January 2022 Audit and Accounting Update

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1 LLP SORP amendments (Lecture A764 – 6.17 minutes)

In July 2021, the Consultative Committee of Accountancy Bodies (CCAB) published a consultation *Draft Statement of Recommended Practice – Accounting by Limited Liability Partnerships*. Comments on the proposals closed on 24 September 2021 and CCAB are planning that the proposed changes are to be effective for financial years beginning on or after 1 January 2022.

1.1 Summary of proposed changes

The draft SORP 2022 has been updated to respond to stakeholder feedback that there is diversity in practice when interpreting whether divisions of profit are automatic or discretionary in certain situations.

To address this feedback, CCAB is proposing the following changes in the draft SORP 2022:

- Changes to the definitions included in the SORP relating to divisions of profit.
- Consequential amendments throughout the SORP to maintain consistency of terminology.
- Additional guidance to help determine when an LLP has an unconditional right to avoid delivering cash or other assets to members.
- Changes to the ordering of the SORP to ensure that the guidance on the division of profits is presented together which, in turn, will reduce duplication and improve the overall flow of the SORP.

CCAB has also identified some diversity in practice in respect of how automatic and discretionary divisions of profit are presented in the cash flow statement. Therefore, additional changes are proposed as follows:

- Provision of additional guidance which sets out the basis for alternative classification of cash flows which relate to profit distributions.
- A requirement for LLPs to disclose their accounting policy for classifying share of profits in the cash flow statement and that cash flows be consistently classified from one period to another.

During this review of the SORP, CCAB are taking the opportunity of proposing other narrow-scope amendments to the SORP. These include reflecting the requirement for large LLPs and groups to produce an energy and carbon report as part of the annual report.

2 Accounting policies, estimates and errors (Lecture A765 – 18.25 minutes)

The issue about accounting policies is still posing a challenge for many practitioners – particularly small practitioners. Over the years, accounting policies have been criticised by file reviewers and professional bodies for their lack of clarity, 'boilerplate' approach and/or inappropriateness. One of the main reasons why accounting policies remain topical is over-reliance on accounts production software systems which often generate generic accounting policies depending on what items appear in the trial balance.

The danger with over-reliance on automated accounts production software systems is that it inevitably leads to accounting policies which are either too long, too short or missed out. To that end, professional bodies encourage practitioners to review a client's accounting policies to ascertain whether, or not, they are appropriate. Superfluous or immaterial accounting policies should be removed and those which are significant should be tailored to be client specific. Do not be afraid to delete software-generated accounting policies; but, conversely, do not overlook those which are deemed to be significant in the preparation of the entity's financial statements.

2.1 FRS 102 requirements

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with accounting policies in Section 10 *Accounting Policies, Estimates and Errors*. FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with the issue in Section 8 *Accounting Policies, Estimates and Errors.*

'Accounting policies' are defined as:

> *The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting **financial statements**.*

FRS 102 Glossary ***accounting policies***

It follows, therefore, that accounting policies are the choices which an entity makes about which facts it will present and how and where it will present them in the financial statements.

Interestingly, the definition makes references to the 'principles, bases, conventions, rules and practices applied by an entity', but does not include accounting estimates which are, in fact, a relevant part of applying an accounting policy and which are usually included in the accounting policy disclosures.

FRS 102, para 10.1 states that Section 10 sets out the requirements for:

FRS 102, para 10.1(a) to (c)

- *(a) selecting and applying the **accounting policies** used in preparing **financial statements**;*
- *(b) accounting for **changes in accounting estimates**; and*
- *(c) accounting for corrections of **errors** in prior period financial statements.*

FRS 102 does not set out the areas to be covered by accounting policies disclosure because these are dealt with in each specific section of the standard.

In terms of restatements, FRS 102, Section 10 distinguishes the situations where an entity restate prior period financial statements for either:

(a) the correction of a prior period error;

(b) a change in accounting policy (for which retrospective restatement is necessary); and

(c) restatements due to changes to an accounting estimate (for which no retrospective restatement is necessary).

2.2 Accounting policies and materiality

Accounting standards only deal with material items in the financial statements. The term 'material' is defined as:

> *Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the* ***financial statements****. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.*

FRS 102 Glossary ***material***

It is generally accepted that materiality has both qualitative and quantitative aspects. FRS 102, para 8.5 states that an entity must disclose its 'significant' accounting policies.

The term 'significant' is not defined in the standard but should be taken to mean material. Hence, only an entity's **material** accounting policies should be included in the notes to the financial statements.

This is an issue which is frequently criticised by file reviewers. Often, accounting policies are too lengthy or are irrelevant. This is usually because the user relies too heavily on automated accounts production software systems without tailoring the policies so they are entity specific. Accounting policies which are required to be disclosed should be concise and relevant to the reporting entity. Just because the accounts production software system may include an accounting policy by default, does not mean it is appropriate.

Conversely, accounting policies which are not included by default may need to be included where they are relevant to the entity. Hence, the message here is to not rely too much on accounts production software systems, but to tailor accounting policies so they are entity specific and relevant.

Example – Goodwill written down to £nil

Spring Ltd has included a lengthy accounting policy disclosure concerning goodwill which was fully amortised two years ago.

There is no need to make a lengthy accounting policy disclosure for an intangible asset which has been fully amortised. This can be removed from the accounting policies section of the notes.

Example – Asset under construction

Four years ago, Summer Ltd completed the building of its new head office. The current year's financial statements include a lengthy accounting policy about the way 'Assets under construction' are accounted for in the entity's accounts.

Provided there are no other assets in the course of construction at the reporting date, there is little to be achieved by having a lengthy accounting policy concerning assets under construction. This accounting policy can be removed.

Example – Financial instruments

Autumn Ltd has a number of financial instruments accounted for as both basic and non-basic under FRS 102. The accounting policy for financial instruments is shown below:

Financial instruments

A financial asset or a financial liability is recognised when the entity becomes a party to the instrument. Financial liabilities are recognised where there is a contractual obligation to pay cash or transfer other assets to the holder of the instrument and equity is recognised where there is no obligation to transfer cash or other assets.

This accounting policy is inadequate. The accounting policy should describe which instruments are accounted for as basic instruments under FRS 102, Section 11 *Basic Financial Instruments* (e.g. trade debtors, trade creditors, straightforward bank loans etc). It should also describe those instruments which are accounted for as non-basic, if appropriate, (such as derivative financial instruments), how transaction costs are accounted for and how fair value gains and losses on non-basic instruments are recognised (e.g. through profit or loss).

While the accounting policy itself need not be excessively lengthy (indeed it is more about quality than quantity), it should be more succinct and entity specific than it currently is.

2.3 Issues not dealt with in an FRS

In the rare situation that an FRS does not specifically address a transaction, event or condition, management must use their judgement to develop and apply an accounting policy. This is not as straightforward as it may first seem because FRS 102, paragraph 10.4 states that the policy developed by management must result in information which is:

(a) *relevant to the economic decision-making needs of users; and*

(b) *reliable, in that the financial statements:*

(i) *represent faithfully the* ***financial position****, financial* ***performance*** *and* ***cash flows*** *of the entity;*

(ii) *reflect the economic substance of transactions, other events and conditions, and not merely the legal form;*

(iii) *are neutral, ie free from bias;*

(iv) *are prudent; and*

(v) *are complete in all material respects.*

FRS 102 para 10.4

It should be noted that under FRS 102, greater emphasis is placed on relevance and reliability. The term 'relevance' is defined as:

The quality of information that allows it to influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

FRS 102 Glossary ***relevance***

The term 'reliability' is defined as:

The quality of information that makes it free from ***material error*** *and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.*

FRS 102 Glossary ***reliability***

For an accounting policy to be reliable, it must reflect the substance of the transaction and not merely legal form. The term 'substance' is essentially the commercial reality of the transaction. For example, an asset acquired through a finance lease is capitalised on the balance sheet with a corresponding finance lease creditor because the entity has acquired an asset for use in the business which has been financed through a leasing transaction. In a finance lease, the risks and rewards incidental to ownership of the asset pass to the lessee. If only the legal form of this transaction were considered, the lease would be treated as an operating lease and hence would not be reported on the balance sheet.

FRS 102, para 10.4(b)(iii) and (iv) refers to 'neutrality' and 'prudence'. The term 'neutrality' is confirmed as meaning 'free from bias'. In other words, management cannot simply choose a policy because it will achieve a desired outcome.

The term 'prudence' is defined as:

> *The inclusion of a degree of caution in the exercise of judgements needed in making the estimates required under conditions of uncertainty, such that **assets** or **income** are not overstated and **liabilities** or **expenses** are not understated.*

*FRS 102 Glossary **prudence***

Prudence is therefore the exercise of caution when making judgements for various uncertainties to avoid overstating assets or income and understating liabilities or expenses. It does not, however, permit management to deliberately understate assets or income or overstate liabilities or expenses, for example because it improves results or is tax efficient.

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) at paragraph 13 brings prudence into the equation, but from a different angle. Paragraph 13 of sch 1 to SI 2008/410 states:

> *The amount of any item must be determined on a prudent basis, and in particular—*
>
> *(a) only profits realised at the balance sheet date are to be included in the profit and loss account, and*
>
> *(b) all liabilities which have arisen in respect of the financial year to which the accounts relate or a previous financial year must be taken into account, including those which only become apparent between the balance sheet date and the date on which it is signed on behalf of the board of directors in accordance with section 414 of the 2006 Act (approval and signing of accounts), and*
>
> *(c) all provisions for diminution in value must be recognised, whether the result of the financial year is a profit or loss.*

SI 2008/410 para 13

(c) above was included as part of the amendments to the Companies Act 2006 by *The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015* (SI 2015/980) and requires a provision for diminution of value to be recognised regardless of whether the result of the financial year is a profit or loss.

GAAP hierarchy

When developing an accounting policy, management must refer to, and consider the applicability of, the following sources in **descending order**:

(a) the requirements and guidance in an FRS which deals with similar and related issues;

(b) if the entity is within the scope of a SORP, the requirements and guidance in that SORP which deals with similar and related issues; and

(c) the definitions, recognition criteria and measurement concepts in respect of assets, liabilities, income and expenses together with the *Concepts and Pervasive Principles* in Section 2 of FRS 102.

Some commentators suggest referring to IFRSs® if FRS 102 does not deal with a specific transaction, event or condition. This would be permissible (indeed paragraph 10.6 of FRS 102 does state that management could consider the requirements and guidance in EU-adopted IFRS). However, as IFRS is not mentioned in the mandatory sources in the GAAP hierarchy, the entity would not be required to follow the provisions in IFRS, if it felt this would be inappropriate to its particular circumstances.

Example – Entity has regard to IAS® 16 *Property, Plant and Equipment*

Wanderers Ltd has an accounting policy of measuring its five owner-occupied buildings under the revaluation model per FRS 102, Section 17 *Property, Plant and Equipment*.

FRS 102 does not deal specifically with the treatment of accumulated depreciation when the buildings have been revalued again. However, IAS 16 does specify two permissible methods in paragraph 35 and hence it would be acceptable to use either one of these methods from IAS 6 when reporting under FRS 102.

When an entity is subject to the requirements of a SORP, it should consider the requirements of that SORP to determine whether it addresses an accounting treatment for a transaction, event or condition that is not dealt with in FRS 102. In situations that a SORP does provide guidance on a specific treatment, but the entity chooses not to apply the SORP's requirements on the grounds that an alternative treatment would be more appropriate, the entity will need to demonstrate that its chosen policy is more appropriate than the SORP's treatment.

In addition, FRS 100 *Application of Financial Reporting Requirements*, para 6 requires that where a non-small entity departs from the provisions of a SORP to which it is subject, it must provide a description of how the financial statements depart from the recommended practice which must include:

(a) for any treatment that is not in accordance with the SORP, the reasons why the treatment adopted is judged more appropriate to the entity's particular circumstances; and

(b) brief details of any disclosures recommended by the SORP that have not been provided, and the reasons why they have not been provided.

Small entities are encouraged, but not required, to provide the above disclosures.

2.4 Consistency of accounting policies

In practice, it is rare for an entity to change accounting policies on a regular basis. Indeed, regular changes in an accounting policy would raise the question of why management consider it appropriate to keep changing their policies as retrospective restatement is needed each time a change in an accounting policy is actioned. Frequent changes in accounting policy are not only costly, but may also impede on the relevance and reliability of the financial statements.

When management are considering changing a policy, they must consider this carefully. This is because they will have significant difficulty in changing it back in the subsequent year. For example, if a reporting entity had a policy of writing off borrowing costs immediately to profit and loss and then decided to capitalise them, management could not then switch back to a policy of expensing them.

Accounting policies must be consistently applied for similar transactions, other events and conditions. The exception to this rule would be where an FRS specifically requires, or permits, categorisation of items for which different policies may be appropriate.

Consistency is important so that the financial statements can be compared to the prior year and with financial information of other entities. While there is no 'hard and fast' rule which stipulates that accounting policies for all entities in the same industry must be uniform, management may have justifiable reasons for developing entity specific policies which may not necessarily be consistent with the industry in which the entity operates.

The Companies Act 2006 (Sch 1, paras 10(2) and 12) also specifies that accounting policies should be applied consistently within the same accounts and from one financial year to the next, unless there are 'special reasons' for departing from this principle. The Act does not define the term 'special reasons' but such reasons could, for example, be due to the issuance of a new FRS or section in an FRS which triggers the requirement to change an accounting policy.

2.5 Changing an accounting policy

There are two situations when an entity can change an accounting policy:

1) If the change is required by an FRS. This could be as a result of a change to FRS 102 by the FRC which then triggers the entity to action a mandatory change in an accounting policy, or multiple accounting policies.

2) If the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. This would effectively be a voluntary change in accounting policy and hence accentuates why it would be difficult for management to justify a switch back to the previous policy if things do not go according to plan.

FRS 102, para 10.9 outlines three issues which are **NOT** changes in accounting policies as follows:

(a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring;

FRS 102 para 10.9(a) to (c)

(b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were not material; and

(c) *a change to the cost model when a reliable measure of **fair value** is no longer available (or vice versa) for an asset that an FRS would otherwise require or permit to be measured at fair value.*

Applying a change in accounting policy

FRS 102, para 10.11 outlines certain principles which must be followed when an entity changes an accounting policy or when it elects to follow certain provisions in IFRS as permitted by FRS 102.

A change in accounting policy is applied retrospectively. In other words, the financial statements of previous periods are restated to reflect the revised accounting policy as if the revised policy had always been applied. This is to ensure that the financial statements are comparable. If a change in accounting policy is not applied retrospectively, the financial statements will not be comparable as the prior year will reflect the old policy, whereas the current year will reflect the new.

If the FRC change FRS 102, any consequential change in an accounting policy is accounted for in accordance with the transitional provisions, if any, which will be specified in the amendment. This is the same if the entity has also elected to apply certain IFRSs as permitted in FRS 102 (i.e. IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*) – any transitional provisions in the revised IAS 39/IFRS 9 must be followed.

Changes to an accounting policy are applied retrospectively to comparative information for prior periods to the **earliest date** for which it is practicable. If it is deemed impracticable to determine the individual-period effects of a change on comparative information for the prior period presented, the entity applies the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable (this may be the current period). A corresponding adjustment is made to the opening balance of each affected component of equity for that period.

Change in accounting policy: borrowing costs

In the financial statements for the year ended 31 March 2019, Frankie Ltd adopted an accounting policy of writing off borrowing costs when it self-constructs an asset to the profit and loss account. In the year to 31 March 2021, management decide to voluntarily change this policy to capitalising borrowing costs as management have concluded that this would result in the financial statements providing reliable and more relevant information about such costs.

This voluntary change in accounting policy should be applied retrospectively for all borrowing costs to the extent that retrospective application is practicable.

Change in accounting policy for inventory

Sunnie Ltd manufactures bedroom furniture and has an accounting reference date of 30 April. Due to changes within the industry, the directors decided to change the method by which they value finished goods at the year end from the first-in first-out (FIFO) method to the average cost method (AVCO). Extracts from the entity's financial statements are as follows:

Value of finished goods	FIFO	AVCO
	£	£
At 30 April 2021		125,000
At 30 April 2020	98,000	112,000
At 30 April 2019	110,000	123,000

The change in accounting policy will be recorded in the financial statements as follows:

At 30 April 2019 (opening balance sheet position of the comparative year)

	£
Dr Inventory	13,000
Cr Retained earnings (P&L reserves)	13,000

Being increase in finished goods as restated under AVCO

At 30 April 2020 (closing comparative year)

	£
Dr Inventory	14,000
Cr Cost of sales (closing stock)	14,000

Being increase in finished goods in prior year as restated

At 30 April 2021 (current year)

	£
Dr Inventory	125,000
Cr Cost of sales (closing stock)	125,000
Being year end inventory calculated at AVCO	

Of course, there may also be tax effects to consider where retrospective restatement due to an accounting policy change has taken place in the financial statements (including deferred tax considerations, where applicable). It follows that when an adjustment is recognised in opening retained earnings, the tax effects should also be accounted for in there as well.

Revaluation of assets

FRS 102, para 10.10A states that the initial application of a policy to revalue assets in accordance with Section 17 or Section 18 *Intangible Assets other than Goodwill* is a change in accounting policy to be dealt with as a revaluation in accordance with those sections, rather than in accordance with FRS 102, paras 10.11 and 10.12.

This particular paragraph does not provide guidance as to how an entity initially changing its accounting policy and revaluing a class of asset should account for it or how it should be disclosed. If we look to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, this standard notes that the initial change from the historic cost model to the revaluation model should be applied **prospectively**. In other words, when an entity first adopts the revaluation model for an asset, it need not obtain a retrospective revaluation for the prior year and hence it would seem reasonable to adopt this approach under FRS 102 (as most entities realistically do, in practice).

Disclosure of a change in accounting policy

FRS 102 requires disclosure of a change in accounting depending on whether the change arises from a mandatory change (i.e. because the FRC have amended an FRS) or a voluntary change.

Mandatory change due to a change in an FRS

Disclose:

(a) the nature of the change in accounting policy;

(b) for the current period and each prior period presented (usually just the prior year), to the extent practicable the amount of the adjustment for each financial statement line item affected;

(c) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

(d) if it is impracticable to determine the amounts to be disclosed in (b) or (c) above, provide an explanation.

The financial statements of subsequent periods do not need to repeat the above disclosures.

Voluntary changes to an accounting policy

Disclose:

(a) the nature of the change in accounting policy;

(b) the reasons why the new accounting policy provides reliable and more relevant information;

(c) to the extent practicable, the amount of the adjustment for each financial statement line item affected, shown separately:

  (i) for the current period;

  (ii) for each prior period presented; and

  (iii) in the aggregate for periods prior to those presented; and

(d) if it is impracticable to determine the amounts to be disclosed in (c) above, provide an explanation.

As with mandatory changes to an accounting policy, the financial statements for subsequent accounting periods need not repeat these disclosures.

Note also that the statement of changes in equity will also show the effects of retrospective application as an adjustment to retained earnings. Small entities choosing to apply the presentation and disclosure requirements of FRS 102, Section 1A *Small Entities* are encouraged to provide a statement of changes in equity.

When the financial statements of prior periods have been restated for the effects of accounting policy changes, it is good practice (although not a legal requirement) to head the comparative year up 'as restated' so it is clear that there has been a change to the comparative year since those financial statements were originally authorised for issue.

2.6 Changing an accounting estimate

A change in an accounting estimate is an adjustment of the carrying amount of an asset or a liability which results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. A change in an accounting estimate does not result from new information or new developments, hence they are not regarded as a correction of a prior period error.

A 'change in accounting estimate' is defined as follows:

*An adjustment of the **carrying amount** of an **asset** or a **liability**, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of **errors**.*

*FRS 102 Glossary **change in accounting estimate***

In situations when management may be uncertain as to whether a change is an accounting policy change, or an accounting estimate change, the change is treated as a change in accounting estimate.

A change in an accounting estimate is accounted for on a prospective basis (i.e. no retrospective restatement is required – it is accounted for in the current and subsequent accounting periods). The most common types of accounting estimates include:

- the useful lives of fixed assets;
- residual values of fixed assets;
- provisions for inventory obsolescence; and
- expected outcome of provisions (such as litigation provisions or warranty provisions).

It must be emphasised that the revision of an estimate will be required if circumstances in which the estimate were originally based change. Such a change is not applied retrospectively as it does not relate to prior periods and is not the same as the correction of an error.

Example – Change in a legal provision

In the financial statements for the year ended 30 April 2020, Dexter Ltd recognised a provision for damages of £25,000. This accounting estimate has been correctly recorded in cost of sales.

The solicitors acting for Dexter confirmed on 30 April 2021 that the damages have reduced to £15,000 due to new evidence presented.

The credit to the profit and loss account of £10,000 (£25,000 less £15,000) should be taken to cost of sales to ensure that the cumulative expense is correctly stated.

Example – Change in depreciation method

During the year to 31 March 2021, Morley Ltd changed the method of depreciating its motor vehicles from 25% reducing balance to four years on a straight-line basis as this revised method better reflects the entity's consumption of the motor vehicles over their useful lives and is consistent with the entity's replacement cycle.

The change in depreciation method is a change in accounting estimate and is accounted for in the period of the change (i.e. in the current year) and continues in subsequent periods.

Disclosures for a change in accounting estimate

Where the entity changes an accounting estimate, it should provide disclosure of the nature of the change and the effect the change has had on assets, liabilities, income and expense for the current period. If it is practicable for the entity to estimate the effect of the change in one, or more, future periods, the entity is to disclose those estimates.

In addition, Sch 1 to *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), para 69(1) states:

> *Where any amount relating to any preceding financial year is included in any item in the profit and loss account, the effect must be stated.*

SI 2008/410, Sch 1. para 69(1)

2.7 Error correction

Under FRS 102 (and FRS 105) **material** errors are corrected by way of a prior period adjustment.

The term 'errors' is defined in the Glossary to FRS 102 as:

> *Omissions from, and misstatements in, the entity's* ***financial statements*** *for one or more prior periods arising from a failure to use, or misuse of, reliable information that:*
>
> *(a) was available when financial statements for those periods were authorised for issue; and*
>
> *(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.*

FRS 102 Glossary ***errors***

FRS 102 identifies the following types of errors (the list below is non-exhaustive):

- effects of mathematical mistakes;
- mistakes in applying the entity's accounting policies;
- oversights or misinterpretation of facts; and

- fraud.

While material prior period errors are corrected retrospectively, FRS 102 does not restrict this requirement to *only* material errors. In practice, an immaterial error would be corrected in the current period.

Errors are distinct from corrections of estimates. A typical estimate would be where a provision for a liability is concerned. The outcome may be higher or lower than previously estimated, but the difference would not be regarded as an error because information was not available prior to the resolution of the issue giving rise to the provision. Similarly, a corporation tax charge for the year may have been estimated and this only becomes final once it has been agreed by HMRC. Any over- or under-provisions would be regarded as a change in accounting estimate and hence would be corrected in the current year.

The correction of a material prior period error is carried out by:

(a) restating the comparative amount for the prior period(s) presented in which the error occurred; or

(b) if the error arose before the earliest prior period presented, restate the opening balances of assets, liabilities and equity for the earliest prior period presented.

FRS 102, para 10.22 goes on to clarify that when it is impracticable to determine the period-specific effects of a material error on comparative information for one, or more, prior periods presented, the entity must restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable and this may be in the current period.

As with changes in accounting policy discussed above, when comparative financial statements have been restated (whether due to error correction or retrospective application of a change in accounting policy), it is best practice to head up the comparative year 'as restated' on each page of the financial statements so the user is aware that the comparative year has been subject to change since those financial statements were originally authorised for issue. Disclosures should also be made where comparative financial statements have been changed.

Disclosures concerning prior period errors

Where material prior period errors have been corrected, disclose:

(a) the nature of the prior period error;

(b) for each prior period presented, to the extent practicable, the amount of the correction in respect of each financial statement line item affected;

(c) to the extent practicable, the amount of the correction at the beginning of the earliest period presented; and

(d) an explanation where it is not practicable to determine the amounts to be disclosed in (b) or (c) above.

The financial statements of subsequent periods do not need to repeat the disclosures above.

When the prior period figures have been restated, it is good practice to head up the comparative period 'As restated' on each page to notify the reader that there has been an adjustment to the comparative period. There is, however, no specific requirement to do this.

3 Business combinations and goodwill (Lecture A766 – 15.12 minutes)

Group issues are largely dealt with in FRS 102, Section 19 *Business Combinations and Goodwill*; although there is a close interaction with Section 9 *Consolidated and Separate Financial Statements*. Section 9 of FRS 102 applies to all parents which are required, or voluntarily choose, to prepare consolidated financial statements.

Groups which are medium-sized and large will invariably be required to prepare consolidated financial statements unless the provisions in FRS 102, para 9.3 (exemption from preparing consolidated financial statements) or para 9.9 (exclusions from consolidation) apply. There are also exemptions in company law that may be claimed in certain circumstances.

It should be noted that groups are beyond the scope of FRS 105.

Small groups are exempt from the requirement to prepare consolidated financial statements (section 399(2A)) of the Companies Act 2006); although that is not to say that all small groups choose to take up this exemption. Indeed, some small groups do voluntarily prepare group accounts and where this is the case, FRS 102, Section 1A *Small Entities* provides guidance for small groups in paragraphs 1A.21 and 1A.22.

3.1 The concept of control

The term 'business combination' is defined as:

> *The bringing together of separate entities or* ***businesses*** *into one reporting entity.*

FRS 102 Glossary ***business combination***

A business combination usually takes place when one entity (the parent) obtains control over another entity (the subsidiary). Control is usually evidenced by way of an ownership interest of more than 50%, but this is not absolute and other characteristics of the relationship can indicate that a parent has obtained control over a subsidiary even with an ownership interest of less than 50.01%, such as:

- the ability to appoint or remove the majority of the board of directors (or equivalent governing body);
- the power to cast the majority of votes at meetings of the board of directors/equivalent governing body where control of the entity is by that board or body;
- the power to govern the entity's financial and operating policies under a statute or an agreement; or
- the power over more than 50% of the voting rights by virtue of an agreement with other investors.

It follows, therefore, that while control over a subsidiary is usually evidenced by an ownership interest of more than 50% of the voting rights/net assets of an entity, regard must be had to other conditions that may indicate control where the parent may not own more than 50% of the voting rights/net assets. This is because control is based on substantive rights.

An investor which only holds **protective rights** does not have the power to direct the activities of the entity. The term 'protective rights' refers to those rights which are designed to protect the interests of the party holding those rights without giving that party power over the entity to which those rights relate.

The substantive rights which create control must be exercisable when the decision concerning the direction of the relevant activities needs to be made. Control will ordinarily be obtained in two specific situations:

(a) The parent company will own more than half (i.e. more than 50%) of the voting rights in the subsidiary.

(b) The parent company has the ability to direct the financial and operating policies of the entity.

Example – Control obtained through direct ownership

Topco Ltd owns 85% of the voting rights in Subco Ltd.

As Topco owns more than half of the voting rights in Subco, it is presumed that Topco has obtained control, hence a parent-subsidiary relationship is created. In this context, Topco will be required to prepare group accounts assuming no exceptions or exemptions are available.

Example – Control obtained via other means

Topco Ltd acquires a 40% ownership interest in Subco Ltd. The terms of the agreement state that Topco has the ability to appoint, or remove, the majority of the board of directors.

In this example, Topco has not obtained control via its ownership interest of 40%. However, because Topco has the ability to appoint, or remove, the majority of the board of directors, this gives rise to control and hence a parent-subsidiary relationship is created and group accounts will need to be prepared if there are no exceptions/exemptions which can be claimed.

3.2 The purchase method

The purchase method of accounting is used when a parent acquires a subsidiary. FRS 102, para 19.7 outlines the way in which the purchase method of accounting works as follows:

(a) Identify an acquirer

(b) Determine the acquisition date

(c) Measure the cost of the business combination

(d) Allocate the cost of the business combination at the date of acquisition to the assets acquired and liabilities and provisions for contingent liabilities assumed and recognise and measure any non-controlling in the acquiree

(e) Recognise and measure goodwill

The purchase method of accounting must start from the date of acquisition, which is the date on which the acquirer gains control of the acquiree. It must be kept in mind that it is not necessary for a transaction to be completed in law before the acquirer obtains control. Instead, FRS 102, para 19.10A requires all pertinent facts and circumstances surrounding a business combination to be taken into account when assessing if the acquirer has obtained control.

Is it an acquisition or is it a group reconstruction?

Group reconstructions are also dealt with in FRS 102, Section 19 and while this course cannot go into the detailed intricacies of group reconstructions due to time constraints, in some situations the first question to ask is whether the transaction is an acquisition of a subsidiary OR whether it is a group reconstruction.

When a group reconstruction takes place, the use of the merger method of accounting may be used instead of the purchase method. (Note that although the standard seems to make the merger method optional, in practice it will be required in order to give a true and fair view, if the transaction is a group reconstruction). The two concepts are fundamentally different. Merger accounting uses book values of assets and liabilities to combine the merging entities (fair values are not used, but some adjustments may be necessary to achieve uniformity of accounting policies). Under the purchase method of accounting, fair values are used to consolidate the subsidiary at the date of acquisition.

In addition, to qualify for the use of the merger method of accounting, it needs not to be prohibited by company law and the ultimate equity holders need to remain the same and their rights relative to each other unchanged. Also, no non-controlling interest in the net assets of the group is altered by the transfer. This is because if the rights are changed this indicates that it is not, in fact, group reconstruction as something else is happening to change the relationship with the group and outside parties.

In many cases, however, it will be clear whether a transaction is a business combination or a group reconstruction.

3.3 Overview of the principles of consolidation

As noted above, the course will not be going into the detailed mechanics of consolidation as it is expected that practitioners will already have a sound grasp of the basics, but an overview is as follows:

Accounting policies

Amounts included within the consolidated financial statements should be based on coterminous accounting policies. Where a subsidiary uses accounting policies that differ to the parent in its individual financial statements, consolidation adjustments will be necessary.

Accounting period end dates

Subsidiaries should, wherever practicable, use the same accounting reference date and accounting period as the parent. Where a different accounting reference date is used, interim financial statements should be prepared to the parent's accounting reference date for use in the consolidation. Where this is not practicable, the subsidiary's financial statements for the previous financial year should be used provided that the year end did not end more than three months before the parent's year end. In these situations, any changes that have taken place in the intervening period that materially affect the view given by the group accounts must be taken into account by way of adjustment in the preparation of the consolidated financial statements.

Consolidated profit and loss account

Each individual entity within the group will prepare its own financial statements (referred to as the 'individual' financial statements). The parent will then consolidate the individual financial statements with those of its own (subject to consolidation adjustments) to arrive at the consolidated financial statements of the group.

The consolidated profit and loss account is quite straightforward. It merely consolidates, line-by-line, up to the levels of profit after tax. After profit after tax, the amounts attributable to the parent and non-controlling interest are shown.

All intra-group sales, purchases and expenses are eliminated together with any unrealised profit (for example in stock).

Intra-group dividends are eliminated from the group's investment income and intra-group interest is eliminated from investment income and interest payable as appropriate.

Eliminating intra-group transactions and balances is essential if the consolidated financial statements are to present a true and fair view. The overarching objective of the group accounts is to present the results of the group in line with its economic substance, which is that of a **single** reporting entity (i.e. as if the group structure did not exist).

Consolidated balance sheet

This is more complicated to prepare than the consolidated profit and loss account. The assets and liabilities section of the consolidated balance sheet reflect the net assets that are under the control of the parent, whereas the capital and reserves section reflects the split of ownership interest between the parent and the non-controlling interest. The table below outlines the preparation of the consolidated balance sheet:

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

Intra-group balances (debtors and creditors) must be eliminated. In practice agreeing intra-group balances can be problematic for some groups; particularly the larger groups. If they do not immediately contra, it is more than likely due to cash or in-transit items.

Intra-group dividends must be cancelled and the consolidated financial statements should only reflect dividends payable to the non-controlling interests.

3.4 Contingent liabilities in a business combination

Contingent liabilities are treated differently in a business combination than they are in the individual financial statements of an entity under FRS 102, Section 21 *Provisions and Contingencies*. In the separate financial statements of a reporting entity, contingent liabilities are not recognised but are instead disclosed because they fail to meet the recognition criteria for a liability due to not meeting the full criteria for a provision in paragraph 21.4(a) to (c).

Under FRS 102, para 19.15(c), contingent liabilities whose fair value can be measured reliably are recognised. This is because the transfer of economic benefit is reflected in the contingent liability's fair value rather than it being a criterion for recognition.

The fair value of a contingent liability is the amount which a third party would charge to assume the contingent liability. In practice, when an acquiree has a contingent liability, the acquirer will seek to pay less for the business given the fact that there is a risk the contingent liability will crystallise, hence the acquirer will suffer an outflow of funds further down the line. The result of this is a reduction in net assets acquired and a corresponding increase in positive goodwill, or a reduction in negative goodwill.

If the fair value of a contingent liability cannot be reliably measured, there is a resulting impact on the amount that is recognised as goodwill or, in the case of a bargain acquisition (i.e. where consideration is less than net assets acquired), negative goodwill. When this situation applies, the parent must disclose information relating to that contingent liability in accordance with Section 21 of FRS 102.

Example – Contingent liability in a business combination

On 1 March 2021, Topco Ltd acquired 100% of the net assets of Subco Ltd. On the date of acquisition, Subco was actively defending a lawsuit brought against the company by one its contractors who is alleging a breach of contract. The maximum amount of the possible payment if breach of contract is proven is judged to be £100,000. The lawyers have said there is a 60% change Subco will pay nothing, a 15% chance they will pay £90,000 and a 25% chance they will have to pay £100,000.

A contingent liability of £38,500 [(60% x £nil) + (15% x £90,000) + (25% x £100,000)] is discounted to present value and is recognised in respect of the claim. This provision must take into account the range of probable outcomes. This would be the case even if no payment is required.

Measurement after initial recognition

FRS 102, para 19.21 says that after initial recognition, the acquirer must measure contingent liabilities at the *higher* of:

(a) the amount which would be recognised under Section 21 *Provisions and Contingencies*; and

(b) the amount initially recognised *less* any amounts recognised as revenue under Section 23.

Applying these subsequent measurement principles, if the provision at the next balance sheet date turns out to be higher than the amount that was initially recognised, then the provision is increased as follows:

Dr Profit and loss account	X
Cr Provisions for liabilities	(X)

On the other hand, if the provision turns out to be *lower*, the liability is not reduced; instead it continues to be measured at fair value at the date of acquisition. The exception to this rule would be where the contingency ceases to exist or, where appropriate, reduced in respect of amortisation of the liability under the revenue recognition section (Section 23). The latter would only apply if the contingent liability relates to a revenue-generating activity.

Example – Potential reduction in a contingent liability

Using the example above in respect of the breach of contract. If it is assumed that at the next balance sheet date the case is still ongoing, but the lawyers advise the subsidiary that there is now a 60% chance of paying nothing, a 15% chance of paying £80,000 and a 25% chance of paying £70,000 (i.e. the contingent liability is now £29,500 rather than £38,500), the contingent liability is not reduced. It continues to be recognised at its fair value at the date of acquisition.

However, if the lawyers now state that there is a 60% chance Subco will pay £10,000, a 15% chance it will pay £95,000 and a 25% chance it will pay £100,000, the provision is increased by £6,750, i.e:

	£
60% x £10,000	6,000
15% x £95,000	14,250
25% x £100,000	25,000
	45,250
Less original provision	(38,500)
Increase in provision	6,750

- Dr Profit and loss £6,750
- Cr Provisions for liabilities £6,750

3.5 Step acquisitions

Step acquisitions (often referred to as 'piecemeal' acquisitions) take place when a parent acquires an additional ownership interest in a subsidiary, thus creating a reduction in non-controlling interest. Some investments can, in fact, turn into subsidiary status when additional acquisitions result in the parent owning more than 50% of the net assets of the investee because, unless there is clear evidence to suggest otherwise, the parent will have obtained control over the investee resulting in classification as a subsidiary.

Quite often a parent company, owning more than 50% of the net assets, will obtain further ownership interest in the subsidiary. When this happens, under FRS 102 the net assets of the subsidiary are **not** revalued and **no** additional goodwill is recognised because FRS 102, para 9.19D would regard this transaction as one among equity holders in their capacity as equity holders.

Example – Acquisition of further ownership interest in a subsidiary

On 1 June 2020, Topco Ltd acquired 70% of the net assets in Subco Ltd for a purchase price of £500,000. On the date of acquisition, the fair value exercise revealed the net assets of Subco to be £380,000, which was also equivalent to book values.

On 1 June 2021, Topco agreed to invest an additional £75,000 in Subco in exchange for a further 10% of the net assets and on this date Subco's net assets had a book value of £435,000 and a fair value of £485,000. The group's accounting reference date is 31 May.

Accounting for the subsidiary at the date of acquisition (1 June 2020)

At the date of acquisition, Topco has acquired control of Subco because it is acquired an ownership interest of 70% of the net assets. Consequently, the identifiable assets and liabilities of Subco are consolidated at their fair value of £380,000. Positive goodwill is recognised in the consolidated financial statements of £234,000, calculated as follows:

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

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

Year end 31 May 2021

The increase in Subco's net assets amounts to £55,000 (£435,000 less £380,000) which has arisen due to the profit yielded by Subco during the year to 31 May 2021. This profit is split £38,500 to Topco (being 70% x £55,000) and £16,500 to the NCI. The NCI share is now £130,500 (£114,000 brought forward plus £16,500).

Further acquisition on 1 June 2021

On 1 June 2021, Topco acquired a further 10% of Subco which means that the NCI share of Subco's net assets drops from 30% to 20%.

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

This further acquisition is accounted for as a transaction among equity holders and the resulting change in NCI is accounted for under FRS 102, para 22.19. In this example, paragraph 22.19 would require the NCI to be adjusted to reflect the parent's additional ownership interest in the subsidiary. Any difference between the value of the NCI adjustment and the consideration paid to acquire the additional 10% interest is recognised in equity and attributed to the equity holders of the parent.

Therefore, the accounting would be as follows:

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

The key point to bear in mind where a parent company increases its shareholding in a subsidiary is that under FRS 102, the subsidiary's net assets are not revalued to fair value, nor is there any consequential increase to goodwill. FRS 102 requires the transaction to be accounted for as one among equity holders in their capacity as equity holders.

3.6 Disposals

When a parent chooses to sell ownership interest in a subsidiary, there are two outcomes to the transaction: the parent either retains control of the subsidiary, or control is lost.

If control is lost (i.e. the parent's ownership interest falls to be less than half following the disposal), the results of the subsidiary are included in the consolidated financial statements up to the date on which control is lost and a gain or loss (calculated as the difference between the fair value of the consideration received and the identifiable net assets (including goodwill) of the subsidiary disposed of) is recognised.

In some instances, however, a parent company may dispose of some, but not all, of its ownership interest in a subsidiary and still retain control of that subsidiary following the disposal (i.e. the parent will still own more than 50% of the net assets following the disposal).

When this happens, the change in the parent's controlling interest is accounted for as a transaction among equity holders in their capacity as equity holders. In other words, the carrying amount of the non-controlling interest is increased to reflect the parent's reduced ownership interest. Any difference between the consideration received by the parent and the amount of the adjustment to non-controlling interest is recognised directly in equity.

Example – Partial disposal where parent retains control

On 31 March 2021, Topco Ltd disposes of a 20% ownership interest in Subco Ltd for £300,000 which reduced Topco's holding from 80% to 60%. On 31 March 2021, the carrying amount of the identifiable net assets in Subco was £500,000 and the carrying amount of goodwill on acquisition at the date of the disposal was £30,000.

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

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

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

	£
Dr Cash at bank	300,000
Cr Non-controlling interest	(100,000)
Cr Equity attributable to Topco	(200,000)

Illustrative statement of changes in equity showing change in ownership interest

Group	Called-up share capital	Retained earnings	Total shareholders' equity	Non-controlling interest	Total equity
	£'000	£'000	£'000	£'000	£'000
At 01.04.2019	100	240	250	60	310
Profit for the year		120	120	30	150
Equity dividend		(50)	(50)		(50)
At 31.03.2020	100	310	320	90	410

Profit for the year		40	40	10	50
Equity dividend		(10)	(10)		(10)
Change in ownership		200	200	100	300
At 31.03.2021	100	540	550	200	750

Deemed disposals

An undertaking may cease to be a subsidiary of a parent, or the group may reduce its ownership interest, as a result of a deemed disposal. A deemed disposal may arise when:

(a) the group does not take up its full allocation of rights in a rights issue;

(b) the group does not take up its full share of a scrip dividend;

(c) another party exercises its options or warrants; or

(d) the subsidiary issues shares to other non-group parties (non-controlling interests).

Deemed disposals have the same effect as changes in ownership by disposal and should be accounted for in the same way.

Again, if the parent still retains control of a subsidiary following the deemed disposal, the transaction is accounted for as a transaction between shareholders. No gain or loss is recorded in the group accounts.

Example – Deemed disposal

Topco Ltd owns 600,000 of the 1 million shares in Subco Ltd which resulted in Topco obtaining a 60% ownership interest. A year later, Subco issues a further 90,909 shares to a third party for £17m. Immediately prior to the share issue, Subco's net assets are £100m.

Following the issue of the shares, Topco's interest in Subco becomes diluted from 60% to 55% (600,000 / 1,090,909). Topco still retains control of Subco because its ownership interest is more than 50%.

This deemed disposal is accounted for as a transaction among the shareholders. Topco does not recognise any gain or loss on disposal and does not adjust any goodwill which was previously recognised. All Topco does in the consolidated financial statements is:

	£
Dr Cash at bank	17m

Cr Non-controlling interest	12.65m*
Cr Equity	4.35m

*Previously, the NCI were 40% and the net assets of Subco are £100m, hence 40% x £100m = £40m. NCI is now 45% and therefore 45% x £117m (£100m net assets plus £17m proceeds from share issue) = £52.65m. Hence £52.65m less £40m is an increase of £12.65m.

3.7 Goodwill

The accounting issues for goodwill are combined with those of business combinations under FRS 102 as opposed to being included in Section 18 *Intangible Assets other than Goodwill*. This is because internally generated goodwill is never recognised on the balance sheet and to reinforce this principle, accounting issues surrounding goodwill were included in Section 19 as goodwill will usually only arise when a business combination takes place.

It should also be borne in mind that the Companies Act 2006 only permits goodwill to be recognised on a balance sheet to the extent that it has been acquired for valuable consideration.

Initial recognition and subsequent measurement

Positive goodwill is essentially the excess of the consideration over the net assets acquired.

After initial recognition, goodwill is measured at cost less amortisation less impairment.

FRS 102 requires goodwill to be amortised on a systematic basis over its useful life. There is no option under the standard to assign an indefinite life to goodwill. This is notably different than the IFRS regime which does not allow goodwill to be amortised; instead it is tested annually for impairment.

In rare cases when management are unable to assign a reliable useful economic life to goodwill, FRS 102, para 19.23(a) caps the amortisation period to ten years. The amortisation period can be shorter, but it cannot be longer. This cap should only be used in exceptional cases because in most instances it is likely that a reliable useful life can be assigned to goodwill.

Negative goodwill

Positive goodwill will usually arise in a business combination which is when the parent pays more than fair value for its share of the net assets in the subsidiary. However, there may be situations giving rise to a 'bargain purchase' which is where the consideration paid for the parent's share of the subsidiary's net assets is less than fair value. This is likely to arise in a distressed sale or when the shareholders want a quick exit out of the business and hence are willing to accept a lower than fair value price.

Negative goodwill is dealt with in FRS 102, para 19.24. This paragraph takes a different approach to dealing with negative goodwill than the IFRS regime (which requires negative goodwill to be immediately recognised in profit or loss). According to FRS 102, para 19.24 there are three steps to dealing negative goodwill:

(a) Reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination.

(b) Recognise and separately disclose the resulting excess on the face of the balance sheet at the date of acquisition, immediately below goodwill, followed by a subtotal of the net amount of goodwill and the excess.

(c) Recognise subsequently the excess up to the fair value of non-monetary assets acquired in profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired is recognised in profit or loss in the periods that are expected to be benefited.

Of course, professional judgement will be required where (b) and (c) are concerned. For example, an acquirer may decide to allocate the excess on a pro-rata basis or to allocate the excess to specific assets, where these can be identified. In practice, amounts which are allocated to, say, stock, will be eliminated quickly; whereas amounts allocated to fixed assets may take a longer period of time to eliminate depending on the entity's depreciation policies.

4 Liabilities and equity (Lecture A767 – 9.15 minutes)

FRS 102, Section 22 *Liabilities and Equity* outlines the requirements in classifying financial instruments as either a financial liability (i.e. debt) or equity. It also deals with the issue of 'compound financial instruments' (see **4.3** below) which are defined in the Glossary to FRS 102 as:

> *A financial instrument that, from the issuer's perspective, contains both a **liability** and an **equity** element.*

*FRS 102 Glossary **compound financial instrument***

There are a couple of other definitions which are important when dealing with FRS 102 as follows:

Financial liability

> *Any **liability** that is:*
>
> *(a) a contractual obligation:*
>
> *(i) to deliver **cash** or another **financial asset** to another entity; or*
>
> *(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or*
>
> *(b) a contract that will or may be settled in the entity's own equity instruments and is:*
>
> *(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or*
>
> *(ii) a **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.*

*FRS 102 Glossary **financial liability***

Equity

> *The residual interest in the **assets** of the entity after deducting all its **liabilities**.*

*FRS 102 Glossary **equity***

In a lot of cases, debt will be treated as a liability in the balance sheet, but this is not always the case. The overriding principle in Section 22 is that where the issuer (i.e. the borrower) does not have an unconditional right to avoid the settlement in cash, or by way of another financial asset, and the contract does not, in substance, evidence a residual interest in the net assets of the issuer (the lender) after deducting all of its liabilities, the financial instrument is classified as a financial liability.

So what does this mean in layman's terms? Effectively, where a borrower has an obligation to part with cash or other assets in either complying with the terms of the financial instrument, such as paying the lender interest; or by way of redemption at some point in the future, the contract is a financial liability. So whenever there is a contractual obligation on the part of the borrower to pay cash or settle an obligation by parting with another asset, a liability is recognised.

Example

Roby Ltd issues 7,000 £1 preference shares and the owners of the preference shares are entitled to receive a 5% dividend each year.

The preference shares contain an obligation to deliver cash to the owners and hence are recognised as a financial liability, they are not recognised as equity despite the name being 'preference **shares**'. The 5% coupon payments are recognised as interest expense in the company's profit and loss account each year.

A financial instrument is classified as equity when it fails to meet the definition of a financial liability (i.e. there is no obligation to deliver cash or other financial assets to another entity). The key requirement is to consider whether there is an unconditional ability to avoid delivering cash or other assets.

Example

Ratchford Ltd wishes to raise finance to help finance its expansion plans. The bank has agreed to finance some of the working capital requirements, but it requires the shareholders to invest further into the business to demonstrate their commitment to the company. Two individuals subscribe to ordinary shares in the company. Dividends on the ordinary shares are paid at the entity's discretion and there is an option whereby the company can redeem equity shares for cash.

The existence of the option which allows the company the option to redeem equity shares for cash does not, in itself, mean the ordinary shares should be classified as a financial liability; nor does the fact that the company may pay future dividends on the ordinary shares. This is because the issuer retains an unconditional right to avoid delivering cash or another financial asset and hence the ordinary shares are recognised in equity. A contractual obligation to deliver cash or another financial asset would only arise at the point when the issuer exercises its right to redeem the shares.

4.1 Equity instruments issued prior to payment being received

FRS 102 does not generally allow offsetting (especially not in the balance sheet). There are limited exceptions to this rule for certain transactions.

When share capital has been issued but not paid for, a debtor balance must be recorded to comply with the requirements of company law. This is notably different than the provisions in *IFRS for SMEs* which would require the debit balance to be offset against equity.

Example

On 29 December 2021, a company issued 5,000 ordinary £1 shares to a long-standing employee at par. Payment for these shares was received on 5 January 2022 and the company is preparing its financial statements for the year-ended 31 December 2021.

In the financial statements to 31 December 2021, the £5,000 share issue will be recorded in the books of the company as:

	£
Dr Called up share capital not paid	5,000
Cr Share capital	5,000

Being share issue on 29 December 2021

4.2 Equity instruments subscribed for but not issued

FRS 102, paragraph 22.7(c) says that when equity instruments have been subscribed for but not issued (or called up), and the entity has not received the cash or other resources to pay for the shares, no increase in equity is recognised.

4.3 Convertible debt

Convertible debt or similar compound financial instruments are dealt with in FRS 102 at paragraphs 22.13 to 22.15. There is also an appendix to Section 22 providing an example of the issuer's accounting for convertible debt.

Convertible debt contains both a liability feature and an equity feature. Convertible bonds, for example, may require the issuer to pay fixed coupons (interest) and there is an option for the holder to convert some of the instrument (usually the capital element) into shares. The legal form of such instruments is that of debt, but its substance is of two instruments:

(a) a financial liability to deliver cash by making interest payments or interest and capital payments as long as the bond is not converted; and

(b) a call option which grants the holder the option to convert the bond into a fixed number of ordinary shares of the entity, thus meeting the definition of equity.

There is a two-stage process to initially recognising convertible debt:

- Stage 1. Determine the amount of the liability component as the fair value of a similar liability which does not contain the conversion option.

- Stage 2. Allocate the difference between the liability calculated in Stage 1 and the fair value of the proceeds received as equity.

It is important that the transaction is accounted for in this order because of the definition of equity which is the residual interest in the assets of the entity **after** deduction of liabilities.

Example – Convertible debt

On 1 April 2021, an 8% convertible bond was issued with a nominal value of £600,000. It is redeemable on 31 March 2025 at par, or it may be converted into equity shares. An equivalent loan note without the conversion option would have carried interest at 10%. Interest of £48,000 has already been paid and has been included within interest payable and similar expenses.

Present value rates are as follows:

End of year	8%	10%
1	0.926	0.909
2	0.857	0.826
3	0.794	0.751
4	0.735	0.683

The first stage involves calculating the amount that has to be recognised as a liability in the entity's financial statements, with the balance being recognised in equity. This is calculated as follows:

	8% interest (£600k x 8%)	10% factor	Present value

Year 1	48,000	0.909	43,632
Year 2	48,000	0.826	39,648
Year 3	48,000	0.751	36,048
Year 4	648,000	0.683	442,584
Liability amount			561,912
Proceeds			(600,000)
Equity			38,088

The journals to record the above are:

	£
Dr Cash at bank	600,000
Cr Loan (financial liability)	561,912
Cr Equity	8,088

The profit and loss account currently recognises year 1 interest of £48,000 being the coupon rate paid to the holder of the bond. An equivalent loan without the conversion option would carry interest at 10% which is the rate that the cash flows in the bond have been discounted at in the table above.

The present value of the debt portion is £561,912 and at 10%, interest would be £56,191. Therefore, additional interest of £8,191 (£56,191 less £48,000) will need to be recognised in the financial statements. The journals to account for the additional interest are:

Dr Interest payable and similar expenses	£8,191	
Cr Loan payable		£8,191

FRS 102.22.14

FRS 102, para 22.14 says that the entity shall not revise the allocation in a subsequent period.

The liability portion of the debt will be subsequently measured at amortised cost using the amortised cost and effective interest method in Section 11 *Basic Financial Instruments*.

Example cont …

The liability of £561,912 is accounted for under the amortised cost method as follows:

Opening balance	Cash flow	Interest 10%	Closing balance
£	£	£	£
561,912	(48,000)	56,191	570,103
570,103	(48,000)	57,010	579,113
579,113	(48,000)	57,911	589,024
589,024	(648,000)	58,976*	-
*=adjusted for rounding			

On conversion, the liability portion is extinguished (as is the case in the example above) and equity is issued. The value of the equity recognised since initial inception will remain in equity, although it may be reallocated to another line item within equity.

4.4 Early redemption of a compound instrument

FRS 102, Section 22 is silent on the issue where a compound instrument is redeemed early (i.e. before the date it contractually matures). It would therefore be acceptable that when a compound instrument is redeemed early, the redemption amount plus any directly attributable transaction costs will need to be allocated between the liability and equity components on the date early redemption takes place. An acceptable method would be to allocate part of the redemption amount to the liability component based on the liability's fair value at the date of redemption, with any residual amount being allocated to the redemption of the equity component.

Where the redemption amount allocated to the liability exceeds the carrying amount of the liability component at the redemption date, a loss is recognised in profit and loss. Where the redemption amount is lower than the carrying amount of the liability, a gain is recognised in profit and loss.

5 Share-based payment (Lecture A768 – 7.23 minutes)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5.1 Cash-settled share-based payment transactions

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

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

Dr Profit and loss	X
Cr Liability	X

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

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

Example – Cash-settled share-based payment arrangement

Currie Ltd awards its managing director 1,000 share options on 31 December 2020 which represents 10% of the company's share capital and on this date (the grant date) the company is valued at £750,000.

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

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

Hence, at each reporting date, the outstanding liability is remeasured to fair value with changes in fair value going to profit or loss. On 31 December 2020, the company recognises the share-based payment arrangement as follows:

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

Being share-based payment expense for the year ended 31 December 2020

5.2 Equity-settled share-based payment transactions

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

- Dr Profit and loss X
- Cr Equity X

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

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

5.3 Recognition when there are vesting conditions

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

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

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

*FRS 102 Glossary **grant date***

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

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

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

The term ‘market condition’ is defined in FRS 102 as:

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

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

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

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

Example – Share-based payment transaction

On 1 January 2021, Wolves PLC grants 2,000 share options to each of its three directors. The terms of the share-based payment arrangement includes a condition stating that all the directors must still be in the employment of the entity on 31 December 2023 when the share options vest. The fair value of each option as at 1 January 2021 is £11 and it is expected that all of the options will vest. A further condition in the agreement is that the options will only vest if the share price reaches £18 per share. On 31 December 2021, the share price was only £9 and, due to market conditions, it is not expected to rise in the next two years. A decline in business and continuing difficulties due to Covid-19 has meant that it is only expected that two out of the three directors will be employed by the entity on 31 December 2023.

Changes in the share-price of an entity are a market vesting condition which is taken into account when the fair value of the share option is calculated. The change in share price is not included in the calculation of the profit and loss account charge or equity movement. However, the company must take into consideration the fact that only two directors will be employed by the business, hence the calculation for the financial statements for the year ended 31 December 2021 will be:

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

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

Example – Share options granted

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

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

Year	Rights expected to vest	Fair value of each share option

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

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

The financial statements for each year will show the following:

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

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

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

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

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

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

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

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

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

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

Example – Market and non-market conditions

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

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

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

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

met.

<u>Employees remain in employment for a minimum three-year period</u>

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

<u>Revenue in year 2 has to be at least 20% higher than in year 1</u>

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

5.5 Modifications

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

FRS 102, para 26.12(a) states:

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

FRS 102, para 25.12(a)

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

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

FRS 102, para 26.12(b)

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

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

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

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

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

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

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

Example – Modifications to a share-based payment arrangement

On 1 January 2021, Harrison PLC, which has an accounting reference date of 31 December, introduced a share-based payment arrangement for its employees in which they have the option to buy 20,000 shares provided they stay in the company's employment for three years. On 1 January 2021 (grant date) the fair value of the share options is £7.

Due to changes in legislation, the company has seen a significant decline in activity which has reduced the value of the company's shares significantly. This means that the fair value of the options is now only £2.80 per option. On 1 July 2021, the company took the decision to change the arrangement so that those employees in the scheme who are still in the employment of the company at the date the options vest have the option to buy 40,000 shares rather than the original 20,000 (i.e. 100% more). The date of the modification is 1 July 2021. The directors expect that 80% of the employees will remain in the company's employment at the date the share options vest.

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

This modification is accounted for in the same way that a new grant of equity instruments would be. At the year end 31 December 2021, the company is one-third of the way through the original tranche of share options and one-fifth of the way through the second tranche of shares issues (6 months / 30 months).

The charge to P&L for the year ended 31 December 2021 is calculated as follows:

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

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

5.6 Cancellations

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

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

On 1 January 2020, Walker PLC granted 100 share options to its sales director. The terms of the agreement are that the sales director must remain in the employment of the business for three years. At the grant date, the fair value of the share options was £1,500 and it was expected that the employee would remain in the employment of the company for a three-year period.

On 1 January 2021, changes in the business resulted in the cancellation of the award and the company agreed to settle the award in cash on a pro-rata basis. The sales director received £500 (£1,500 x 1/3) and this amount was recognised in the financial statements.

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

vesting.

6 ISQM 1 – Part 2

As noted in the Quarter 3 *Audit and Accounting Quarterly Update*, the FRC have published two new standards on quality management:

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

Both ISQMs are mostly effective for periods beginning on or after 15 December 2022 and, as we explained in Quarter 3, it is important that firms do start to consider the impact that these ISQMs (UK) will have on their audit work. ISQM 1 requires the systems of quality management to be designed and implemented by 15 December 2022.

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

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

In this quarter, we will examine the governance and leadership component.

6.1 Governance and leadership

ISQM (UK) 1, para 28 states:

The firm shall establish the following quality objectives that address the firm's governance and leadership, which establishes the environment that supports the system of quality management:

ISQM (UK) 1, para 28

(a) The firm demonstrates a commitment to quality through a culture that exists throughout the firm, which recognizes and reinforces:

(i) The firm's role in serving the public interest by consistently performing quality engagements;

(ii) The importance of professional ethics, values and attitudes;

> (iii) *The responsibility of all personnel for quality relating to the performance of engagements or activities within the system of quality management, and their expected behavior; and*
>
> (iv) *The importance of quality in the firm's strategic decisions and actions, including the firm's financial and operational priorities.*

(b) *Leadership is responsible and accountable for quality.*

(c) *Leadership demonstrates a commitment to quality through their actions and behaviors.*

(d) *The organizational structure and assignment of roles, responsibilities and authority is appropriate to enable the design, implementation and operation of the firm's system of quality management.*

(e) *Resource needs, including financial resources, are planned for and resources are obtained, allocated or assigned in a manner that is consistent with the firm's commitment to quality.*

Effective governance and leadership is crucial to quality management at both the firm and the engagement level. It is the way in which the audit firm embeds its culture and ethics and self-regulates. A firm's governance also affects the public's perception of the firm, and essentially a firm without effective leadership and governance will be viewed as one which does not operate within the public interest.

ISQM (UK) 1 has changed various aspects of ISQC (UK) 1 with respect to governance and leadership. The changes are summarised as follows:

- There are new and enhanced requirements concerning the firm's commitment to quality through its culture. As part of the firm's culture, the requirements now also address:
  - the firm's public interest role;
  - the importance of professional ethics, values and attitudes;
  - the responsibility of all personnel for quality relating to the performance of engagements or activities within the system of quality management and their expected behaviour; and
  - quality in the context of the firm's strategic decisions and actions, including the firm's financial and operational priorities.
- New requirements which address leadership's behaviour and commitment to quality and their accountability for quality.
- New requirements which address the organisational structure of the firm and the assignment of roles, responsibilities and authority.

- New requirements which address resource needs, resource planning, allocation and assignment (which also includes financial resources).

6.2 'Tone at the top'

ISQM (UK) 1 deals with the tone at the top through the various requirements of the standard addressing leadership:

- The requirements that specify the responsibilities that need to be assigned, and who these need to be assigned to.
- Leadership's responsibility for understanding ISQM (UK) 1.
- Leadership's responsibility and accountability for quality.
- Leadership's responsibility for evaluating and concluding on the effectiveness of the system of quality management.
- Leadership's performance evaluations.

6.3 General commitment to quality by all personnel

ISQM (UK) 1 provides guidance on the actions and behaviour of personnel and their commitment to quality through the following quality objectives:

- Reinforcing the responsibility of all personnel for quality relating to the performance of engagements or activities within the system of quality management and their expected behaviour.
- As part of resources, personnel being expected to demonstrate a commitment to quality through their actions and behaviours, develop and maintain the appropriate competence to perform their roles, and being held accountable or recognised through timely evaluations, compensation, promotion and other incentives.

To address the firm's personnel's commitments to quality, the firm could establish a code of conduct, define how quality will be measured and establish developmental opportunities for personnel that reinforce quality.

6.4 Embedding quality in strategic decisions and operational priorities

An underpinning principle in ISQM (UK) 1 is that quality management is not a separate function of the firm. However, to be effective, a culture which demonstrates a commitment to quality must be integrated within the firm's strategy, operational activities and business processes.

ISQM (UK) 1 includes a quality objective addressing the firm's strategic decisions and actions, including the firm's financial and operational priorities, which needs to recognise quality.

Strategic decisions and actions may include the firm's business strategy, financial goals, how resources are managed, growth of the firm's market share, industry specialisation or new service offerings.

6.5 Other issues relevant to the system of quality management

The firm's culture is pervasive and hence, many other aspects of the system of quality management should reinforce the firm's commitment to quality.

To achieve this, the firm's policies or procedures may address consultation and encourage such consultation on difficult or contentious matters. This can reinforce the benefit of consultation could help to emphasise the importance of quality.

In addition, the firm may implement a robust system for supporting decisions concerning the acceptance and continuance of client relationships and/or specific engagements. This may contribute to the firm's tone concerning quality.

Smaller firms may be able to establish the desired culture of the firm through direct interaction of firm leadership with other personnel. This is not always possible for larger firms.

7 Deficiencies in reporting on irregularities in the auditor's report (Lecture A769 – 14.02 minutes)

The requirement to report how the audit was capable of detecting irregularities, including fraud, in the auditor's report has been a mandatory requirement for all audits from December 2020 year ends.

File reviews over the last year have indicated that while there is some narrative contained in auditors' reports about irregularities and fraud, the narrative is not necessarily in compliance with ISA (UK) 700 *Forming an Opinion and Reporting on Financial Statements*. Some auditors' reports simply explain what irregularities and fraud are, or merely report that no irregularities or fraud have been found during the course of the audit. This often results in deficiencies being noted during a file review and can also lead to a file being failed for compliance with ISAs (UK).

Here we will examine exactly what ISA (UK) 700 requires when it comes to reporting on irregularities including fraud in the auditor's report.

7.1 Capability of the audit to detect irregularities including fraud

ISA (UK) 700 states:

> *The auditor's report shall explain to what extent the audit was considered capable of detecting irregularities, including fraud.*

ISA (UK) 700, para 29-1

The application and explanatory material at paragraphs A39-1 to A39-6 then go into more detail as to how the auditor should deal with this in the auditor's report. Indeed, ISA (UK) 700, para A39-3 provides the following examples of how the auditor's work addressed the detection of irregularities as follows:

- How the auditor obtained an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- Which laws and regulations the auditor identified as being of significance in the context of the entity.
- The auditor's assessment of the susceptibility of the entity's financial statements to material misstatement, including how fraud might occur.
- The engagement partner's assessment of whether the engagement team collectively had the appropriate competence and capabilities to identify or recognise non-compliance with laws and regulations.
- Matters about non-compliance with laws and regulations and fraud that were communicated with the engagement team.
- The auditor's understanding of the entity's current activities, the scope of its authorisation and the effectiveness of its control environment where the entity is a regulated entity.

- In the case of a group, how the auditor addressed these matters at both the group and component levels.
- Communications with component auditors to request identification of any instances of non-compliance with laws and regulations that could give rise to a material misstatement of the group financial statements.

Hence, the auditor must describe **how** the audit was designed to detect irregularities including fraud as opposed to describing what irregularities are (indeed there is no specific definition of 'irregularities' in the ISAs (UK)) or the fact that fraud, including fraud risk factors, have not been detected during the course of the audit.

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

The illustration below is not prescribed text for an auditor's report. It merely shows how reporting irregularities may look in the auditor's report. Entity specific considerations will have to be taken into account, including the entity's legal and regulatory framework which may differ from client to client.

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.

8 Emphasis of Matter and Material Uncertainties Related to Going Concern (Lecture A770 – 15.09 minutes)

While this section has recently been covered in previous updates, there still appears to be confusion surrounding the use of Emphasis of Matter (EoM) and Material Uncertainties Related to Going Concern (MURGC) paragraphs. This confusion results in auditors' reports which are not technically correct, fail to comply with the requirements of the ISAs (UK) and result in failures of audit files.

With the above in mind, we consider it worthwhile revisiting the technical areas where audit firms appear to be confused.

8.1 EoM paragraphs

As we discussed in the Quarter 3 update, an EoM paragraph is used to refer to a matter which has been adequately presented or disclosed in the financial statements by the directors. The auditor will include an EoM paragraph when they consider that the matter(s) is of such fundamental importance to users' understanding that attention should be drawn to the matter in the auditor's report.

What is going wrong?

File reviews have indicated that some auditor's reports contain inappropriate EoM paragraphs. In some, more serious cases, it is clear that the auditor has used an EoM paragraph as a substitute for modifying the auditor's opinion. For example, an incorrect accounting treatment or inadequate disclosure has been dealt with through an EoM paragraph rather than through a modified auditor's opinion.

If an EoM paragraph is used as a substitute for a modified opinion, the auditor may receive sanctions from their professional body. Audit risk is the risk that the auditor forms an incorrect opinion on the financial statements. Where an unmodified opinion is expressed when a modified opinion should have been expressed, but an EoM paragraph is used instead as a substitute for modifying the opinion, the auditor has still expressed the wrong opinion on the financial statements.

EoM paragraphs are **not** a substitute for a modified opinion and cannot be used as such. Keep in mind the definition of an EoM paragraph according to ISA (UK) 7606 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* which is:

> *A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.*

ISA (UK) 706, para 7

The definition above confirms that such a paragraph is <u>only</u> to be used in respect of a matter which is appropriately presented or disclosed in the financial statements. It does not refer to it being a substitute for a modified audit opinion. Indeed, all EoM paragraphs must refer to the paragraph **not** modifying the auditor's opinion in respect of the matter(s) being emphasised.

Example – Incorrect use of an EoM paragraph

An auditor's report contains the following EoM paragraph:

Emphasis of matter

In our opinion, the information given in the strategic report and directors' report for the financial year for which the financial statements are prepared are consistent with the financial statements.

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Heading up this section 'Emphasis of matter' is incorrect. The matters above are not matters which should be covered in an EoM paragraph; they are opinions on other matters prescribed by the Companies Act 2006 which should be headed up as such.

In addition, the four bullet points are matters on which the auditor is required to report by exception and, again, they should not be included within an EoM paragraph.

It is evident from the above that the auditor drafting this auditor's report does not have a sound understanding of ISA (UK) 706. In addition, it is also clear that the audit firm does not have an understanding of when and how an EoM paragraph is used.

8.2 Ensuring the EoM paragraph is technically correct

Remember, an EoM paragraph is only used to cross-reference to a matter that has **already** been adequately presented or disclosed in the financial statements. It is also worth revisiting the technical content of ISA (UK) 706, para 9, which states:

> *When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:*
>
> *(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";*

ISA (UK) 706, para 9

> (b) *Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and*
>
> (c) *Indicate that the auditor's opinion is not modified in respect of the matter emphasized.*

Example – Correct use of an EoM Paragraph

Opinion

We have audited the financial statements of …

Emphasis of matter

We draw attention to note 34 of the financial statements, which describes the effects of a fire at the premises of a third party warehouse provider. Our opinion is not modified in respect of this matter.

In the above example, the EoM paragraph is correctly headed up 'Emphasis of matter' and correctly cross-refers to the relevant note in the financial statements which describes the issue at hand. The EoM paragraph also correctly indicates that the auditor's opinion is not modified in respect of the fire at the third party warehouse provider.

If the matter had not been adequately described in the financial statements, the auditor could not use an EoM paragraph because they cannot cross-refer to an inadequate disclosure. Instead, the auditor would modify their opinion accordingly because of inadequate disclosure of a material issue. Keep in mind that an EoM paragraph is used to highlight matters in the auditor's report which, in the auditor's professional judgement, are **fundamental** to the users' understanding of the financial statements.

8.3 MURGC paragraphs

MURGC paragraphs are also another issue which seem to have caused an element of confusion.

Where an entity has **adequately** disclosed a material uncertainty related to going concern, this will give rise to the auditor including a MURGC paragraph in the auditor's report. ISA (UK) 570 *Going Concern*, paragraph 22 states:

> *If appropriate disclosure about the material uncertainty related to going concern is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:*

ISA (UK) 570, para 22

(a) *Draw attention to the note in the financial statements that discloses the matters set out in paragraph 19;*

(b) *State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter; and*

(c) *For entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have 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 twelve months from the date of approval of the financial statements.*

What is going wrong?

File reviews often indicate that an audit firm has included references to material uncertainties within an EoM paragraph. This is not technically correct and does not comply with ISA (UK) 570, para 22. Where the entity has adequately disclosed material uncertainties related to going concern, a MURGC paragraph must be used instead.

While the MURGC paragraph acts in much the same way as an EoM paragraph (in that it cross-references to the relevant disclosure note in the financial statements and contains a confirmation that the auditor's opinion is not modified in respect of the matter), it is not the same thing. As going concern is such a fundamental concept, any material uncertainties need to be highlighted and the way to do that through the auditor's report is to use a MURGC paragraph.

In addition, there have been instances where an audit client has made adequate disclosure of a material uncertainty, but no MURGC paragraph has been included in the auditor's report. Indeed, some firms have continued to include the 'Conclusions related to going concern' paragraph which states that based on the work performed, the auditor has not identified any material uncertainties related to events or conditions that, individually or collectively, may cast significant doubt on the company's ability to continue as a going concern for the foreseeable future. This means the auditor's report is inconsistent with the financial statements and indicates a lack of attention on the part of the auditor, or a lack of awareness as to the requirements of ISA (UK) 570.

Example – Correct use of a MURGC paragraph

Material Uncertainty Related to Going Concern

We draw your attention to note 23 which indicates that the company must retender for a large contract in June 2022. If the company were to fail to win the bid, the loss of the contract may have a detrimental impact on the company's operations and cash flows. As stated in note 23, these events or conditions along with other matters as set forth in note 23 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.

8.4 Inadequate or absent going concern disclosures

If the auditor becomes aware of a material uncertainty related to going concern and the audit client has either made inadequate disclosure or has failed to include any disclosure, the auditor must discuss the issue with the directors. If the directors do not remedy the issue the auditor will have to consider the implications on the auditor's report.

ISA (UK) 570, para 23 states that if appropriate disclosure concerning the material uncertainty is not made in the financial statements, the auditor must:

(a) express a qualified opinion or adverse opinion, as appropriate, to comply with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*; and

(b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not disclose this matter.

8.5 Key points to remember

EoM and MURGC paragraphs do lend themselves a number of pitfalls which must be avoided. The key points to remember are:

- Not to use an EoM paragraph as a substitute for modifying the audit opinion.
- Cross-reference to the relevant disclosure note in the financial statements when including both an EoM and MURGC paragraph.
- Confirm that the auditor's opinion is not modified in respect of the matter giving rise to an EoM or MURGC paragraph.
- Go back to ISA (UK) 570 or ISA (UK) 706 if there are any issues giving rise to confusion or uncertainty.

9 Type 1 and type 2 reports (Lecture A771 – 9.48 minutes)

ISA (UK) 402 *Audit Considerations Relating to an Entity Using a Service Organization* requires the auditor to obtain an understanding of the nature and significance of services which are provided to an audit client and the effect of these services on the entity's internal control.

Many audit clients buy-in services from external parties, such as payroll providers and HR services. The auditor is required to identify and assess the risks of material misstatement where service providers are used. In addition, ISA (UK) 402, para 7(b) requires the auditor to design and perform audit procedures which are responsive to those risks.

ISA (UK) 402 is effectively an extension of ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* (now rebranded as *Identifying and Assessing the Risks of Material Misstatement*). This is because the auditor must obtain a thorough understanding of the client's business (including its system of internal control) in accordance with ISA (UK) 315.

In many cases, the auditor may decide it necessary to obtain a type 1 or type 2 report from the service organisation. The problem with these sorts of reports is that they are often just put on the audit file with no evidence that the auditor has actually considered the content of either report.

9.1 Type 1 report

A type 1 report is less comprehensive than a type 2 report (see below). A type 1 report describes the service entity's control objectives and controls. This is then supported by the service entity's auditor's opinion but it does not relate specifically to any period. Essentially a type 1 report focuses on the description and design of controls.

9.2 Type 2 report

A type 2 report is more comprehensive than a type 1 report and will often be more costly to prepare. A type 2 report will also cover the operating effectiveness of the controls and can provide some assurance over the controls which should have operated at the service organisation.

9.3 Review of the report

Auditors must take time to carefully review the content of the type 1 or type 2 report, paying particular attention to the service organisation's auditor's report on the controls. It may be the case that the auditor has qualified the report due to either missing controls or controls that have been deemed as inadequate. The auditor's report will also describe the effect that the missing or inadequate control(s) has on the entity.

Keep in mind that if the service organisation's auditors have qualified the type 1 or type 2 report, it is unlikely that the auditor will place any reliance on those controls that have been subject to the modification. There is little to be gained from placing reliance on any weak or ineffective internal control because this will only serve to increase the risk of material misstatement and increase audit risk. In such instances, the auditor must increase substantive testing on the relevant areas as substantive procedures are aimed at detecting misstatements at the financial statement assertion level.

File reviewers and professional bodies have frequently criticised the use of type 1 or type 2 reports. The main criticism is that there is no evidence that the auditor has actually done anything with them other than place them on the audit file. The content should be carefully reviewed and conclusions drawn by the auditor as to whether reliance can be placed on the service organisation's controls.

9.4 Bridging letters

In some cases, it may be worthwhile requesting a 'bridging letter'. This is used when the audit client's reporting date is different than the service providers. For example, the service provider may have a 31 December year end, but the client may have a 31 March year end. In some cases the auditor may need to consider whether a bridging letter should be obtained to cover the intervening period up to the 31 March year end. This letter will provide the auditor with additional information and confidence that control have operated effectively (or not as the case may be) in the intervening period.

10 Written representations (Lecture A772 – 8.37 minutes)

ISA (UK) 580 *Written Representations* provides the guidance to auditors on obtaining written representations from clients during the course of an audit. Written representations are often scrutinised as part of file reviews and, quite often, there are deficiencies noted in the content of the representation itself. It should be noted that for the purposes of ISA (UK) 580, written representations do not include the financial statements or assertions therein and do not include the books and records supporting the amounts and disclosures in the financial statements.

10.1 Auditor's objectives

The objectives of the auditor where written representations are concerned are outlined in ISA 580, paras 6(a) to (c). These paragraphs state that the auditor's objective are:

(a) to obtain written representations from management and, where applicable, those charged with governance that they believe they have fulfilled their responsibilities in respect of the preparation of the financial statements as well as for the completeness of the information that they have provided to the auditor;

(b) to support other audit evidence relevant to the financial statements or specific assertions within those financial statements where such written representations are considered necessary by the auditor, or are required by other ISAs (UK); and

(c) to respond appropriately to written representations provided by management and, where appropriate, those charged with governance or where management, and those charged with governance, do not provide written representations requested by the auditor.

An important point to emphasise at the outset is that written representations are **not** sufficient appropriate audit evidence on their own. This is because they are internally generated and hence written representations must **complement other forms of audit evidence**. A frequent criticism by file reviewers and professional bodies is that written representations are often used as sole audit evidence and this cannot be the case because of the inherent limitations of written representations.

10.2 Management's responsibilities

The auditor has a responsibility to request management to provide a written representation that they have fulfilled their responsibilities for the preparation of the financial statements in accordance with the applicable financial reporting framework (e.g. FRS 102), including, where relevant, their fair presentation. Management must also confirm that the financial statements are complete and hence they must also provide the auditor with a written representation that:

(a) management have provided the auditor with all relevant information and access to such information as agreed in the letter of engagement; and

(b) all transactions have been recorded and have been reflected within the financial statements.

10.3 Other representations

The following ISAs (UK) specifically require the auditor to obtain written representations from the audit client. It should be noted that the list below is not a substitute for requesting any other representations that the auditor may consider necessary:

Relevant ISA	Para number
ISA (UK) 240 (Revised June 2016) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	39
ISA (UK) 250 (Revised November 2019) *Section A – Consideration of Laws and Regulations in an Audit of Financial Statements*	17
ISA (UK) 450 (Revised June 2016) *Evaluation of Misstatements Identified During the Audit*	14
ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items*	12
ISA (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures*	37
ISA (UK) 550 *Related Parties*	26
ISA (UK) 560 *Subsequent Events*	9
ISA (UK) 570 (Revised September 2019) *Going Concern*	12-2(f)
ISA (UK) 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements*	9
ISA (UK) 720 (Revised November 2019) *The Auditor's Responsibilities Relating to Other Information*	13(c)

Audit firms are encouraged to ensure that their written representation letters comply with ISA (UK) 580 and include management representations in respect of the above ISAs (UK).

As noted above, written representations may be requested from management in respect of any areas of the financial statements that the auditor deems necessary.

10.4 Timing of representations

Written representations should be obtained on the client's letterhead and must always be dated as near as practicable to, but not after, the date of the auditor's report on the financial statements. Firms have been criticised in the past from professional bodies for failing to ensure that the date of the written representation is either on, or immediately prior to, the date of the auditor's report.

10.5 Doubts concerning the reliability of written representations

When the auditor has any doubts concerning the audit client's competence, integrity, ethical values or diligence of management, or concerns relating to the enforcement of these values, the auditor must consider the effect those concerns have on the reliability of the representations (whether oral or written) received. This is because the representations received may be inconsistent with other audit evidence obtained by the auditor.

If the auditor concludes that the representations are inconsistent with other audit evidence, the auditor must perform audit procedures in an attempt to resolve the matter. When the matter remains unresolved, the auditor reconsiders the assessment of the competence, integrity, ethical values or diligence of management, or of management's commitment to, or enforcement of, these values.

The auditor may conclude that the written representations are unreliable. In such instances, ISA (UK) 580 requires the auditor to take appropriate actions, including determining the potential effect on the auditor's opinion.

10.6 Management fail to provide written representations

If management fail to provide written representations specifically requested by the auditor, the auditor must discuss the issue with management and re-evaluate the integrity of management together with the effect that this may have on the overall reliability of the representations (whether oral or written) received and audit evidence in general. The auditor must also take appropriate action, including considering the effect that management's failure to provide written representations may have on the auditor's opinion.

If the auditor concludes that there is sufficient doubt concerning the integrity of management to such an extent that management's assertion concerning their responsibilities relating to the preparation of the accounts and assertion relating to the provision of information to the auditors is brought into doubt, the auditor must express a disclaimer of opinion. This will also be the case if management fail to provide written representations concerning their responsibilities for the preparation of the financial statements. This is because the auditor will be unable to obtain sufficient appropriate audit evidence. The potential effects on the financial statements of such an inability to obtain representations are not confined to specific elements and hence are deemed to be pervasive which would warrant a disclaimer of opinion.

10.7 Key points to bear in mind

Key points to bear in mind where written representations are concerned are as follows:

- Ensure written representations are obtained on the client's letterhead.
- Ensure the written representation letter includes reference to all the paragraphs required by other ISAs (UK) from which management must provide representations.
- Request that the written representation letter is dated as near as practicable to, but not after, the date of the auditor's report.
- Do not regard written representations on their own as sufficient appropriate audit evidence because they are not; they are designed to complement other forms of audit evidence.
- Always consider the reliability of the representations received (both oral and written) in light of other audit evidence obtained by the auditor as inconsistencies may become apparent between the representations received and the audit evidence.