Audit and Accounting Quarterly Update – Q1 2023

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1 FRC periodic review (Lecture A811/ A812/ A813 – 16.19/ 19.38/ 14.30 minutes)

On 15 December 2022, the Financial Reporting Council (FRC) issued FRED 82 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review.* This 346-page document contains some significant proposals for change following the Requests for Views phase which ended on 31 October 2021.

Comments on FRED 82 are open until 30 April 2023. All interested parties areencouraged to submit their comments on the proposals by email to ukfrsperiodicreview@frc.org.uk.

For some, it will be pleasing to see the FRC confirm that no amendments to FRS 102 are proposed to reflect the expected credit loss model from IFRS® 9 *Financial Instruments* in this periodic review. Although, it has stated that it will reconsider this issue in due course.

A couple of the principal amendments are summarised as follows (note references to 'draft para X' refer to the proposed paragraph in FRED 82):

1.1 On-balance sheet lease accounting

As expected, the FRC propose to change the lease accounting requirements in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. There are no equivalent changes proposed in this area for FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. The proposed changes are intended to align FRS 102 to IFRS 16 *Leases* (albeit with a number of simplifications).

Interestingly, the International Accounting Standards Board® (IASB®) has decided not to change the equivalent Section 20 *Leases* in the *IFRS for SMEs Accounting Standard* in its current comprehensive review of that Accounting Standard. However, the IASB may well decide to align *IFRS for SMEs* with IFRS 16 during a future review. This accentuates the point that the FRC does not necessarily follow in the footsteps of the IASB when developing accounting standards.

Essentially, the vast majority of leases for a lessee (with some limited exceptions related to 'short-term leases' and low-value leases) will be reported on-balance sheet. A short-term lease is a lease which, at the commencement date, has a lease term of 12 months or less. Draft para 20.9 confirms that the value of an underlying asset is based on the value of the asset at the start of the lease. Draft para 20.11 cites the following examples of underlying assets that would typically be considered to be of low value:

- tablet computers;
- personal computers;

- home printers and photocopiers;
- mobile phones;
- desk phones;
- televisions;
- small items of furniture; and
- portable power tools.

The FRC has cited ‘efficiency within groups’ as one of the reasons for aligning lease accounting within FRS 102 to that of IFRS 16. Some entities applying FRS 102 could well be members of a group which prepares consolidated financial statements in accordance with IFRS Accounting Standards. Hence, the proposed change to lease accounting in FRS 102 would minimise accounting differences, thus enabling comparability. To that end, the proposed simplifications in FRS 102 are optional rather than mandatory.

The simplifications within FRS 102, Section 20 are as follows:

	IFRS 16	FRS 102 simplification
Discount rate	IFRS 16 requires a lessee to use the interest rate implicit in a lease. If that is not readily determinable, the lessee’s incremental borrowing rate is used to discount lease payments to present value.	The lessee’s *obtainable borrowing rate* can be used as an alternative to the incremental borrowing rate. This is expected to be easier to determine so is deemed to represent a proportionate simplification. If, in exceptional cases, the lessee’s incremental (or obtainable) borrowing rate cannot be readily determined, the lessee can apply a publicly available rate (referred to as the ‘gilt rate’).
Determining a revised discount rate	A lessee must revise the discount rate when there is a modification that is not accounted for as a separate lease.	FRED 82 proposes to reduce the number of situations in which a lease modification requires a revised discount rate.
Practical expedients for lease agreements	Lease agreements may contain multiple components and both lessors and lessees must identify and separate	There are additional practical expedients proposed for contracts containing multiple components (for example, draft para 20.33).

containing multiple components	lease and non-lease components in applying IFRS 16. For a lessee this will determine what proportion of the contract will be recognised on-balance sheet.	
Sale and leaseback transactions	The approach taken by IFRS 16 where a sale and leaseback transaction is concerned is complex and there will often be a need to consider whether, in fact, the transfer qualifies as a sale in accordance with IFRS 15 *Revenue from Contracts with Customers*.	There is a simpler approach proposed for dealing with sale and leaseback transactions in FRED 82, which is broadly consistent with the approach currently in FRS 102 (January 2022). There is a requirement to consider if the transfer of an asset by the seller-lessee satisfies the requirements of FRS 102, draft Section 23 *Revenue from Contracts with Customers* (draft paras 20.128 to 20.130) or not (draft para 20.131) as this will affect the accounting treatment
Variable lease payments	Changes in lease payments arising from a change in an index or rate would trigger recalculation of the lease liability.	Draft para 20.74 provides an option for the lessee to choose *not* to remeasure the lease liability where there has been such a change. Where this is the case, the difference between the lease payments included in the lease liability at the commencement date and the revised lease payments is recognised in profit or loss in the period to which each payment relates (see also draft para 20.58).

So, how could leasing work under the proposals? The example below illustrates some of the principles contained in IFRS 16 which may apply in FRS 102 if the periodic review amendments are finalised as drafted:

Example – On-balance sheet lease accounting

On 1 January 2025, Sunnie Ltd enters into a contract to lease a specialist machine for three years. The lessor agrees to maintain the machine during the term of the lease. The total contract cost is £210,000 and Sunnie must pay £5,833 per month (or £70,000 per annum). Sunnie Ltd accounts for non-lease components separately from leases.

If contracted separately, it has been determined that the standalone price for the lease of the specialist machine is £190,000 and the standalone price for the maintenance services is £48,000.

If Sunnie Ltd were to go to its bank for an equivalent borrowing, the bank would charge a rate of 4%.

Step 1: Allocation of payments

The annual payments of £70,000 are allocated between the lease and non-lease components of the contract based on their standalone selling prices as follows:

Lease of machine: (£190k / £190k + £48k) x £70k = £56,000

Maintenance: (£48k / £190k + £48k) x £70k = £14,000

If Sunnie Ltd did not have a policy of separating lease and non-lease components, the entire £70,000 would be recorded as lease payments.

Step 2: Accounting treatment

The lease liability is calculated as the present value of the minimum lease payments:

Date	Cash flow	Discount rate	Present value
	£		£
31.12.2025	56,000	1 / 1.04	53,846
31.12.2026	56,000	$1 / 1.04^2$	51,775
31.12.2027	56,000	$1 / 1.04^3$	49,784
			155,405

There are no directly attributable costs associated with the right-of-use asset (otherwise these would be included in the cost of the right-of-use asset itself). The entries are:

	£
Dr Right-of-use asset (balance sheet)	155,405
Cr Lease liability	155,405
Being initial recognition of right-of-use asset	

The lease liability is then accounted for using the amortised cost method per FRS 102, Section 11 *Basic Financial Instruments* as follows:

Year	Opening balance	Cash flow	Interest (4%)	Closing balance
	£	£	£	£
2025	155,405	(56,000)	6,216	105,621
2026	105,621	(56,000)	4,225	53,846
2027	53,846	(56,000)	2,154	-

In year 1:

	£
Dr Lease liability	56,000
Cr Cash at bank	56,000
Being payment to lessor	
Dr Finance costs (profit or loss)	6,216
Cr Lease liability	6,216
Being interest paid at 4%	

At the end of 2025 the lease liability of £105,621 will be split between its current portion of £51,775 (£105,621 - £53,846) and its non-current liability of £53,846 to comply with the statutory formats of the balance sheet.

Step 3: Depreciate the right-of-use asset

The right-of-use asset is depreciated over the three-year lease term. This gives a depreciation charge of £51,802 (£155,405 / 3 years).

	£
Dr Depreciation expense	51,802
Cr Accumulated depreciation	51,802
Depreciation of right-of-use asset over 3 years	

In the above example, you can contrast between the current accounting treatment under FRS 102 and the proposed new treatment. As the lessor agrees to maintain the machine at its cost over the term of the lease, it could be argued that under the current edition of FRS 102 this lease is an operating lease. Hence lease rentals would simply be charged to profit or loss on a straight-line basis over the three-year term. Under the proposals, the lease rentals would not be charged to profit or loss, so the impact can be seen as follows:

Impact on profit or loss at 31 December 2025	
FRS 102 (January 2022)	**FRS 102 proposals**
• Lease rental expense is £70,000	• Interest charge of £6,216 • Depreciation of £51,802 • Total expense £58,018

Impact on the balance sheet as at 31 December 2025	
FRS 102 (January 2022)	**FRS 102 proposals**
• No impact as the lease would be an operating lease	• Asset reported of £103,603 • Liability reported of £105,621

1.2 Revenue

The title of FRS 102, Section 23 is proposed for change from *Revenue* to *Revenue from Contracts with Customers*.

Section 23 has been completely re-written in FRED 82 and reflects a simplified version of IFRS 15 *Revenue from Contracts with Customers*. Notably, the 'five-step model' approach to recognising revenue as follows.

- **Step 1** – Identify the contract(s) with a customer (draft paras 23.6 to 23.15)
- **Step 2** – Identify the promises in the contract (draft paras 23.16 to 23.40)
- **Step 3** – Determine the transaction price (draft paras 23.41 to 23.60C)
- **Step 4** – Allocate the transaction price to the promises in the contract (draft paras 23.61 to 23.74)
- **Step 5** – Recognise revenue when (or as) the entity satisfies a promise (draft paras 23.75 to 23.101)

The term 'promise (in a contract with a customer)' is defined as an obligation to transfer a good or service (or bundle of goods or services) that is distinct.

While many of the requirements in proposed Section 23 are consistent with the IASB's Exposure Draft of the third edition of *IFRS for SMEs*, there are some FRED 82-specific amendments to permit entities to use an accounting policy for revenue which meets the requirements of both FRS 102 and IFRS 15 as follows:

- The proposals require an entity to account for a warranty as a separate promise when the warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. This applies even if the warranty is insignificant to the contract.

- FRED 82 proposes to allow an entity to account for an option to provide a customer with a material right as a separate promise when the effect of doing so is insignificant to the accounting of the individual contract.

- There is a proposal to require refund liabilities to be measured based on amounts of consideration received which are not included in the transaction price, where such amounts are determined by considering the requirement to constrain estimates of variable consideration.

1.3 For smaller entities applying FRS 102, Section 1A

Following the UK's departure from the EU, the FRC is now able to require more disclosure from small companies in the UK. Previously, the FRC was constrained by the requirements of the EU Accounting Directive, but this is no longer the case. However, this does remain the case for entities in the Republic of Ireland so FRS 102, Section 1A, Appendix D *Disclosure requirements for small entities in the Republic of Ireland* remains unchanged.

Some of the notable changes proposed in FRED 82 to FRS 102, Section 1A, Appendix C *Disclosure requirements for small entities in the UK* include:

- A requirement to make an explicit and unreserved statement of compliance with FRS 102, including Section 1A. Currently this is an encouraged disclosure per FRS 102, para 1AE.1(a).

- Mandatory going concern disclosures to comply with draft para 3.8A, which states:

> *When an entity prepares financial statements on a going concern basis, it shall disclose that fact, together with confirmation that it has considered information about the future as set out in paragraph 3.8. It shall also disclose, in accordance with paragraph 8.6, any significant judgements made in assessing the entity's ability to continue as a going concern*.

In addition, the small entity will be required to provide disclosures relating to material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern as set out in para 3.9. Currently, this requirement is an encouraged disclosure per FRS 102, para 1AE.1(c).

- There are additional disclosures proposed in respect of leasing arrangements (draft para 1AC.31A) including short-term leases, leases of low-value assets and variable lease payments (draft para 1AC.32A); provisions and contingencies (draft para 1AC.31B); share-based payment transactions (draft para 1AC.31C); and promises in contracts with customers (draft para 1AC.32B).

- Disclosures in respect of deferred tax (draft para 1AC.36A).

- Dividends declared and paid or payable during the period (draft para 1AC.40). Currently this is an encouraged disclosure per FRS 102, para 1AE.1(d).

- Transition information on first-time adoption of FRS 102 (draft para 1AC.41). Currently this is an encouraged disclosure per FRS 102, para 1AE.1(e).

1.4 Other notable changes

The main focus of FRED 82 is, of course, on leasing and revenue recognition and these are the areas likely to attract a lot of attention during the comment period on the Exposure Draft.

Some other notable changes proposed in FRED 82 are as follows:

1.4.1 Section 2 Concepts and Pervasive Principles

The entire *Concepts and Pervasive Principles* in FRS 102, Section 2 has been revised and updated to reflect the IASB's *Conceptual Framework for Financial Reporting* which was issued in 2018.

This redrafted section is structured as follows:

- The objective of financial statements

- Qualitative characteristics of information in financial statements

- Financial statements and the reporting entity

- The elements of financial statements

- Recognition and derecognition

- Measurement

- Presentation and disclosure

There is also an additional Section 2A *Fair Value Measurement* which replaces the Appendix to FRS 102, Section 2 in the January 2022 edition.

1.4.2 Going concern

There is a new paragraph 3.8A proposed which states that when an entity prepares its financial statements on a going concern basis, it must disclose that fact. In addition, the entity must also disclose confirmation that it has also considered information about the future to comply with paragraph 3.8. Keep in mind that the entity is required to consider all available information about the future, which is at least, but not limited to, 12 months from the date when the financial statements are authorised for issue.

In addition, paragraph 3.8A will also require an entity to disclose any significant judgements made in assessing the entity's ability to continue as a going concern.

1.4.3 Accounting policies

Currently, FRS 102 requires an entity to disclose a summary of its **significant** accounting policies (FRS 102, para 8.5). The term 'significant' is not defined in FRS 102 and the FRC propose changing this paragraph to require an entity to disclose its **material** accounting policies. The paragraph goes on to clarify that accounting policy information is material if, when considered together with other information included in the financial statements, it can reasonably be expected to influence decisions that the users of the financial statements make on the basis of those financial statements. The disclosure must also include the measurement basis (bases) used when preparing the financial statements.

A new paragraph 8.5B is also proposed which provides further clarification on when accounting policy information is material. It states that an entity is likely to consider accounting policy information material if it relates to material transactions, other events or conditions and:

a) the entity has changed an accounting policy during the period which has resulted in a material change to the information in the financial statements;

b) the entity chose the accounting policy from one or more options permitted by FRS 102;

c) the accounting policy was developed in line with FRS 102, Section 10 *Accounting Policies, Estimates and Errors* in the absence of a specific section of FRS 102 which would otherwise apply;

d) the accounting policy relates to an area that requires significant judgement or assumptions in applying an accounting policy (and the entity discloses those judgements or assumptions in accordance with FRS 102, paras 8.6 and 8.7); or

e) there is complex accounting required and the users would otherwise not understand those material transactions, other events or conditions (for example if an entity applies more than one section of FRS 102 to a class of material transactions).

1.4.4 Accounting estimates

The FRC have proposed to include an additional paragraph 10.14A which provides a non-exhaustive list of examples of accounting estimates as follows:

- Estimated selling price less costs to complete of inventory
- Recoverable amount of a fixed asset
- Depreciation expense for a fixed asset
- Fair value of asset or liability, applying FRS 102, Section 2A *Fair Value Measurement*
- A provision for warranty obligations

Proposed paragraph 10.14D clarifies that an entity will need to change an accounting estimate if changes arise in the circumstances on which the accounting estimate was based, or as a result of new information, new developments or more experience.

1.4.5 Financial instruments

There is a new paragraph 11.14A proposed which clarifies when a dividend receivable is recognised in profit or loss which is when:

- The entity's right to receive payment is established
- It is probable (i.e. more likely than not) that the economic benefits associated with the dividend will flow to the entity
- The amount of the dividend can be reliably measured

An equivalent new paragraph has been included in Section 12 *Other Financial Instruments Issues* at paragraph 12.9A.

There are additional paragraphs 11.48ZA and 11.48ZB proposed which relate to financial institutions and retirement benefit plans. These new paragraphs require quantitative and qualitative information to be disclosed concerning amounts that have arisen due to expected credit losses. This would apply where the financial institution or retirement benefit plan has used the accounting policy option to apply IFRS® 9 *Financial Instruments*.

1.4.6 Investments in associates

A new paragraph 14.3A provides examples of situations when significant influence can usually be evidenced as follows:

a) Representation on the board of directors or equivalent governing body

b) Participation in the policy-making processes (including participation in decisions concerning dividends or other distributions)

c) Material transactions between the investor and its associate

d) Interchange of managerial personnel

e) Provision of essential technical information

1.4.7 Investment property

A new paragraph 16.2A is proposed which clarifies that an entity must use its professional judgement in determining whether the acquisition of investment property is the acquisition of an asset or a group of assets or a business combination which would fall in scope of Section 19 *Business Combinations*. Hence reference to both FRS 102, Section 16 and Section 19 will need to be made in this respect.

There are also consequential amendments proposed to Section 16 as a result of the proposed on-balance sheet lease accounting for lessees. For example, the amendments proposed to paragraph 16.7 clarify that when the lessee uses the fair value model to measurement investment property that is held as a right-of-use asset, it must measure the right-of-use asset and not the underlying property at fair value.

1.4.8 Intangible assets other than goodwill

A new paragraph 18.3B is proposed which clarifies the accounting treatment for an intangible asset that may be contained in, or on, a physical asset. The paragraph cites an example of software for a machine that cannot be operated without that specific software and confirms that this is an integral part of the related hardware and hence is treated as property, plant and equipment (FRS 102, Section 17). The same treatment would apply to the operating system of a computer or mobile device.

If the software is not an integral part of the related hardware, the software is treated as an intangible asset.

1.4.9 Business combinations

There is a new paragraph 19.11B proposed that confirms that a transaction that remunerates employees or former owners of the acquiree for services in the future is not part of the cost of a business combination.

There are more paragraphs proposed which clarify the accounting treatments for provisions and contingent liabilities. Proposed paragraph 19.15F states that contrary to paragraphs 21.4(b) and 21.12, the acquirer must recognise a contingent liability assumed in a business combination at the date of acquisition, even if it is not probable that the acquirer will be required to transfer economic benefits in settlement. To qualify for recognition, the contingent liability must be a present obligation that arises from past events **and** its fair value can be measured reliably.

There are also consequential amendments to Section 19 in respect of the proposed on-balance sheet lease accounting treatment as well as additional disclosure requirements for business combinations.

There is a new appendix proposed to Section 19 which is an integral part of Section 19 and provides guidance on identifying an acquirer. This appendix replaces the guidance provided in paragraph 19.10.

1.4.10 Share-based payment

There is a new paragraph 26.1B proposed which confirms that equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of Section 26. However, equity instruments granted to employees of the acquiree in their capacity as employees are within the scope of the section.

There is also clarification in proposed paragraph 26.1C which confirms that the term 'fair value' is used in a different context in Section 26. For the purposes of Section 26, fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Proposed paragraph 26.13A clarifies that the settlement of an equity-settled share-based payment transaction may involve an entity transferring cash or other assets as an alternative (or partial alternative) to the transfer of equity instruments. In such cases, the payment made is treated as a deduction from equity. The exception to this would be where the payment exceeds the fair value of the equity instruments. In such cases, the excess is recognised as an expense.

Paragraph 26.15B is proposed to be changed to clarify that where a counterparty has a choice of settlement of a share-based payment in cash or equity, the transaction is treated as wholly cash-settled unless:

- the choice of settlement in cash or other assets bears no commercial substance; or
- the choice of settlement relates only to a net settlement feature.

In these cases, the entity accounts for the transaction as a wholly equity-settled transaction.

1.4.11 Taxation

There is additional clarification in proposed paragraphs 29.17A to 29.17C which clarifies the treatment of uncertain tax treatments.

1.4.12 Related parties

Paragraph 33.9 is proposed to be changed to require the amount of outstanding balances **and commitments** to be disclosed in addition to the terms and conditions and details of any guarantees given or received. Currently, the paragraph just requires the amount of outstanding balances, terms and conditions and guarantees given or received.

1.4.13 Specialised activities

There is a new paragraph 34.9A proposed which clarifies the elements of cost of a biological asset.

There is clearer guidance on when an asset is a heritage asset. In addition, separate disclosure is required of heritage assets held by a lessee as a right-of-use asset.

For public benefit entities, there is clearer guidance in proposed paragraph PBE34.70A in respect of donations and legacies.

Appendix B to Section 34 *Guidance on incoming resources from non-exchange transactions* is deleted as much of this has been moved into the main body of the section.

1.4.14 Transition to FRS 102

Paragraph 35.10(a)(ii) is proposed to be amended to confirm that where goodwill was previously assessed as having an indefinite useful life under the entity's previous financial reporting framework, it must be re-assessed to determine its remaining useful life and then subsequently measured in accordance with FRS 102, para 19.23. This is because goodwill must always be amortised on a systematic basis over its useful life under FRS 102.

There is an additional transitional exemption proposed in paragraph 35.10(IA) in respect of decommissioning liabilities included in the cost of right-of-use assets.

In addition, there are additional optional exemptions in respect of development costs, leases, revenue from contracts with customers and cost determined under a previous financial reporting framework as deemed cost.

There are also additional disclosure requirements for an entity transitioning to FRS 102 for the first time.

1.5 Effective date

The FRC have stated that the planned effective dates of the amendments arising from the periodic review are expected to be for accounting periods commencing on or after 1 January 2025. Early adoption will be permissible, provided all the amendments are adopted at the same time.

As always, at this stage, it is important to keep in mind that these dates are tentative and may be subject to change by the FRC once the comment period has closed. Further updates will be covered as developments in this area progress.

2 New edition of FRS 100 issued (Lecture A814 – 6.09 minutes)

On 18 November 2022, the FRC issued a revised edition of FRS 100 following a public consultation through FRED 80 *Draft amendments to FRS 100 Application of Financial Reporting Requirements Application Guidance – The Interpretation of Equivalence*.

The Application Guidance contained in FRS 100 was amended in November 2022 to reflect changes in company law and decisions on equivalence following the UK's departure from the EU. The revised guidance is immediately effective and is based on current legal requirements. The structure of the Application Guidance is as follows:

Section	Relevant paragraphs
Introduction	AG1 to AG4
Assessing equivalence	AG5 to AG6
The exemptions from consolidation	AG7 to AG22
The exemptions in financial reporting standards	AG23 to AG28

Claiming exemption from preparing consolidated financial statements requires an analysis of whether the framework (or specified elements of it) applied in practice are equivalent to another framework (or specified elements of it).

References to equivalence to another framework do not mean compliance with *every* aspect of that framework. Instead, it is necessary to consider whether the basic requirements of that framework are met (especially the requirements to give a true and fair view). The revised Application Guidance clarifies that a qualitative approach is more in keeping with the deregulatory nature of the exemption rather than a requirement to consider the detailed requirements on a checklist basis.

2.1 Equivalent GAAPs

The UK government has recognised the equivalence to UK-adopted IFRS of the following GAAPs, which includes those GAAPs previously recognised by the EC as equivalent to EU-adopted IFRS:

- GAAP of Canada
- GAAP of the People's Republic of China
- GAAP of Japan
- GAAP of the Republic of Korea

- GAAP of the United States of America
- IFRS as adopted by the EU
- IFRS as issued by the IASB

3 Going concern (Lecture A815 – 17.46 minutes)

The current economic climate, high inflation and rises in interest rates are likely to impact on businesses up and down the country. The high cost of energy, fuel and other materials means many businesses (particularly those in the hospitality sector) are struggling and the issue of going concern continues to be a very important issue when it comes to financial reporting.

Going concern issues are frequently cited as being deficient during audit file reviews and when reviewing sets of financial statements. In today's climate it's crucial that practitioners have a sound understanding of the rules around going concern in UK and Ireland GAAP to ensure that they can not only advise the client appropriately, but that they can also ensure the financial statements are prepared on the correct basis and contain appropriate disclosures.

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, para 3.8 states:

> *When preparing financial statements, the management of an entity using this FRS shall make an assessment of the entity's ability to continue as a* ***going concern****. An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue.*

FRS 102, para 3.8

The approach taken by FRS 102 (and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*) is to use the going concern basis as a 'default'. In other words, even if the company is experiencing significant cash flow difficulties, the entity prepares the financial statements on a going concern basis. FRS 102 would only require a basis other than the going concern basis to be used when management intend to liquidate the entity, or cease trading, or have no realistic alternative but to do so.

As noted above, FRS 102 only refers to circumstances of liquidation or cessation of trade as a reason not to use the going concern basis of accounting. In the absence of such intentions, management continues to prepare the financial statements on a going concern basis and will disclose any material uncertainties in the notes to the financial statements.

When management is undertaking its assessment (see **3.1** below), it may conclude that there are material uncertainties relating to the entity's ability to continue as a going concern. Even with those material uncertainties, the directors may conclude that the going concern basis of preparing the financial statements is appropriate and, in such situations, disclosure of the material uncertainties will be required. This ensures that the users of the entity's financial statements are clear that the going concern basis is subject to material uncertainties.

3.1 Management's assessment

FRS 102, para 3.8 requires management to carry out an assessment of going concern using information at its disposal concerning the future which is **at least but not limited to 12 months from the date when the financial statements are authorised for issue**.

The requirements of UK and Ireland GAAP are more onerous than their international equivalent which some accountants may also be familiar with. IAS 1 *Presentation of Financial Statements* requires management to conduct a going concern assessment for a period of at least 12 months from the balance sheet date which is not the same as UK and Ireland GAAP. It is important, therefore, that accountants ensure they know the correct period that management should be assessing going concern for. This is also particularly important for auditors as any incorrect assessment may have an impact on the auditor's opinion.

The wording '… not limited to' means that even if the directors do not intend to cease trading until, say, 18 months after the date the financial statements are authorised for issue, the accounts should still not be prepared on a going concern basis. This is because going concern is a forward-looking concept and there is no limit as to how long management look forward in assessing going concern.

3.2 Small companies applying FRS 102, Section 1A *Small Entities*

Small companies choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A are encouraged to disclose material uncertainties related to going concern (FRS 102, para 1AE.1(c)). It should be noted that for small entities in the UK, the proposals in FRED 82 will mandate going concern disclosures.

This does not relieve the directors from their duties to carry out an assessment of whether the entity can adopt the going concern basis of accounting in preparing its financial statements – this must still be done.

Where a small company has identified material uncertainties related to going concern, it would be encouraged to disclose these uncertainties in order that the financial statements give a true and fair view. As going concern has such a material and pervasive impact on the financial statements, it would be difficult to justify a true and fair view is presented where any material uncertainties related to going concern are not disclosed. Where the small entity has an audit (e.g. a voluntary audit or because one is mandated by a shareholder or financier), any non-disclosure of material uncertainties related to going concern could (and is likely to) impact the auditor's opinion, which may be modified accordingly.

As discussed in the previous section, FRED 82 proposes to make such disclosures for UK-based small entities mandatory rather than encouraged.

ACCA's Technical Factsheet issued in October 2020 in respect of Covid-19 grants and reliefs states:

ACCA Technical Factsheet – Accounting for Covid-19 grants and reliefs

> *Where there are material uncertainties relating to the small entity's ability to continue as a going concern, it is ACCA's view that if such disclosures are* ***not*** *made, it would be extremely difficult to justify that the financial statements give a true and fair view and hence are misleading. For ACCA member firms, this creates an ethical threat as member firms cannot have their names associated with financial statements that are misleading.*

While the citation above is from ACCA's Technical Factsheet on accounting for Covid-19 grants and reliefs, this paragraph should be applied across the board.

The ethical threat created by non-disclosure of material uncertainties related to going concern must be carefully considered by the practitioner. ACCA (like other professional bodies) do not allow members to have their names associated with accounts that are misleading and hence it may be that the practitioner has no option but to resign if the accounts would be misleading without going concern disclosures.

In such instances, advice should be sought by the practitioner to ensure they comply with ethical requirements and the relevant professional body's Code of Ethics [and Conduct].

3.3 Indicators of material uncertainties related to going concern

The current economic climate may mean that some businesses that have previously been profitable may now be sustaining losses and could find that they now have material uncertainties related to going concern. Keep in mind that uncertainties are considered to be material if their disclosure could reasonably be expected to affect the decision-making process of the users (including the shareholders) of the financial statements. This is a wholly judgemental issue and one that may need careful documentation.

The following is a non-comprehensive list of examples of indicators that an entity has material uncertainties related to going concern:

Indicator	Why it is an issue
The balance sheet shows a net current liabilities or net liabilities position	This indicates the entity may be unable to meet debts as they fall due
The bank does not renew borrowing facilities or expresses an unwillingness to support the business	A lack of cash makes it difficult for a company to pay suppliers, employees and other liabilities
Loan agreements have been breached	Breaches of a loan agreement may trigger immediate repayment of the loan hence placing additional pressure on cash flow

Staff are not paid on time	This indicates a lack of working capital and potential loss of employee goodwill
Legal claims have been brought against the entity	If successful, these claims may result in significant cash outflows thus placing additional pressure on working capital
Loss of key staff	This may make it difficult for the entity to trade
Changes in law and regulation	Such changes may make it costlier for the business to comply and the costs of compliance may be more than the company can realistically afford
Withdrawal of credit facilities by suppliers or a failure to obtain credit	This indicates a bad credit-rating which usually arises from a failure to pay liabilities
Missing payments to HMRC	Payments to HMRC should be prioritised and any missed payments may indicate the company has a lack of working capital
Negative cash flows	This indicates overtrading
Significant bad debts	Significant bad debts will also place pressure on the company's cash flow resulting in an inability to meet its liabilities
Successful competitors	These will have a detrimental impact on revenue if customers decide to buy from the competitor
Uninsured catastrophes	A fire or a flood or other disaster which is uninsured may mean the company cannot survive
Major technological change	An inability to keep up with major technological changes or an inability to afford to keep up with such changes may result in a loss of customers and inventory obsolescence

3.4 Reporting on material uncertainties related to going concern

FRS 102, para 3.9 states:

> *When management is aware, in making its assessment, of **material** uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.*

FRS 102, para 3.9

Example – Going concern uncertainty

The financial statements of Currie Ltd for the year ended 31 December 2022 are going to be authorised for issue on 2 April 2023. During the year the company lost a number of contracts that are unlikely to return. The company's overdraft facility (on which the company is currently reliant) is due for renewal in three months' time and the bank has not yet given any indication as to whether, or not, the overdraft facility will be renewed.

If the company had received indications that the overdraft facility was going to be renewed, the directors may conclude that there is no material uncertainty related to going concern. However, the fact that the bank has not given any indications of continued support (which the company is currently reliant on), disclosure of a material uncertainty related to going concern will be needed.

If Currie Ltd is a small company reporting under FRS 102, Section 1A, then it would be encouraged to make such disclosures (FRS 102, para 1AE.1(c)).

Example – Material uncertainty related to going concern

Ratchford Ltd operates from four outlets in the UK but has warehouses located in Spain and Italy. The company is preparing its financial statements for the year ended 31 December 2022 and the impact of high inflation and global economic challenges has had an adverse effect on operations. In addition, on 27 December 2022, a large contract to supply goods was cancelled indefinitely.

The company's overdraft was nearing its limit and the balance sheet as at 31 December 2022 is showing a large level of net current liabilities.

The company reports under full FRS 102.

An example disclosure is as follows:

Note 20: Going concern

The company has been materially and adversely affected by the effects of high inflation and global economic challenges. This has resulted in demand for the company's products and services becoming reduced. Operating results have been negatively impacted.

The company has incurred operating losses of (£X) in the year to 31 December 2022 (2021: Operating profit £X). In addition, the company has reported net current liabilities for the year ended 31 December 2022 amounting to (£X) (2021: net current assets £X).

Due to the current economic situation and unfavourable forecasts in the economy, the directors are uncertain when, and if, the company will return to profitability and positive cash flows from operations. These uncertainties cast significant doubt on the entity's ability to continue as a going concern for the foreseeable future. The company has applied for additional borrowings to provide working capital but the outcome of these applications is yet unknown.

3.5 Going concern basis is inappropriate

The economic uncertainties currently being experienced around the world will inevitably give rise to businesses ceasing to trade. This will mean that the going concern basis of preparing the financial statements is not appropriate.

When the going concern basis of accounting is inappropriate, UK and Ireland GAAP does not specify on which basis the financial statements should be prepared. The standards require a basis other than the going concern basis to be applied when management intend to liquidate, cease trading or have no realistic alternative but to do so.

Many accountants are nonetheless familiar with the concept of the 'break-up basis'. Under this basis, assets are restated to recoverable amount and long-term liabilities are restated as current, with provisions being made for unavoidable costs under onerous contracts and the costs of winding the business down. Hence, the accruals concept becomes secondary because under the break-up basis, the financial statements reflect a forecast of future realisation rather than how the business has performed up to, and its financial position as at, the balance sheet date.

In addition, fixed assets are not restated to current assets if their role within the ongoing business remains unchanged. It should also be borne in mind that there is no 'held for sale' classification under UK and Ireland GAAP as there is under IFRS Accounting Standards.

The break-up basis will generally only be used in very rare situations as it is not compliant with the normal recognition and measurement principles of FRS 102. However, FRS 102 states that the entity must not prepare its financial statements on a going concern basis if management intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

3.5.1 Going concern basis deemed inappropriate after the reporting date

FRS 102 and FRS 105 normally require the financial statements to reflect all transactions, events and conditions which have arisen up to, and exist as at, the reporting date. However, if an entity determines **after** the year end that it intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so, it shall not prepare its accounts on a going concern basis (FRS 102, para 32.7). In this way, what would normally be a non-adjusting event because it occurs after the balance sheet date, becomes an adjusting event if it means the entity is no longer a going concern. This is a necessary exception because, as explained earlier, going concern is a forward-looking concept.

Example – Going concern basis is inappropriate

Osbourne Ltd is preparing its financial statements for the year ended 31 December 2022. Due to the impact of high inflation, the loss of a number of significant contracts and an inability to secure additional financing, the directors have decided to cease trading on 30 April 2023. The following note illustrates the wording that may be used in the Basis of Preparation of the Financial Statements paragraph included within the accounting policies note:

As explained in note X to the financial statements, the company will cease trading on 30 April 2023 and the financial statements have been prepared on a basis other than that of the going concern basis. This basis includes, where applicable, writing the company's assets down to net realisable value. Provisions have also been made in respect of contracts which have become onerous at the reporting date. No provision has been made for the future costs of terminating the business unless such costs were committed at the reporting date.

3.6 Summary of reporting requirements

In 2016, the FRC published *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks*. This guidance is non-mandatory but is intended to serve as best practice for directors in assessing the going concern ability of an entity. Companies which are required, or choose to voluntarily apply, *The UK Corporate Governance Code* are excluded from the scope of this guidance.

The 2016 guidance states that there are three scenarios which can be identified when concluding on the entity's ability to continue as a going concern for the foreseeable future as follows:

Situation	Basis of accounting	Disclosure requirements
The going concern basis of accounting is appropriate and there are no material uncertainties	The directors should use the going concern basis of accounting when preparing the financial statements	No specific disclosure requirements for the financial statements
The going concern basis of accounting is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to adopt the going concern basis of accounting in the future	The directors should use the going concern basis of accounting when preparing the financial statements	When the directors are aware, in making their assessment, of material uncertainties related to events or conditions that cast significant doubt upon the company's ability to continue to adopt the going concern basis of accounting, the entity shall disclose those uncertainties
The going concern basis of accounting is not appropriate	The directors should use a basis other than that of the going concern basis of accounting when preparing the financial statements	When a company does not prepare financial statements on a going concern basis of accounting, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the going concern basis of accounting is inappropriate

4 Consolidated financial statements (Lecture A816 – 13.50 minutes)

Issues relating to consolidated financial statements are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 9 *Consolidated and Separate Financial Statements*, and there is overlap with FRS 102, Section 19 *Business Combinations and Goodwill*.

4.1 General recap of consolidated financial statements

Under Companies Act 2006, a parent is required to prepare consolidated financial statements (or group accounts) if it cannot claim any exemptions from this requirement in company law. The general principle where consolidated financial statements are concerned is that the results of each subsidiary within the group are included in the parent's financial statements and the consolidated financial statements then show the results of the group in line with its economic substance, which is that of a single reporting entity (i.e. as if the group structure does not exist).

It is for this reason that all intra-group transactions and balances are eliminated on consolidation. This includes removing any intra-group profits that are not realised at group level (which would often arise if a parent or subsidiary has acquired inventory from another group member and the selling entity has included a profit margin in the 'sale' and all, or some of that inventory is held at the year end and included in the buying subsidiary's inventory valuation). Only when that inventory is sold to an entity outside of the group can any profit element be recognised.

The requirement to present consolidated financial statements is outlined in FRS 102, paras 9.2 to 9.9B. FRS 102, para 9.9A states that a subsidiary may be excluded from consolidation when its inclusion is not material for the purpose of giving a true and fair view. However, two or more subsidiaries may be excluded **only if they are not material when taken together**.

4.2 What are the issues when it comes to consolidated financial statements?

Excluding auditing requirements, consolidated financial statements often contain incorrect accounting treatments which render them misleading. For example, incorrect consolidation of share capital (the consolidated balance sheet should only recognise the parent's share capital). In addition, pre-acquisition reserves are sometimes incorrectly included in group retained earnings (pre-acquisition reserves are included in the goodwill calculation – it is the parent's share of the *post-acquisition* reserves that are included in group retained earnings).

The consolidated profit and loss account is fairly straightforward to prepare once intra-group transactions have been eliminated. It is simply consolidated on a line-by-line basis up to the profit after tax line. It must then present the profit (or loss) attributable to both the parent and the non-controlling interest at the foot of the consolidated profit and loss account:

Illustrative example – consolidated profit and loss account		
	31.12.2022	31.12.2021
	£	£
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

The consolidated balance sheet is inherently more complex to prepare. Under UK and Ireland GAAP, the consolidated balance sheet must show the ownership split between the parent and the non-controlling interest (although this will not be the case where the subsidiary is wholly owned). FRS 102, para 9.14 requires profit or loss and changes in equity attributable to the owners of the parent and non-controlling interest to be determined on the basis of existing ownership interest. The allocation at the balance sheet date does not reflect the potential exercise or conversions of options or convertible instruments (e.g. convertible loans).

The table below summarises the consolidation method for the consolidated balance sheet:

Area	Consolidation method
Assets	Amalgamate on a line-by-line basis
Liabilities	Amalgamate on a line-by-line basis
Share capital	Parent company only
Reserves	Group reserves comprise: • Parent's reserves plus (profit) or minus (loss) • Share of subsidiary's post-acquisition profit or loss
Goodwill	Capitalise and amortise
Non-controlling interest	Their share of the subsidiary's net assets at the balance sheet date

4.3 Goodwill

Firms need to understand that some accountants may be more familiar with the requirements of IFRS® Accounting Standards when it comes to consolidated financial statements (particularly where the preparer is newly qualified or is a trainee studying examinations that examine IFRS Accounting Standards). Under IFRS Accounting Standards, goodwill is **not** amortised, but is instead tested annually for impairment at each reporting date.

Under FRS 102, goodwill is capitalised and amortised over its useful life on a systematic basis. In practice, the amortisation method is usually the straight-line method. There is no option under FRS 102 to assign an indefinite useful life to goodwill and, in some cases, it does not appear that goodwill has been amortised which contravenes the requirement in FRS 102, para 19.23(a).

If management are unable to make a reliable estimate of the useful life of goodwill, FRS 102, para 19.23(a) states that the useful life must not exceed ten years. Keep in mind that this ten-year 'cap' is a maximum (not a minimum). An entity could assign a shorter useful life in the rare instance that management cannot assign a reliable useful economic life to goodwill. What they cannot do in this situation is assign a longer useful life.

Auditors must also obtain sufficient appropriate audit evidence concerning the amortisation period and rate for goodwill (where material). Recalculating goodwill amortisation will often be insufficient and the auditor must ensure they obtain corroborative reasons for the goodwill amortisation rate – especially where this is over a long period (such as 20 years). Firms are often criticised for the lack of audit work that they perform on goodwill (and intangible assets) as the evidence obtained is often weak.

IFRS 3 *Business Combinations* allows an entity to recognise the non-controlling interest share of goodwill at fair value at the date of acquisition. This is often called the 'full goodwill method'. Under FRS 102, this method is not permitted and only the parent's proportionate share of goodwill can be recognised.

4.3.1 Goodwill impairment

Confusion often surrounds the issue of goodwill impairment and this is an area that lends itself to many pitfalls which must be avoided if the consolidated financial statement are to give a true and fair view.

Impairment of goodwill is dealt with in FRS 102, Section 27 *Impairment of Assets*, paras 27.24 to 27.27. FRS 102, para 27.24 recognises that goodwill, on its own, cannot be sold. In addition, it does not create cash flows for an entity which are independent of the cash flows of other assets. This means that the fair value of goodwill cannot be measured directly and hence the fair value of goodwill must be derived from measurement of the cash-generating unit (CGU) of which the goodwill forms part. In other words, goodwill can never be treated as a separate asset for the purpose of impairment testing and must be included as part of an existing (or newly created) CGU.

FRS 102, para 27.25 then goes on to state that, for the purpose of impairment testing, goodwill that has been acquired in a business combination, from the date of acquisition, must be allocated to each of the acquirer's CGU's that are expected to benefit from the synergies of the combination, regardless of whether other assets or liabilities of the acquiree are assigned to those units.

For non-wholly owned subsidiaries, part of the recoverable amount of a CGU is attributable to the non-controlling interest. During the impairment test, FRS 102, para 27.26 requires the carrying amount of that unit to be notionally adjusted before being compared with recoverable amount. This is done by grossing up the carrying amount of goodwill that is allocated to the unit to include the goodwill attributable to the non-controlling interest. It is this notionally adjusted carrying amount which is then included within the CGU to determine if the CGU is impaired.

Example – Notionally adjusted goodwill and impairment loss calculation

Holdco owns 80% of Subco. At the balance sheet date, the carrying amount of Subco's net assets were £880,000 which excludes goodwill of £120,000 (net of amortisation).

During the year, Subco was the subject of adverse publicity due to unorthodox practices which has had a detrimental impact on the business. Subco's individual financial statements are showing a large loss has been incurred at the year end and some large customers have chosen not to deal with the business.

The finance director has calculated recoverable amount of Subco's net assets to be £950,000.

As Subco is not wholly owned, goodwill must be notionally adjusted to take account of the non-controlling interest. The impairment loss is calculated as follows:

	£'000	£'000
Goodwill	120	
Unrecognised NCI (£120k x 20/80)	30	
Notionally adjusted goodwill		150
Net assets		880
Carrying amount		1,030
Recoverable amount		(950)
Impairment loss		80

All £80,000 is allocated to the notionally adjusted goodwill, but as the subsidiary is only 80% owned, only £64,000 is actually booked as the other £16,000 is allocated to the non-controlling interest and will appear in their financial statements.

A common pitfall for groups is to try and impairment test goodwill in isolation, which is incorrect because goodwill does not generate cash flows by itself. Another pitfall to avoid is forgetting to notionally adjust goodwill when the subsidiary is not wholly owned by the parent.

4.4 Acquisitions and disposals

This area of consolidated financial statements is an area in which the preparer must have a sound understanding because the rules changed when FRS 102 was brought in.

Acquisitions may take place over a long period of time and these are often referred to as 'step' acquisitions or 'piecemeal' acquisitions. Such acquisitions arise when a parent acquires additional ownership interest in an investee, thus creating a reduction in non-controlling interest. Some investments can, in fact, become a subsidiary when additional acquisitions result in the parent acquiring more than 50% ownership interest (unless there is clear evidence to suggest control has not been obtained).

Where a parent already has control over a subsidiary (i.e. when it already owns more than 50%) and it acquires further ownership interest, non-controlling interest will reduce.

Under FRS 102, the net assets of the subsidiary are **not** revalued and no additional goodwill is recognised because FRS 102, para 9.19D would regard this as a transaction among equity holders in their capacity as equity holders.

Example – Further investment in a subsidiary

On 1 June 2021, Topco Ltd acquired 70% of the net assets in Subco Ltd for a consideration of £500,000 in cash. On the date of acquisition, the fair value exercise revealed the net assets of Subco to be £380,000 and (for simplicity) this value is also equivalent to book values (this would rarely be the case in practice). On 1 June 2022, Topco agreed to invest an additional £75,000 in Subco in exchange for a further 10% of the net assets and on this date Subco's net assets had a book value of £435,000 and a fair value of £485,000. The group's accounting reference date is 31 May.

Accounting for the subsidiary at the date of acquisition (1 June 2021)

At the date of acquisition, Topco has acquired control of Subco because it has acquired an ownership interest of 70% of the net assets. Consequently, the identifiable net assets and liabilities of Subco are consolidated at their fair value of

£380,000. Positive goodwill arises amounting to £234,000 as follows:

	£
Cost of investment	500,000
Less net assets acquired	
(70% x £380,000)	(266,000)
Positive goodwill	234,000

At the date of acquisition, non-controlling interest (NCI) is £114,000 (or 30% x £380,000).

Year end 31 May 2022

The increase in Subco's net assets amounts to £55,000 (£435,000 less £380,000) which has arisen due to the profit yielded by Subco during the year to 31 May 2022. This profit is split £38,500 to Topco (being 70% x £55,000) and £16,500 (30% x £55,000) to the NCI. NCI share is now £130,500 (£114,000 brought forward plus £16,500).

Further acquisition on 1 June 2022

On 1 June 2022, Topco acquired a further 10% of Subco which means that the NCI's share of Subco's net assets falls from 30% to 20%.

NCI's share in Subco decreases by £43,500 ((30% - 10%) x £435,000) and their share will now equal £87,000 (£130,500 less £43,500) or 20% x £435,000.

This further acquisition is accounted for as a transaction among equity holders and the consequential change in NCI is accounted for under FRS 102, para 22.19. This means the NCI is adjusted to reflect the parent's additional ownership interest in the subsidiary. Any difference between the value of the NCI adjustment and the consideration paid to acquire the additional 10% is recognised in equity and attributed to the equity holders of the parent as follows:

	£
Dr Non-controlling interest	43,500
Dr Equity attributable to the parent	31,500
Cr Cash at bank	(75,000)

4.4.1 Disposals

When a parent disposes of ownership interest in a subsidiary such that control is lost (hence ownership interest reduces to 50% or less), a gain or loss is recognised in the consolidated profit and loss account, calculated as the difference between:

(a) the disposal proceeds (or the event which resulted in the parent losing control); and

(b) the proportion of the carrying amount of the subsidiary's net assets, including any related goodwill, disposed of (or lost) at the date of disposal, or the date on which control is lost.

A partial disposal may arise, but the parent may still retain a controlling interest (i.e. the parent may own more than 50% of the subsidiary following the disposal). In such situations, the disposal is accounted for as a transaction among equity holders in their capacity as equity holders. In other words, the carrying amount of the NCI is increased to reflect the parent's reduced ownership interest. Any difference between the consideration received by the investor and the amount of adjustment to NCI is recognised directly in equity.

Example – Disposal where parent retains control

On 31 March 2022, Topco Ltd disposes of a 20% ownership interest in Subco Ltd for £300,000 which reduced Topco's holding from 80% to 60%. On this date, the carrying amount of the identifiable net assets in Subco was £500,000 and the carrying amount of goodwill on acquisition at the date of disposal was £30,000.

Under FRS 102, no gain or loss is recognised on the disposal as the transaction is treated as one between equity holders in their capacity as equity holders because Topco still retains control of Subco.

The NCI will increase from 20% to 40% and hence the NCI's share of Subco's net assets will increase from £100,000 (£500,000 x 20%) to £200,000 (£500,000 x 40%), i.e. by £100,000. No goodwill is attributable to the NCI.

As Topco has retained control following the partial disposal, FRS 102, para 22.19 will apply. The carrying amount of the NCI is adjusted to reflect the change in Topco's ownership of Subco's net assets. The difference between the NCI adjustment and the fair value of the consideration received is recognised in equity and attributed to the equity holders of Topco, i.e.:

	£
Dr Cash at bank	300,000

Cr Non-controlling interest	(100,000)
Cr Equity attributable to Topco	(200,000)

4.5 Disclosures

There are many disclosures that need to be made in consolidated financial statements which are covered as follows:

FRS 102, para 9.23

FRS 102, para 9.23 requires the following to be disclosed in the consolidated statements:

FRS 102, para 9.23

(a) the fact that the statements are consolidated financial statements;

(b) the basis for concluding that control exists when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;

(c) any difference in the reporting date of the financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements;

(d) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans;

(e) the name of any subsidiary excluded from consolidation and the reason for exclusion; and

(f) the nature and extent of its interest in unconsolidated special purpose entities, and the risks associated with those interests.

Company law disclosures

The Large and Medium-sized (Companies and Groups) (Accounts and Reports) Regulations 2008 (SI 2008/410), Sch 6 require the following to be disclosed:

(2) There must be stated—

SI 2008/410, Sch 6, para 13

(a) the name of the undertaking acquired or, where a group was acquired, the name of the parent undertaking of that group, and

(b) whether the acquisition has been accounted for by the acquisition or the merger method of accounting;

and in relation to an acquisition which significantly affects the figures shown in the group accounts, the following further information must be given:

(3) *The composition and fair value of the consideration for the acquisition given by the parent company and its subsidiary undertakings must be stated.*

(4) *Where the acquisition method of accounting has been adopted, the book values immediately prior to the acquisition, and the fair values at the date of acquisition, of each class of assets and liabilities of the undertaking or group acquired must be stated in tabular form, including a statement of the amount of any goodwill or negative consolidation difference arising on the acquisition, together with an explanation of any significant adjustments made.*

(5) *In ascertaining for the purposes of sub-paragraph (4) the profit or loss of a group, the book values and fair values of assets and liabilities of a group or the amount of the assets and liabilities of a group, the set-offs and other adjustments required by this Schedule in the case of group accounts must be made.*

Goodwill

There must also be stated in a note to the accounts the cumulative amount of goodwill resulting from acquisitions in that and earlier financial years which has been written off otherwise than in the consolidated profit and loss account for that or any earlier financial year.

SI 2008/410, Sch 6, para 14

That figure must be shown net of any goodwill attributable to subsidiary undertakings or businesses disposed of prior to the balance sheet date.

Disposals

Where during the financial year there has been a disposal of an undertaking or group which significantly affects the figures shown in the group accounts, there must be stated in a note to the accounts—

SI 2008/410, Sch 6, para 15

(a) *the name of the undertaking or, as the case may be, of the parent undertaking of that group, and*

(b) *the extent to which the profit or loss in the group accounts is attributable to profit or loss of that undertaking or group.*

The Regulations do not require the disclosures by paras 13, 14 and 15 if the subsidiary:

- is established under the law of a country outside the UK; or
- carries on its business outside the UK.

Where the directors deem the information required by paras 13, 14 and 15 to be seriously prejudicial to the business of that undertaking, or the business of the parent and/or group, and the Secretary of State is in agreement, that information should not be disclosed.

In-year acquisition accounted for by the merger method

Where an acquisition has taken place in the financial year and the merger method of accounting has been adopted, the notes to the accounts must also disclose— *SI 2008/410, Sch 6, para 16A*

(a) the address of the registered office of the undertaking acquired (whether in or outside the United Kingdom),

(b) the name of the party referred to in paragraph 10(a),

(c) the address of the registered office of that party (whether in or outside the United Kingdom), and

(d) the information referred to in paragraph 11(6).

Exempt groups

Where consolidated financial statements are not prepared, para 10(1) of Sch 4 *Information on related undertakings required whether preparing Companies Act or IAS accounts* requires disclosure as to the reasons why the company is not required to prepare group accounts.

Excluded subsidiaries

Where a subsidiary has been excluded from consolidated financial statements, para 16 of Sch 4 to the Regulations requires the reason for its exclusion to be disclosed. In addition, paragraph 2 requires the following to be disclosed:

- the aggregate amount of its capital and reserves as at the end of its relevant financial year; and
- its profit or loss for that year.

This information is not required if:

- the investment is accounted for using the equity method of accounting; or
- the subsidiary is not required to deliver a copy of its balance sheet and does not publish that balance sheet in the UK or elsewhere and the holding of the group is less than 50% of the nominal value of the shares in the undertaking; or

- the information is immaterial; or
- the company is exempt by virtue of CA06, ss 400 or 401 from the requirement to prepare consolidated financial statements.

FRS 102, Section 19: Business combinations effecting during the period

For business combinations that have taken place during the reporting period, FRS 102, para 19.25 requires the following to be disclosed:

(a) *the names and descriptions of the combining entities or businesses;*

(b) *the acquisition date;*

(c) *the percentage of voting equity instruments acquired;*

FRS 102, para 19.25

(d) *the cost of the combination and a description of the components of that cost (such as cash, equity instruments and debt instruments);*

(e) *the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, including goodwill;*

(f) *[Deleted]*

(fA) *a qualitative description of the nature of **intangible assets** included in goodwill;*

(g) *the useful life of goodwill, and if this cannot be reliably measured, supporting reasons for the period chosen; and*

(h) *the periods in which the excess recognised in accordance with paragraph 19.24 will be recognised in profit or loss.*

Paragraph 19.25A also requires the following:

The acquirer shall disclose, separately for each material business combination that occurred during the reporting period, the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period. The disclosure may be provided in aggregate for business combinations that occurred during the reporting period which, individually, are not material.

FRS 102, para 19.25A

FRS 102, Section 19: All business combinations

FRS 102, para 19.26 states:

*An acquirer shall disclose a reconciliation of the **carrying amount** of goodwill at the beginning and end of the reporting period, showing separately:*

FRS 102, para 19.26

(a) changes arising from new business combinations;

(b) amortisation;

(c) impairment losses;

(d) disposals of previously acquired businesses; and

(e) other changes.

This reconciliation need not be presented for prior periods.

Finally, FRS 102, para 19.26A states:

An acquirer shall disclose a reconciliation of the carrying amount of the excess recognised in accordance with paragraph 19.24 at the beginning and end of the reporting period, showing separately:

FRS 102, para 19.26A

(a) changes arising from new business combinations;

(b) amounts recognised in profit or loss in accordance with paragraph 19.24(c);

(c) disposals of previously acquired businesses; and

(d) other changes.

This reconciliation need not be presented for prior periods.

5 Share-based payment (Lecture A817 – 14.28 minutes)

FRS 102 deals with share-based payment transactions in Section 26 *Share-based Payment*. The term 'share-based payment' is defined as:

> *The equity instruments (including shares and **share options**), **cash** or other **assets** to which a counterparty may become entitled in a **share-based payment transaction**.*

*FRS 102 Glossary **share-based payment***

The term 'share-based payment arrangement' is defined as:

> *An agreement between the entity (or another **group** entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive:*
>
> *(a) **cash** or other **assets** of the entity for amounts that are based on the price (or value) of equity instruments (including shares or **share options**) of the entity or another group entity; or*
>
> *(b) equity instruments (including shares or share options) of the entity or another group entity,*
>
> *provided the specified **vesting conditions**, if any, are met.*

*FRS 102 Glossary **share-based payment arrangement***

A 'share-based payment transaction' is defined as:

> *A transaction in which the entity:*
>
> *(a) receives goods or services from the supplier of those goods or services (including an employee) in a **share-based payment arrangement**; or*
>
> *(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another **group** entity receives those goods or services.*

*FRS 102 Glossary **share-based payment transaction***

An 'equity-settled share-based payment transaction' is defined as:

> *A **share-based payment transaction** in which the entity:*
>
> *(a) receives goods or services as consideration for its own equity instruments (including shares or **share options**); or*
>
> *(b) receives goods or services but has no obligation to settle the transaction with the supplier.*

*FRS 102 Glossary **equity-settled share-based payment transaction***

A 'cash-settled share-based payment transaction' is defined as:

*A **share-based payment transaction** in which the entity acquires goods or services by incurring a **liability** to transfer **cash** or other **assets** to the supplier of those goods or services for amounts that are based on the price (or value) of the **equity** instruments (including shares and **share options**) of the entity or another **group** entity.*

*FRS 102 Glossary **cash-settled share-based payment transaction***

5.1 Cash-settled share-based payment transactions

The definition of a cash-settled share-based payment transaction is noted above. When an entity enters into a cash-settled share-based payment transaction, it will recognise a liability at fair value and this liability is then remeasured at each balance sheet date, charging the profit and loss account with the related expense until the liability is settled.

A liability is recognised if goods or services have been acquired in a cash-settled share-based payment transaction, i.e.:

Dr Profit and loss	X	
Cr Liability		X

For presentational purposes, company law would require the liability to be split or classified as current and/or non-current as appropriate on the face of the balance sheet and within the notes in the same way as other current and non-current liabilities.

The cash paid to settle a share-based payment will be the cost to the entity of the goods and services received or rendered. The settlement may not take place for several years and hence in a cash-settled share-based payment arrangement, the estimated liability is remeasured until the final amount is known. Where there is a change in the liability, the change is taken to the profit and loss account.

Example – Cash-settled share-based payment arrangement

Currie Ltd awards its managing director 1,000 share options on 31 December 2022 which represents 10% of the company's share capital and on this date (the grant date) the company is valued at £750,000.

The managing director has requested that a clause be incorporated into the agreement which allows the share options to be converted into cash if he leaves the company or dies to which the owners have agreed as they want to retain the managing director due to his knowledge and expertise within the industry. The agreement states that the company will buy back the share options on retirement, death or where the cessation of employment is not due to incompetence, acting in the detriment of the company or being convicted of a criminal offence. Where such acts occur, the arrangement is forfeited for nil consideration and the directors consider the managing director committing such acts to be remote.

The buyback clause results in the arrangement being treated as a cash-settled share-based payment arrangement because eventually the company will have to settle the transaction via cash payment. Had there been no buyback clause, it would be equity-settled.

Hence, at each reporting date, the outstanding liability is remeasured to fair value with changes in fair value going to profit or loss. On 31 December 2022, the company recognises the share-based payment arrangement as follows:

Dr Share-based payment expense	£75,000	
Cr Liabilities		£75,000

Being share-based payment expense for the year ended 31 December 2022

5.2 Equity-settled share-based payment transactions

When an entity receives goods or services in an equity-settled share-based payment transaction, it recognises a corresponding increase in equity, i.e.:

Dr Profit and loss	X	
Cr Equity		X

It should be noted that the issuance of any shares would be a separate entry in the books of the entity.

In terms of presenting this transaction, some entities choose to show the credit to equity in retained earnings (P&L reserves), or they maintain a separate reserve which reflects the total charges for share-based payment arrangements which have not yet vested. There is no specific guidance in FRS 102 and, in practice, most entities simply take the credit to retained earnings, although they can maintain a separate reserve. An entity cannot, however, use a share premium account to take the credit.

5.3 Recognition when there are vesting conditions

Vesting conditions are those conditions which a third party must satisfy in order to become entitled to receive cash, other assets or shares of the business in a share-based payment transaction by the 'vesting date'. The 'vesting date' is the date on which the shares or share options are able to be exercised.

Where share-based payments granted to a counterparty vest immediately, they are not required to complete a specified period of service before they become unconditionally entitled to those share-based payments. Hence, in the absence of any information to suggest otherwise, the entity presumes that services rendered by the counterparty as consideration for the share-based payments have been received and therefore on the grant date, the entity recognises the services received in full, with a corresponding increase in equity (equity-settled) or liabilities (cash-settled). The term 'grant date' is defined as:

> *The date at which the entity and another party (including an employee) agree to a **share-based payment arrangement**, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to **cash**, other **assets**, or equity instruments of the entity, provided the specified **vesting conditions**, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.*

*FRS 102 Glossary **grant date***

Where share-based payments do not vest until the counterparty provides a specified period of service, the entity must assume that the services to be rendered as consideration for those share-based payments will be received in the future, during the vesting period. The entity accounts for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity or liabilities.

For example, an employee may have to complete a certain specified period of service prior to becoming entitled to exercise the share options (or not as the case might be) which entitles the employee to purchase the shares. This would represent a vesting condition which is conditional on service.

Conditions may also be imposed in the share-based payment arrangement which are conditional on the performance of the company, such as achieving a certain profit benchmark. These conditions would be non-market vesting conditions (a term which is not defined in FRS 102) and which are taken into account when estimating the number of equity instruments which are expected to vest.

The term 'market condition' is defined in FRS 102 as:

> *A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of **intrinsic value** of a **share option**, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities.*

*FRS 102 Glossary **market vesting condition***

Market vesting conditions, such as specified increases in the entity's share price, are **not** taken into consideration when estimating the number of equity instruments expected to vest because these conditions have already been taken into consideration when fair-valuing the shares or other equity instruments. Hence, an expense is recognised regardless of whether market conditions are satisfied.

At the vesting date, the entity revises the estimated number of equity instruments expected to vest so that they equal the number of equity instruments that have actually vested.

Example – Share-based payment transaction

On 1 January 2022, Wolves PLC grants 2,000 share options to each of its three directors. The terms of the share-based payment arrangement include a condition stating that each director must still be in the employment of the entity on 31 December 2024 in order for their share options to vest. The fair value of each option as at 1 January 2022 is £11 and it is expected that all of the options will vest. A further condition in the agreement is that the options will only vest if the share price reaches £18 per share. On 31 December 2022, the share price was only £9 and, due to market conditions, it is not expected to rise in the next two years. A decline in business has meant that it is only expected that two out of the three directors will be employed by the entity on 31 December 2024.

Changes in the share-price of an entity are a market vesting condition which is taken into account when the fair value of the share option is calculated. The change in share price is not included in the calculation of the profit and loss account charge or equity movement. However, the company must take into consideration the fact that only two directors will be employed by the business, hence the calculation for the financial statements for the year ended 31 December 2022 will be:

2,000 options x 2 directors x £11 x 1/3 = £14,667

- Dr Profit and loss account £14,667
- Cr Equity £14,667

Example – Share options granted

Harrison PLC offers its ten directors a share option scheme provided they each remain in the employment of the entity for a period of three years. The number of options granted to each director was 1 million. The options are exercisable immediately after the end of the third year and those directors which are eligible would be required to pay £2 for each share of £1 par value.

The fair value of the options and the estimates of the number of options which are expected to vest are as follows:

Year	Rights expected to vest	Fair value of each share option

		£
Grant date	6m	0.30
1	5m	0.38
2	6m	0.42

At the end of year 3, 7 million rights actually vested.

The financial statements for each year will show the following:

		Equity	Expense
Year	**Calculation**	**£'000**	**£'000**
1	5m x £0.30 x 1/3	500	500
2	6m x £0.30 x 2/3	1,200	700
3	7m x £0.30	2,100	900

Assuming that all eligible directors exercised their options, the entries in the financial statements are:

	£m
Dr Cash	14
Cr Share capital (7m x £1)	7
Cr Share premium	7

A transfer may be made from the share-based payment reserve to retained earnings to clear the reserve out, but this is not required.

Where share-based payments are used with employees, the share premium account will not include any element of the 'value' of those share-based payments which have been recognised as an expense and in equity. This is because in law, the services of an employee cannot be recognised as part of the consideration for shares. The situation can vary somewhat if share-based payments are used to pay a supplier, for example, as the fair value of the goods purchased with shares will be the value of the consideration for the shares.

5.4 Measurement principle for equity-settled share-based payment transactions

The general measurement principles in respect of an equity-settled share-based payment transaction are outlined in FRS 102, paras 26.7 to 26.9. FRS 105 does not allow a micro-entity to account for equity-settled share-based payment transaction until the shares are issued. Once they are issued, FRS 105 requires the micro-entity to apply the requirements of FRS 105, Section 17 *Liabilities and Equity*.

Under FRS 102, equity-settled share-based payment transactions are measured at the fair value of the goods or services received with a corresponding increase in equity. Where fair value cannot be determined reliably, FRS 102, para 26.7 cross-references to paras 26.10 and 26.11 which relate to shares, share options and equity-settled share appreciation rights. FRS 102, para 26.7 also clarifies that the fair value is in respect of the fair value of equity instruments granted to employees and others providing similar services and *not* to the fair value of services received because usually it is not possible to fair value the latter.

In respect of transactions with employees (including others providing similar services), the fair value of equity instruments is measured at grant date. In respect of transactions with parties other than employees, the measurement date is the date when the entity obtains the goods or the counterparty renders the service.

When dealing with the accounting treatment for a share-based payment transaction, the first thing to do is to split the conditions into 'market' and 'non-market' conditions.

Example – Market and non-market conditions

Hill PLC has a share-based payment arrangement in place. The terms of the arrangement are as follows:

- there must be a minimum 7.5% increase in the company's share price;
- employees must remain in the company's employment for a minimum of three years; and
- revenue in year 2 must be at least 20% higher than in year 1.

<u>7.5% increase in the company's share price</u>

The 7.5% increase in the share price is a market condition. At the grant date it is included in the measurement of the fair value of the share option based on an assessment of the outcome but is not reflected in the revised number of shares on 'true up' (the term 'true up' refers to the ability of the entity to revise its estimates of likely vesting at the grant date to reflect the actual level of vesting). The share-based payment expense continues regardless of whether, or not, the market condition is

met.

Employees remain in employment for a minimum three-year period

This is a non-market condition and hence is excluded from measurement of the grant date fair value. It is, however, reflected in the revised number of shares and the share-based payment expense is reversed if the condition is not met.

Revenue in year 2 has to be at least 20% higher than in year 1

This is a non-market condition and hence is excluded from measurement of the grant date fair value. It is, however, reflected in the revised number of shares and the share-based payment expense is reversed if the condition is not met.

5.5 Modifications

Any modification to a share-based payment arrangement could be beneficial or not beneficial to the employee.

FRS 102, para 26.12(a) states:

> *The entity shall take the modified vesting conditions into account in accounting for the share-based payment transaction, as follows:*
>
> *If the modification increases the fair value of the equity instruments granted (or increases the number of equity instruments granted) measured immediately before and after the modification, the entity shall include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the equity instruments granted. The incremental fair value granted is the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.*

FRS 102, para 25.12(a)

Where a change reduces the total fair value of the arrangement, FRS 102, para 26.12(b) is relevant, which states:

> *If the modification reduces the total fair value of the* ***share-based payment arrangement****, or apparently is not otherwise beneficial to the employee, the entity shall nevertheless continue to account for the services received as consideration for the equity instruments granted as if that modification had not occurred.*

FRS 102, para 26.12(b)

During a vesting period, an entity could alter the terms and conditions of a share option scheme and there are several reasons why this could be the case, for example it may increase or decrease the exercise price of the share options which would make the scheme more or less favourable to the employees.

Where there is no change to the vesting period, the steps to follow for the modification are as follows:

1. Calculate the fair value of the award immediately prior to the modification

2. Calculate the fair value of the award immediately after the modification

3. If the value in 2 is less than 1 there is no incremental fair value. The original grant date fair value continues to be charged over the remaining vesting period

4. If the value in 2 is more than 1 the difference is the incremental value. The original grant date fair value continues to be charged over the remaining vesting period plus the additional incremental fair value over the remaining vesting period

If the vesting date is changed, the incremental fair value is charged over the period to the new vesting date, but the original grant date fair value must continue to be charged over the period ending on the original vesting date.

Example – Modifications to a share-based payment arrangement

On 1 January 2022, Harrison PLC, which has an accounting reference date of 31 December, introduced a share-based payment arrangement for its employees in which they have the option to buy 20,000 shares provided they stay in the company's employment for three years. On 1 January 2022 (grant date) the fair value of the share options is £7.

Due to changes in legislation, the company has seen a significant decline in activity which has reduced the value of the company's shares significantly. This means that the fair value of the options is now only £2.80 per option. On 1 July 2022, the company took the decision to change the arrangement so that those employees in the scheme who are still in the employment of the company at the date the options vest have the option to buy 40,000 shares rather than the original 20,000 (i.e. 100% more). The date of the modification is 1 July 2022. The directors expect that 80% of the employees will remain in the company's employment at the date the share options vest.

The fair value of each additional equity instrument granted is determined to be the share price at the date of the grant. Hence, the incremental fair value granted is 20,000 additional shares at £2.80 per share.

This modification is accounted for in the same way that a new grant of equity instruments would be. At the year end 31 December 2022, the company is one-third of the way through the original tranche of share options and one-fifth of the way through the second tranche of shares issues (6 months / 30 months). The charge to P&L for the year ended 31 December 2022 is calculated as follows:

(16,000* x £7 x 1/3) + (16,000* x £2.80 x 1/5) = £46,293

*The number of shares is 16,000 based on the fact that the directors only expect 8% of the employees to remain in the company's employment once the options vest (20,000 originally granted x 80%).

5.6 Cancellations

FRS 102, para 26.13 states that an entity accounts for a cancellation or settlement of an equity-settled share-based payment arrangement as an acceleration of vesting, and hence shall recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

FRS 102 is unclear as to whether the amount which would have been recognised is the expense that would have been recognised had all the awards outstanding at the cancellation or settlement date vested, or whether it is the entity's estimate of the number of awards which would have vested has the cancellation or settlement not occurred. Hence, an accounting policy should be developed and this should be disclosed in the financial statements.

On 1 January 2021, Walker PLC granted 100 share options to its sales director. The terms of the agreement are that the sales director must remain in the employment of the business for three years. At the grant date, the fair value of the share options was £1,500 and it was expected that the employee would remain in the employment of the company for a three-year period.

On 1 January 2022, changes in the business resulted in the cancellation of the award and the company agreed to settle the award in cash on a pro-rata basis. The sales director received £500 (£1,500 x 1/3) and this amount was recognised in the financial statements.

The application of FRS 102, para 26.13 states that a cancellation must be accounted for as an acceleration of vesting and the entity should immediately recognise the amount which would otherwise have been recognised for services received over the remaining vesting period. To comply with FRS 102, para 26.13, the entity should also recognise an additional £1,000 (£1,500 less £500) to reflect the acceleration of

vesting.

6 ISQM 1 – Part 7

As noted in previous updates, in July 2021, the FRC issued two new quality standards:

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

As explained in previous quarters, the implementation date for ISQM (UK) 1 was 15 December 2022. An evaluation of the firm's system of quality management must take place within one year following this date.

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

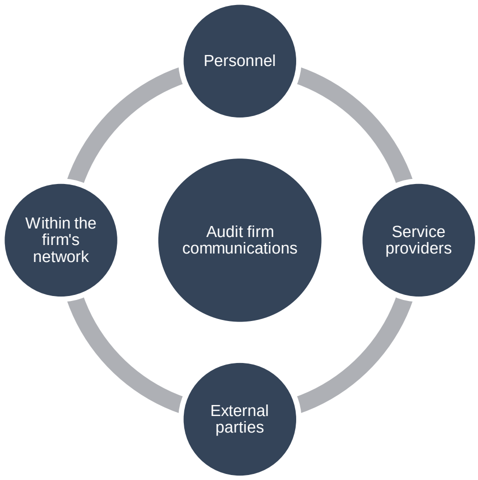
1. The firm's risk assessment process (see quarter 3 2021 notes)
2. Governance and leadership (see quarter 4 2021 notes)
3. Relevant ethical requirements (see quarter 1 2022 notes)
4. Acceptance and continuance of client relationships and specific engagements (see quarter 2 2022 notes)
5. Engagement performance (see quarter 3 2022 notes)
6. Resources (see quarter 4 2022 notes)
7. Information and communication
8. The monitoring and remediation process

In this quarter, we will examine 'information and communication'.

6.1 The information system

ISQM (UK) 1 requires the audit firm to establish a quality objective that is related to the firm's information system. The information system can include manual or automated elements.

An audit firm will communicate and exchange information with various parties as follows:



ISQM (UK) 1 deals with:

- The responsibility of personnel to communicate.
- The exchange of information between the firm and engagement teams. In this context, engagement teams include personnel and any individuals from within the firm's network or from a service provider who is part of the engagement team.
- The exchange of information between the firm and personnel performing activities within the system of quality management.
- Communicating information within the firm's network or to service providers.
- Communication with other external parties.

For scalability purposes, in the case of a smaller or less complex audit firm, communication may be more informal and achieved through direct discussions with personnel and engagement teams. ISQM (UK) 1 does not require all communications to be documented, but the firm would need to document communication to the extent it is deemed necessary to address the documentation requirements in ISQM (UK) 1, paras 57 to 60-1.

6.2 Communicating with external parties

An audit firm may communicate with a variety of external parties. Communication related to a firm's system of quality management may include, for example, direct conversations with external parties, audit oversight bodies or management and those charged with governance.

The requirements in ISQM (UK) 1 to communicate with external parties are summarised as follows:

Communication with external	Who is the communication	What is	How is it

parties required or appropriate?	with?	communicated?	communicated?
Law, regulation or professional standards require communication externally	Rxternal party specified by law, regulation or professional standards	Information specified by law, regulation or professional standards	Nature, timing and extent specified by law, regulation or professional standards
Firm performs audits of financial statements of listed entities	Those charged with governance of the entity	How the system of quality management supports consistent performance of quality engagements	Nature, timing and extent determined by the firm
Communication is otherwise needed to support external parties' understanding of the system of quality management	Communicate with external party determined by the firm	Communicate information determined by the firm	Nature, timing and extent determined by the firm

For smaller firms, the firm may identify limited cases when communication with external parties is appropriate. For example, the small firm may communicate with those charged with governance in circumstances where there are particularly findings from an engagement.

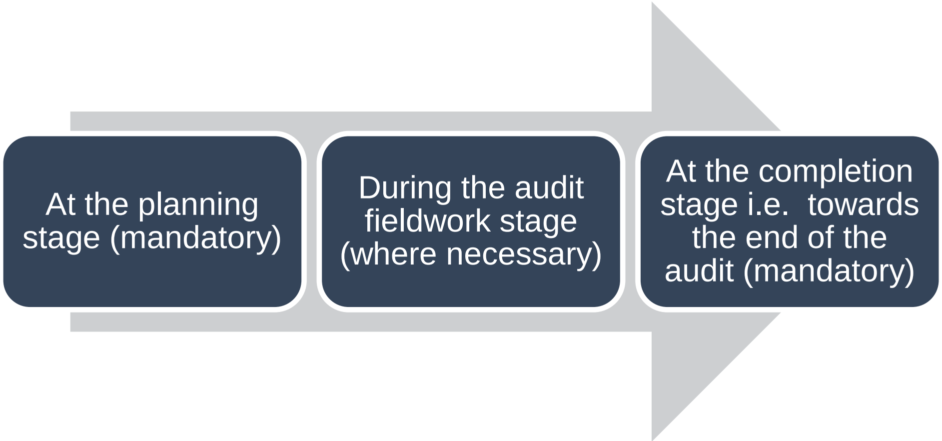
7 Analytical review (Lecture A818 – 9.28 minutes)

Analytical review is dealt with in ISA (UK) 520 *Analytical Procedures.* For the purposes of ISA (UK) 520, the term 'analytical procedures' means:

> *… evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.*

ISA (UK) 520, para 4

There are three areas of the audit where analytical procedures are applied:



7.1 At the planning stage

At the planning stage, the auditor must apply analytical procedures as risk assessment procedures in order to:

(a) help them assess the risk of material misstatement so as to provide a basis for designing and implementing responses to assessed risks;

(b) help identify the existence of unusual transactions, amounts, ratios and trends which may indicate a risk of material misstatement (e.g. a significant increase or decrease in a gross profit margin that could indicate problems such as cut-off errors/incorrect revenue recognition practices); and

(c) help the auditor to identify risks of material misstatement due to fraud.

Typically, analytical procedures include a mix of ratio analysis, comparison of current year figures against prior year, calculation of anticipated results (e.g. by way of proof in total) or comparison of the entity's results against any available industry averages.

The majority of the work involving analytical procedures at planning will involve the calculation of various ratios and percentages. However, analytical procedures also include the consideration of relationships within the financial statements, for example:

- Gross profit margins involve a relationship between the entity's revenue and cost of sales and, in most entities, are expected to remain relatively static from one reporting period to the next.

Hence, disproportionate increases/decreases within the gross profit margin are indicative of a risk of material misstatement (although do keep in mind that this is not the case in every industry – some industries do operate on volatile gross margins).

- Financial information and non-financial information, such as payroll costs in relation to the number of employees.

Modern audit software contains sophisticated methods of producing analytical review, including the calculation of ratios to assist the auditor in identifying where risks of material misstatement may lie.

Whenever analytical procedures are used, it is important to consider the expectations for the relationship being analysed. For instance, if there has been a change in the operating model of a business, or a new branch has opened or others have closed, last year's revenue or gross profit margins may not be a good comparison. Instead, the auditor should consider what change may be expected, if any, and whether this is borne out by the analysis.

Key ratios the auditor may use include the following:

Ratio	Calculation
Profitability ratios	
In most cases, the auditor would expect profitability ratios to stay relatively stable, although issues which can affect these ratios include, among other things, payroll increases, changes in sales prices and bulk discounts received.	• Gross profit margin (GP / sales x 100) • Net profit margin (pre-tax profit/sales x 100) • Operating profit margin (operating profit/sales x 100)
Efficiency ratios	
These ratios show how long, on average, a client takes to collect cash from customers, pay suppliers and hold inventory. Ideally, debtor and stock days should be as short as possible (without affecting the relationship with the supplier) to maximise cash flows.	• Trade debtor days (trade debtors/sales x 365) • Trade creditor days (trade creditors/purchases x 365) • Stock holding days (stock/cost of sales x 365)
Liquidity ratios	
These ratios indicate how capable a company is in meeting its short-term obligations. These ratios are used by the auditor in assessing going concern.	• Current ratio (current assets/current liabilities) • Quick ratio (current assets less stock/current liabilities) • Gearing ratio (borrowing/share

	capital + reserves)
Investor ratios	
These are a measure of external debt finance to internal equity finance. The return on capital employed measures the returns investments have generated. These are important in identifying material changes to the balance sheet and for assessing the overall performance of the entity.	• Return on capital employed (profit before interest and tax/share capital + reserves + borrowing)

7.2 During the audit fieldwork stage

During the audit fieldwork stage (the evidence-gathering stage), analytical procedures may be used as substantive procedures when the auditor considers that the use of analytical procedures can be more effective or efficient than tests of details in reducing the risk of material misstatement at the assertion level to an acceptably low level.

Important point

Where reliance is placed on substantive analytical procedures in order to reduce sample sizes, the substantive analytical procedures must be robust and compliant with the requirements of ISA (UK) 520.

File reviews often identify inappropriate reliance placed on substantive analytical procedures which are of poor quality or provide little or no evidence because they do not follow the requirements of ISA (UK) 520.

During the audit fieldwork stage, the auditor may use substantive analytical procedures to obtain relevant and reliable audit evidence. However, the relationships being examined must be capable of a high enough degree of predictability and hence accuracy to be useful. For instance, analytical review of fees for a private school based on pupil numbers could be expected to be accurate; whereas analytical review of revenue of a wholesaler of sports equipment is unlikely to have a predictable enough relationship to act as a substantive test. ISA (UK) 520, para 5 sets out specific steps required where substantive analytical procedures are to be used as follows:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions.

(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually, or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

7.3 Final analytical review

Analytical procedures are performed as an overall review of the financial statements at the end of the audit process to assess whether the financial statements are consistent with the auditor's understanding of the entity. Final analytical procedures are not conducted to obtain additional substantive assurance. If irregularities are found, risk assessment should be performed again to consider any additional audit procedures which may be necessary.

The auditor will usually consider the following factors when carrying out final analytical procedures:

- whether the financial statements adequately reflect the information and explanations previously obtained from the client and the conclusions reached thereon;
- whether the analytical procedures reveal any new factors which may affect the presentation of the financial statements or disclosures therein;
- whether the analytical procedures produce results which assist the auditor in arriving at the overall conclusion as to whether the financial statements, as a whole, are consistent with the auditor's knowledge of the entity;
- whether the financial statements have been unduly influenced by management bias, such as to achieve a desired outcome; and
- the potential impact on the financial statements of the uncorrected misstatements identified during the course of the audit (including those arising as a result of bias in arriving at estimates).

8 ICAEW audit monitoring 2021/22 (Lecture A819 – 10.22 minutes)

In the year ended 31 March 2022, ICAEW's QAD conducted 555 audit monitoring reviews. Most of these monitoring visits were onsite following the disruption caused by the Covid-19 pandemic. Going forward, some audit file reviews at the largest firms are likely to retain a combination of onsite and remote aspects.

8.1 Summary of findings

76% of audits reviewed were either good or generally acceptable and the improvement seen in 2020/21 has been maintained. Audits requiring significant improvement are down to 4% compared to 7% in 2020/21 and 8% in 2019.

80% (2020/21: 76%) of visits were closed without follow-up action. 14% of visits (2020/21: 17%) required some follow-up action to satisfy QAD that the necessary improvements would be made and 6% (2020/21: 8%) were referred to the ARC for more significant action.

Follow-up action taken by ARC included:

- A requirement to submit audit file reviews carried out by specialist third parties of either future audits pre-issuance (hot file reviews) or post-issuance (cold file reviews).
- A requirement to provide further explanations or documentation demonstrating changes to procedures or planned training to address matters raised during the visit.
- A requirement from the firm to be subject to another QAD monitoring visit to check the firm's progress.
- Referral of particularly serious matters for investigation by ICAEW's Professional Conduct Department leading to possible sanctions on the firm or individuals involved.
- Regulatory (financial) penalties.

8.2 Areas for improvement

Areas for improvement fall into a number of categories. The ICAEW's monitoring report cites the following areas for improvement:

Lack of audit planning and risk assessment

This leads to limited knowledge about the client and its activities, processes and controls. Consequently, firms do not adequately address the risk of fraud arising from management override of controls and audit procedures are poorly designed and sometimes inappropriate given the activities of the audit client. Even where audit procedures are considered adequate, they will sometimes lack consideration of risk and may result in over-auditing of some areas.

Audit evidence

Issues discovered by QAD include:

- Cases where QAD is presented with an accounts preparation file, with virtually no evidence of any audit work being completed
- Lack of consideration of asset valuations and existence
- Insufficient procedures over income and expenditure
- Lack of consideration of the use of service organisations by the audit client

Going concern issues have also risen in the ranks of importance since the Covid-19 pandemic, accentuated by recent changes to ISA (UK) 570 *Going Concern.* These changes require a positive statement on the appropriateness of the going concern basis in every auditor's report.

ICAEW have stated that they see firms which have carried out insufficient work to evaluate and challenge material uncertainties over audited entities' forecasts and assumptions underlying going concern.

Compliance with the FRC Ethical Standard

The ICAEW monitoring report acknowledges that significant ethical issues are rare but, where they do occur, they are of critical importance in the assessment of audit quality because they can bring into question the fundamental independence of the audit firm and those working on the audit engagement.

During 2021/22, QAD identified one case where the responsible individual (RI) and two fellow principles in a firm had entered into a business relationship with the director of an audit client, and two cases where the RI or another covered person was trustee of a trust with a material interest in the shares of the audit client.

Audit firms are reminded that breaches of the FRC Ethical Standard require biannual reporting to ICAEW (or where the firm is a PIE audit firm, the FRC).

Whole-firm procedures

As audit firms grow, they will become increasingly dependent on strong whole-firm procedures to monitor and control the quality of audit work across multiple audit teams and locations. Even smaller firms will need some key policies and procedures to ensure their audit practice is up to date.

CPD is an important factor where audit is concerned (particularly as auditing standards change on a frequent basis). The ICAEW monitoring report states that QAD have seen firms where there was little or no CPD undertaken by the RI over a number of years and/or no monitoring of CPD completed by sub-contractors and staff involved in audit work. These gaps were evident from the poor-quality audit work seen by QAD.

Cold file reviews are deemed to be an essential check on audit quality that enables a firm to identify and resolve emerging issues. Firms without anyone who can conduct a cold file review independently of the audit engagement team must have an external cold file review at least once every three years. QAD have seen firms that have not arranged a cold file review (either internally or externally) for three to four years which has led to the firm carrying out poor quality audit work.

Eligibility and control of audit firms

The management and control of an audit firm is important to safeguard the tone and message from leadership and to ensure that decisions are made that are in the public interest.

QAD monitoring visits that have led to a report to the ARC for consideration of further action include those where QAD have identified eligibility issues (although in some cases there may be little immediate concern about audit quality on engagements QAD have reviewed).

Cases include firm restructuring such that ownership is no longer with audit qualified individuals or other registered auditors, and appointment of directors/principals without properly notifying ICAEW.

8.3 Good practice

The ICAEW audit monitoring report for 2021/22 highlights four key areas that are considered to be good practice as follows:

- **Audit risk assessment** – depth of understanding of the business, structure and control of an audited entity enabling the firm to clearly identify areas of risk to plan effective audit procedures.
- **Challenge of management** – robust challenge of an audited entity's management to explain and justify key judgements underlying the information in their financial statements, whether this is in assessment of going concern, provisions or valuations of assets.
- **Documentation** – working papers that provide a clear narrative of the audit work completed and conclusions drawn, often with comprehensive cross-referencing across the audit file.
- **High quality reporting** – management of the audited entity and those charged with governance, explaining the work done and conclusions on the audit, and highlighting the principal risks and uncertainties with judgements made by management and the auditor's conclusions.

9 Audit risk and responses

Risk assessment (as highlighted in ICAEW's QAD audit monitoring report – see section 10 above) is a critical aspect of planning. Understanding how business risk and financial statement risk may impact the audit client is crucial because this can highlight areas where the financial statements contain material misstatement.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements contain a material misstatement. Audit risk is a function of the risks of material misstatement and detection risk (see below).

There are three components of audit risk:

1. Inherent risk
2. Control risk
3. Detection risk

9.1 Inherent risk

This is the susceptibility of an assertion about a class of transaction, account balance or disclosure to material misstatement **BEFORE** the auditor considers any related controls.

This risk is beyond the control of the auditor and arises for various reasons include the nature of the industry in which the client operates, the nature of the entity itself or the nature of the item. Inherent risk is a broad concept and can result in material misstatement at the assertion level.

For example, where an audit client has a portfolio of derivative financial instruments, material misstatement could arise because such financial instruments are inherently complex to account for.

Notwithstanding the fact that there is guidance in the form of accounting standards for complex financial instruments and disclosure issues, the client could misinterpret, or fail to understand, the requirements which is likely to result in a material misstatement arising in the financial statements.

9.2 Control risk

This is the risk that a misstatement that could occur and that could be material, either individually or in aggregate, will not be prevented, or detected and corrected on a timely basis by the entity's system of internal control. Control risk primarily arises in two instances: either controls in place are inadequate or non-existent; or they have not been applied effectively during the reporting period.

Example – Weak bank reconciliation controls

Birchwood Ltd requires bank reconciliations to be carried out every month as part of its month end routine.

In the last four months of the financial year, the bank reconciliation has contained small unreconciled differences. The finance director has informed the audit manager that these will be written off at the year end.

If reconciling items on the bank reconciliation are not investigated and corrected on a timely basis, the cash at bank balance could be misstated in the balance sheet. Unreconciled differences on bank reconciliations may represent a control weakness and even small differences could represent large differences that net off to a small amount.

In combination, inherent risk and control risk make up the risk of material misstatement. This is the risk that the financial statements contain material misstatement prior to the audit fieldwork commencing. Material misstatement could arise due to fraud or error occurring during the year and it is important that the auditor undertakes a thorough programme of planning to identify such risks.

9.3 Detection risk

This is the risk that the audit procedures performed by the auditor to reduce audit risk to an acceptable level will not detect a misstatement that exists and which could be material.

Out of the entire audit risk model, detection risk is the only risk that is under the control of the auditor and comprises:

- **Sampling risk** – which is the risk that the auditor's conclusion based on a sample is different from the conclusion that would be reached had the auditor tested the entire population.

- **Non-sampling risk** – which is the risk that the auditor's conclusion is inappropriate for any other reason such as the application of inappropriate audit procedures, or the failure to recognise a misstatement.

9.4 Responses to assessed risks

Once the auditor has identified those risks which may cause material misstatement at the assertion level, they must devise appropriate responses.

Some of the more common risks that are identified in practice, together with their associated responses, are shown in the table below (the table below is not comprehensive and is based on a client preparing financial statements under FRS 102). An auditor's response is not a detailed procedure, the response merely demonstrates the approach the auditor will take in tackling a specific risk. Detailed procedures are developed into an audit plan.

Audit risk	Auditor's response
This is the first year the audit firm has audited this client. The risk is that the firm has no prior experience of the client and hence detection risk is increased. Opening balances may be misstated as the firm did not carry out the audit last year and the firm is unfamiliar with the accounting systems and policies of the client.	Devote more time to obtain an understanding of the client at the start of the audit to include documenting systems and controls and devising larger sample sizes to reduce detection risk. Understand the accounting systems and policies and ensure the latter are compliant with FRS 102. Apply additional procedures over opening balances as required by ISA (UK) 510 *Initial Audit Engagements – Opening Balances* and agree these to the prior year's audit file of the predecessor auditor. Review the previous auditor's responses to the firm to identify any issues which may be relevant to this year's audit.
There is concern that the company may not be a going concern, as there have been significant reductions in sales and little financial headroom.	ISA (UK) 570 *Going Concern* sets out the specific requirements in terms of auditing and reporting on going concern. This will nearly always be a complex area, as it will involve estimates of future performance, the availability of finance or the ability to take mitigating actions (such as selling an asset or part of a business). Where there are indicators of going concern problems, care must be taken to allow sufficient time and expertise to look at the area thoroughly.
During the year an amount of £120,000 was capitalised as development expenditure. FRS 102, Section 18 *Intangible Assets other than Goodwill* allows capitalisation of development expenditure if it meets the recognition criteria. If research expenditure has been	Review a schedule of capitalised development expenditure and ascertain the stage of the project to ensure that the costs capitalised are of a development nature and are not research expenditure. (Note: Intangible assets are a subjective area of the financial statements and hence where there are material amounts of intangible assets that have been capitalised during the year, appropriate

capitalised, there is a risk that intangible assets and profit are overstated.	responses by the auditor must be developed).
The company acquired a complex piece of machinery during the year and staff were required to be trained in its use. The cost of the training was £16,000. Training costs are specifically excluded from the cost of an item of property, plant and equipment. If the training costs have been capitalised, fixed assets and profit are overstated.	Review the costs capitalised in respect of the new machine and ensure the costs of training have been written off to profit or loss as required by FRS 102, para 17.11(c).
During the inventory count, a batch of damaged inventory was identified whose estimated selling price less costs to complete and sell was less than cost. If a write-down to estimated selling price has not been carried out, inventory will be overvalued and cost of sales understated.	Trace the damaged items to the final inventory valuation and assess whether the items have been written down to estimated selling price. Discuss with management any other items of inventory whose estimated selling price may be lower than cost to assess whether any further write-downs may be necessary.
The company manufactures complex work in progress (WIP) and the amounts of WIP at the year end are likely to be material. Determining the quantity and value of WIP may be complex and hence there is a risk of material misstatement in the valuation of WIP.	Review the calculation of WIP and agree the components of the calculation to supporting documentation, such as purchase invoices for materials and payroll records for labour costs. Ascertain the stage of completion of WIP and assess this for reasonableness. Consider whether the audit firm should use an auditor's expert to carry out the valuation of WIP.
The company stores inventory at third party bonded warehouses. It is impractical for the audit firm to attend all these warehouses. There is an increased detection risk over the completeness, existence and valuation of inventory where the auditor does not attend the third-party warehouses.	Establish those warehouses which hold material amounts of inventory and attend those. Also attend those warehouses which have had a history of exceptions. For those warehouses not attended, obtain external confirmation from the warehouse regarding the quantity and condition of the inventory or consider asking another audit firm to attend those which the auditor cannot attend.

Trade debtor days in the 90 to 120 days column on the debtors listing have increased from the prior year. There is a risk that debtors may be overvalued if specific bad debt provisions have not been made against these debtors.	Extended post-year-end after date cash testing to establish whether cash has been received from the se debtor after the year. *Note: Obtaining a debtors circularisation letter from these customers would be an irrelevant response in this respect because a debtor's circularisation letter does not confirm the valuation assertion (it only confirms existence).* Discuss with management whether any of the balances in the 90 to 120 days column are irrecoverable and hence whether additional specific bad debt provisions are required. *Note: Under FRS 102, general bad debt provisions (e.g. 5% of total trade debtors) are not allowed. Only specific provisions are allowed.*
At the year end, several correcting journals were included in the financial statements to correct errors. There is a risk that transactions and balances are misstated due to errors.	Review the correcting journals and agree that these are appropriate by reference to corroborating evidence. Also consider the possibility of fraud and whether there is evidence that contradicts any corroborating evidence. Extend cut-off procedures on sales and purchases to ensure transactions are recorded in the correct accounting period. Discuss with management the reasons for the errors and consider whether the controls over the year-end process require improvement.

9.5 Other areas of risk

Other areas the auditor may generally have concerns about at the planning stage, and hence which must be factored into account when carrying out risk assessment procedures including the following (note the list below is not comprehensive):

- Manipulation of the financial statements where there are loan covenants in place in respect of borrowings to maintain those covenants.

- Directors' bonuses which are profit dependent as there is a risk the financial statements may have been manipulated to achieve these bonuses.
- Large profits or losses on disposal of assets recorded in profit or loss as this may indicate that the entity's depreciation policies are inappropriate.
- Complex revenue recognition policies as this could result in revenue being misstated.
- Poor internal controls as this increases the risk of material misstatement.
- Aggressive management styles.
- A desire to achieve a certain level of profit or a desire to reduce profit as much as possible to reduce associated tax liabilities.
- A frequent change of auditor.
- Errors in opening balances that remain uncorrected.
- A tolerance of petty theft (this is a fraud risk factor).
- A failure to address issues raised by the auditor in previous audits.
- Inadequate disclosures being made in the financial statements (e.g. in relation to provisions, contingent liabilities, post-balance sheet events or going concern issues).
- An unwillingness by management to accept any other audit opinion other than an unqualified opinion (this creates an intimidation threat for the auditor).