Audit and Accounting Quarterly Update – Quarter 4

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1 FRC amends UK GAAP (Lecture A721 – 10.26 minutes)

On 19 October 2020, the Financial Reporting Council (FRC) issued three sets of amendments to UK and Irish GAAP. Two of the amendments are unlikely to have a major impact on reporting entities in the UK in the immediate future; whereas the changes to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* will have more of an impact (especially for clients in the retail sector).

1.1 Amendment to FRS 101 *Reduced Disclosure Framework*

The FRC have issued an amendment to FRS 101 in respect of IFRS 17 *Insurance Contracts*. The amendment to FRS 101 changes the effective date of an amendment to the definition of a 'qualifying entity'.

The definition of a 'qualifying entity' in FRS 101 was changed in July 2019 to scope out entities that apply Schedule 3 to the Regulations (or similar) that have contracts within the scope of IFRS 17. This amendment was necessary because there are incompatibilities between the requirements IFRS 17 and UK company law (the Schedule 3 formats) so there would have to be a change to the law in order to allow insurers to use FRS 101. The original effective date of this change was 1 January 2021.

Revised effective date

The IASB have deferred the 'effective from' date of IFRS 17 until 1 January 2023 and the amendment to FRS 101 in October 2020 aligns the effective dates.

1.2 Amendments to FRS 102 and FRS 105

The pandemic has given rise to lessors providing lessees with rent concessions (in respect of operating leases). This has most notably been the case for clients operating in the retail sector when all 'non-essential' businesses were forced to close in March 2020 due to lockdown restrictions.

A rent concession arises when the lessor 'forgives' a portion of the lease payments that would otherwise have fallen due according to the lease agreement. So essentially the lessor receives less rental payments over the life of the lease after granting the rent concession than was the case prior to the pandemic.

It should be noted at the outset that a rent **deferral** is only a deferral of the cash outflows for the lessee and hence is not the same as a rent concession so the amendments to UK GAAP would not apply to rent deferrals.

Prior to the amendments, both FRS 102 and FRS 105 did not address the accounting treatment for rent concessions. Some commentators suggested that rent concessions arising from Covid-19 should be spread over the remaining lease term (in the same way that a lease incentive is spread); whereas others disagreed and said that they should be recognised in the period that benefits from the concession. The FRC concluded that such differences of opinion would result in diversity in practice that would be unhelpful to the users of the financial statements and hence a change to the relevant standards was needed to address the specifics of a Covid-19-related rent concession.

Recognition of a rent concession

FRS 102, Section 20 *Leases* and FRS 105, Section 15 *Leases* have been amended to require changes in operating lease payments **which are Covid-19-related** to be recognised on a systematic basis over the period(s) that the change in lease payments is intended to compensate.

It is important to emphasise that this concession only relates to rent concessions that arise purely because of the pandemic. In addition, the concession only relates to reductions in lease payments which were originally due on or before 30 June 2021. These restrictions have been included to reflect the economic substance of the benefit of these concessions and their temporary nature.

FRS 102, paras 20.15C and 20.15D have both been inserted into FRS 102 (March 2018) which state:

A lessee shall recognise any change in lease payments arising from rent concessions that meet the criteria in paragraph 20.15D on a systematic basis over the periods that the change in lease payments is intended to compensate.

FRS 102, para 20.15C

An entity shall apply the requirements in paragraphs 20.15C and 20.25B to temporary rent concessions occurring as a direct consequence of the COVID-19 pandemic if, and only if, all of the following conditions are met:

FRS 102, para 20.15D

(a) the change in lease payments results in revised consideration for the lease that is less than the consideration for the lease immediately preceding the change;

(b) any reduction in lease payments affects only payments originally due on or before 30 June 2021; and

(c) there is no significant change to other terms and conditions of the lease.

The FRC have also amended FRS 102, para 20.16 to require the amount of the change in lease payments recognised in profit or loss to be disclosed.

Finally, FRS 102, para 20.25B has been inserted which relates to lessors and states:

A lessor shall recognise any change in lease income arising from rent concessions that meet the criteria in paragraph 20.15D on a systematic basis over the periods that the change in lease payments is intended to compensate.

FRS 102, para 20.25B

The above changes will mean that Covid-19-related rent concessions are recognised in the period that benefits from the concession. This is similar to the other types of Covid-19-related grants and reliefs, such as the CJRS grant and the business rates relief which are recognised in the period that benefits.

FRS 105 amendments

The amendments to FRS 105 are consistent with those made to FRS 102 with the exception of the disclosure requirements.

Effective date

The effective date of the amendments to FRS 102 and FRS 105 is for accounting periods beginning on or after 1 January 2020. Early adoption is permitted. Where an entity early adopts the amendments, it must disclose that fact. If the entity is a small entity and early adopts the amendments, it is encouraged to disclose that fact.

1.3 Amendment to FRS 104 *Interim Financial Reporting*

An amendment has been made to FRS 104 in respect of the going concern requirements. FRS 104 is based on the provisions in IAS 34 *Interim Financial Reporting*.

Prior to the amendments, FRS 104 did not explicitly require management to undertake a going concern assessment when preparing the interim financial statements. Nor did the standard explicitly require management to make any disclosures in respect of material uncertainties related to going concern in the interim financial statements. This was not consistent with the requirements of IAS 1 *Presentation of Financial Statements*, paragraph 4. Although IAS 1, para 4 scopes out interim financial statements as needing to comply with IAS 1, the standard does bring paragraphs 15-35 within its scope. This includes paragraph 25 which requires management to carry out a going concern assessment, make going concern disclosures where necessary and to explain the basis of preparation where the going concern basis is not used and why the entity is not regarded as a going concern.

However, FRS 104 does require an entity to include a statement that the same accounting policies are applied in the interim financial statements as those in the most recent annual financial statements of the reporting entity. This would include any statement about the going concern basis of accounting.

FRS 104 has been amended to include requirements relating to going concern in a similar way to EU-adopted IFRS. This will ensure that FRS 104 is consistent with its international counterpart, IAS 34.

Therefore, when preparing the interim financial statements, management must make an assessment of the entity's ability to continue as a going concern. This assessment must take into account all available information about the future which is at least, but not limited to, 12 months from the date the interim financial statements are authorised for issue.

Where there are any material uncertainties relating to going concern, management must disclose those uncertainties in the interim financial statements. If the entity does not prepare the interim financial statements under the going concern basis of accounting, it must disclose that fact, together with the basis on which the financial statements have been prepared and the reason why the entity is not regarded as a going concern.

Effective date

The effective date of the amendments to FRS 104 is interim periods beginning on or after 1 January 2021. Early adoption is permissible.

2 Going concern (Lecture A722 – 20.52 minutes)

The impact of Covid-19 has had a huge impact on businesses up and down the country. Inevitably there are going to be some casualties of the pandemic as we progress through the remainder of 2020 and into 2021 and the issue of going concern has moved up the ranks of importance.

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 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.

Given the unpredictability the UK is currently facing with Covid-19 (in particular 'tiered' lockdown restrictions), there may be material uncertainties that cast significant doubt on the entity's ability to continue as a going concern (even with the Chancellor's additional measures for businesses affected by the lockdowns which he announced on 22 October 2020). Hence, disclosure of such material uncertainties will be required in order to make it clear to the users of the financial statements that the going concern basis is subject to material uncertainties.

2.1 Management's assessment

FRS 102, para 3.8 requires management to carry out an assessment of going concern using information at their 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 GAAP are more onerous than their international equivalent which some accountants may 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 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.

2.2 Small companies reporting under FRS 102, Section 1A *Small Entities*

Small companies choosing to report under FRS 102, Section 1A are encouraged to disclose material uncertainties related to going concern (FRS 102, para 1AE.1(c)). 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.

ACCA's Technical Factsheet which was issued in October 2020 confirms that where a small company chooses **not** to make going concern disclosures where there are, in fact, material uncertainties relating to going concern, this will give rise to an ethical issue which 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.

2.3 Indicators of material uncertainties related to going concern

The current state of the crisis will 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 does not approve a Bounce Back Loan or Coronavirus Business Interruption Loan	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

2.4 Short-term closure

The unpredictable nature of the virus means that some 'non-essential' businesses may be forced to close given the government's current strategy of trying to contain the virus. On 12 October 2020, the prime minister announced a 'tiered' system of restrictions where non-essential businesses in the 'very high risk' category (e.g. beauty salons and betting shops) may be forced to close for a period of time.

Any type of restrictions on trade, no matter how short, are going to have a detrimental impact on the business. The going concern basis of accounting will, therefore, be called into question when a business is forced to close because of government intervention.

In the situation that a business may have to close for a short period, management must carefully consider whether the going concern basis remains appropriate. They must do this having regard to the following (note the list below is not comprehensive and other entity-specific factors may need to be considered):

- Current levels of working capital available (e.g. cash deposits)
- Availability of borrowings if needed
- Order levels once the business is reopened
- Additional measures needed to be 'Covid-safe' which may incur additional costs
- Availability of supplies (especially if the company is reliant on supplies coming from overseas)
- Staff availability and flexibility (especially if certain staff members are required to self-isolate once the business reopens)
- Contingency plans if the business is forced to close again in the future due to government-imposed restrictions

In some cases, management may deem the business to be unviable in the event of any government-imposed closedown. In this case, the going concern basis will not be appropriate.

2.5 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.

Example – Going concern uncertainty

The financial statements of Taylor Ltd for the year ended 31 July 2020 are going to be authorised for issue on 25 September 2020. During the lockdown 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

Matthews 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 August 2020 and the impact of Covid-19 has had an adverse effect on operations. The company has also experienced significant problems in sourcing goods due to border closures and manufacturers in overseas countries that have had to close down due to lockdown restrictions. In addition, on 27 July 2020, a large contract to supply goods was cancelled indefinitely. The company's overdraft was nearing its limit and the balance sheet as at 31 August 2020 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 the Covid-19 pandemic. Demand for the company's products and services has reduced due to lockdown restrictions and customers' businesses being forced to close. Operating results have been negatively impacted.

The company's two warehouses in Spain and Italy have been subject to strict lockdown measures therefore impacting on the company's supply chain and significant delays have been experienced in receiving products from suppliers.

The company has incurred operating losses of (£X) in the year to 31 August 2020 (2019: Operating profit £X). In addition, the company has reported net current liabilities for the year ended 31 August 2020 amounting to (£X) (2019: net current assets £X).

Due to the rapid and ongoing nature of Covid-19, 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.

2.6 Going concern basis is inappropriate

The economic uncertainties currently being experienced around the country 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 GAAP does not specify on which basis the financial statements should be prepared. The standards do require a basis other than the going concern basis of accounting 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.

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.

2.6.1 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 August 2020. Due to the impact of Covid-19, the loss of a number of significant contracts and an inability to secure additional financing, the directors have decided to cease trading on 30 September 2020. 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 September 2020 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.*

2.7 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. In addition, in March 2020, the FRC published guidance for companies and auditors in respect of Covid-19.

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 overleaf:

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

3 Government assistance (Lecture A723 – 24.55 minutes)

As we head towards the end of 2020, many entities will be in the process of preparing their financial statements. These financial statements may include the effects of government assistance that has been received since lockdown measures were first introduced in March 2020.

This part of the course provides a recap on the accounting issues that should be borne in mind to ensure that the financial statements are prepared correctly and give a true and fair view.

3.1 Government grants

Government grants are dealt with in FRS 102 in Section 24 *Government Grants* and in Section 19 of FRS 105. The term ‘government grant’ is defined as:

> *Assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the* ***operating activities*** *of the entity.*

FRS 102 Glossary ***government grant***

> *Government refers to government, government agencies and similar bodies whether local, national or international.*

Under FRS 102 and FRS 105 an entity must not recognise a grant in the financial statements until there is reasonable assurance[1] that:

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

(b) the grants will be received.

Once this recognition criteria has been met, the entity must then apply the relevant accounting policy to the grant. Under FRS 102, this will be either the accrual model or the performance model. Micro-entities choosing to report under FRS 105 do not have an option – they must apply the accrual model to government grants.

3.2 Performance model

FRS 102, para 24.5B states that an entity applying the performance model must recognise grants as follows:

FRS 102, para 24.5B

> *(a) A grant that does not impose future performance-related conditions on the recipient is recognised in income when the grant proceeds are received or receivable.*
>
> *(b) A grant that imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.*
>
> *(c) Grants received before the revenue recognition criteria are satisfied are recognised as a liability.*

[1] FRS 102 and FRS 105 do not define ‘reasonable assurance’ but it should be taken to have the same meaning as ‘probable’ which is defined as ‘more likely than not’.

3.3 Accrual model

The accrual model requires the grant to be classified as either 'revenue-based' grant or a 'capital-based' grant. Most, if not all, of the Covid-19 grants provided by the government will be revenue-based grants.

FRS 102, para 24.5D states that grants relating to revenue must be recognised in income on a systematic basis over the periods in which the entity recognises the related costs for which the grant is intended to compensate. FRS 102, para 24.5E then goes on to state that a grant which becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs is recognised in income in the period that it become receivable.

Professional bodies such as ICAEW and ACCA have provided guidance to member firms on these issues and they take a consistent stance in that Covid-19-related grants are treated in the same way regardless of whether the performance model or accrual model is used by the entity. They are recognised as income in profit or loss.

3.4 CJRS grant

The CJRS grant in respect of the furlough scheme stopped being received on 31 October 2020 after starting to taper off from 1 August 2020. The Chancellor has announced that the Job Support Scheme is to replace the furlough scheme.

Regardless of whether an entity has an accounting policy option of either the accrual model or the performance model, this will not affect the accounting treatment for this grant. Under both models, the grant is recognised as income in profit or loss.

The grant must be recognised within **income**. It cannot be offset against the expenditure to which it relates (i.e. payroll costs). Offsetting such grants will be in contravention of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2009 (SI 2008/410), Sch 1, para 8 which states:

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

SI 2008/410, Sch 1, para 8

There is a similar restriction contained in The Small Companies and Groups (Accounts and Directors' Reports) Regulations 2008 (SI 2008/409).

FRS 102, para 2.52 is also consistent with company law which states:

> *An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by an FRS.*

FRS 102, para 2.52

> (a) *Measuring assets net of valuation allowances (for example, allowances for inventory obsolescence and allowances for uncollectible receivables) is not offsetting.*
>
> (b) *If an entity's normal **operating activities** do not include buying and selling **fixed assets**, including investments and operating activities, then the entity reports gains and losses on disposal of such assets by deducting from the proceeds on disposal the **carrying amount** of the asset and related selling expenses.*

Therefore, the entries required to recognise the grant in the financial statements are:

Dr Cash at bank X

Cr Sundry income/Grant income X

Grants in respect of the job retention schemes are taxable and must be brought into the company's tax computation as such.

Example – Grant receivable by the reporting date
Holmes Ltd has an accounting reference date of 31 August and still has some staff on furlough. On 26 August 2020 it applied for the CJRS grant for its August payroll run. The company has met the recognition criteria for the grant. HMRC paid this grant to the company on 2 September 2020. In the financial statements for the year ended 31 August 2020, a debtor balance will be recognised as follows: Dr Sundry debtor X Cr Grant income X

3.5 Small Business Grants Fund and Retail, Hospitality and Leisure Grant Fund

As with the CJRS grant, the accounting policy of either the accrual or performance model would not make any difference to the accounting treatment for these types of grants because they are recognised in income once the recognition criteria in FRS 102 or FRS 105 are met.

Under the performance model, income would be recognised once the entity's eligibility has been established.

Under the accrual model, FRS 102, para 24.5E/FRS 105, para 19.8 would apply. These paragraphs state that a grant that becomes receivable as compensation for expenses or losses already incurred, or for the purpose of giving immediate financial support to the entity with no future related costs is recognised in income in the period in which it becomes receivable.

Hence, under both the accrual and performance model, the grants would be recognised as income immediately in profit or loss.

3.6 SSP rebate

The SSP rebate is a payment from the government to compensate employers for the sick pay they have to pay to employees for periods of sickness commencing on or after 13 March 2020. The SSP rebate will fall under the scope of a government grant.

In practice, it will make no difference as to whether an entity adopts the accounting policy of the accrual model or performance model, because this grant is recognised immediately in profit or loss. The relevant accounting policy choice should, however, be disclosed by the entity in the financial statements.

The grant must be recognised within income. As with other types of grant, it must not be offset against the related payroll costs.

3.7 Disclosure requirements for grants

The level of disclosure in respect of government grants will depend on whether the entity is reporting under full FRS 102, Section 1A or FRS 105.

Full FRS 102

FRS 102, para 24.6 requires an entity to disclose:

(a) the accounting policy adopted for grants (i.e. the performance model or the accrual model);

(b) the nature and amounts of grants recognised in the financial statements;

(c) unfulfilled conditions and other contingencies attaching to grants that have been recognised in income; and

(d) an indication of other forms of government assistance from which the entity has directly benefited.

FRS 102, Section 1A

A small company choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A is only required to disclose the accounting policy in respect of grants. However, consideration must also be given as to whether additional disclosures are needed in order to give a true and fair view and, if so, the relevant disclosures in FRS 102, Section 24 would be made.

FRS 105

FRS 105 contains no disclosure requirements in respect of grants. If the directors wish to make additional voluntary disclosures, they must have regard to FRS 102, Section 1A.

3.8 Business rates relief

Business rates relief is not a government grant and hence FRS 102, Section 24 and FRS 105, Section 19 would not apply. Where an entity has taken advantage of the business rates relief, it will be treated as an absent cost and the profit and loss account charge is reduced for the period of the relief.

Example – Rates relief

Byrne Ltd is preparing its financial statements for the year ended 31 August 2020. Its rates bill for the tax year ended 31 March 2020 was £40,000. Its rates bill for the tax year ended 31 March 2021 is £nil as it is has been able to take advantage of the rates relief.

Period	Calculation	P&L charge
01.09.2019 to 31.03.2020	£40,000 x 213 days/366 days	23,279
01.04.2020 to 31.08.2020	£0 x 152 days/365 days	0
Rates charge in profit or loss		**23,279**

As rates bills are aligned with the tax year, where an accounting period spans the tax year, take care to ensure you pro-rata the relief so the profit and loss account charge is correct.

The business rates relief is not a government grant as there is no transfer of economic resources; the bill is simply not being levied to the entity from the local authority. It does, however, represent a form of government assistance and hence will require disclosure in the notes to the financial statements.

3.9 Coronavirus Business Interruption Loan Scheme (CBILS)

The CBILS provides financial support to smaller businesses across the UK that have been adversely affected by the impact of Covid-19. Such loans are beginning to come through as clients' financial statements from April 2020 year ends begin to be prepared.

On 24 September 2020, the Chancellor announced that the CBILS will be extended until 30 November 2020.

In a CBILS, a lender can provide up to £5 million in the form of:

- term loans;
- overdrafts;
- invoice finance; and
- asset finance.

The CBILS is not a government grant. However, the government have undertaken to pay the first year's interest together with any lender-levied fees on inception of the loan, which are referred to as a 'Business Interruption Payment' (BIP). The BIP is treated as a government grant.

While the BIP does not actually get paid to the company, it is still treated as a government grant because of the **substance** of the arrangement. The definition of 'government grant' refers to a '… transfer of resources to an entity'. In substance, the entity has benefitted from no interest payments in year 1 (and a refund of any lender-levied fees) which would not usually be the case in a 'normal' loan arrangement. As the government have met the cost of the first year's interest and any lender-levied fees, the BIP is treated as a government grant. The reduced interest payments and non-payment of any lender-levied fee is the transfer of resources to the entity.

It should be noted that some lenders are not charging arrangement fees in a CBILS. However, they may levy a document fee for taking a debenture for the first time.

A CBILS loan is treated as a basic financial instrument under FRS 102, Section 11 *Basic Financial Instruments*. FRS 102, Section 11 uses the amortised cost method which uses the effective interest method to allocate the loan interest.

The examples used below are for illustrative purposes only and do not reflect actual loan terms or rates of interest paid in such loans. They are to be used to demonstrate the accounting treatments for such loans.

Example – CBILS loan

Adams Ltd takes out a CBILS loan on 1 April 2020 for £250,000 and agrees a five-year repayment term. The bank does not charge an arrangement fee, but it does charge a £200 document fee for taking a debenture for the first time. Repayments are £4,543 per month for 60 months (£54,516 per annum) and the first year's interest amounts to £4,516. The government has undertaken to pay any lender-levied fees plus the first year's interest charge in year 1 for this type of loan.

Note: the effect of discounting using a 'market' rate of interest is considered to be immaterial in this example (see also below).

Using the Goal Seek function in Microsoft Excel which calculates the amortised cost of the loan, the loan is profiled as follows:

	Bal b/f	Interest	cash flow	Bal c/f
Year	£	£	£	£
1	250,000	0	(50,000)	200,000
2	200,000	7,102	(54,516)	152,586
3	152,586	5,418	(54,516)	103,488
4	103,488	3,675	(54,516)	52,647
5	52,647	1,869	(54,516)	-
		18,064		

On initial drawdown:	£
Dr Bank	250,000
Cr Loan payable	250,000

Year 1 repayment:	
Dr Loan payable	50,000
Cr Bank	50,000

The loan would then be presented in the balance sheet as a current liability of £47,414 and a non-current liability of £152,586 to comply with the statutory formats.

The government have undertaken to pay the lender-levied fee of £200 for handling the debenture paperwork plus the bank loan interest of £4,516. This is recorded in the financial statements as follows:

Dr Finance costs (P&L)	4,716
Cr Grant income	4,716

Determining a prevailing market rate of interest for such loans is likely to be difficult and the costs of doing so may outweigh the benefits. In most cases, it is likely (given the very low interest rates at present) that the effects of discounting are going to be immaterial. An acceptable (and preferable) alternative may be for the entity to disclose the fact that the entity has benefited from this form of government support, without having to actually quantify it. This would also provide the users of the financial statements with the information they need in respect of the government assistance received.

3.10 Bounce Back Loans (BBL)

Under this scheme, a small business can get access to finance more quickly. They are only available for small or medium-sized businesses who can borrow between £2,000 and up to a maximum of 25% of their turnover. The maximum amount of the loan is £50,000.

As with a CBILS, there is no interest to pay for the first 12 months. In addition there are no repayments due until the first anniversary of the loan. No arrangement fees are payable on a BBL.

After 12 months, the interest is capped at 2.5% per year.

Example – Bounce Back loan

Henley Ltd takes out a £50,000 BBL. No loan arrangement fee is charged.

On initial drawdown:	£
Dr Bank	50,000
Cr Loan payable	50,000

In year 1, the interest charge is £1,250 (£50,000 x 2.5%). The government makes a business interruption payment to cover the first 12 months of interest. This is recorded in the books as follows:

Dr Finance costs (P&L)	£1,250
Cr Grant income	£1,250

3.11 Time to pay arrangements

The government have implemented various 'time to pay' arrangements aimed at helping businesses with their cash flow during the pandemic.

VAT deferral

For VAT liabilities falling due during the period 20 March 2020 to 30 June 2020, the government granted a deferral of such payments until 31 March 2021. On 24 September 2020, the Chancellor announced that the government will allow businesses to spread that VAT liability over 11 smaller repayments with no interest to pay.

Corporate Financing Facility

This scheme helps large businesses through the purchase by the Bank of England of their short-term debt. This is a financial liability (not a government grant or government assistance) and will be accounted for like any other issue of debt. However, as with the CBILS, the entity must consider whether a market rate of interest has been applied and, if not, the accounting would follow the requirements of the amortised cost method in FRS 102, Section 11 (i.e. discounting the financial liability to present value using a market rate of interest for the debt).

Annual leave

Workers in key industries (e.g. food and healthcare), who are unable to take all their statutory annual leave entitlement due to Covid-19 will be able to carry their leave over to the next two leave years. This is neither a government grant or government assistance – but it will mean that more unused holidays are carried forward by employees in key industries. This will, in turn, increase holiday pay accruals that are recognised in the balance sheet. For tax purposes, it will be necessary to consider whether these unused holidays are incurred within nine months of the year end and, if not, relief may need to be deferred. This will result in a potential deferred tax asset being recognised (subject to the recognition criteria in FRS 102, Section 29 *Income Tax*).

4 Judgements and uncertainties (Lecture A724 – 9.26 minutes)

The impact of Covid-19 has been significant and will lead to many more judgements and uncertainties which need to be dealt with in the financial statements. The pandemic is not currently showing any signs of going away and local lockdown restrictions in the form of 'tiers' will mean that many businesses continue to suffer adversely.

FRS 102, para 8.6 says:

An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 8.7), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

FRS 102, para 8.6

FRS 102, para 8.7 says:

An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the ***reporting date****, that have a significant risk of causing a* ***material*** *adjustment to the* ***carrying amounts*** *of* ***assets*** *and* ***liabilities*** *within the next financial year. In respect of those assets and liabilities, the notes shall include details of:*

FRS 102, para 8.7

(a) their nature; and

(b) their carrying amount as at the end of the ***reporting period****.*

Notwithstanding the effect of the global pandemic, there is another issue which need to be carefully considered – that of Brexit.

Towards the end of 2020, the FRC are due to issue further amendments to UK GAAP which are Brexit-related in light of the fact that the transition period ends on 31 December 2020.

The FRC have confirmed that there will be no consultation where the changes are concerned because they are legislative changes and will come into effect for accounting periods commencing on or after 1 January 2021.

4.1 Judgements

Judgements are an area where particular care needs to be taken. Judgements are a critical aspect of applying an entity's accounting policies and may include the following:

- Additional impairment losses (which take account of cash flow forecasts) may need to be recognised.
- Provisions for liabilities in respect of onerous contracts may be more likely in the current climate.
- Additional bad debt provisions will be likely due to customers' inability to pay their debts when they become due.
- Inventory provisions may be higher due to obsolete and slow-moving items.
- Where hedge accounting is being used, there will be an impact on effectiveness for any cash flow hedges if cash flows are no longer 'highly probable'.

Given the transition period for Brexit ends on 31 December 2020, it is likely that financial statements will reflect additional judgements which are Brexit-related.

4.2 Estimates

At the present time, Covid-19 may have more of an impact on accounting estimates than at any other time.

Estimates will need to be carefully considered because not only is there a risk of management bias, but there is also a risk that they may not stand up to scrutiny (for example, by HMRC who may challenge – what appear to be – excessive provisions to ensure the requirements of UK GAAP have been correctly followed).

Cash flow forecasts and budgets will also need to be carefully considered to ensure that these reflect the current economic climate as well as uncertainties relating to Brexit. At the time of writing, there was an indication by government that a 'no deal' Brexit is likely and this may have an impact on an entity's financial statements in terms of the recognition and measurement of amounts as well as on the disclosures.

The primary difference between judgements (see 4.1 above) and sources of estimation uncertainty is that judgements which are disclosed under FRS 102, para 8.6 do not include those that involve estimations which are addressed by the requirements of FRS 102, para 8.7. In practice, information about judgements and key sources of estimation uncertainty are disclosed as two separate headings, usually within the accounting policies section of the notes.

Examples of key sources of estimation uncertainty	
Stock provisions	• Covid-19-related restrictions may affect companies that hold inventories which are subject to changing consumer demands and seasonal trends. Consequently, companies should review the recoverability of the cost of inventories which may result in write-downs to estimated selling price. • When assessing recoverability of inventories, entities are encouraged to disclose the assumptions which were applied around the timing for easing of the trade restrictions and the future saleability of items.
Impairment of property, plant and equipment	• Entities should disclose significant estimation uncertainty in relation to assumptions used in impairment assessments (e.g. cash flow projections, long-term growth and discount rate).

Post-employment benefits	• Covid-19 (and Brexit) may have a significant impact on financial markets. Reporting entities whose pension assets include a significant portion of unquoted investments should disclose sources of estimation uncertainty used in valuing these assets (e.g. market indices and estimated valuations from portfolio investment managers).
Investment properties	• Companies operating in the property business should disclose certain issues such as where the valuer has include a 'material valuation uncertainty' clause in their report. This usually states that valuers can attach less weight to previous market evidence for comparison purposes, and hence a higher degree of caution should be attached to their valuations than would normally be the case. The valuers generally do clarify in their report that this does not mean the valuation cannot be relied upon.

In July 2020, the FRC issued *Covid-19 Thematic Review: Review of financial reporting effects of Covid-19.* This Thematic Review places an increased emphasis on the transparency of such disclosures. Some common issues flagged up in relation to Covid-19-related estimations include the following:

- Some companies may have explained the impact of Covid-19 on stock provisions, but sometimes it is not clear why certain sensitivity ranges were chosen and what were the key assumptions on which the sensitivities were based.

- Sensitivities for discount rates used in value in use calculations are sometimes only provided for certain key input values, with the commentary stating that there is a risk that those values may increase, hence implying that the values for which sensitivities were provided do not necessarily express the extent of reasonably possible changes.

- There are often a higher number of instances where disclosures around sensitivities of ranges of possible outcomes were incomplete or are missing altogether. Financial statements should include disclosures in this area.

- Companies should explain the reasons for the sensitivities chosen or ranges of outcomes for major sources of estimation uncertainty.

As we progress towards the transition period deadline in respect of Brexit (particularly for 31 December 2020 year ends), disclosures in respect of estimation uncertainty are likely to move up the ranks of importance. A key message from various regulators and professional bodies is that reporting entities should respond to current levels of uncertainty with increased disclosure. This should involve a consistent 'story' being presented throughout the accounts.

5 Impairment of assets

Impairment of assets has also been an issue that has moved up the ranks of importance – especially where the pandemic is concerned. As we move towards the end of, what has been a turbulent 2020, it is worthwhile revisiting this area to ensure that financial statements correctly reflect any impairment losses that may need to be recognised. Auditors will also be paying particular attention to the carrying values of assets to ensure that any impairment losses have been appropriately reflected.

At the outset it is worthwhile emphasising the order in which an impairment test is carried out:

- First: consider whether the asset(s) in question is showing indicators of impairment. If it is; then

- Second: carry out an impairment test.

The impairment test involves establishing recoverable amount and comparing this recoverable amount to the asset's carrying amount in order to determine the level of impairment loss that is to be recognised.

FRS 102 defines 'recoverable amount' as:

*'The higher of an **asset's** (or **cash-generating unit's**) **fair value less costs to sell** and its value in use.'*

FRS 102 Glossary ***recoverable amount***

Where an impairment loss is required, it is usually recognised in profit or loss if the asset is not measured under the revaluation model.

If the asset is measured under the revaluation model, then an 'impairment loss' is recognised as a revaluation loss in accordance with FRS 102, para 17.15F which says:

> *The decrease of an asset's carrying amount as a result of a revaluation shall be recognised in other comprehensive income to the extent of any previously recognised revaluation increase accumulated in equity, in respect of that asset. If a revaluation decrease exceeds the accumulated revaluation **gains** accumulated in equity in respect of that asset, the excess shall be recognised in profit or loss.*

FRS 102, para 17.15F

Example – Impairment on an asset measured under the revaluation model

Harrison Ltd acquired a freehold property on 1 September 2018 at a cost of £125,000. The directors have elected to measure this property under the revaluation model in FRS 102, Section 17 *Property, Plant and Equipment*.

At the year end 31 August 2019, the property's value increased by £75,000 to £200,000 and the revaluation gain was recorded as follows:

	£
Dr Property, plant and equipment	75,000
Cr Revaluation reserve	75,000
Being revaluation gain at 31 August 2019	
Dr Revaluation reserve	12,750
Cr Deferred tax provision	12,750
Being deferred tax on revaluation gain at 17%	

The balance on the revaluation reserve at 31 August 2019 was £62,250 (£75,000 - £12,750).

On 31 August 2020, a surveyor confirmed that due to property prices in the area declining significantly due to the effects of the pandemic, the fair value of the building at 31 August 2020 is £110,000.

The revaluation loss is recorded as follows:

	£	
Dr Revaluation reserve	75,000	
Dr Impairment loss (P&L)	15,000	
Cr Property, plant and equipment	90,000	
Being write-down to fair value at 31 August 2020		
Dr Deferred tax provision	17,100	(£90,000 x 19%[2])
Cr Revaluation reserve	12,750	
Cr Deferred tax charge (P&L)	4,350	
Being adjustment to deferred tax re revaluation loss		

There is now a deferred tax asset of £4,350 due to the decline in the value of the property being below its original cost price. This deferred tax asset should only be recognised on the balance sheet if it is capable of recovery. If it considered **not** to be capable of recovery, then it should be offset against the deferred tax credit in P&L and

[2] On 11 March 2020, the Chancellor announced the rate of tax for companies would remain at 19% and would not reduce to 17% (as was previously anticipated). The 19% rate was substantively enacted on 17 July 2020 and became enacted on 22 July 2020. Hence, for balance sheet dates of 17 July 2020 onwards, deferred tax is calculated using a rate of 19% (not 17%).

no deferred tax asset should be recognised.

Reversals of impairment losses on individual assets

Where assets are measured under the revaluation model, impairment reversals are considered to be a revaluation increase and are treated in the same way that a normal revaluation increase would be treated (i.e. Dr PPE, Cr Revaluation reserve). However, to the extent that an impairment loss on the same revalued asset was previously recognised in profit or loss, the subsequent reversal is recognised in profit or loss with any excess being recognised in the revaluation reserve. The depreciation charge is then recalculated based on the asset's revised carrying amount, less residual value (if any) on a systematic basis over the remaining useful life of the asset.

Also, do not forget to bring in the deferred tax consequences.

5.1 Impairment of goodwill

Goodwill is dealt with in FRS 102, Section 19 *Business Combinations and Goodwill*. There are specific impairment requirements relating to goodwill in FRS 102, paras 27.24 to 27.27 and groups must carefully consider these.

FRS 102, para 27.24 recognises that goodwill, on its own, cannot be sold. Goodwill does not generate cash flows to an entity which are independent of the cash flows of other assets. Hence, the fair value of goodwill cannot be measured directly. As a consequence, the fair value of goodwill must be derived from measurement of the fair value of the cash-generating unit(s) to which it belongs.

A 'cash-generating unit' (CGU) is defined in the Glossary to FRS 102 as:

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

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

Examples of CGUs include:

- an individual hotel in a chain;
- an individual branch of a retailer;
- books published in electronic format and hard copy for a book publisher; and
- an individual restaurant in a chain.

Each of these individual entities/products would be classed as a CGU because they generate their own revenue for the business.

In a group context, a subsidiary would normally be designated as a CGU.

FRS 102, para 27.26 says:

*'Part of the recoverable amount of a cash-generating unit is attributable to the **non-controlling interest** in goodwill. For the purpose of impairment testing of a non-wholly-owned cash-generating unit with goodwill, the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount, by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the non-controlling interest. This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.'*

FRS 102, para 27.26

Therefore, where a parent does not wholly-own a subsidiary, FRS 102, para 27.26 requires the goodwill to be grossed up to include the goodwill attributable to the non-controlling interests (NCI). NCI used to be called 'minority interests' in old UK GAAP.

This grossing up calculation must be done **before** conducting the impairment review because it is the notionally adjusted goodwill figure which is then aggregated with the other net assets of the CGU. The aggregate amount is then compared to recoverable amount to determine the value of any write-down.

Example – Notionally adjusted goodwill

Topco Ltd owns 80% of Subco Ltd and the group has an accounting reference date of 31 March each year. On 31 March 2020, the carrying amount of Subco's net assets were £880,000, excluding goodwill of £120,000 (net of amortisation). Due to the coronavirus, management have decided that they will have to restructure the group and announced this restructuring exercise immediately prior to the reporting date.

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

FRS 102, paragraph 27.26 requires Topco to notionally adjust the goodwill to take into account the NCI. 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

The impairment loss of £80,000 is allocated against the total notional goodwill of £150,000 with the corresponding debit being recognised in group profit or loss.

Important point relating to reversals of impairment losses on goodwill

Impairment losses in respect of goodwill cannot be reversed at a subsequent date. This applies even if the circumstances giving rise to the original impairment loss cease to apply (FRS 102, para 27.28). This prohibition arose as a result of amendments to the Accounting Regulations in 2015 so once an impairment loss on goodwill has been recognised, it remains.

5.2 Other considerations for CGUs

The order in which an impairment loss is to be allocated to a CGU is prescribed in FRS 102, para 27.21 which states:

An impairment loss shall be recognised for a cash-generating unit if, and only if, the recoverable amount of the unit is less than the carrying amount of the unit. The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit in the following order:

FRS 102, para 27.21

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

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

Care needs to be taken when dealing with such impairment losses because there is a restriction in FRS 102, para 27.22 which states that an entity cannot reduce the carrying amount of any asset in a CGU below the highest of:

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

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

(c) zero.

FRS 102, para 27.23 then goes on to say that any excess amount of the impairment loss which cannot be allocated to an asset because of the above restriction must be allocated to the other assets of the unit pro rata on the basis of the carrying amount of those other assets.

Example – Allocating an impairment loss

The Ratchford Group is a clothing retailer. One of its subsidiaries, Charnley Clothing Ltd, suffered a fire during the lockdown and management have decided to close the store permanently and redeploy staff to other stores. The loss adjuster has determined that 40% of the machinery has been destroyed but the remaining 60% can be sold. The carrying amount of Charnley's assets are as follows:

	£'000
Goodwill	100
Licences	250
Machinery	850
Other fixed assets	220
Vehicles	48
Buildings	1,500
Cash at bank	82
	3,050

An independent surveyor has suggested a selling price of £1.6m could be achieved for the building. The finance director has calculated a recoverable amount for the CGU (being the subsidiary) of £2.5 million.

40% of the machinery was destroyed in the fire therefore 40% of the carrying amount should be written off immediately (i.e. £340,000) which leaves a carrying amount for the machinery of £510,000 (£850k - £340k).

The total carrying amount of the CGU after impairment of the machinery is £2,710,000 (see below). Recoverable amount is £2.5m so a further impairment loss of £210,000 is needed.

This is allocated first to goodwill and then to the other assets in the CGU on a pro rata basis (FRS 102, para 27.21). Goodwill of £100,000 is written off in full leaving £110,000 to allocate. So, for example, the amount attributable to licences is £53,000 ((250 / (250 + 220 + 48)) x 110).

There should be no further impairment to the machinery because these have already been written down to their recoverable amount. In addition, the impairment loss cannot be set against the building because its fair value is greater than its carrying amount (£1.6m as suggested by the independent surveyor) so the restriction in FRS 102, para 27.22(a) applies. The monetary asset (cash at bank) is also not affected by the impairment because this will be realised at full value.

The impairment is allocated as follows:

	Post machinery impairment	**Further Impairment**	**Post-impairment**
	£'000	**£'000**	**£'000**
Goodwill	100	(100)	-
Licences	250	(53)	197
Machinery	510	-	510
Other fixed assets	220	(47)	173
Vehicles	48	(10)	38
Buildings	1,500	-	1,500
Cash at bank	82	-	82
	2,710	(210)	2,500

5.3 Reversing an impairment loss

With the exception of goodwill (see earlier), impairment losses on other assets can be reversed when the circumstances giving rise to the original impairment loss cease to apply. However, FRS 102, paras 27.29 to 27.31 restrict the amount of the impairment loss that can be reversed. Consideration also needs to be given as to whether recoverable amount was estimated for an individually-impaired asset (FRS 102, para 27.30) or whether it was estimated for a CGU (FRS 102, para 27.31).

Effectively, for fixed assets, a previously recognised impairment loss can only be reversed to the extent that it brings the asset back up to the carrying amount it would have been stated at (net of depreciation/amortisation) had no impairment loss originally been recognised, so do be careful of this restriction to avoid overstating assets and impairment reversals. In almost all cases the value of a subsequent impairment reversal will be less than the original impairment loss because of this restriction.

For inventory, FRS 102, para 27.4 limits the impairment reversal to the amount of the original impairment loss to prevent inventory being valued in excess of cost.

Example – Prior period impairment loss based on an individual asset

Chatsworth Ltd has an accounting reference date of 31 March. On 31 March 2019, it had an asset in the balance sheet with a net book value of £90,000. Stiff competition in the marketplace meant that the asset in question had a recoverable amount of £30,000 and hence in the financial statements for the year ended 31 March 2019, an impairment loss was recognised of £60,000 (£90,000 carrying amount less £30,000 recoverable amount). If there had not been any impairment, the carrying amount as at 31 March 2020 would have been £75,000 as the asset is being depreciated on a ten-year straight-line basis.

The directors have now obtained evidence that competition is not as fierce and some have ceased trading during the year. The finance director is proposing to reverse the entire impairment loss of £60,000 in the financial statements for the year ended 31 March 2020.

If the asset had not suffered any impairment in 2019, the carrying value would have been £90,000 and £75,000 in 2020. Assuming that the carrying value of the asset is still at its post-impairment carrying amount of £30,000, the maximum amount of the reversal that can be recognised in 2020 is £45,000 (£75,000 net book value as at 31 March 2020 less £30,000 current carrying amount). This is because FRS 102, para 27.30(c) states that the reversal of a previously recognised impairment loss cannot increase the carrying value of an asset above the carrying amount that would have been determined (net of depreciation or amortisation) had no impairment loss been recognised for the asset in previous years.

The finance director should record the impairment loss as follows:

Dr Property, plant and equipment £45,000

Cr Profit and loss £45,000

The depreciation charge should then be adjusted prospectively to allocate the asset's depreciable amount over its estimated useful life (i.e. over the remaining five-year life).

In the example above, the reversal had been recognised immediately in profit and loss. The exception to this rule would be where the asset had been subject to the revaluation model (see earlier) as the reversal would only be recognised in profit or loss to the extent of the previous revaluation loss. The remaining reversal would be taken to the revaluation reserve via other comprehensive income.

Recoverable amount estimated for a cash-generating unit

When the original impairment loss was based on the recoverable amount of a cash-generating unit to which the asset (including goodwill) belongs, FRS 102, para 27.31 outlines the process for the reversal as follows:

FRS 102, para 27.31 (a) to (e)

'(a) The entity shall estimate the recoverable amount of that cash-generating unit at the current reporting date.

(b) If the estimated recoverable amount of the cash-generating unit exceeds it carrying amount, that excess is a reversal of an impairment loss. The entity shall allocate the amount of that reversal to the assets of the unit, except for goodwill, pro rata with the carrying amount of those assets, subject to the limitation described in (c) below. Those increases in carrying amounts shall be treated as reversals of impairment losses and recognised immediately in profit or loss unless an asset is carried at revalued amount in accordance with another section of this FRS (for example, the revaluation model in Section 17 Property, Plant and Equipment). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with the relevant section of this FRS.

(c) In allocating a reversal of an impairment loss for a cash-generating unit, the reversal shall not increase the carrying amount of any asset above the lower of:

(i) its recoverable amount; and

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

(d) Any excess amount of the reversal of the impairment loss that cannot be allocated to an asset because of the restriction in (c) above shall be allocated pro rata to the other assets of the cash-generating unit, except for goodwill.

(e) After a reversal of an impairment loss is recognised, if applicable, the entity shall adjust the depreciation (amortisation) charge for each asset in the cash-generating unit in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.'

Where an impairment loss for a CGU is being reversed, the reversal is allocated to increase the carrying amount of the assets of the unit (but not goodwill) pro rata based on the carrying amount of each asset in the unit. This can be done using the same basis as in the example of the Ratchford Group above where the impairment loss was allocated on a pro rata basis.

As with individually-impaired assets, a reversal of an impairment loss for a CGU cannot be used to increase an asset above the lower of its recoverable amount (if determinable) and the carrying amount that would have been determined (net of depreciation or amortisation) had no impairment been previously recognised. This is because any further increase would be treated as a revaluation.

Therefore, any reversal of a previously recognised impairment loss is allocated between those assets against which the original impairment loss was allocated, although it may not necessarily be in the same proportions.

Where this allocation results in a reversal being allocated to an asset which is less than its original pro rata share of the reversal, the amount of the reversal which would otherwise have been allocated to the asset should be allocated to the other assets of the unit (not goodwill) on a pro rata basis.

Post reversal, the depreciation/amortisation charge for each asset is adjusted prospectively to allocate the asset's revised carrying amount, less residual value (if any), on a systematic basis over its remaining useful life.

6 Change to pension scheme disclosures

There have been changes made to investment disclosures and governance arrangements as a result of recent changes to the *Occupational Pension Scheme (Investment) Regulations 2005*. These new regulations place a mandatory requirement on pension schemes to make the Statement of Investment Principles (SIPs) publicly available. In addition, schemes must also make publicly available an annual Implementation Statement which describes the trustees voting and engagement behaviour and, for defined contribution/hybrid schemes, also illustrates how their strategic aims have been enacted in practice.

A summary of the new SIP requirements is as follows:

- Prior to 1 October 2020, SIPs must be expanded so that they address stewardship in more detail. Since 1 October 2019, defined contribution pension scheme have been required to publish their SIP and to inform members of its availability in their annual benefit statement.
- Defined benefit pension plans must publish their SIP online by 1 October 2020.
- All annual reports produced on or after 1 October 2020 must include an Implementation Statement (IS). The content of the IS will vary depending on whether the scheme is a defined contribution or a defined benefit scheme.
- All ISs must be published online. The ultimate deadline for publication of the first defined benefit ISs and aspects of defined contribution ISs is 1 October 2021.

6.1 Implementation statements (IS)

All pension schemes are required to prepare an annual report and accounts within seven months of the scheme's reporting date. Any annual report produced on or after 1 October 2020 must contain an IS.

Defined benefit pension schemes

In respect of defined benefit pension schemes, the IS must:

- Set out how, and the extent to which, the scheme's policies on stewardship have been followed during the scheme year.
- Describe the voting behaviour by, or on behalf of, the trustees. This must include the most significant votes cast by the trustees or on their behalf during the scheme year. In addition, the IS must also state any use of the services of a proxy voter.

Defined contribution or hybrid schemes

For defined contribution schemes, the IS must:

- Set out how, and the extent to which, the Statement of Investment Principles (SIP) has been followed during the scheme year.
- Describe any formal review of the SIP (as required by the Regulations) undertaken during the year together with any other review of how the SIP has been met.
- Explain any changes made to the SIP during the scheme year together with the reasons for the changes.
- If no formal review was undertaken during the scheme year, provide the date of the last review.
- Describe the voting behaviour by, or on behalf of, the trustees. This must also include the most significant votes cast by the trustees or on their behalf during the year. In addition, the IS must also state any use of the services of a proxy voter during the year.

Guidance issued by the Department for Work and Pensions makes it clear that schemes need only address the policies that have been in place during the relevant scheme year. Therefore, if a pension scheme updates it SIPs during the year, any new policies would only need to be reported on in relation to the part of the scheme year after they were adopted. Auditors will need to carefully check that the trustees have reported against the right policies at the right times.

Online publication

Once the scheme's annual report and accounts have been finalised, the IS should be published. Trustees are also advised to be aware of the ultimate deadline for publication of the first defined benefit scheme IS which is 1 October 2021. This is also the same date for publication of the first year's information in relation to aspects of a defined contribution scheme's stewardship policies.

For annual reports finalised on or before 30 September 2020, which do not need to include an IS, the trustees must bear in mind that they will need to produce their next annual report for 2020/21 (or at least the relevant part of it) in time for the 1 October 2021 publication deadline.

It must be emphasised that the annual report and accounts themselves **do not** need to be published online. Regulation 29A of the Disclosure Regulations requires certain information to be made publicly available on a website. Trustees may, therefore, extract the IS from the annual report and accounts and only publish that information which is required rather than publish the entire annual report and accounts.

6.2 Summary of reporting requirements

The Pensions and Lifetime Savings Association have published some useful guidance for scheme trustees. The following table provides a high level overview of what different schemes are required to do:

Reporting requirements	Relevant scheme (DC or hybrid)	Defined benefit only
Description of any review of the SIP during the period covered by the Statement including an explanation of any changes to the SIP.	Yes	No
Details of how and the extent to which, in the opinion of the trustees, the SIP has been followed during the year.	Yes	Yes (in relation to voting and engagement only)
Description of voting behaviour (including 'most significant' votes by, or on behalf of, the trustee) and any use of a proxy voter during the year.	Yes	Yes

6.3 Further information

Further information which can be provided to trustees in preparation for the new regulations can be found at www.plsa.co.uk/Policy-and-Research-Document-library-Implementation-Statement-guidance-for-trustees.

7 Going concern reporting in auditor's reports (Lecture A725 – 22.04 minutes)

ISA (UK) 570 *Going Concern* provides the guidance that auditors must follow when it comes to dealing with going concern of an entity. At the outset, it is worth noting that concluding on whether, or not, an entity is a going concern is not the responsibility of the auditor. The auditor's responsibility is to obtain sufficient and appropriate audit evidence that management's use of the going concern basis of accounting is appropriate and that any relevant disclosures are adequately made in the financial statements.

The impact of the global pandemic has meant that it is critical that going concern issues are dealt with properly in the auditor's report. File reviews have indicated various weaknesses where auditor's reports are concerned and it is important to have a sound understanding of the relevant edition of ISA (UK) 570 to ensure the requirements are correctly reflected in the report.

It should also be noted that ISA (UK) 570 was revised in September 2019. ISA (UK) 570 (Revised September 2019) is effective for audits of financial statements for periods commencing on or after 15 December 2019 (i.e. from December 2020 year ends onwards). ISA (UK) 570 (Revised) places more responsibility on the auditor and hence it is critical that auditors understand the new requirements.

A summary of the new requirements is as follows:

7.1 Responsibilities of the auditor

The previous version of ISA (UK) 570 stated at paragraph 6 that the auditor's responsibilities are to '… obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting … and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.' This responsibility still applies under the revised ISA (UK) 570 but paragraph 6 has been restructured so it is clearer to understand as follows:

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on:

ISA (UK) 570 (Revised), para 6-1

- *whether a material uncertainty related to going concern exists; and*
- *the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.*

These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

7.2 Definitions

ISA (UK) 570 (Revised September 2019) contains defined terms in paragraph 9-2 which defines 'management bias' and a 'material uncertainty related to going concern' as follows:

Management bias – A lack of neutrality by management in the preparation of information.

ISA 570 (Revised September 2019) para 9-2

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Material uncertainty related to going concern – An uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern, where the magnitude of its potential impact and likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for:

(i) in the case of a fair presentation financial reporting framework, the fair presentation of the financial statements; or

(ii) in the case of a compliance framework, the financial statements not to be misleading.

In terms of a 'fair presentation financial reporting framework' this would be FRS 102. In terms of a 'compliance framework' this would be FRS 105.

7.3 Extended auditor's responsibilities

The risk assessment procedures and related activities section of ISA (UK) 570 (Revised September 2019) has been significantly increased. ISA (UK) 570 (Revised September 2019) requires the auditor to obtain an understanding of:

- the entity and its environment;
- the applicable financial reporting framework; and
- the entity's system of internal control.

In addition, if the auditor identifies events or conditions which may cast significant doubt on the entity's ability to continue as a going concern which management has not previously identified or disclosed to the auditor, ISA (UK) 570 (Revised September 2019) requires the auditor to:

a) request management to perform additional procedures to understand the effect of the events or conditions on management's going concern assessment;
b) inquire as to why management's going concern assessment failed to identify or disclose the events or conditions; and
c) perform additional audit procedures relating to the newly identified events or conditions.

7.4 Evaluating management's assessment of going concern

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

The auditor's responsibilities are extended further as ISA (UK) 570 (Revised September 2019) also requires the auditor to:

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

The auditor is also required to make greater use of the entity's viability statement where one is produced.

When management are assessing the going concern ability of the organisation, they should have regard to current and expected profitability, debt repayment and (potential) sources of financing. For example, if the entity's borrowings are coming up for renewal, management must consider whether the bank are likely, or unlikely, to renew such borrowing facilities. If it is unlikely that the bank will renew the facilities and the entity is reliant on them, this will indicate a material uncertainty in respect of going concern which will require disclosure in the financial statements.

Typical procedures management may adopt in respect of assessing going concern include:

- reviewing cash flow forecasts and budgets for the next financial year and performing a sensitivity analysis on these cash flows;
- reviewing current and future order levels;
- reviewing management accounts to assess profitability and liquidity;
- considering the working capital requirements of the business for the next financial year and whether these will be available;
- assessing the likelihood that key customers and suppliers will remain in business;
- considering the impact of competitors and whether these are likely to impact on the profitability of the entity; and
- considering factors in the external environment in which the business operates, such as those related to political, economic, social and technological environments.

7.5 Reporting

ISA (UK) 570 (Revised September 2019) uses the words 'appropriate' and 'appropriateness' in terms of the disclosures made in the financial statements relating to going concern rather than 'adequate' and 'adequacy'. In practice, there is not expected to be any significant differences between the differing terminology in this respect.

Use of the going concern basis is inappropriate

As is currently the case, if the financial statements have been prepared on a going concern basis, but, in the auditor's judgement, this basis is inappropriate, the auditor expresses an adverse opinion. This opinion states that the financial statements do not give a true and fair view. This is because going concern is both a material and pervasive matter and hence a qualified 'except for' opinion would not be sufficient.

It is worth noting that where the entity does conclude that the going concern basis is inappropriate and is preparing its financial statements under FRS 102, it would not be appropriate to use the 'break up' basis to prepare the financial statements as this basis is inconsistent with FRS 102 (as discussed earlier). A basis other than the going concern basis would be required and the basis on which the financial statements have been prepared will be disclosed in the financial statements.

Use of the going concern basis is appropriate

Where the auditor concludes that the going concern basis is appropriate, the auditor must include a section in the auditor's report headed up 'Conclusions related to going concern' or other appropriate heading and include:

- where there is no material uncertainty related to going concern (see below), a statement that the auditor has not identified a material uncertainty related to events or conditions which, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern for a period of at least 12 months from the date on which the financial statements are authorised for issue (not 12 months from the balance sheet date);

- a conclusion that management's use of the going concern basis is appropriate;

- where the entity is required to, or voluntarily chooses to, report under the UK Corporate Governance Code, or to explain why they have not, the auditor is required to state that they have nothing material to add or draw attention to in respect of the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements; and

- for public interest entities, other listed entities, entities that are required, and those that voluntarily choose to report on how they have applied the UK Corporate Governance Code, and other entities which are subject to the governance requirements of The Companies (Miscellaneous Reporting) Regulations 2018 (SI 2018/800), an explanation as to how the auditor evaluated management's assessment of the entity's ability to continue as a going concern and, where relevant, key observations arising with respect to that evaluation.

Example – New audit reporting bulletin in relation to ISA (UK) 570 (Revised September 2019)
Conclusions relating to going concern In auditing the financial statements, we have concluded that the director's use of the going concern basis of accounting in the preparation of the financial statements is appropriate. Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the [entity]'s ability to continue as a going concern for a period of at least twelve months from when the financial statements are authorised for issue. Our responsibilities and the responsibilities of the directors with respect to going concern are described in the relevant sections of this report.

Use of the going concern basis is appropriate but a material uncertainty exists

Where management have made **appropriate** disclosures in the financial statements, the auditor expresses an unmodified (unqualified) opinion. The auditor's report must include a section headed up 'Material Uncertainty Related to Going Concern' (which is currently the case under ISA (UK) 570 (Revised June 2016)) which:

- draws attention to the relevant note in the financial statements that discloses the material uncertainties;
- states that these events or conditions indicates a material uncertainty exists and that it may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's report is not modified in respect of this matter; and
- for entities which are required, or voluntarily choose to, report on how they have applied the UK Corporate Governance Code, or to explain why they have a not, a statement that the auditor has nothing material to add or draw attention to in respect of the directors' identification in the financial statements of any material uncertainties to the entity's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements.

Example – Material Uncertainty Related to Going Concern paragraph
We draw your attention to note 19 which indicates that the effects of the Covid-19 pandemic has had a detrimental impact on the company's operations and cash flows. As stated in note 19, these events or conditions, along with other matters as set forth in note 19 indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

The example above cross refers the user to the relevant disclosure note (note 19) and also provides a brief explanation of the issues. The paragraph also confirms that the opinion is not modified in respect of the material uncertainty.

Recent reviews of audit files indicates that some firms are still including Emphasis of Matter (Eom) paragraphs to highlight going concern uncertainties. Auditors must keep in mind that it is not correct to use an EoM paragraph where material uncertainties related to going concern have been appropriately/adequately disclosed in the financial statements.

It should also be noted that the use of a Material Uncertainty Related to Going Concern (MURGC) paragraph is only used when **adequate** or **appropriate** disclosure has been made in the financial statements. If inadequate/inappropriate disclosure has been made, the auditor's report will be modified (qualified) accordingly and hence a MURGC paragraph is not used.

Appropriate disclosure has not been made in the financial statements

Where the entity has not made appropriate disclosures in the financial statements about a material uncertainty related to going concern, the auditor expresses a qualified opinion or adverse opinion in accordance with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report* as appropriate.

8 FRC Ethical Standard (Lecture A726 – 28.37 minutes)

In December 2019, the FRC issued a revised Ethical Standard (ES). This came into effect on 15 March 2020. The only exception relates to paragraph 5.42 of the ES 2019 which comes into effect for periods commencing on or after 15 December 2020. Paragraph 5.42 of the ES 2019 relates to an entity which is not a public interest entity, but is an other entity of public interest.

It is important that auditors have a sound understanding of the requirements of the ES because non-compliance can result in heavy sanctions being imposed by the FRC and/or professional bodies.

We have put together some of the more frequently asked questions in respect of the ES as follows:

Do all audit firms have to report breaches of the FRC Ethical Standard?

Yes. Some auditors seem to have made the mistake of thinking that it is only auditors of public interest entities (PIEs) that have to report.

In fact all firms need to report all breaches [of the Ethical Standard, or policies and procedures] to the Competent Authority on a biannual basis **and** to those charged with governance of an entity relevant to an engagement, where a breach relates to a specific engagement or engagements in a timely manner.

Can an auditor provide non-audit services which include attendance at board meetings?

The prohibition of the provision of non-audit services where the firm plays a part in the management decision-taking of the client has been extended from just PIE audits to all statutory audits. The third-party test must be applied in determining whether the firm is involved in management decision-making.

The definition of 'management threat' requires the third-party test to be applied, and if such a person concludes that the firm would be involved in management decision-making, the firm is prohibited from undertaking such work.

Therefore, auditors must not assist in management decision-making at board meetings. Auditors are often invited to board meetings in their role of auditor and this is not an issue. An auditor might be invited to report to the board as part of providing a non-audit service such as tax planning or management accounting, which is permitted provided that no part is played in management decision-making and appropriate safeguards are applied.

What should be avoided is a non-audit service where the audit firm provides board level expertise to directly assist in the decision-making process of the board, particularly in a finance director type role.

Am I permitted to do audits and not charge a fee for my work?

The extant requirement that the engagement partner shall be satisfied and able to demonstrate that the engagement has assigned to it sufficient partners and staff with appropriate time and skill to perform the engagement in accordance with all applicable engagement and Ethical Standards, irrespective of the engagement fee to be charged still stands.

This is still backed by a note that there are no circumstances where the fee can justify a lack of appropriate resource. The revised standard adds the following requirement, however:

However, where an engagement partner agrees a fee for an engagement that an objective, reasonable and informed third party would conclude that it is probable that the independence of the auditor would be compromised as a result, the engagement partner shall report the safeguards applied to ensure the delivery of a fully compliant audit to those charged with governance in accordance with paragraph 1.62 of this Ethical Standard.

ES 2019, para 4.2

Would an objective, reasonable and informed third party think that not charging a fee could compromise the auditor's independence? Almost certainly, yes. At the very least, safeguards will be needed. The relevant safeguards applied should also be carefully documented in the audit file.

Do I need to rotate audit partner every 10 years now?

No, but engagement partners and audit firms will have to give long association a lot more thought than before. Also, it is possible that the changes explained below might make auditors more seriously consider the need for rotation more than they do now. Note PIEs and listed audits have different requirements.

There is a subtle change in the way that the paragraph that applies where an engagement partner has held this role for a continuous period of 10 years is worded. Where they are not rotated after 10 years, it is noted as important that:

(a) *safeguards, such as those noted in paragraph 3.5, are applied;* ***and***

ES 2019, para 3.6

(b) *the reasoning as to why the individual continues to participate in the engagement is documented, and the facts are communicated to those charged with governance of the entity in accordance with paragraphs 1.54 – 1.62 of this Ethical Standard.*

Notice the word '**and'**, between sections (a) and (b). This was changed from 'or'.

This means that safeguards will always have to be applied when rotation is not applied at the 10-year mark and the reasoning behind rotation not being applied will need to be communicated to those charged with governance. And, of course, this will all need to be properly documented.

Note

For PIEs and listed entities, whilst the rotation period for engagement partner remains at five years, this period now includes time spent on the same engagement but at different firms (for example, where the client moved firms with the partner). In addition, they now must not have 'significant or frequent' interaction with senior management in the 'cooling off' period.

Can I make donations to my audit clients that are charities?

As well as the firm establishing policies on the nature and value of gifts/hospitality acceptable to/from clients, the firm must now have a similar policy for such to/from potential clients.

This has been the situation since 2016, but the ES 2019 is now much clearer on this point.

Therefore, auditors must consider the impact on independence of making donations (gifts) to charities that they audit.

However, when considering this, remember the third party test. An objective, reasonable and informed third party (ORITP), would be unlikely to think about a donation to charity in the same way as an auditor paying for tickets to a sporting event, a luxury meal or a personal gift to the CEO. What the third party might think of as insignificant might be different in this case.

What is an 'OEPI'?

Other Entity of Public Interest - this is new definition in the ES 2019. A new section 5B has been inserted concerning the provision of permitted non-audit/additional services to PIEs, the application of the 70% cap and disclosure in the auditor's report if non-permitted services provided. All of the services in the permitted list are 'closely related' to an audit or are required by law and/or regulation. No other services can be provided. This should significantly reduce the scope for interpretation and improve consistency of application. A new Appendix B lists prohibited non-audit services for Public Interest Entities (PIEs) and also transitional details.

This section also applies to Other Entities of Public Interest, the definition for which was added to the Glossary in January 2020, as follows:

An entity which does not meet the definition of a Public Interest Entity, but nevertheless is of significant public interest to stakeholders. This includes:

ES Glossary

(a) AIM listed entities which exceed the threshold to be an SME listed entity as calculated using the definition in this glossary;

(b) Lloyd's syndicates;

(c) Private sector pension schemes with more than 10,000 members and more than £1 billion of assets, by reference to the most recent set of audited financial statements;

(d) Entities that are subject to the governance requirements of The Companies (Miscellaneous Reporting) Regulations 2008 (SI 2018/860) by reference to the most recent set of audited financial statements [the requirements apply to the audit of the next financial period commencing after the signing of the auditor's report for the period in which the entity met the OEPI criteria], excluding fund management entities which are excluded within a private equity or venture capital limited partnership fund structure.

A company that is subject to the governance requirements of The Companies (Miscellaneous Reporting) Regulations 2018, will have:

- more than 2,000 employees; **or**
- turnover of more that £200m and balance sheet total (gross assets) over £2bn.

These thresholds apply to a single company and globally.

Charities are excluded.

What is the difference between internal audit and extended external assurance?

The issue is that there is a removal of a conditional prohibition – based on management role and significant reliance on output – to an outright prohibition over the provision of internal audit services to audit clients:

> *The firm shall not provide internal audit services to an entity relevant to an engagement or a significant affiliate of such an entity, where the firm is undertaking an engagement.*

ES 2019, para 5.44

An internal audit function is defined in the Glossary (and within ISA (UK) 610 *Using the Work of Internal Auditors*) as a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

However, extended external assurance is still permitted. At management's request, the auditor might extend the scope of the external audit to report on additional matters. In reality there is a grey area here on what is internal audit versus extended external audit.

To establish the nature of the additional work the auditor should consider:

- the work itself – would an ORITP think that the work was internal audit?
- the reporting – extended external assurance reporting tends to have a formality and structure to it that internal audit sometimes lacks;
- the way that the service is delivered; and
- the terms of the engagement.

What is 'tax advocacy'?

Another example of the replacement of a conditional prohibition with an outright prohibition is seen in this area. This prohibition has been amended further since it was last revised in 2016 and, in essence, a firm may now no longer act as an advocate for the client for the resolution of a tax issue, whether material to the financial statements or not.

The old prohibition (ES 2016 Part B 5.97) noted:

> *The firm shall not provide tax services to an entity relevant to an engagement where this would involve acting as an advocate for the entity in the resolution of an issue:*
>
> *(a) that is material to the entity's present or future financial statements, or the subject matter information or subject matter of the engagement; or*
>
> *(b) where the outcome of the tax issue is dependent on a future or contemporary judgment by the firm in relation to the financial statements, or other subject matter information or subject matter of the engagement.*

ES 2016, para B 5.97

The updated prohibition in the 2019 ES simply states:

> *The firm shall not provide tax services to an entity relevant to an engagement where this would involve acting as an advocate for the entity in the resolution of an issue.*

ES 2019, para 5.75

However, auditors might continue to provide non-audit services to their audit client in assisting with tax investigations. With the application of the appropriate safeguards, auditors could continue to provide information to the tax authorities and communicate management's arguments. However, auditors must not closely align themselves with management's position. Auditors might also provide a technical resource to management to help management formulate their arguments.

A good example would be where the finance director (FD) and the auditor were to have a meeting with HMRC on a tax dispute. The FD should be doing most of the talking.

Note

The use of separate teams to provide this service is a good safeguard but it does not allow the audit firm to continue to provide tax advocacy services. In fact using a tax partner to deliver the services might risk breaching the ES as they might lack the audit ethics training on how to limit their involvement in the right way to avoid tax advocacy.

Can my firm provide someone to sit in on the job interviews for a new FD?

No, unless they are not there to advise on the appointment, which seems unlikely.

The restrictions in this area of the standard have been both reworded for clarification purposes and the prohibitions expanded.

The firm shall not provide recruitment services to an entity relevant to an engagement, that would involve the firm taking responsibility for, or advising on the appointment of any director or employee of the entity, or a significant affiliate of such an entity, where the firm is undertaking an engagement.

ES 2019, para 5.55

Unlike the ES 2016 requirement, the above prohibits the advisory aspect and broadens the director and employee reference to refer to significant affiliates of the audited entity.

Has anything changed regarding the provision of accounting services?

Nothing of substance has changed for unlisted, non-PIE or non-OEPI audits.

Provision of accounting services are particularly prevalent and whilst existing restrictions in respect of listed entities, PIEs and OEPIs still apply (and in fact have been tightened up in various ways), there are some changes of emphasis for other entities that will require careful consideration.

The firm shall not provide accounting services to an entity relevant to an engagement where:

ES 2019, para 5.120

(a) the entity is a listed entity, relevant to an engagement by the firm, or a significant affiliate of such an entity; or

(b) for any other entity:

- those accounting services would involve the firm undertaking part of the role of management, or initiating transactions; or

- the services are anything other than of a routine or mechanical nature, requiring little or no professional judgement.

The underlined text above represents additional wording that was not bold text in the 2016 standard. The guidance around these restrictions is essentially unchanged, with information included in paragraphs 5.121 to 5.127 that provides information on types of service that may be a by-product of the audit, rather than accounting services, where lines may be drawn in the determination of what is mechanical and the safeguards that may be appropriate when providing accounting services.

What do I do if I have already started providing a non-audit service which is now banned?

The ES 2019 recognises that there may be problems for firms already engaged in providing non-audit services so there are clear transitional provisions:

- In the main, the new ES is effective from 15 March 2020 (with the December exception noted above).
- A firm can complete any engagement started before this date by continuing to apply the old ES.
- If there are engagements already entered into before 15 March 2020 which relate to services that will be prohibited under the new standard, *and work has begun on these engagements*, it will be acceptable to continue and complete the work under the original terms, with appropriate safeguards applied.
- Appendix B (prohibited non-audit services for PIEs) of the standard sets out a cooling-in period prohibiting certain non-audit services between the beginning of the period being audited and the issue of the auditor's report and the financial year immediately preceding it. This cooling-in period does not apply retrospectively in relation to internal audit services.

Are there still exemptions for audits of small entities?

There are some minor consequential amendments arising from revisions to ISQC (UK) 1 (Revised November 2019) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* and the new ISA (UK) 220 (Revised November 2019) *Quality Control for an Audit of Financial Statements*.

There is now reference within the 'self-review threat alternative provision - cyclical inspection condition' to inspection cycles 'not being more than three years' (from 'ordinarily not more than three years'). There is also now reference to the documentation requirements in ISA (UK) 220 when those inspecting the engagement evaluate whether there is documentary evidence of informed management making judgements and decisions needed.

9 Fraud and the auditor's report (Lecture A727 – 17.03 minutes)

ISA (UK) 700 (Revised January 2020) *Forming an Opinion and Reporting on Financial Statements* applies for audits of financial statements for periods commencing on or after 15 December 2019 (i.e. from December 2020 year ends onwards).

ISA (UK) 700 (Revised) extends the requirement to include an explanation of the extent to which the audit was capable of detecting irregularities, including fraud, to all auditor's reports rather than just those of public interest entities (PIEs). It is therefore important that audit firms ensure that their audit programmes and software are up-to-date to cater for the new requirements.

9.1 Irregularities

The term 'irregularities', or its singular, is not defined in the ISAs (UK) or in company law but should be taken to mean the same as 'non-compliance' which is defined in ISA (UK) 250 Section A – *Consideration of Laws and Regulations in an Audit of Financial Statements*, para 12 as follows:

> *Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.*

ISA (UK) 250 Section A, para 12

9.2 Content of the explanation

The FRC's Compendium of Illustrative Auditor's Reports issued in March 2020 contains various illustrations of companies' auditors reports. Appendix 1 illustrates an auditor's report for a non-publicly traded company preparing financial statements under the small companies regime.

In the illustrative example per the FRC's Compendium, the auditor's explanation of the extent to which the audit was capable of detecting irregularities, including fraud, is contained within the 'Auditor's Responsibilities for the audit of the financial statements' paragraph as follows:

> *Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud is detailed below:*
>
> *[Explanation as to what extent the audit was considered capable of detecting irregularities, including fraud].*

Some aspects which the auditor may wish to consider including within this paragraph include the following (the list below is not comprehensive):

- How the auditor obtained an understanding of the entity's policies and procedures in respect of compliance with laws and regulations (including significant laws and regulations). This can also include any documentation reviewed by the auditor in respect of non-compliance with laws and regulations (NOCLAR).

- The engagement partner's assessment of whether the audit staff deployed on the audit had sufficient knowledge/expertise to identify or recognise NOCLAR together with any discussions with specialists on those areas of the financial statements which may be particularly susceptible to fraud.

- The effectiveness of the entity's internal control environment.

- The nature, timing and extent of the audit procedures that have been performed.

- For groups, communications with component auditors to request identification of any instances of NOCLAR which could give rise to a material misstatement in the consolidated financial statements.

- For groups, how the auditor addressed issues relating to fraud/irregularity at both the group and component levels.

- The auditor's assessment of the risk of material misstatement due to fraud, including how fraud may occur.

- How the auditor obtained an understanding of the entity's fraud risks, including policies and procedures relating to fraud, including addressing known fraud risk factors or knowledge of any actual, suspected or alleged fraud.

When the auditor is preparing their explanation for inclusion in the auditor's report, they must have regard to the various risks that have been identified. There is no 'one-size-fits-all' approach and each auditor's report will have different levels of explanations. Factors which the auditor may need to consider in preparing this part of their report include the following (note the list below is not comprehensive):

- Results of inquiries of management and other staff/third parties or those charged with governance concerning actual and potential litigation and claims.

- Reviews of minutes of meetings of those charged with governance.

- Results of inquiries of tax staff/lawyers concerning any instances of NOCLAR.

- Results of audit procedures over the testing of journal entries (particularly around the year end) and other adjustments for appropriateness. This should also include consideration of the rationale of significant transactions outside the normal course of business.

- The results of audit procedures, including tests of controls and how the auditor's procedures dealt with the risk of management override of those controls.

- Reviews of the financial statement disclosures and testing to supporting documentation for compliance with laws and regulations.

Example – How the audit was capable of detecting irregularities, including fraud

Auditor's Responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatement misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud is detailed below:

We gained an understanding of the legal and regulatory framework applicable to the company and the industry in which it operates, and considered the risk of acts by the company that were contrary to applicable laws and regulations, including fraud. We designed audit procedures to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

We focussed on laws and regulations which could give rise to a material misstatement in the financial statements, including, but not limited to, the Companies Act 2006 and UK tax legislation. Our tests included agreeing the financial statement disclosures to underlying supporting documentation, enquiries with management and enquiries of legal counsel. There are inherent limitations in the audit procedures described above and, the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it. We did not identify any key audit matters relating to irregularities, including fraud. As in all our audits, we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

9.3 Key Audit Matters (KAMs)

ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report* defines KAMs as:

> *Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.*

In respect of KAMs, the auditor may have determined that NOCLAR or fraud are KAMs. Where this is the case, the auditor is still required to include an explanation as to what extent the audit was considered capable of detecting irregularities, including fraud. The auditor can, however, cross-reference to a KAM where that KAM provides further explanation.

10 Auditing accounting estimates (Lecture A728 – 30.52 minutes)

In quarter 3 we examined the main changes brought about by ISA (UK) 540 *Auditing Accounting Estimates and Related Disclosures* which was issued by the FRC in December 2018 and applies mandatorily for audits of financial statements for periods beginning on or after 15 December 2019 (i.e. from December 2020 year ends onwards).

It is important that auditors understand the new requirements in ISA (UK) 540 (Revised) in order to ensure that their audit work in respect of accounting estimates is in compliance with those requirements.

There are some areas which involve a large degree of accounting estimate and which are often flagged up during file reviews as containing weaknesses. These are:

- Construction contracts
- Property valuations including internal valuations
- Revaluation decreases not being considered (the focus of management being only on assets which have increased in value)

10.1 Construction contracts

Construction contract accounting is dealt with in FRS 102, Section 23 *Revenue* at paragraphs 23.17 to 23.20. There is also close overlap with the 'percentage of completion method' where construction contracts are concerned as during the course of a construction contract the stage of completion will have to be ascertained in order to determine the amount of revenue that is to be recognised in the financial statements.

In order to apply appropriate audit procedures, it is important that the auditor understands the circumstances surrounding the contract. In some cases separation may be needed which is reflected in FRS 102, para 23.19 which states:

*When a contract covers a number of **assets**, the construction of each asset shall be treated as a separate construction contract when:*

FRS 102, para 23.19

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation, and the contractor and customer are able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

This is a very important consideration because if the client has got this wrong, the chances are the amount of revenue and profit that has been recognised is wrong as well as can be seen in the following examples:

Example – Separate contract identified but accounted for as one contract

You are auditing the financial statements of a construction company for the year ended 30 September 2020. At the year end, the company had three construction contracts underway as follows:

	Contract 1	Contract 2	Contract 3	Total
	£'000	£'000	£'000	£'000
Contract revenue	120	200	650	970
Contract costs	70	250	420	740
Contract profit (loss)	50	(50)	230	230
Costs incurred at year end	35	210	315	560
Stage of completion at year end	50%	84%	75%	76%

The stage of completion for each contract is determined using the proportion that costs incurred for work performed to date bear to the total estimated costs (FRS 102, para 23.22). Hence, in total all the contracts are 76% complete (£560k / £740k).

If all the contracts were treated as one contract, the company would recognise 76% of total contract profit of £230,000 using percentage costs as its percentage of completion calculation. So the amount of profit recognised would be £174,800 (£230,000 x 76%).

If each contract is treated separately, the following profits and losses are recognised:

	Contract 1	Contract 2	Contract 3	Total
	£'000	£'000	£'000	£'000
Profit (loss) expected	50	(50)	230	230
Stage of completion at year end	50%	84%	75%	
% of profit (loss) recognised at the year end	50%	100%	75%	
Profit (loss) recognised	25	(50)	173	148

From the above example you can see that if the company were to misapply the requirements of FRS 102 there can be a significant difference between the amount of profit recognised at the year end. Contract profit recognised in the first instance would be £174,800; whereas if the contracts are separated, contract profit is £148,000 (rounded up). Also, in the first scenario, contract 2 is expected to make a loss. Where contracts are expected to make a loss, the entity should immediately recognise the loss with a corresponding provision for an onerous contract (FRS 102, para 23.26). If this is not done, provisions and expenses will be understated.

Construction contract accounting can lend itself to many pitfalls and hence it is important that the auditor fully understands the mechanics of the financial reporting framework (e.g. FRS 102) in order to determine whether the entity has correctly accounted for the contract. Separation/non-separation requirements should be looked at first.

However, not all contracts need to be separated and FRS 102, para 23.20 states:

FRS 102, para 23.20

A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

Audit procedures

As noted (and demonstrated) above, construction contract accounting lends itself to many pitfalls. In addition, management may also deliberately overstate or understate contract revenue to achieve a desired outcome. Auditors must pay particular attention to this issue and apply professional scepticism.

Auditors must also bear in mind that ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires the auditor to presume that there are risks of fraud in respect of revenue and to evaluate which revenue streams give rise to such risks. Fraud risks in respect of revenue (including construction contract revenue) may arise as follows:

- Overstatement of revenue in respect of:
    - aggressive or inappropriate accounting policies;
    - creation of fictitious sales/contracts;
    - inflating the percentage of completion of contracts at the year end; or
    - incorrect calculation of the percentage of completion at the year end; and
- Contract revenue may also be understated and this is more likely to be because of a desire by management to suppress pre-tax profits which will then reduce the tax charge for the year.

Where a risk is identified as significant, the ISAs (UK) require a number of specific procedures to be applied by the auditor including:

(a) obtaining an understanding of the entity's controls, including control activities, relevant to the significant risks;

(b) where controls are to be relied upon, testing them for effectiveness in the current period (controls can normally be tested on a rotational basis over three years where there have been no changes to those controls); and

(c) where substantive tests (tests of detail or substantive analytical procedures) only are being performed in respect of significant risk, these must include tests of detail rather than solely analytical substantive procedures, for example.

Typical procedures over construction contracts include the following (note the list below is not comprehensive):

- Obtain an understanding of how the stage of completion for each contract is determined by management.

- Carry out procedures to verify the stage of completion (note that vouching to internal progress billings/progress reports may be weak evidence as these documents are internally generated).

- If possible, verify the stage of completion to architects'/surveyors' certificates or the latest cumulative billings certified by independent surveyors for those contracts selected for testing.

- Where documentation confirms the value of work done pre or post the reporting date, the auditor should carry out procedures to ascertain whether there were any significant work or services performed between the date of the latest documentation available and the reporting date to ensure completeness and cut-off of revenue is correct.

- Perform an analysis on a contract-by-contract basis to review the correlation of the stage of completion, contract revenue, contract costs and profits/losses recognised.

- Verify the completeness and accuracy of total contract revenue by verifying the amount to the original contract for the initial contract sum and any subsequent variations to that amount (this is to ensure that all subsequent variations to the contract (if any) are correctly included in the amount of contract revenue recognised).

- In respect of contract costs, discuss with management the estimation and bidding process to gauge an understanding of whether there are suitable procedures in place to ensure the accuracy and completeness of the estimated contract costs (the auditor should carefully document this discussion).

- Inquire of management as to the procedures involved when contract costs are revised and carry out procedures that review actual costs incurred compared to estimated contract costs at a particular stage of completion.

- Review 'cost overrun' reports (if available) to determine whether there are any change in circumstances (e.g. due to Covid-19) which may result in costs being more than budget. The auditor should confirm that these circumstances have been adjusted for and taken into account in the revised estimated total contract cost.

- For contracts completed post-year end, but prior to the auditor's report being signed, carry out procedures to determine whether there are any significant differences between the total actual contract costs incurred and the total contract cost estimated at the reporting date. Any unexplained material difference may be an indicator that management's cost estimation, monitoring and revision controls are not sufficiently robust to provide an accurate and complete estimated total contract cost for other contracts. This may require more substantive procedures being performed to address any control weaknesses.

- For contracts expected to yield a loss, ensure the loss has been recognised immediately. Also, carry out procedures to ensure the loss recognised is at the individual contract level and has not been offset against other profit-making contracts.

- Where the entity has contracts which are expected to generate a loss, the auditor must apply professional scepticism to the other contracts to ensure these, too, are not loss-making by:
  - analysing total contract revenue and comparing to estimated total contract costs on a contract-by-contract basis to identify those contracts whose costs exceed revenue;
  - analyse cumulative progress billings and compare to cumulative total actual costs incurred. Contracts with unexplained cumulative total actual costs exceeding cumulative progress billings may be indicative of loss-making contracts;
  - analyse actual progress of the contract and compare to the contractually agreed timeline to identify any major delays and/or cost overruns which may result in profitable contracts becoming loss-making;
  - discuss with management to ascertain if there are any major delays (especially due to Covid-19), cost overruns and/or terminated contracts which may result in profitable contracts becoming loss-making; and
  - review contracts for penalty clauses and other such potential costs which may need to be provided for.
- Recalculate the gross amount due to/from the customer and ensure it is correctly stated in the balance sheet.
- Ensure correct allocation of progress payments (which are not revenue) via the contract account in the nominal ledger. Progress billings are included the amount due to/from the customer at the reporting date.

If it is not possible to rely on external surveyors reports/other external documentation to verify the stage of completion at the reporting date, keep in mind that ISA (UK) 500 *Audit Evidence*, paragraph 8 (which refers to use of a management's expert) requires the auditor to:

- *Evaluate the competence, capabilities and objectivity of that expert;*
- *Obtain an understanding of the work of that expert; and*
- *Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.*

ISA (UK) 500, para 8

10.2 Property valuations

The issue of property valuations can relate to two specific sections of FRS 102:

- Section 16 *Investment Property*
- Section 17 *Property, Plant and Equipment*

It is important that the auditor understands the accounting treatments for both types of property (as well as what constitutes 'investment property' and 'owner-occupied' property). File reviews have indicated that there is often a misunderstanding of the accounting treatment for property revaluations – particularly when it comes to understanding the accounting treatments for investment property versus property, plant and equipment.

Fair value gains and losses on investment property are taken to profit or loss. Revaluation gains and losses on property, plant and equipment are taken to the revaluation reserve (losses to the extent of a surplus in respect of that asset). Excess revaluation losses are taken to profit or loss.

Both sections of FRS 102 do not mandate professional valuations of property to be carried out. However, FRS 102, para 16.10(b) requires the entity to disclose:

> *… the extent to which the fair value of investment property (as measured or disclosed in the **financial statements**) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and class of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.*

FRS 102, para 16.10(b)

Small companies applying the presentation and disclosure requirements of FRS 102, Section 1A *Small Entities* are not required to make this disclosure (although they could choose to do so if they wish).

In respect of revalued property, plant and equipment, FRS 102, para 17.32A(b) requires an entity to disclose whether an independent valuer was involved.

Again, small companies applying FRS 102, Section 1A are not required to disclose this, but may choose to do if they wish.

Audit procedures: investment property valuations

The principal audit risk where investment property valuations are concerned is that they have not been accounted for correctly and hence fair value gains/losses are recognised as other comprehensive income rather than within profit or loss. The auditor must ensure that the valuation has been correctly accounted for at the outset.

In addition, the auditor should:

- Consider whether the valuation has been carried out at the reporting date in accordance with FRS 102,
- Agree the movement in fair value to the valuation report to ensure accuracy.
- Ensure deferred tax consequences have been correctly recognised in respect of the fair value gain or loss at the reporting date (paying particular attention to the rate of tax used in the calculation of deferred tax to ensure it is the rate 'enacted or substantively enacted by the reporting date' (FRS 102, para 29.12)).
- If the valuation is internally generated, apply the requirements of ISA (UK) 500, para 8 (see above).
- If a professional valuation has been obtained:
    - Evaluate the competence of the valuer, including their qualifications, experience and reputation.
    - Evaluate the objectivity and independence of the valuer.
    - Review copies of written correspondence between the entity and the valuer during the period.
    - Obtain a copy of the valuation and assess the reasonableness of the assumptions, source data and methods used by way of discussions with

management and the valuer, market research, comparison with other data, or by using the work of an auditor's expert.
  - Where the valuation is obtained at a date different to the reporting date, assess the reasonableness of the valuation reflected in the financial statements.

- Agree the disclosures in the financial statements are in compliance with FRS 102.

Internally generated valuations/use of an auditor's expert

Internally generated property valuations (i.e. those carried out by management themselves) pose a particular risk to auditors. The principle risk is management bias being involved in the valuation. This must be factored into the auditor's planning and audit plan with appropriate procedures designed to address this risk.

Many entities choose to use their own valuer to value investment property, or a portfolio of investment properties. ISA (UK) 620 *Using the Work of an Auditor's Expert* at paragraph A9 recognises such situations and does not necessarily mandate the auditor to use an auditors expert to perform the valuation as well (indeed, in some cases, this may incur additional costs). Instead, the standard provides some factors which the auditor should consider in determining whether, or not, an auditor's expert should be used, such as:

- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the reporting entity.
- Whether the management's expert is a party engaged by the reporting entity to provide the relevant services.
- The extent to which management can influence the work of the valuer.
- The management's expert's competence and capabilities.
- Whether the management's expert is bound by technical, professional or other industry guidance when performing the valuation.
- Any controls within the entity over the management's expert's work.

If the auditor has any concerns over the valuation – for example, if the auditor considers the valuer **not** to be independent of the entity, or there is evidence that management have influenced the valuation, the auditor may determine it necessary to use their own auditor's expert to carry out a valuation.

Audit procedures: revalued property, plant and equipment (PPE)

Again, it is important that the auditor understands the accounting treatment to be applied in respect of the revaluation model in FRS 102, Section 17. This model uses the Alternative Accounting Rules in company law and hence revaluation gains and losses are taken to the revaluation reserve and are reported as other comprehensive income.

Audit procedures that should be applied by the auditor in respect of revalued items of PPE include the following:

- Obtain the valuation at the reporting date and agree the movement has been correctly recorded in the financial statements.
- Agree all assets within the asset class have been revalued at the same time (management cannot 'cherry pick' those assets which have increased in value – all assets in the same class must be revalued at the same time).
- Recalculate the movement on deferred tax due to the revaluation and agree to the nominal ledger/trial balance/financial statements.
- Ensure the deferred tax consequences of the revaluation have been correctly recorded in other comprehensive income and the rates/allowances used are those which apply to the sale of the asset (FRS 102, para 29.15).
- Where a revaluation loss creates a deferred tax asset, ensure the deferred tax asset meets the recognition criteria in FRS 102, para 29.7.
- Review the financial statement disclosures in respect of the revalued assets and ensure they are in compliance with FRS 102 and Companies Act 2006 (historical cost comparable disclosures will be needed per The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch 1, para 34).

Internally generated valuations for PPE

As with internally generated valuations for investment property, the principal risk is management bias coming into the valuation. Any internally generated valuation will create additional risks of material misstatement for the auditor for which additional procedures may be required. This may involve using an auditor's expert.

10.3 Revaluation decreases for properties

Management may invariably want to focus on improving the balance sheet position of the entity and hence may only want to reflect increases in the fair value of properties and might wish to disregard decreases.

FRS 102, Section 16 requires investment property to be remeasured to fair value at each reporting date. There are no longer any 'undue cost or effort' exemptions for management to rely on. If management do not carry out a valuation exercise for their investment property at the reporting date, any material fluctuation that has not been recognised in the financial statements will give rise to a modified auditor's opinion unless it is corrected.

FRS 102, para 17.15B

FRS 102, Section 17 leaves the revaluation frequency down to professional judgement. FRS 102, para 17.15B says that revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

In uncertain economic times, the likelihood is that property prices will decline. Management may be unwilling to reflect any material decrease in value due of a property because of the impact it will have on the balance sheet (it will reduce the value). That aside, the standard is clear – revaluations have to be carried out with sufficient regularity to ensure that carrying amount does not differ materially than fair value at the reporting date.

Auditors must therefore devise procedures to identify whether there has been a material change in value of the property. This could be, for example, looking at what has happened at similar prices in the same area (e.g. via Zoopla or commercial property agents) and comparing the value of these prices to the client's.

Where the auditor concludes that there has been a material change in value that has not been reflected in the financial statements (which is likely to be a revaluation or fair value decrease) then there could be an impact on the auditor's opinion if management do not agree to remedy the situation.

Clients should be informed as soon as possible towards their reporting date of the need to carefully consider the value of properties at the reporting date and ensure that they have made appropriate arrangements for the valuation exercise to be carried out (especially if the year end is 31 December).

Revaluation decreases

Revaluation decreases can be taken to the revaluation reserve to the extent that there is a surplus on that revaluation reserve in respect of that asset (offsetting decreases of one asset against gains of another is not permitted). If there is any excess revaluation loss, this is taken to profit or loss.

Auditors must carefully check that this accounting has been done correctly because the main risk is that the entire loss is taken to profit or loss; or the entire loss is taken to the revaluation reserve which creates a debit balance in respect of that asset. Debit balances cannot arise on a revaluation reserve in respect of any asset.

Auditors should also check that the associated deferred tax consequences have been properly recorded and deferred tax assets are only recognised if they are capable of recovery.

Note, there is also a risk that where a debit balance has arisen on a revaluation reserve in respect of a single asset, this balance is 'masked' because other assets still have revaluation surpluses. Therefore, the auditor would be advised to carry out a reconciliation of the balance on the revaluation reserve of the entity where several assets are measured under the revaluation model.

11 Charities: Issues to be aware of (Lecture A729 – 7.15 minutes)

Acting for charities can be risky if you aren't fully aware of the requirements. The Charity Commission review the accounts filed on their registry to ensure that the work carried out by independent examiners and auditors is of an acceptable quality. The Charity Commission have stated that they view independent examiners and auditors as being their 'second line of defence' after the trustees, against mismanagement in charities.

11.1 The Charity Commission's benchmark

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

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

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

11.2 Charity Commission's review

The Charity Commission undertakes a quality control review of financial statements for all classes of charity, i.e.:

- Income between £25,000 to £250,000 (charities with income of less than £25,000 can also be selected)
- Income between £250,000 to £1 million
- £1 million and over

The Charity Commission will note the deficiencies they come across in the financial statements of a charity. Where the independent examiner or auditor is a member of a professional body (which an auditor would be anyway), they will send details of the independent examiner/auditor to the relevant professional body where the regulator concludes that the financial statements have failed to meet the benchmark.

The key message here is that all accountants who deal with charities must ensure they have a good understanding of the financial reporting and accounting requirements for charities. It is not enough to simply rely on automated accounts production software programs to get disclosures correct – human input will be required as well as a sound understanding of the Charities SORP.

11.3 Matters of material significance

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

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

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

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

11.4 Reportable matters

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

(a) the auditor or independent examiner become aware of it; or

(b) the auditor or independent examiner intends to offer a modified audit opinion, an audit opinion with an emphasis of matter or material uncertainty related to going concern; or

(c) a qualified independent examination report identifies one or more concern about the charity's accounts.

The nine reportable matters of material significance are as follows:

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

11.5 Failure to report

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

11.6 Anti-money laundering (AML) issues

Auditors and independent examiners must take care when it comes to AML issues, particularly where (suspected) fraud is concerned. Professional accountants must ensure they do not 'tip off' the client inadvertently and this is not just concerned with informing the client that a money laundering report may have been prepared (or is going to be prepared). In practice, the tipping off provisions go much further.

Professional accountants must not say anything, or act in any way, that may rouse the suspicions of the charity where fraud-related issues are concerned. Careful documentation of all actions taken, all conversations entered into (either with the client or third parties) and all suspicions must be maintained.

It is always advisable that when a professional accountant encounters acts of (suspected) fraud or other sensitive issues (not just for charity clients, but for all clients), that they enter into dialogue with a third party who is well-versed in all aspects of AML at the outset. Discussions with the Technical Advisory Service/Ethics Advisory Service at the relevant professional body can also help the accountant ensure they do not inadvertently commit any acts of tipping off.

12 Revised ISA (UK) 240 in respect of fraud (Lecture A730 – 4.26 minutes)

On 20 October 2020, the FRC issued a consultation on the proposed revision of ISA (UK) 240 (Updated January 2020) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. This consultation is on the back of the recommendations made by Sir Donald Brydon in his review of the audit profession and the overall quality and effectiveness of audit.

ISA (UK) 240 has seen minor updates over the years, but has not been substantively changed since it was first adopted in the UK in 2004. The FRC issued an Exposure Draft (ED) of the revised ISA (UK) 240 which is currently proposed to come into mandatory effect for audits of accounting periods commencing on or after 15 December 2021.

Concerns have been raised by various stakeholders that auditors are not doing enough work to detect material fraud. This is primarily because ISA (UK) 240 places the responsibility for the prevention and detection of fraud with management. This is still the case in the ED, but the auditor's responsibilities are increased.

The ED recognises that the risk of not detecting a material misstatement resulting from fraud may be higher than the risk of detecting one resulting from error. However, the ED recognises that this does not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement due to fraud (ED Proposed ISA (UK) 240 (Revised 2021), para 7.1).

Essentially, the revised ISA (UK) 240 will place more responsibility on the part of the auditor to look for fraud. The current version of ISA (UK) 240 only requires the auditor to:

- identify and assess the risks of material misstatement of the financial statements due to fraud;
- obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- to respond appropriately to fraud or suspected fraud identified during the audit.

The ED expands the above objectives by requiring the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud.

12.1 Links to ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement*

ISA (UK) 315 was revised in July 2020 and is almost three times the size of its predecessor. ISA (UK) 315 (Revised) is also due to come into effect at the same time as Proposed ISA (UK) 240 (Revised 2021) so as to enable firms to address both revised standards in a single update of their procedures as opposed to two separate updates within a relatively short period of time.

Future Audit and Accounting Quarterly Updates will consider the technical content of the Proposed ISA (UK) 240 (Revised 2021).

It is also expected that in the future, there may well be further updates to the ISAs (UK) in response to the Brydon review.

13 Appendix 1: Example audit working paper for accounting estimates (Lecture A728 – 30.52 minutes)

The following example illustrates an audit working paper in respect of accounting estimates. This demonstrates how such a working paper *may* look and is not intended to be prescriptive in any way.

Client: Masuka Pharma (UK) Ltd **Prepared by:** AB
Subject: Accounting Estimates **Date:** 20/11/2020
File Ref: B2 **Reviewed by:** CD
Year end: 31 December 2020 **Date:** 25/11/2020

Accounting estimate	**Investment property valuations**	**Property accounted for under a policy of revaluation**
Background	The company owns an industrial unit on the ABC industrial estate let under a 10 year operating lease expiring in 2026.	The company operates from a large unit with adjoining offices and yard on the ABC industrial estate.
From reviewing board minutes, management representations and walkthroughs (where relevant), has anything been identified that might impact on this accounting estimate?	No	The company is refinancing and has been asked by the bank to revalue the property.
Prior period (PP) review (or where applicable their subsequent re-estimation)	The PP review is not particularly relevant. The valuations in the past few years have been progressing at about 2-3% each year which does not indicate any particular risks.	See valuation report
How is the estimate made?	The directors periodically obtain an external professional valuation. The last valuation was in 2016 and was performed JC & Co. Otherwise, every year the valuation is reviewed by the directors. The valuation uses price comparisons with similar units on the estate.	The directors periodically obtain an external professional valuation. A valuation was performed by JC & Co at 31/12/2020. The previous valuation was in 2015. The valuation is on a yield basis using estimated rental rates per square metre.
What are the relevant internal controls	The FD performs the valuation and it is reviewed by the board when the financial statements are approved. An external valuer is used periodically.	The valuer is appointed by the board. Information is provided to the valuer, were relevant by the FD. The final valuation is reviewed by the board.

Accounting framework	FRS 102 requires the property to be revalued through P&L at the end of every accounting period. There is no explicit requirement for a professional valuer.	FRS 102 requires the property to be regularly revalued. The Standard says that this is normally done by a professional valuer.
Inherent risk assessment		
Subjectivity	There are over 100 similarly sized units on the estate that are frequently bought and sold. Price comparisons are not particularly subjective because there are few differences between the units.	Some subjectivity will be present in determining expected rental income and the expected yield for this type of property.
Complexity	The valuation is not complex.	The valuation is not complex.
Estimation uncertainty	Estimation uncertainty is limited as the units used for price comparison are invariably very similar.	There is a degree of estimation uncertainty in using the yield basis.
Are there any other inherent risk factors? (Such as bias and fraud)	No	Management might be motivated to overstate the value to support additional borrowing.
Control risk assessment	Internal controls are very limited and they will not be used as part of the audit. Control risk will be no lower than inherent risk.	Internal controls are very limited and they will not be used as part of the audit. Control risk will be no lower than inherent risk.
Are any of these risks significant risks?	No	The valuation is subject to a degree of subjectivity and estimation uncertainty. Also, the property's market valuation at the year end is £8.5m which is a significant number in the balance sheet and a large increase from the previous valuation of £7.5m.
Is there any need to use an auditor's expert or to obtain specialist knowledge.	No	The audit team will have to obtain market data from property data in the public domain and apply this properly.

Testing		
Obtaining audit evidence from events occurring up to the date of the auditor's report	N/A	N/A
Testing how management made the accounting estimate	Review management's valuation. Corroborate comparison properties in terms of sales price and equivalence to sales details and the Land Registry.	Determine the appropriateness of the valuers. Is the valuation method appropriate? Review the valuation and corroborate key assumptions to source data. Evaluate the appropriateness of the data source.
Developing an auditor's point estimate or range	Independently review market for similar industrial units.	Independently review market for similar rental industrial units on a square meter basis. Look at market date for local trends in the property market and compare.
Addition testing	N/A	N/A
Is the planned testing unbiased?	Yes - tests are balanced	Yes - tests are balanced
Corroborating evidence	See Sch E400	See Sch E500
Contradictory evidence	See Sch E401	See Sch E501 and discussions on A23
Evidence of operating effectiveness of internal controls	N/A	N/A
Has management been sufficiently challenged?	No need for challenge. Risk is low and audit evidence was strong.	As risk was higher and the amounts large, we met with the valuers, JC&Co (Sch E504). The valuers used fairly modest yields because of the location of the site. Management and valuers were challenged to corroborate this.
Audit evidence to support disclosures	Yes	Checked date of valuation and method to report.
'Stand back' review	Everything is in line with our understanding of the property.	Everything is in line with our understanding of the property.

Written representations obtained?	Nothing specific added other than the general reps regarding the methods, significant assumptions and the data used in accounting estimates.	Specific representations obtained as to the valuation methods and data used.
Management letter points	Nothing specific.	Communicate the importance of properly using the professional valuer and the risks involved in the valuation. Recommend more frequent revaluations.