, based on this better data, then exercise its new querying power to obtain further information or report it to law enforcement for further investigation.

Corporate directorships

The government also intends that corporate directorships will be restricted to entities registered in the UK. It said that 'experience has shown that illicit activity is facilitated by multi-layered company control across multiple jurisdictions where the use of registered UK companies can give organised crime a respectable front behind which to pursue their activities'.

Commenting on the reform of Companies House, secretary of state Kwasi Kwarteng said: 'The agency will be transformed into a custodian of accurate and detailed information – ensuring that we can clamp down on those who seek to abuse UK corporate structures to launder money.

'Anyone setting up, running, owning or controlling a company in the UK will need to verify their identity with Companies House, who will then be able to challenge dubious information and inform the security agencies.

'Company agents from overseas will no longer be able to create companies in the UK on behalf of foreign criminals or secretive oligarchs.'

To improve privacy, it will also remove the requirement to provide a business occupation.

Funding has been increased with the government committing a further £63m at the 2021 Spending Review to allow for upgrading of IT systems and an overhaul of services from 2022-25.

The impact assessment shows that the cost to business will be £27.3m annually. 'Were the measures in the impact assessment to increase the quality of Companies House information by 5%, then the estimated benefit would offset the estimated cost to business for the entire policy package. This excludes any wider benefits from helping to tackle economic crime,' the government said.