Audit and Accounting Quarterly Update – January 2023

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1 Transitioning between FRS 102 v FRS 105 (Lecture A802 – 11.48 minutes)

The two 'main' accounting standards in the suite of UK and Ireland GAAP consist of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Both standards are applied widely throughout the UK and Republic of Ireland and questions often arise as to the suitability of each standard depending on whether the client is a micro-entity or small entity. This section of the course considers the differences between the two standards to help aid practitioners in advising clients as to the appropriateness of each one.

The section has been written in the context of a micro-entity that is eligible to apply *either* FRS 102 or FRS 105. It also looks at the factors to consider when a small company contracts so that it becomes eligible to use FRS 105.

At the outset it is worth noting that FRS 105 is an optional standard. Just because a micro-entity may be eligible to use FRS 105 does not mean it has to (and there are genuine reasons why FRS 105 may not be appropriate to a micro-entity). FRS 105 should therefore be considered on a case-by-case basis.

1.1 FRS 102

FRS 102 includes a separate section in the form of Section 1A *Small Entities*. FRS 102, Section 1A only deals with the **presentation** and **disclosure** requirements applicable to a small entity eligible to report under Section 1A. Recognition and measurement principles are dealt with in full FRS 102.

The idea of this is that if a small company outgrows Section 1A (i.e. it becomes, say, a medium-sized entity), then the disclosure requirements become more comprehensive as they are based on individual sections of FRS 102 rather than Section 1A. The recognition and measurement of amounts are still the same hence this avoids a transition to another alternative framework, or a transition to full FRS 102.

FRS 102, Section 1A currently contains the minimum disclosures required by company law. The section itself is optional – a small company need not apply Section 1A if they do not wish to, although most small entities do choose to apply Section 1A. If the company grows from small to medium-sized, Section 1A will not apply and the disclosures required by full FRS 102 will be applied.

FRS 102, Section 1A was drafted in line with the requirements of the EU Accounting Directive. As the UK has now left the EU, it is no longer subject to the Accounting Directive. This allows the FRC to change the disclosure requirements for small entities and this is something that could potentially be seen in the forthcoming Exposure Draft of amendments arising from the FRC's current periodic review (although at the time of writing, it was currently unknown what will be in the Exposure Draft). Reporting entities in the Republic of Ireland are still subject to the requirements of the Accounting Directive, so disclosures for Irish reporting entities will not change.

The same recognition and measurement principles apply to all entities, regardless of size, that report under FRS 102. Therefore, a micro-entity choosing to report under FRS 102 will use the same recognition and measurement principles as a large entity. Entities are unable to 'cherry pick' between standards so a micro-entity that chooses to report under FRS 102 cannot then apply certain provisions of FRS 105 (for example, by ignoring deferred tax).

There is one exception to full recognition and measurement principles which is available only to small entities (including small LLPs) in FRS 102, para 11.13A which relates to a loan to a small entity.

FRS 102, para 11.13A allows a small entity which receives a loan from a director who is also a shareholder, or a person who is within a director's group of close family members, when that group of close family contains a least one shareholder, to recognise the loan at transaction price (i.e. at cost). For clarity, the definition of 'close members of the family of a person' is:

> *Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:*
>
> *(a) that person's children and spouse or domestic partner;*
>
> *(b) children of that person's spouse or domestic partner; and*
>
> *(c) dependants of that person or that person's spouse or domestic partner.*

FRS 102 Glossary ***close members of the family of a person***

In practice, this would apply to a loan provided by a director-shareholder (or, if the director is not a shareholder, a member of the close family of the director who is a shareholder), which is covered by formal terms and which is at below market rates of interest. The exception in paragraph 11.13A means the small entity does not have to impute a market rate of interest and then discount the loan on initial recognition. If the loan does not contain formal loan terms, then it need not be discounted in any event because it would be repayable on demand, so would be recognised as a current liability in the entity's financial statements. This is because where no formal loan terms exist, there is no agreement to defer settlement beyond 12 months from the balance sheet date.

FRS 102, Section 1A contains five **encouraged** disclosures which preparers cannot disregard which are found in Appendix E *Additional disclosures encouraged for small entities*. Over the last couple of years, the one that has been the most important one to consider is the going concern disclosure. FRS 102, Section 1A, para 1AE.1(c) encourages a small entity to provide the disclosures relating to **material uncertainties** [emphasis added] related to events or conditions that cast significant doubt upon the small entity's ability to continue as a going concern as set out in paragraph 3.9.

This paragraph is important because going concern is such a fundamental concept. The fact that the paragraph encourages the small entity to disclose material uncertainties means that if the directors choose not to (on the basis that the disclosure is encouraged rather than legally required), it will be difficult to justify that the financial statements give a true and fair view. Hence, in the absence of such disclosures the financial statements will contain material misstatement and will be misleading (even if those financial statements are unaudited). Keep in mind that professional bodies do not allow member firms to have their names associated with financial statements which are misleading, so this is a particularly important issue to consider.

1.2 FRS 105

FRS 105 is viewed as a 'compliance framework' rather than a 'true and fair framework'. The standard is prescriptive and includes much simpler recognition and measurement principles and a vastly reduced disclosure regime (for UK-based micro-entities at least). There is only one format permitted for the profit and loss account (a Format 2 profit and loss account which presents expenses by nature) and there is no requirement for additional primary financial statements.

A notable feature of FRS 105 is the presumption in law that if the micro-entity's financial statements are prepared in accordance with the minimum legal requirements (i.e. FRS 105), the financial statements are presumed in law to give a true and fair view. This means the directors need not consider making any additional disclosures, beyond those required in the standard, to achieve a true and fair view.

Other notable simplifications in the standard are shown in the table below:

Topic	Simplification
Deferred tax	Micro-entities are prohibited from accounting for deferred tax.
Revaluations and the use of fair values	Micro-entities cannot revalue assets, nor can they apply fair value accounting. This is because application of the Alternative Accounting Rules and Fair Value Accounting Rules are prohibited in the micro-entities' legislation.
Equity-settled share-based payments	Micro-entities need not account for equity-settled share-based payments prior to the issue of the shares. This is because of the prohibition in the use of fair values and the lack of disclosure.
Defined benefit pension plans	These are accounted for in the same way as defined contribution plans, i.e. contributions into the plan are accounted

	for as an expense. A liability is recognised in respect of any agreements to fund a deficit (a schedule of contributions) because the pension obligation is not reported on the micro-entity's balance sheet.
Foreign currency	There is no distinction between functional and presentation currency and the micro-entity must use contracted rates to translate assets and liabilities denoted in a foreign currency as opposed to closing rate.
Borrowing and development costs	All borrowing and development costs must be expensed. There is no option to capitalise such costs on the balance sheet.
Government grants	These are recognised under the accrual model. The performance method of grant recognition is not recognised under FRS 105.
Financial instruments	Micro-entities are not required to use the amortised cost and effective interest method as this is considered to be too onerous for micro-entities. Financial instruments are effectively recognised and measured at cost.
Imputed market rates of interest	This requirement is removed in FRS 105 as the costs of applying this outweigh the benefits.
Recognition of separately identifiable intangible assets in a trade and asset acquisition	This requirement is removed in FRS 105 because they are not required items in the financial statement formats.
Hyperinflation	The accounting issues relating to hyperinflation are not included in FRS 105 as this is unlikely to be an issue for micro-entities.
Specialised activities	The only specialised activity is that of agriculture. Activities such as extractive

	industries, service concessions, heritage assets and funding commitments are unlikely to apply to micro-entities.

1.3 Transitioning between frameworks

Applying the correct financial reporting framework at the outset cannot be over-emphasised. Over the years, a common question asked by practitioners is whether FRS 102 could be applied in year 1, then if appropriate, FRS 105 in year 2, switch back to FRS 102 in year 3 and so on. This is not how the standards are designed to work and doing this is costly and inappropriate.

A micro-entity (which is eligible to use FRS 105) should consider all the benefits and drawbacks of the standard before concluding that FRS 105 is appropriate in its individual circumstances. If, for example, the micro-entity has an investment property on the balance sheet and the directors want to reflect the property's fair value at each reporting date in the financial statements, FRS 105 will not be appropriate. Under FRS 105, the investment property must be measured at cost less depreciation less impairment under that standard. Similarly, if an entity has a history of revaluing certain fixed assets, then FRS 105 will also not be appropriate and the micro-entity should be advised to report under FRS 102, including applying the presentation and disclosure requirements of Section 1A if it wishes.

Some micro-entities do outgrow FRS 105 and therefore will need to transition to FRS 102 (including Section 1A, if applicable). Conversely, some small entities will contract and hence become eligible to use FRS 105.

Whenever there is a switch between financial reporting frameworks, a transition must be carried out. This involves restating the transition date balance sheet (i.e. the opening balance sheet position at the start date of the comparative year) and then restating the closing comparative year to comply with the requirements of FRS 102 or FRS 105.

The table below provides some non-comprehensive factors to consider when switching between frameworks:

From FRS 102 to FRS 105	From FRS 105 to FRS 102
Remove any fair values and revalued amounts (a revaluation reserve should never be seen on a micro-entity's balance sheet).	Consider additional accounting policies permitted in FRS 102, such as revaluing fixed assets and capitalising development expenditure. Also FRS 102 requires all investment property (except intra-group investment property) to be measured at fair value.

Remove any deferred tax balances.	Recognise deferred tax balances.
Apply the disclosure requirements per FRS 105 (which does not include issues such as related party transactions and transitional information).	Consider whether the entity will apply the presentation and disclosure requirements of Section 1A or whether full FRS 102 disclosures are to be made (related party disclosures are limited under Section 1A but are more comprehensive under Section 33 *Related Party Disclosures* and the disclosure of transitional information is encouraged).
Restate foreign currency denominated assets and liabilities to contract rate where applicable.	Only use closing rate for such assets and liabilities. Contracted rates are not allowed under FRS 102.
Present the profit and loss account in Format 2.	Use a Format 1 (expenses by function) or Format 2 (expenses by nature) presentation.
Remove additional statements such as the statement of changes in equity and other comprehensive income statement.	Small entities are encouraged to present a statement of changes in equity and other comprehensive income statement.
Restate basic financial instruments as the amortised cost and effective interest method are not permitted.	Basic financial instruments are measured at amortised cost using the effective interest method. A small entity can apply the simplification in FRS 102, para 11.13A(a) for directors' loans to the entity at below market rates.
Remove transactions related to equity-settled share-based payment transactions where shares have not yet been issued.	Recognise equity-settled share-based payment transactions even if the shares have not yet been issued.
Remove the defined benefit pension liability and account for the defined benefit pension plan as a defined contribution plan but recognise a liability in respect of an agreement to fund a deficit in the form of a schedule of contributions.	Remove the liability in respect of an agreement to fund a deficit in the form of a schedule of contributions and apply defined benefit accounting (i.e. bring the defined benefit obligation onto the small entity's balance sheet).

This section has considered some of the more notable issues relating to FRS 102 and FRS 105 and how they interact with each other – especially when it comes to transitioning between the frameworks. The section has not covered every eventuality and preparers must, therefore, have a sound understanding of the differences of each framework in order to advise their client of the most appropriate framework correctly.

1.4 Filing issues for small entities

At the present time, there is an option for a small company to file 'filleted' or 'filleted abridged' financial statements. Abridged financial statements are not a 'replacement' for the old abbreviated accounts regime. In addition, abridging is not applicable to financial statements that have been prepared under the micro-entities regime.

Abridged accounts omit information in the financial statements which are preceded by Arabic numerals in the statutory formats of the financial statements, for example when abridged accounts are prepared:

- Turnover, cost of sales and other income are combined so the abridged profit and loss account starts with gross profit or loss
- There is no detailed breakdown of classes of fixed assets (just a total column)
- There is no detailed breakdown of debtors or creditors (although there are details of creditors falling due after more than five years)

Hence the information contained in abridged accounts is much less than in unabridged accounts. Where the entity elects to prepare abridged accounts, the shareholders and HMRC will also receive abridged accounts.

The small entity can only file filleted abridged financial statements if abridged financial statements have been prepared for the shareholders. If unabridged accounts have been drawn up, the small entity only has the option of filing filleted accounts. This is because the legislation requires that the shareholders **unanimously** agree to the small entity preparing abridged accounts.

The agreement referred to where abridged accounts are concerned is an annual process (i.e. one agreement cannot cover all subsequent years) and the agreement must be in place **before** the accounts are approved. The small entity can abridge either the profit and loss account **or** the balance sheet **or** both. There must also be a statement made above the signature on the face of the balance sheet confirming the shareholders have approved to the company preparing abridged financial statements, i.e.:

> *All the members have consented to the preparation of abridged financial statements for the year ended 31 March 2022 in accordance with Section 444(2A) of the Companies Act 2006.*

Or, if only the balance sheet has been abridged:

All the members have consented to the preparation of an abridged balance sheet for the year ended 31 March 2022 in accordance with Section 444(2A) of the Companies Act 2006.

Example – Incorrect protocol followed

Smallco Ltd has prepared its financial statements for the year ended 31 October 2022 under FRS 102, including the presentation and disclosure requirements of Section 1A. The shareholders have not agreed to the entity preparing abridged financial statements.

The external accountant has prepared two versions of the accounts. The 'full' accounts will be distributed to the shareholders and HMRC. An additional filleted abridged version has been prepared for delivery to Companies House.

Smallco cannot file filleted abridged accounts with Companies House because the shareholders have not unanimously agreed to the entity preparing abridged accounts. Consequently, they can only file the full accounts or filleted accounts (i.e. remove the directors' report, profit and loss account and any notes relating to the profit and loss account and file the rest).

The shareholders would need to unanimously agree to the company preparing abridged accounts before they are approved in order to be able to file filleted abridged accounts.

Companies House reforms and the potential impact on filing requirements

In 2021, the government published its consultation on wide-ranging reforms to the powers and role of Companies House. The objective of these reforms is to improve business transactions and tackle fraud.

In March 2022, BEIS issued a White Paper on corporate transparency and register reform. This White Paper proposes to give new powers to the Registrar of Companies (and equivalents in Scotland and Northern Ireland) to maintain the integrity of the register. These new powers will include powers to query suspicious appointments or filings and, in some cases, request further evidence or reject the filing. These are just a couple of a number of reforms proposed.

For practitioners, a notable proposal comes in the form of the filing options that are currently available to small and micro-entities. Paragraphs 232 and 233 of the White Paper states:

> *We have reviewed the filing options available to small and micro companies and intend to simplify the framework by reducing the filing options to just two: micro-entities and small companies. Removing the abridged[1] and "filleted"[2] accounts options will make the options easier to understand, reduce fraud and error and increase transparency.*

Corporate Transparency and Register Reform White Paper, para 232

> *All small companies will then be required to file a profit and loss account. This will ensure that key information such as turnover and profit or loss is available on the public register to help creditors and consumers make informed decisions. Small companies will be required to file all the constituent parts of their accounts, so they will actually file what they prepare with no additional effort required to "fillet out" certain information. This means that Companies House will receive a balance sheet and profit and loss account for all small companies including micro-entities. Small companies will also file a director's report unless they meet the micro-entity thresholds, when they will still have the option to not prepare or file a director's report. Although we will be asking for additional information to be filed by small companies, this will be information that they already hold and report to HMRC.*

Corporate Transparency and Register Reform White Paper, para 233

Views on these proposals are mixed. Some preparers are in favour of Companies House requiring a full set of financial statements to be filed; whereas others are not. At the time of writing, there was no implementation date for these proposals and preparers are advised to keep abreast of developments in this area and advise clients accordingly.

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[1] Abridged accounts allow a small company to prepare and file a shortened version of the balance sheet and profit and loss account which contains a subset of the information in full accounts. All shareholders must agree to the abridgement each year. No other version of the accounts should be prepared.

[2] "Filleted" accounts is a term used by the profession to describe accounts that do not contain the director's report and/or the profit and loss accounts as the company has taken advantage of the small company's option to remove them before filing.

2 FRS 102: Property, plant and equipment (Lecture 803 – 12.08 minutes)

Property, plant and equipment is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 17 *Property, Plant and Equipment*.

The term 'property, plant and equipment' is defined as:

Tangible assets that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and

(b) are expected to be used during more than one period.

FRS 102 Glossary ***property, plant and equipment***

Under the Accounting Regulations, fixed assets are defined slightly differently as assets which are '... intended for use on a continuing basis'.

FRS 102, Section 17 applies to:

(a) property, plant and equipment (PPE); and

(b) investment property which is rented to another group member and is measured under the cost model (as permitted by FRS 102, para 16.4A).

FRS 102, Section 17 does not apply to:

(a) biological assets that are related to agricultural activity as these are dealt with in Section 34 *Specialised Activities*; and

(b) mineral rights and mineral reserves, such as oil, natural gas and similar non-regenerative resources as these are also dealt with in Section 34.

To qualify for recognition on the balance sheet, FRS 102 contains two strict criteria which must be met. An entity can only recognise an asset on the balance sheet if, and only if:

*(a) it is **probable** that future economic benefits associated with the item will flow to the entity; and*

(b) the cost of the item can be measured reliably.

FRS 102, para 17.4 (a) and (b)

These recognition criteria are also contained in FRS 102, Section 2 *Concepts and Pervasive Principles*, para 2.27. In addition, the definition of an asset also must be carefully considered because this is considered the 'backbone' underpinning the principles involved in the recognition of PPE on the balance sheet. The definition of an 'asset' is:

A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

*FRS 102 Glossary **asset***

The definition above refers to 'control' as opposed to 'ownership'. An entity has control over an item of PPE when it is able to determine what the item will be used for; how long it will be used for; and when it will be disposed of.

Example – Classification of assets in a holiday park

Harvey's Holiday Park owns several static caravans which are rented out to visitors during the season. The company has an accounting reference date of 31 December and on 30 November 2022 it decides to invest in five new caravans to replace five older ones. The older caravans will be put up for sale but will continue to be used in the business. The finance director has reclassified the older caravans as inventory on the basis that they can be sold at any time.

The new caravans held for rental are capitalised in the balance sheet as tangible fixed assets because they meet the definition of property, plant and equipment. Those held for sale should remain as tangible fixed assets until such time that they are sold because they continue to be used in the business (i.e. they will still generate an income stream for the entity).

Even if the old caravans were surplus to requirements, that, in itself, does not change the nature of the asset, hence they should not be reclassified as inventory.

2.1 Spare parts and servicing equipment

FRS 102 deals with the accounting for spare parts and servicing equipment at paragraph 17.5. Paragraph 17.5 recognises that such items are usually carried as inventory in the reporting entity's accounting records and are included in profit or loss as they are consumed. Consideration must, however, be given to major spare parts and stand-by equipment because such items are fixed assets under FRS 102 when the entity expects to use them for more than one accounting period and they meet the rest of the definition of PPE (otherwise they are classified as inventory and accounted for under FRS 102, Section 13 *Inventories*). A similar principle also applies if the spare parts and servicing equipment can only be used in connection with an item of fixed asset.

Example – Entity acquires spare parts

A garage is in the business of repairing cars and vans and prepares its financial statements under FRS 102, including the presentation and disclosure requirements of Section 1A. It acquires old vehicles to remove reusable parts and components in its day-to-day business.

These items are not spare parts for the entity's use in its own business and should not be classified as PPE. They should be treated as inventory and accounted for under Section 13 and valued at the lower of cost and estimated selling price less costs to complete and sell at each balance sheet date.

2.2 Component accounting

FRS 102 places emphasis on component accounting. Component accounting would be appropriate when certain parts (i.e. components) of an item of PPE might require replacement at regular intervals (the standard cites an example of a roof on a building). The standard requires that the cost of replacing such a component is added to the carrying amount of the asset when the cost is incurred but only if the replacement part is expected to provide incremental future benefits to the company. The carrying value of the part(s) that have been replaced are derecognised from the accounts in the usual way.

Component depreciation is also a feature of FRS 102. Component depreciation is appropriate when the major components of an item of fixed asset have a significantly different useful economic life than the rest of the asset. Examples frequently cited include the linings of blast furnaces and the engines of aircraft. When the major components of a fixed asset have significantly shorter lives than the main asset itself, FRS 102 would require the entity to depreciate each such component separately over its useful life.

Example – Component depreciation

Sunnie Ltd manufactures chemicals for use in domestic cleaning products. It purchased a new machine on 1 January 2022 for £60,000 that is expected to have a useful economic life of ten years with a nil residual value at the end of this useful economic life. The company identifies the following major components:

Component A:	Cost £8,500 with a useful life of four years
Component B:	Cost £7,200 with a useful life of three years
Component C:	Cost £6,500 with a useful life of five years

In this example, the cost attributable to the remainder of the asset is £37,800. The company will depreciate components A, B and C over their useful lives of four, three and five years respectively. The remainder of the machine is treated as a single asset and is depreciated over ten years. The depreciation charges in year 1 if component accounting is not used and if component accounting is used can be compared as follows:

No component accounting	Component accounting	
£60,000 ÷ 10 years = £6,000	Component A: £8,500 ÷ 4 years	£2,125
	Component B: £7,200 ÷ 3 years	£2,400
	Component C: £6,500 ÷ 5 years	£1,300
	Remaining asset: £37,800 ÷ 10 years	£3,780
	Total depreciation	£9,605

In the above example, while the depreciation charge is essentially higher under component accounting, this is representative of the fact that various major components of the asset have significantly shorter lives than the main asset itself and therefore gives a more representative depreciation charge than if the asset were written off over ten years as a single asset.

2.3 Initial recognition of PPE

PPE are initially recognised at cost. Cost can be made up of several components, including:

- the initial purchase price;
- irrecoverable taxes;
- duties;
- legal fees;
- brokerage fees;
- other costs directly attributable[3] to bringing the asset to its location and condition intended by management; and
- borrowing costs capitalised in accordance with paragraph 25.2.

However, paragraph 17.11 specifically disallows certain types of expenditure from forming part of the cost of an asset and include:

- the costs of opening a new facility;
- the costs of introducing a new product or service, including advertising costs and promotional activities;
- costs of conducting business in a new location or with a new class of customer and this includes staff training; and
- administration and other general overhead costs.

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[3] The term 'directly attributable' is not defined in FRS 102 but should be taken to mean any costs which the entity would have avoided had it not entered into the transaction in the first place.

Ordinarily the cost of an item of fixed asset is the cash price equivalent at the date of recognition and this will usually be found on the supplier's invoice. If, however, payment is deferred beyond normal credit terms, then the cost price is the present value of all future payments.

Example – Identification of costs to be capitalised

Birchwood Co Ltd acquired a machine from a supplier based in the USA an incurred expenditure relating to the following:

1. Costs of purchase including import duties.
2. Costs of transporting the equipment to its site in a factory in Birmingham.
3. Labour and material costs incurred in modifying the equipment to meet the specific needs of the entity's potential customers.
4. Training costs relating to staff directly involved in operating the machinery.
5. Operating losses incurred between the time the equipment was ready for use and when it was operating at full capacity (when customer order levels were on target).

Items 1, 2 and 3 are capitalised as they satisfy the test of being necessary in bringing the item of equipment to its intended location and operating condition.

Items 4 and 5 do not satisfy the capitalisation criteria and must be recognised as expenses in the period in which they are incurred. Training costs are not part of the directly attributable costs of bringing the machine to the location and condition necessary for it to be capable of operating as intended by management because this would be the case regardless of the fact that the staff need training to use it.

Operating losses do not qualify to be included in the cost of the new machine because these are not costs directly attributable to bringing the machine to the location and condition necessary for it to be capable of operating as intended by management. Such losses are an inherent business risk.

2.4 Subsequent measurement

After initial recognition, FRS 102 allows two subsequent measurement bases for PPE:

- the cost model; and
- the revaluation model.

Cost model

Under the cost model, items of PPE are measured at cost less depreciation less impairment losses.

In practice, the cost model is the most popular model and applies to most assets. Generally, all assets are depreciable assets and hence will be subject to depreciation except in the case of land which does not usually depreciate.

FRS 102, para 17.13 states that the cost of an item of PPE is the cash price equivalent at the recognition date. Where payment is deferred beyond normal credit terms, the cost is the present value of all future payments.

Example – Deferred payment terms

Philbin Ltd enters into a transaction to acquire four machines at a cost of £650,000. Repayment is over three years in annual payments of £250,000. This gives an implicit rate of interest of 7.51% calculated using the internal rate of return function in Excel as follows:

	A	B	C
1	(650,000)		
2	250,000		
3	250,000		
4	250,000		
5		7.51%	
6		Formula in B5 is =IRR(A1:A4)	

The arrangement is profiled as follows:

	Opening balance	Interest at 7.51%	Cash flow	Closing balance
	£	£	£	£
Year 1	650,000	48,815	(250,000)	448,815
Year 2	448,815	33,706	(250,000)	232,521
Year 3	232,521	17,479	(250,000)	-

Year 1	£
Dr PPE additions	650,000

Dr Interest payable (P&L)	48,815
Cr Bank	250,000
Cr Trade creditors	448,815
Year 2	
Dr Interest payable (P&L)	33,706
Cr Trade payable	33,706
Dr Trade payable	250,000
Cr Bank	250,000
Year 3	
Dr Interest payable (P&L)	17,479
Cr Trade payable	17,479
Dr Trade payable	250,000
Cr Bank	250,000

At the end of year 1, the balance owing to the supplier is split between the current liability of £216,294 (£448,815 - £232,521) and the non-current portion of £232,521 to comply with the statutory formats of the balance sheet.

Revaluation model

FRS 102 allows an entity to subsequently measure items of PPE using the revaluation model. Under the revaluation model, PPE are carried at their latest revaluation amount less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

Revaluation frequency

FRS 102 does not prescribe a set time limit for revaluations. Paragraph 17.15B says that revaluations shall be made with **sufficient regularity** to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. Therefore, some items of revalued PPE may go several years without a revaluation being undertaken, but these would tend to be assets whose fair value remains relatively static over a long period of time. Conversely, some assets (such as properties) may require revaluations on a much more regular basis. The judgement call that is required here is to consider whether the carrying value of the revalued assets is materially higher or lower than its fair value; if it is, then a revaluation is needed.

Revaluation gains are taken to a revaluation reserve within equity and are reported as other comprehensive income. The exception to this would be where the revaluation gain reverses a previous revaluation loss that has been reported in profit or loss in respect **of the same asset**. A revaluation loss is taken to the revaluation reserve to the extent of a surplus on the revaluation reserve in respect **of the same asset** with any excess being taken to the profit and loss account (there cannot be a debit balance on the revaluation reserve). Care must be taken not to offset gains and losses of one revalued asset against gains and losses of another revalued asset, hence the phrase '… of the same asset' being emphasised above.

The statutory formats of the balance sheet require the revaluation reserve to be disclosed below 'Share premium account'. Prior to the amendments to company law by virtue of The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980), the revaluation reserve did not have to be called that. SI 20915/980 removed this flexibility by deleting the words *'… but need not be shown under that name'* in para 35(2) of the Regulations. Hence, the revaluation reserve must no longer be referred to by another name in the statutory balance sheet.

Entities are free to decide which types of assets are subjected to revaluation. However, in practice, the main assets that are subjected to the revaluation model are buildings. Other items such as plant and machinery may also be revalued. Where an asset is subject to the revaluation model, then all assets within that same class of asset must also be revalued. This rule is in place to stop entities from deliberately revaluing assets which may have increased in value and leaving out those that have either not increased or have decreased.

For clarity, the term 'class of asset' is defined as:

> *A grouping of **assets** of a similar nature and use in an entity's operations.*

*FRS 102 Glossary **class of asset***

Example – Revaluation loss with a subsequent revaluation gain

On 31 March 2021, Runcorn Ltd revalued an asset which had a carrying value of £100,000 down to £70,000. The revaluation reserve in respect of this asset stood at £20,000. Deferred tax has been ignored for the purposes of this example.

The revaluation loss on 31 March 2021 is recorded as follows:

	£
Dr Revaluation reserve	20,000

Dr Loss on revaluation (P&L)	10,000
Cr Property, plant and equipment	30,000
Being revaluation loss as at 31 March 2021	

On 31 March 2022, the fair value of the asset had increased to £110,000 and the finance director wishes to incorporate this fair value gain into the financial statements. The entries are:

	£
Dr Property, plant and equipment	40,000
Cr Gain on revaluation (P&L)	10,000
Cr Revaluation reserve	30,000
Being revaluation gain as at 31 March 2022	

The revaluation gain is not taken wholly to the revaluation reserve as £10,000 of it reverses the previously recognised revaluation loss in respect of the asset.

Relevant deferred tax adjustments would also be made as this is a non-monetary asset subject to revaluation.

Determining fair value

FRS 102, paras 17.15C and 17.15D refer to the determination of fair value for the purpose of applying the revaluation model. FRS 102, para 17.15C states that the fair value of land and buildings is derived from market-based evidence which is usually obtained by appraisal by professionally qualified valuers. Such professionally qualified valuers would include chartered surveyors. Fair value in respect of plant and equipment is usually derived from their market value determined by appraisal. This could be obtained from a dealer in such plant and equipment.

Where there is no market-based evidence of fair value due to the asset being specialised in nature (e.g. a school building), and the item is rarely sold, except as part of a continuing business, the entity may need to estimate fair value using an income or depreciated replacement cost approach.

The term 'depreciated replacement cost' is defined as:

> *The most economic cost required for the entity to replace the **service potential** of an **asset** (including the amount that the entity will receive from its disposal at the end of its **useful life**) at the **reporting date**.*

FRS 102 Glossary ***depreciated replacement cost***

Deferred tax

Where an entity adopts the revaluation model, deferred tax must be brought into account in accordance with the requirements of FRS 102, para 29.8 (as non-monetary assets subject to revaluation attract deferred tax consequences). Deferred tax is measured at the tax rates and allowances that have been enacted or substantively enacted by the reporting date and which will apply when the timing differences reverse.

As noted in the quarter 1 update, the headline rate of corporation tax is due to increase to 25% on 1 April 2023. This tax rate became substantively enacted on 24 May 2021 and hence for balance sheet dates ending on or after 24 May 2021, deferred tax is calculated as follows:

- At 19% where the entity's taxable profits are expected to be £50,000 or less.
- At 25% where the entity's taxable profits are expected to be more than £250,000.
- At the marginal rate where the entity's taxable profits are expected to fall between £50,001 and £250,000.

Deferred tax recognised in respect of revalued items of PPE is taken to the revaluation reserve.

Transfer between revaluation reserve and retained earnings

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) and The Small Companies and Groups (Accounts and Directors' Report Regulations 2008) (SI 2008/409) state that an amount may be transferred from the revaluation reserve to retained earnings (profit and loss reserves) if the amount was previously charged to that account or represents realised profit. There is no specific requirement to make this transfer as the Act uses the word 'may'. However, if the transfer is not done, the balance on retained earnings will understate the profits available for distribution. It is worth noting that even where this adjustment is made, there is no guarantee that the balance on retained earnings is the same as the amount of profit available for distribution.

There are two types of transfer that can be done in this respect:

- Each year, a transfer from the revaluation reserve to retained earnings equivalent to the excess depreciation that has been charged in respect of the revalued asset (i.e. the depreciation charged under the revaluation model less the depreciation that would have been charged under the cost model).

- When the entity disposes of the asset, the balance remaining on the revaluation reserve is transferred to retained earnings.

2.5 Depreciation

All items of PPE must be depreciated; although in most cases, land will not depreciate as this is considered to have an indefinite useful life. FRS 102 does not stipulate which assets must be subjected to which depreciation methods; however, in practice the straight-line and reducing balance (sometimes referred to as the 'diminishing balance method') are used. In a manufacturing company, it may be appropriate to use the 'usage method' of depreciation for certain types of machinery. Under the usage method, depreciation is only charged when an asset is being used; hence under this method the depreciation charge can be nil while there is no production.

FRS 102, para 17.21 provides factors which the entity must consider when determining the useful life of an asset as follows:

FRS 102, para 17.21 (a) to (d)

(a) *The expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.*

(b) *Expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.*

(c) *Technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.*

(d) *Legal or similar limits on the use of the asset, such as the expiry dates of related* ***leases****.*

If an entity changes its depreciation method (for example, depreciating an asset at 33% on a straight-line basis instead of 25% on a reducing balance basis), then this represents a change in estimation technique (a change in accounting estimate). This type of change is not applied retrospectively because changes in estimation are accounted for prospectively; only changes in accounting policy are applied retrospectively and a change in depreciation method is not a change in accounting policy.

Depreciation must begin when the asset is available for use. The term 'available for use' means when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Example – Asset unavailable for use

Tennyson Ltd has a year end of 31 October 2022. On 30 October 2022, a new office building was completed but was awaiting approval and sign-off by the Health and Safety inspector. This is due to take place on 6 December 2022 at which point the new building will become available for use (subject to the Health and Safety inspector being satisfied that it is suitable for occupancy).

In the financial statements for the year ended 31 October 2022, the asset will not be depreciated. This is because the asset was not available for use by the balance sheet date.

Depreciation ceases when the asset is derecognised (i.e. sold or scrapped). Any decision to sell an asset may trigger the impairment requirements of FRS 102, Section 27 *Impairment of Assets* if disposal is to take place earlier than planned.

Depreciation does not cease when the asset becomes idle, or management decides to sell it because it has become retired from active use. As noted above, it ceases when the asset is derecognised.

2.6 Depreciable amount

The term 'depreciable amount' is defined as:

> *The cost of an **asset**, or other amount substituted for cost (in the **financial statements**), less its **residual value**.*

*FRS 102 Glossary **depreciable amount***

The depreciable amount of an asset is calculated as cost less residual value. The balance is then depreciated over the asset's useful economic life.

Under FRS 102, residual values are based on the price which an entity would **currently** obtain if it were to dispose of the asset less the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. This means that depreciation charges could fluctuate from one period to the next because the depreciable amount could go up or down depending on what happens with the residual value. In most cases, the fluctuation is immaterial.

2.7 Impairment

It is important to remember a fundamental principle that underpins financial reporting which is that assets must not be stated in the balance sheet at any more than recoverable amount. If assets are overstated this clearly results in the accounts becoming misleading.

To achieve this, management must review the entity's assets at each balance sheet date to identify if there are indicators that any asset is impaired. If an asset is impaired, the requirements of FRS 102, Section 27 *Impairment of Assets* will apply, and this involves calculating recoverable amount and comparing recoverable amount to the carrying amount. If carrying amount is higher than recoverable amount, the difference is recognised as an impairment loss in profit or loss.

If the entity is going to be reimbursed for an asset that is impaired; for example, if an insurance company is going to reimburse the entity for a vehicle that has been damaged in an accident, then that compensation can only be recognised as a debtor when its receipt is **virtually certain**. Note the term 'virtually certain' is not the same as 'probable'. The term 'probable' is defined as 'more likely than not'; virtually certain is not defined in FRS 102 and in practice there would have to be official confirmation from the third party that they do intend to reimburse the entity.

Impairments can be reversed when the circumstances giving rise to the impairment cease to apply. Impairments can only be reversed to bring the carrying amount of the asset up to the value which would have been stated – net of depreciation/amortisation – had no impairment been recognised. It must also be emphasised that impairment losses in respect of goodwill must never be reversed.

3 Investment property (Lecture A804 – 11.07 minutes)

Investment property is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 16 *Investment Property*. For micro-entities choosing to prepare their financial statements under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, Section 12 *Property, Plant and Equipment and Investment Property* is relevant.

To qualify for treatment as an investment property, a property must be able to meet the definition of such. FRS 102 defines an 'investment property' as:

> *Property (land or a building, or part of a building, or both) held by the owner or by the lessee under a **finance lease** to earn rentals or for capital appreciation or both, rather than for:*
>
> *(a) use in the production or supply of goods or services or for administrative purposes, or*
>
> *(b) sale in the ordinary course of **business**.*

FRS 102 Glossary ***investment property***

Generally, where a property provides a rental income stream for the business then the property will meet the definition of an investment property and will be accounted for under FRS 102, Section 16 at fair value through profit or loss. The definition also refers to '… land or a building, or part of a building, or both'. This means that land held for capital appreciation purposes is classed as investment property; so too are properties in the course of construction that are being developed as investment property.

The definition of Investment property under FRS 102 can cause ambiguities. The key question that should be asked is *'What is the property being used for?'* The answer to this question will usually lead to the correct accounting treatment.

Example – Property acquired to be redeveloped and sold

Holmes Homes Ltd is a house builder and acquires a block of terraced houses on 1 September 2022 which it is planning to redevelop and sell at a profit. The finance director has treated these properties as investment property in the balance sheet.

The finance director is incorrect to treat these properties as investment property because they have been specifically acquired for redevelopment and subsequent sale. The finance director should reclassify these properties as inventory and account for them at the lower of cost and estimated selling price less costs to complete and sell (i.e. FRS 102, Section 13 *Inventories*).

Example – Property leased to another party

Harper Ltd leases one of its properties to a third party under a finance lease. The finance director has classified this property as an investment property.

This treatment is incorrect as a property leased to another party under a finance lease should be treated as a debtor.

Example – Purchase of land

Revere Ltd acquires a large area of land that it is planning to hold for several years until the value of it increases to an optimum level, at which point it will sell the land. The finance director has treated this land as investment property.

Land which is held for long-term capital appreciation would meet the definition of investment property and hence the finance director is correct to treat this land as such.

3.1 Mixed use property

Mixed use property can be problematic because this has to be separated between the portion of the property which is owner-occupied (to which FRS 102, Section 17 will apply) and the part of the property which is investment property (to which FRS 102, Section 16 will apply). This separation is carried out if the resulting portions could be sold separately or leased out separately under a finance lease.

If the fair value of the investment property component cannot be measured reliably, Section 16 requires the entire property to be accounted for as property, plant and equipment in accordance with Section 17.

3.2 Initial recognition

On initial recognition, an investment property is recognised at cost. Cost may comprise several elements and includes the initial purchase price plus all directly attributable costs, such as:

- Legal fees
- Property transfer taxes
- Estate agency fees

An important point to emphasise is that only costs which are **directly attributable** to the acquisition of the investment property are capitalised on initial recognition. The term 'directly attributable costs' is not defined in FRS 102 but should be regarded as those costs which would have been avoided had the entity not entered into the transaction.

Certain costs may relate to the property's subsequent use but are not directly attributable to the acquisition of the property, such as marketing costs to attract new tenants and operating costs which are incurred prior to the property reaching its target occupancy rate. These costs are written off to profit or loss as incurred.

Leased investment property

FRS 102, para 16.6 says that the initial cost of a property interest held under a lease which is classified as investment property is to be treated as a finance lease regardless of the fact that it might have otherwise been classified as an operating lease if the lease fell under the provisions of Section 20 *Leases*. This means that the asset is recognised at the *lower* of the fair value of the property and the present value of the minimum lease payments.

The term 'minimum lease payments' is defined as:

*FRS 102 Glossary **minimum lease payments***

*The payments over the **lease term** that the lessee is or can be required to make, excluding **contingent rent**, costs for services and taxes to be paid by and reimbursed to the lessor, together with:*

(a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or

*(b) for a lessor, any **residual value** guaranteed to the lessor by:*

(i) the lessee;

(ii) a party related to the lessee; or

(iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

*However, if the lessee has an option to purchase the **asset** at a price that is expected to be sufficiently lower than **fair value** at the date the option becomes exercisable for it to be reasonably certain, at the **inception of the lease**, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.*

When a property interest held under a lease is classified as an investment property, it is the leasehold interest element that is classified at fair value and not the property itself. Applying this concept correctly means that the financial statements will reflect the fair value of the leasehold interest and not the fair value of the investment property.

FRS 102, para 20.9 states that at the start of the lease, the lessee recognises its rights of use and obligations under a finance lease at amounts equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments which are determined at the start of the lease. FRS 102, para 16.6 states that the asset is recognised at the lower of the fair value of the property and the present value of the minimum lease payments with an equivalent amount being recognised as a liability in accordance with paragraphs 20.9 and 20.10 of the standard.

It should also be noted that all initial direct costs attributable in negotiating and arranging a lease are included in the amount recognised as an asset (e.g. directly attributable legal fees).

3.3 Subsequent measurement

Investment property is required to be revalued to fair value at each balance sheet date (with the exception of some investments properties in a group context – see **3.7** below). Changes in fair value are taken to the profit and loss account and are usually recognised within operating profit.

FRS 102 does not require the use of an operating profit line on the face of the profit and loss account; although in practice, many of the reputable accounts production software systems are including an operating profit line for clarity. There are no restrictions on including additional line items on the face of the profit and loss account under FRS 102 if doing so allows a true and fair view to be given.

The term ‘fair value’ is defined as:

> *The amount for which an **asset** could be exchanged, a **liability** settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in the Appendix to Section 2 Concepts and Pervasive Principles shall be used in determining fair value.*

*FRS 102 Glossary **fair value***

Essentially, fair value is an exit price.

The use of fair values will invariably contain some element of judgement and estimation, particularly those which are carried out in-house. Auditors will have to devise specific audit procedures to corroborate the valuations because in-house valuations will often be harder to audit (mainly because they will not be independent valuations) than those which have been commissioned by a qualified external valuer.

It should be remembered that even where accounts are not audited, they must still be properly prepared in accordance with the relevant standards, so investment property will still need to be held at a fair value, where appropriate, under FRS 102. Obviously if there is no audit, there is no requirement to gather specific evidence to support the valuation, so it is less likely that directors will need to seek an external valuation.

As there are invariably elements of judgement and estimation involved in arriving at fair value of investment property, the provisions in FRS 102, para 8.6 (information about judgements) and 8.7 (information about key sources of estimation uncertainty) should be carefully considered. Where judgements and estimation uncertainty are considered material, information about significant judgements should be disclosed in the entity's significant accounting policies or in the notes; whereas information about key sources of estimation uncertainty should be disclosed in the notes to the financial statements. In practice, the two are often disclosed together within the accounting policies section of the notes, though care should be taken to ensure both aspects are fully covered.

The Appendix to Section 2 of FRS 102 which contains the fair value guidance sets out three 'levels' in a hierarchy when determining fair value as follows (although FRS 102 does not refer to 'Levels' (rather it refers to a 'methodology' in FRS 102, para 2A.1) but 'Levels' have been used below to articulate the issue):

- Level 1: The best evidence of fair value is a quoted price for an identical asset in an active market.
- Level 2: The next best evidence when quoted prices are unavailable are prices of recent transactions for identical assets, provided there has not been a significant change in economic circumstances, or a significant lapse of time since the transaction took place.
- Level 3: The use of valuation techniques.

Level 1 refers to an 'active market' which is defined as:

A market in which all of the following conditions exist:

FRS 102 Glossary ***active market***

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

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

(c) prices are available to the public.

In practice, there are no active markets for investment properties, as an active market requires the assets to be homogenous. Even flats in the same block will have differences, such as the floor or aspect in which it is situated, so though prices may be available it fails to meet the definition of an active market.

A Level 2 valuation may also be fairly rare, but in this case the recently sold asset can be similar, rather than identical, so a recent sale of a flat in a block, for example, may be sufficient to allow such a valuation.

In practice a Level 3 valuation methodology will most commonly be used. External valuations also tend to be carried out by professionally qualified valuers with experience in valuing the relevant investment property. Such valuations are usually performed using the *Appraisal and Valuation Manual* of the Royal Institution of Chartered

Surveyors (the 'Red Book') and such valuations are permissible under UK and Ireland GAAP.

FRS 102, para 16.7 says that changes in the fair value of investment property at each reporting date are to be recognised in profit or loss – not other comprehensive income (i.e. through a revaluation reserve). This is because FRS 102, Section 16 uses the Fair Value Accounting Rules in company law and hence changes in fair value pass through the profit and loss account and are reported within the make-up of operating profit (i.e. through cost of sales or administrative expenses where a Format 1 profit and loss account is being used).

Example – Change in fair value of an investment property

Dexter Ltd has an investment property on its balance sheet which is measured at fair value through profit or loss. At the year end 31 October 2022, the property had increased in value by £35,000. The company's taxable profits are expected to be approximately £400,000 over the next few years.

The fair value gain is recorded as follows:

	£
Dr Investment property	35,000
Cr Fair value gain (profit and loss)	35,000
Being fair value gain on investment property at year end	

Deferred tax

FRS 102, para 29.16 states:

> *Deferred tax relating to* ***investment property*** *that is measured at* ***fair value*** *in accordance with Section 16 Investment Property shall be measured using the tax rates and allowances that apply to the sale of the asset, except for investment property that has a limited* ***useful life*** *and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time.*

FRS 102, para 29.16

Example – Deferred tax on investment property gain

Continuing with the example of Dexter Ltd above. Assume that the company is not planning on selling the investment property. The company is expected to make taxable profits of £400,000 (i.e. more than £250,000) hence will pay tax at 25%. The associated deferred tax consequence is £8,750 (£35,000 x 25%) and is recorded as follows:

	£
Dr Deferred tax expense (P&L)	8,750
Cr Deferred tax provision	8,750
Being deferred tax on fair value gain	

3.4 Impact on distributable profit

Where gains are concerned, there may be a net gain which increases a company's profits once deferred tax has been brought into account and this is where caution needs to be exercised.

Net gains on fair value fluctuations of investment property are **not** distributable to the shareholders. This is because profits must be realised to be distributable which in essence means that they have been converted into cash or can be readily converted into cash. There is no guarantee that an investment property can be sold at the drop of a hat and so any net gains recorded in the profit and loss will not be distributable. Therefore, in the examples of Dexter Ltd above, the net gain taken to profit and loss would be £26,250 (£35,000 less £8,750) and this is not distributable.

It is advisable to keep a record of the value of reserves which are not distributable to the shareholders, either in the accounting records or by way of ring-fencing them in a 'Non-distributable reserve[4]' within the equity section of the balance sheet, so that they cannot be inappropriately distributed to the shareholders (as the distribution will then be unlawful). There is nothing in company law which requires such non-distributable reserves to be ring-fenced by way of an additional component of equity, but it is an effective way of ensuring they are kept separate from those reserves which are distributable. In any event, it is important that fair value gains and losses on investment property pass through the profit and loss account and are not taken directly to reserves because this would be incorrect.

3.5 Subsequent expenditure on investment property

Properties will require regular maintenance and repair to keep them up to a certain required standard and investment properties will, in most cases, often require maintenance to ensure compliance with legislation (such as Health and Safety legislation). Certain costs may qualify for recognition as capital expenditure, such as new equipment or an extension to an existing investment property. However, most maintenance costs will be expensed to the profit and loss account.

Where costs qualify for capitalisation on the balance sheet the issue which arises is one of presentation, such as whether to present the costs and change in the investment property's fair value as two separate items, or whether to present both as one single item. In such cases, the reporting entity should ensure that its accounting policy is clear.

Routine costs of maintaining an investment property are expensed to the profit and loss account. Routine costs of repair would include items such as replacing items due to

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[4] It should be noted that firms regulated by ICAEW are advised not to call the reserve a 'Fair value reserve' as ICAEW view this as implying financial instruments and hedge accounting. ICAEW advise their member firms to call the reserve a 'Non-distributable reserve'.

general wear and tear, repairing the costs of breakage of equipment (such as windows and doors) and replacement of minor consumables or parts.

The fair value exercise may recognise a reduction in value due to the deterioration of major parts or the overall condition of the property. The costs of replacement or redevelopment of major parts of an investment property can be capitalised, provided they are adequately disclosed as movements in the notes to the financial statements, otherwise they should be expensed as repairs and maintenance expenditure.

3.6 Transfers

The transfer of properties from one classification to another can have tax consequences, some of which may not be advantageous to the reporting entity, therefore management should be aware of these once a property meets, or ceases to meet, the definition of investment property or property, plant and equipment.

FRS 102, para 16.9 states that a transfer to, or from, investment property classification must only be carried out when the property first meets, or ceases to meet, the definition of investment property or if otherwise required by FRS 102. Care should be taken to ensure that any changes of use are identified each time accounts are prepared, so that the assets can be transferred to a different class if appropriate.

Where a property is subsequently reclassified from investment property to property, plant and equipment or inventory, because it ceases to meet the definition of investment property, FRS 102, para 16.9A states that the deemed cost for subsequent accounting as property, plant and equipment or inventory is fair value at the date of change in use. Where the investment property is reclassified to property, plant and equipment, it will effectively be carried at a revalued amount in the financial statements and hence the disclosure requirements in respect of revalued assets will apply (i.e. the comparable amount under the historical accounting rules). In addition, there should also be a separate revaluation reserve recognised.

Property which has previously been accounted for as property, plant and equipment under FRS 102, Section 17 can only be reclassified to investment property status once it meets the definition of investment property. FRS 102, Section 17 will apply up to the date of change in use to comply with paragraph 16.9B. Any difference between the carrying amount of the property at the date of change in use and its fair value is treated in the same way as a revaluation under Section 17.

Where a property previously accounted for as inventory under Section 13 becomes investment property, any difference between the fair value of the property at the date of change and its previous carrying amount is recognised in profit or loss.

3.7 Intra-group investment property

FRS 102, para 16.4A provides an accounting policy choice for group members to either account for such properties at fair value through profit or loss or transfer them to property, plant and equipment (Section 17) and apply the cost model contained in that section in the individual financial statements of the group member.

FRS 102, para 16.4B states that when only part of a property is rented out to another group member and the remainder of the property is used for other purposes (e.g. rented to an external third party or owner-occupied), para 16.4A (i.e. the accounting policy choice) only applies to the component of that property which is rented out to the group entity.

The option to carry investment property at fair value or at cost **only relates to groups**. It is not an accounting policy choice for other investment property.

4 Deferred tax assets (Lecture A805 – 7.19 minutes)

Deferred tax is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 29 *Income Tax*.

Deferred tax has been a contentious issue for many years and there are many challenges where the concept is concerned.

Deferred tax is the application of the accruals concept. That is, FRS 102 requires the tax effects of transactions to be recognised in the financial statements regardless of when those transactions are assessed for tax. Doing this reduces profit and loss volatility and gives a more accurate earnings profile for the business.

4.1 Recognition of deferred tax assets

'Deferred tax assets' are defined as:

> ***Income tax*** *recoverable in future* ***reporting periods*** *in respect of:*
>
> *(a) future tax consequences of transactions and events recognised in the* ***financial statements*** *of the current and previous periods;*
>
> *(b) the carry forward of unused tax losses; and*
>
> *(c) the carry forward of unused tax credits.*

FRS 102 Glossary ***deferred tax assets***

Care must be taken when it comes to recognising a deferred tax asset to ensure that it is only recognised when it is **capable of recovery**. This is especially the case with transactions such as unused tax losses that are available for carry forward. FRS 102, para 29.7 is restrictive where these transactions are concerned and states:

> *Unrelieved tax losses and other* ***deferred tax assets*** *shall be recognised only to the extent that it is* ***probable*** *that they will be recovered against the reversal of* ***deferred tax liabilities*** *or other future taxable profits (the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved).*

FRS 102, para 29.7

Hence, prior to the recognition of a deferred tax asset that arises from an entity's unutilised tax losses, the entity must be satisfied that the entity will have sufficient future taxable profit to recover the deferred tax asset. This will require corroboratory information (such as budgets and forecasts which show the entity will return to profitability, or the securing of a lucrative contract which will enable the entity to generate sufficient taxable profits). Auditors must ensure that they obtain sufficient appropriate audit evidence to corroborate the recognition of a deferred tax asset and that any associated disclosures are adequate.

4.2 FRC Thematic Review on deferred tax assets

On 21 September 2022, the FRC published *Thematic Review: Deferred tax assets*. The FRC were prompted to revisit the topic of deferred tax asset accounting following the Covid-19 pandemic on the basis that the pandemic caused many companies to report losses or reduced profits.

The FRC's Thematic Review involved a selection of 20 companies and how they had recognised and disclosed deferred tax under IAS® 12 *Income Taxes*. While the focus of the FRC's Thematic Review is that of IAS 12, the content may be relevant to UK and Ireland GAAP reporters, where deferred tax assets have arisen from unutilised tax losses.

FRS 102 is brief where deferred tax assets are concerned. In contrast, IAS 12 contains significantly more requirements but both standards take the same stance in terms of only recognising a deferred tax asset when its recovery is probable (i.e. more likely than not). This is notably different than what is required under FRS 102, Section 21 *Provisions and Contingencies* (and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) in that recognition of a deferred tax asset is not dependent on recovery being virtually certain.

The companies selected in the FRC's sample reported material deferred tax assets (either on a gross basis or offset against an overall deferred tax liability). In most cases, the deferred tax assets included a material amount relating to trading or capital losses.

Availability of future taxable profits

The Thematic Review clarifies that in assessing the availability of future taxable profits, companies should consider all available evidence (negative and positive). In addition, if the company uses forecasts, they should be reasonable, realistic and achievable. Appendix A to the Thematic Review sets out a table of positive and negative evidence:

Positive evidence	Negative evidence
Losses occurred due to identifiable one-time/non-recurring event	A recent history of operating losses for tax purposes
A strong earnings history exclusive of a non-recurring loss	Start-up business
New business opportunities, e.g. new patents	History of significant variances of actual outcomes against business plans
Restructuring or disposal which clearly eliminates the loss sources	Losses of major customers and/or significant contracts

Convincing tax planning strategies	Uncertainty regarding going concern
Firm sales backlog or new contracts	History of restructuring without returning to profitability, or emerging from bankruptcy
Business acquisitions generating sustainable profit margins in the relevant taxable entity sufficient to enable the utilisation of tax losses	Losses expected in early future years
	History of unused tax losses and/or credits expiring
	The losses relate to core activities and thus may recur

Consistency with going concern conclusion

A company cannot simply recognise a deferred tax asset on the balance sheet just because management concludes the entity is a going concern. Recoverability must always be assessed by reference to forecast future taxable profits.

The FRC found that two companies within their sample disclosed the existence of a material uncertainty related to going concern. One of these companies had not recognised a deferred tax asset in excess of its deferred tax liabilities. The other company disclosed the recognition of deferred tax assets as a major source of estimation uncertainty and stated that the existence of losses as a result of the pandemic resulted in greater uncertainty over the recognition of deferred tax assets.

Period of assessment

The Thematic Review acknowledges that there is no set time limit to the period of any profit forecast. However, the further into the future the forecast goes, the less reliable it becomes. Hence, companies should exercise caution when the assessment period for deferred tax asset recognition exceeds the normal planning cycle.

The FRC confirm that during their review, better disclosures in the financial statements set out the period of assessment that has been used and the basis on which it was selected. In addition, the FRC encourages companies to consider whether, when addressing the recoverability of deferred tax assets, their rationale for the assessment period used should be disclosed as a key judgement.

History of losses – convincing evidence

IAS 12, para 35 states that the existence of unused tax losses is strong evidence that future taxable profit may not be available. FRS 102 takes a similar stance to this in paragraph 29.7 by stating that the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved.

There should be convincing evidence to support the recognition of a deferred tax asset (i.e. evidence that sufficient taxable profit will be available against which the unused tax loss or credit can be used).

The Thematic Review clarifies that it is not sufficient to simply discontinue making losses. Profit forecasts used in assessing whether a deferred tax asset is recognised should be used with caution if these require significant judgements to be made concerning the future. In particular, start-up companies, or companies with a volatile profit (or loss) history may need more extensive convincing evidence than other companies which a history of reliable and stable profit forecasts.

Example – Losses arising due to the pandemic

In the last two years, Vilamoura Ltd has sustained material losses as a result of the Covid-19 pandemic. The draft accounts for the year ended 31 October 2022 show a return to profitability (albeit at a low level) and a deferred tax asset has been recognised in the previous two years as the directors considered the event giving rise to the loss (Covid-19) will not recur.

The Thematic Review clarifies that where material losses have occurred as a result of a specific event which is not expected to recur, such as the Covid-19 pandemic, they will need to consider whether, and how, their business will recover or adapt. The FRC expect companies to disclose the key assumptions made in this respect.

4.3 What UK and Ireland GAAP reporters must consider

The focus of the FRC's Thematic Review is on public interest entities reporting under IAS 12. Deferred tax under IAS 12 is notably different than under FRS 102 as IAS 12 calculates deferred tax using a temporary difference approach (whose focus is on the balance sheet differences between assets and liabilities and their associated tax written down values); whereas FRS 102 uses the timing difference plus approach (whose focus is on the differences inherent between accounting profit and taxable profit – i.e. the profit and loss account). However, some of the content of the Thematic Review is relevant to UK and Ireland GAAP reporters, notably:

- To ensure that deferred tax assets are only recognised when they are capable of recovery.
- To ensure that there is corroboratory evidence that the entity will generate future taxable profit enabling the deferred tax asset to be utilised.

- Ensuring that profit forecasts used when determining whether a deferred tax asset should be recognised are reliable.
- Disclosing information as key sources of estimation uncertainty or judgements (for non-small entities).

5 Share buyback transactions (Lecture A806 – 8.48 minutes)

It is not uncommon to hear of companies purchasing their own shares from shareholders. A typical scenario which would involve a share buyback transaction would be where a shareholder wishes to retire and asks the company to buyback his/her shares.

The accounting for share buybacks can be tricky and there is a whole host of legalities to consider – some of which are obvious; whereas other are not. In this section of the course, we take a look at some of the more common scenarios where share buybacks are concerned and the legal issues that must also be considered.

5.1 Company law considerations

Companies Act 2006 (CA 2006) deals with the acquisition by a company of its own shares in Part 18, Sections 658 to 737. S658, CA 2006 places a restriction on companies acquiring their own shares (whether by purchase, subscription or otherwise) unless the exceptions in s659, CA 2006 apply. The exceptions are summarised as follows:

(a) A limited company may acquire any of its own fully paid shares otherwise than for valuable consideration.

(b) Section 658 [the section which places a general prohibition on a company acquiring its own shares] does not prohibit:

- (a) the acquisition of shares in a reduction of capital duly made;
- (b) the purchase of shares in pursuance of an order of the court under:
  - (i) section 98 (application to court to cancel resolution for re-registration as a private company);
  - (ii) section 721(6) (powers of court on objection to redemption or purchase or shares out of capital);
  - (iii) section 759 (remedial order in case of breach of prohibition of public offers by private company); or
  - (iv) part 30 (protection of members against unfair prejudice);
- (c) The forfeiture of shares, or the acceptance of shares surrendered in lieu, in pursuance of the company's articles, for failure to pay any sum payable in respect of the shares.

5.2 Accounting issues

S686(1), CA 2006 only allows redeemable shares to be redeemed if they are fully paid. A similar rule is contained in s691(1), CA 2006 which prohibits companies from purchasing their own shares if the shares are not fully paid. S691(2), CA 2006 also requires companies that purchase their own shares to pay for those shares on acquisition.

S733, CA 2006 *Supplementary Provisions* refers to the 'capital redemption reserve'. S733(2), CA 2006 requires a company whose shares are redeemed or purchased wholly out of a company's retained earnings to transfer a sum equivalent to the amount by which the company's share capital is diminished on cancellation of those shares.

This rule is there to maintain the company's capital and also to protect creditors. It should be borne in mind that the capital redemption reserve can only be used to make a bonus issue of shares.

Example – Share buyback at par value

The balance sheet of Parr Ltd is as follows:

Cash at bank	£40,000
Ordinary share capital (£1 shares)	18,000
Retained earnings	22,000
	£40,000

A resolution was passed for the company to repurchase 4,000 shares at par value. The share buyback is recorded as follows:

Dr Ordinary share capital	£4,000
Cr Cash at bank	£4,000

Redemption of capital

Dr Retained earnings	£4,000
Cr Capital redemption reserve (equity)	£4,000

To maintain capital following buyback

Alternatively, the journals could be:

Dr Retained earnings	£4,000
Cr Cash at bank	£4,000
Dr Share capital	£4,000
Cr Capital redemption reserve	£4,000

The balance sheet will now look like this:

Cash at bank	36,000
Ordinary share capital (£1 shares)	14,000
Capital redemption reserve	4,000
Retained earnings	18,000
	36,000

5.3 Share buyback at a premium

There may be occasions when a company decides to repurchase some shares at a premium. Using the same example as Parr Ltd above, if it is assumed that the company has repurchased the shares at a 50p premium, the entries to record the transaction are:

Dr Ordinary share capital	£4,000
Dr Retained earnings (4,000 shares x 0.50p)	£2,000
Cr Cash at bank	£6,000

Redemption of shares at a premium

Dr Retained earnings	£4,000
Cr Capital redemption reserve	£4,000

To maintain capital following buyback

The balance sheet will then look like this:

Cash at bank	£34,000
Ordinary share capital (£1 shares)	14,000
Capital redemption reserve	4,000
Retained earnings	16,000
	34,000

Hence, the company has still maintained capital at £18,000 and the company has made the purchase out of distributable profits (because the total debited to retained earnings is the £6,000 which is equivalent to the consideration for the share buyback).

5.4 Shares purchased out of a fresh issue of shares

The general rule is that any premium that is paid on the shares that a company acquires must be made out of distributable profits. S687(4), CA 2006 states that if the redeemable shares were issued at a premium, any premium payable on their redemption may be funded from the proceeds of the new share issue.

The amount of the premium that can be funded in this way is equal to the *lower* of:

(a) the aggregate of the premiums the company received on issuance of the shares that it is now redeeming; and

(b) the amount of the company's share premium account after crediting the premium (if any) on the new issue of shares it makes to fund the purchase or redemption.

Example – Share purchase out of a fresh issue of shares

On 1 January 2018, Harper Ltd issued 100,000 ordinary £1 shares. Included in this share issue are Stefan's 10,000 ordinary shares which were issued to him at a premium of 0.10p per share. Follow this issue, the balance on Harper Ltd's share premium account was £3,500. On 1 January 2020, Harper Ltd made a bonus issue of shares to its shareholders and used the entire balance on the share premium account to carry out this bonus issue.

In 2022, Stefan announced that he would like to retire and has asked the company to purchase his shares. The company has agreed to purchase his shares for £2.50 per share (hence at a premium of £1.50 per share) and to do this has made a further issue of 10,000 ordinary shares with a par value of £1 at a premium of 0.75p (hence the shares have been issued at £1.75). The balance to purchase Stefan's shares of £7,500 has been made from the bank account.

The premium on the purchase is the *lower* of the initial premiums the company received on the original issuance of the shares and the balance on the share premium account after the issue as follows:

Par value of Stefan's shares purchased		10,000
Lower of:		
▪ initial premium on share issue (10,000 shares at 10p premium)	1,000	
▪ balance on share premium including premium on new shares	7,500	
		1,000
Total (which cannot exceed the proceeds of the new issue)		11,000
Balance funded from distributable profit		14,000
Cost of purchase of Stefan's shares		25,000

The transaction is recorded as follows:

Dr Cash at bank	£17,500	
Cr Ordinary share capital	£10,000	
Cr Share premium	£7,500	
Being new share issue at 0.75p premium		
Dr Ordinary share capital	£10,000	
Dr Share premium	£1,000	Note 1
Dr Retained earnings	£14,000	Note 2

Cr Cash at bank	£25,000

Purchase of 10,000 shares at a premium of £1.50

Note 1

S692(4), CA 2006 allows the share premium account to be reduced by part of the premium payable on the purchase/redemption that is allowed to be funded out of the proceeds of the new share issue, rather than it being made out of retained earnings.

Note 2

In this scenario, no amounts have been credited to the capital redemption reserve. This is because the par value of the shares purchased (£10,000) is less than the total proceeds of the new issue of £17,500 (10,000 shares x £1.75) hence the company's capital has been maintained so there is no requirement for a capital redemption reserve.

This section of the course has considered some of the more complex scenarios where share buyback transactions are concerned. There are several legal and ethical factors that must be considered. CA 2006 also requires strict procedures to be carried out **before** a payment out of capital can be made as follows:

- The payment out of capital must be approved by way of a special resolution
- A statement must be made by the directors
- The company's auditors must include a report annexed to the directors' statement
- A notice of the proposed capital payment, together with information required by s719, CA 2006 must be published in *The Gazette* within a week of the date of the special resolution

A notice of the proposed capital payment, together with the information required by s719, CA 2006 must be published in a national newspaper, or written notice given to each creditor.

6 ISQM 1 – Part 6

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

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

As explained in previous quarters, it is important that by now firms have considered the impact these two ISQMs will have. ISQM (UK) 1 requires the system of quality management to be designed and implemented by **15 December 2022**, with an evaluation of this within one year following this date.

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

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

In this quarter, we will examine 'resources'.

6.1 Resources

Resources are dealt with in ISQM (UK) 1, para 32 which is quite a lengthy paragraph and states:

The firm shall establish the following quality objectives that address appropriately obtaining, developing, using, maintaining, allocating and assigning resources in a timely manner to enable the design, implementation and operation of the system of quality management:

Human resources

(a) Personnel are hired, developed and retained and have the competence and capabilities to:

(i) *Consistently perform quality engagements, including having knowledge or experience relevant to the engagements the firm performs; or*

(ii) *Perform activities or carry out responsibilities in relation to the operation of the firm's system of quality management.*

(b) *Personnel demonstrate a commitment to quality through their actions and behaviors, develop and maintain the appropriate competence to perform their roles, and are held accountable or recognized through timely evaluations, compensation, promotion and other incentives.*

(c) *Individuals are obtained from external sources (i.e., the network, another network firm or a service provider) when the firm does not have sufficient or appropriate personnel to enable the operation of firm's system of quality management or performance of engagements.*

(d) *Engagement team members are assigned to each engagement, including an engagement partner, who have appropriate competence and capabilities, including being given sufficient time, to consistently perform quality engagements.*

(e) *Individuals are assigned to perform activities within the system of quality management who have appropriate competence and capabilities, including sufficient time, to perform such activities.*

Technological Resources

(f) *Appropriate technological resources are obtained or developed, implemented, maintained, and used, to enable the operation of the firm's system of quality management and the performance of engagements.*

Intellectual Resources

(g) *Appropriate intellectual resources are obtained or developed, implemented, maintained, and used, to enable the operation of the firm's system of quality management and the consistent performance of quality engagements, and such intellectual resources are consistent with professional standards and applicable legal and regulatory requirements, where applicable.*

Service providers

(h) *Human, technological or intellectual resources from service providers are appropriate for use in the firm's system of quality management and in the* *performance of engagements, taking into account the quality objectives in paragraph 32 (d), (e), (f) and (g).*

6.2 Human resources

The term 'human resources' is quite wide when it comes to ISQM (UK) 1 and covers individuals within the firm and individuals outside of the firm:

Human resources	
Individuals within the firm	**Individuals outside of the firm**
• Partners • Staff • Experts used on the audit	• Individuals from within the firm's network • Individuals employed by a service provider • Component auditors

Generally, when the term 'personnel' is used in ISQM (UK) 1, it means individuals within the firm. When the term 'individual' or 'individuals' is used, it is intended to be interpreted in the context in which it is being used. It may refer to a specific individual, a group of specific individuals or to all human resources involved in the firm's system of quality management or performance engagements. The table below illustrates how this may work in practice:

All individuals used in the system of quality management or performance of engagements	Only the individuals within the firm	Only the individuals external to the firm who are used in the system of quality management or performance of engagements
The engagement team's responsibilities, direction, supervision and review of the engagement team and their work, exercising professional judgement and differences of opinion.	Responsibility of personnel for quality relating to the performance of engagements or activities within the system of quality management and their expected behaviour.	Relevant ethical requirements in the context of others who are subject to the relevant ethical requirements to which the firm and the firm's engagements are subject.
Assigning engagement team members and individuals to perform	Relevant ethical requirements in the context of the firm and its	Obtaining individuals from

activities within the system of quality management. Exchanging information between the firm and engagement teams. Individuals who perform monitoring activities. Communicating matters related to monitoring and remediation to engagement teams and other individuals assigned activities within the system of quality management.	personnel. Hiring, developing and retaining personnel. Personnel's commitment to quality. Responsibility of personnel to exchange information. Confirming compliance with independence requirements.	external sources.

ISA (UK) 220 (Revised) *Quality Management for an Audit of Financial Statements* outlines the audit engagement partner's responsibility in ensuring there are sufficient and appropriate resources available to perform the engagement in a timely manner. In the case of a group audit, component auditors are part of the engagement team and hence the provisions of ISA (UK) 220 will also apply to them.

6.3 Technological resources

Not all technological resources used by the audit firm will fall in scope of ISQM (UK) 1. Technological resources may serve multiple purposes within the firm and hence some may be unrelated to the firm's system of quality management. ISQM (UK) 1, para A99 states:

A technological resource may serve multiple purposes within the firm and some of the purposes may be unrelated to the system of quality management. Technological resources that are relevant for the purpose of this ISQM (UK) are:

ISQM (UK) 1, para A99

- *Technological resources that are used in designing, implementing or operating the firm's system of quality management;*
- *Technological resources that are used directly by engagement teams in the performance of engagements; and*
- *Technological resources that are essential to enabling the effective operation of the above, such as, in relation to an IT application, the IT infrastructure and IT processes supporting the IT application.*

Examples of technological resources used in designing, implementing or operating the system of quality management	Examples of technological resources used by engagement teams in the performance of engagements	Examples of technological resources essential to enabling the effective operation of IT applications
IT applications for independence monitoring and client acceptance and continuance.	IT applications used to prepare and compile engagement documentation.	The operating systems and databases supporting the IT applications used in operating the system of quality management or performance of engagements.
IT applications used to monitor the system of quality management.	IT applications used for intellectual resources (e.g. IT applications with policy manuals and methodologies).	The hardware to support the operation of the IT applications (e.g. network systems and user hardware such as laptops).
IT applications for recording time, and to track personnel's time off.	IT applications that are used as automated tools and techniques, including the use of Excel and macros in Excel.	IT systems to manage access to the operating system and IT applications (i.e. password applications).
IT applications to support training and for personnel's performance evaluations.		
IT applications for budgeting (planning and allocation of financial resources).		
IT applications for retaining and maintaining engagement documentation.		
IT applications for recording and tracking consultations.		

There may be some quality risks that arise where technological resources are concerned as follows:

(a) Engagement teams could place undue reliance on IT applications and the IT applications may inaccurately process data, process inaccurate data, or both. This may give rise to quality risks related to engagement performance, particularly with regard to exercising appropriate professional scepticism.

(b) Security breaches may lead to unauthorised access to client's data. This, in turn, may give rise to a quality risk related to relevant ethical requirements (e.g. a breach of GDPR).

6.4 Intellectual resources

Intellectual resources include the information used by the firm to enable the operation of its system of quality management and promotes consistency in the performance of engagements. Examples include:

- Written policies or procedures
- A specific methodology
- Industry or subject matter-specific guides
- Accounting guides
- Standardised documentation or access to information sources (e.g. subscriptions to websites)

ISQM (UK) 1, para A104 states:

> *The firm may establish policies or procedures regarding the use of the firm's technological and intellectual resources. Such policies or procedures may:*
>
> - *Require the use of certain IT applications or intellectual resources in the performance of engagements, or relating to other aspects of the engagement, such as in archiving the engagement file.*
> - *Specify the qualifications or experience that individuals need to use the resource, including the need for an expert or training, for example, the firm may specify the qualifications or expertise needed to use an IT application that analyzes data, given that specialized skills may be needed to interpret the results.*
> - *Specify the responsibilities of the engagement partner regarding the use of technological and intellectual resources.*
> - *Set out how the technological or intellectual resources are to be used, including how individuals should interact with an IT application or how the intellectual resource should be applied, and the availability of support or assistance in using the technological or intellectual resource.*

ISQM (UK) 1, para A104

6.5 Service providers

ISQM (UK) 1 recognises that the firm may not necessarily have all of the resources it needs internally and hence may need to use service providers. Resources from service providers include technological, intellectual or human resources used by the firm in the system of quality management or performance of engagements. This includes human resources (e.g. component auditors) from other firms which are **not** within the firm's network.

Example – Outsourcing the system of quality management
Espresso & Co are a firm of auditors who are looking to outsource their system of quality management to a service provider as it will free up some time for the partners to source new audit clients as the partners are keen to expand its audit department. ISQM (UK) 1 does not allow the firm to outsource its system of quality management, or its responsibility for the system. Instead, the resources from service providers may assist the firm in fulfilling the requirements of ISQM (UK) 1. Hence, when using resources from service providers, the firm is responsible for ensuring that the resources are appropriate for use in its system of quality management or performance of engagements.

Service providers may be engaged by the firm, the engagement team or a component auditor. In all cases, the firm's system of quality management must address the appropriateness of the service provider, even if engaged by the engagement team or another party.

There are a number of examples of factors which may affect the quality risks related to resources from service providers, which affects the nature, timing and extent of the firm's responses to those risks. The table below outlines some of these examples:

Examples of factors	Examples of how the factors affect quality risks
The nature of the resource	When using a technological resource from a service provider, the quality risks may include: • A lack of appropriate updates to the IT application, resulting in it becoming unreliable or unusable, and therefore not appropriate for use in the firm's system of quality management or in performing engagements. • Access to client data, particularly when the data is stored in a database managed and operated by the service provider, which could result in confidentiality breaches.

	When using human resources from a service provider, the quality risks may include: • A lack of appropriate competence and capabilities to perform the activity for which the human resource has been engaged, resulting in the resource not being appropriate for use in the firm's system of quality management or in performing engagements. • Changes in the individuals assigned by the service provider (e.g. due to reassignment) during the course of the activity for which they have been engaged, and new individuals assigned being inappropriate due to lack of continuity or experience related to the activity.

The firm's responsibilities to take further actions in using the resource	• The firm uses an IT application from a service provider that is an off-the-shelf package. The IT application is maintained by the service provider. The service provider distributes updates automatically, and the firm receives an automated alert to accept the update In this case, since the firm has relatively few responsibilities related to the IT application, the quality risks may relate to:
	    ○ Whether the IT application is appropriate for the purposes it will be used for;
	    ○ Whether the service provider provides the necessary updates; and
	    ○ The risk that the firm does not accept the automated updates.
	• The firm uses an IT application from a service provider. Although the IT

	application is an off-the-shelf package and is maintained by the service provider, the firm builds on custom-developed applications that enables the firm to integrate the IT application with other IT applications. In addition, there are a number of responsibilities for the firm in using the IT application, including: ○ Capturing firm-specific data into an underlying database, and maintaining the date; and ○ Selecting various options related to the functionality of the IT application, which require a periodic review as the functionalities may change when the service provider updates the IT application. In this case, in addition to the quality risks described in the example above about whether the IT application is appropriate for the purpose it will be used for, and the quality risks related to the updates, the firm may also identify quality risks related to: ○ The custom-developed applications not functioning correctly; ○ Firm-specific data being incorrectly captured or not properly maintained; and ○ The selected functionality options being inappropriate.

Obtaining information from service providers

ISQM (UK) 1, para A107 states:

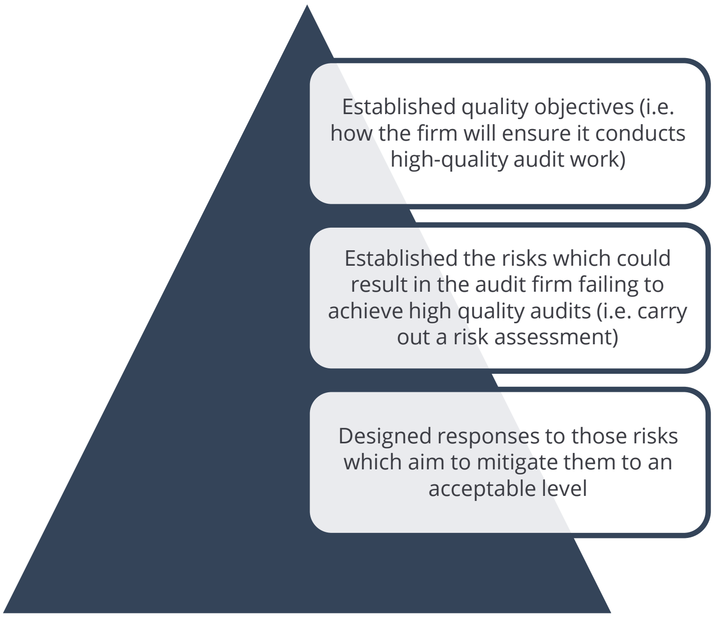
In determining whether a resource from a service provider is appropriate for use in the firm's system of quality management or in the performance of engagements, the *firm may obtain information about the service provider and the resource they provide from a number of sources. Matters the firm may consider include:*

- *The related quality objective and quality risks. For example, in the case of a methodology from a service provider, there may be quality risks related to the quality objective in paragraph 32(g), such as a quality risk that the service provider does not update the methodology to reflect changes in professional standards and applicable legal and regulatory requirements.*
- *The nature and scope of the resources, and the conditions of the service (e.g. in relation to an IT application, how often updates will be provided, limitations on the use of the IT application and how the service provider addresses confidentiality of data).*
- *The extent to which the resource is used across the firm, how the resource will be used by the firm and whether it is suitable for that purpose.*
- *The extent of customization of the resource for the firm.*
- *The firm's previous use of the service provider.*
- *The service provider's experience in the industry and reputation in the market.*

In situations when the service provider does not provide the information required by the firm, and the firm is unable to obtain alternative information to satisfy themselves that the service provider is appropriate for use in the firm's system of quality management or performance of engagements, the firm may need to use an alternative service provider. In some cases, the firm may be required to use the service provider, and if the firm is unable to satisfy themselves about the appropriateness of the resource, the firm may need to take other action to appropriately respond to the situation.

6.6 Effective date is nearly here

Audit firms must keep in mind that the effective date for ISQM (UK) 1 is 15 December 2022. By now firms should have:



The key point to emphasise is that the approach to audit quality managemnet is based on a risk assessment process. So, the audit firm should have established a process which tailors the system of quality management to the audit firm's individual circumstances. This risk assessment process will be very different in a smaller audit firm with no listed company clients compared to a large audit firm with a more high-profile client base.

7 ICAEW practice assurance (Lecture A807 – 12.26 minutes)

Each year, the Institute of Chartered Accountants in England and Wales (ICAEW) issues a report outlining the work they have performed on practice assurance reviews. These reports are useful in that they can identify pitfalls which firms must avoid. Breaches of rules and regulations frequently result in disciplinary action being taken against the firm.

All regulated firms will undergo some form of assurance review and the frequency of these reviews usually depends on the relevant professional body's requirements. These types of reviews may look at the firm as a whole to see how their procedures and processes are working, or they may focus on individual aspects of the firm, such as audit work and in-house procedures.

The latest report by ICAEW concerns reviews of firms which were carried out in 2021 when government guidance relating to the pandemic was still in force. In 2021, practice assurance focused on assurance and other reports, specifically:

- Independent examination reports on charities
- SRA Accounts Rules
- Service charge accounts
- Assurance reports on client assets to the Financial Conduct Authority

7.1 Independent examination reports (IER) on charities

The report confirms that specific teams often carry out the work on these assignments, which is understandable given their specialist nature. Findings by ICAEW were as follows:

- 94% had sent a letter of engagement to the client covering the IER services and these included references to whistleblowing to The Charity Commission. ICAEW have stated that some of the engagement letters they saw were quite old and were poorly tailored (e.g. referring to incorporated charities when the client was an unincorporated charity and vice versa).
- 94% of the files contained evidence that the firm had checked that the client did not require an audit. However, only 75% had documented an understanding of how the charity was constituted, its objectives, organisational structure and activities.
- 15% of the firms had considered the independence of the engagement team carrying out the work.

Most firms had sufficient documentation in respect of the work they had done during the examination. However, ICAEW only found that 65% of the firms had documented procedures to:

- identify and consider significant estimates and judgements;

- ensure the trustees had undertaken a review of internal financial controls during the year;
- review steps taken by the trustees to ensure that restricted or endowed funds were correctly reported in the financial statements; and
- establish that related party disclosures were correct and complete.

The report also confirms that:

- 69% of firms had obtained written representations from the trustees.
- 88% of firms demonstrated there was evidence of a review of the work carried out (although all firms informed ICAEW that there was a process in place to review all reports prior to their issuance).
- Only 58% of firms had carried out a 'cold' file review of IER assignments.
- 3% of firms had reported matters of material significance to The Charity Commission.

7.2 SRA Accounts Rules assignments

The ICAEW found that all firms were using standard checklists or work programmes to carry out SRA Accounts Rules assignments. All firms reviewed had updated these programmes to reflect the 2019 changes to the SRA Accounts Rules.

The ICAEW findings were as follows:

- 96% of firms said they had strengthened their planning procedures following the 2019 rules and they had an increased emphasis on risk assessment.
- 92% of firms had specific teams that were used to carry out these assignments and all key staff and principals had received specific training on the 2019 changes.
- 66% of firms had carried out 'cold' reviews of SRA Accounts Rules assignments.
- 36% of firms had issued a qualified accountant's report in the last 12 months and 4% had made whistleblowing reports to the Solicitors Regulation Authority.

7.3 Service charge accounts

The report confirms that ICAEW only reviewed a small number of firms in 2021 that prepare service charge accounts and hence their findings may not be representative. The findings were as follows:

- 50% of firms engaged with managing agents rather than directly with the directors.
- Only 75% of firms had obtained a copy of the lease and had reviewed it to ensure that they would adhere to all the requirements of the lease.
- Only 86% of engagement letters made the scope of the assignment clear.

- 87% of firms have procedures manuals to assist them when carrying out service charge accounts work and 88% of the firms had a record of the work being reviewed.
- Only 27% of firms carried out 'cold' file reviews of service charge assignments.

7.4 Assurance reports on client assets to the FCA

The ICAEW confirmed that all firms reviewed were using standard checklists or work programmes and had ensured that members of the engagement team had access to the Client Asset Assurance Standard.

All firms reviewed had an understanding of the client's business models and the permissions they had been granted by the FCA.

The ICAEW also found that firms had appropriate procedures in place to plan their assignments, document the work performed and carry out a quality review prior to the report being signed.

7.5 Referrals to the Practice Assurance Committee (PAC)

Sometime standards fall short of the mark and practice assurance reviewers may decide that a firm's deficiencies are serious enough to warrant a report to the PAC.

The report confirms that the PAC considered 24 reports in 2021 as opposed to 34 in 2020. Some of the reasons include:

- Seven firms had failed to address issues that had been raised at their previous reviews which found significant weaknesses in their approach to compliance with anti-money laundering regulations. In some cases the weaknesses were in relation to compliance with Clients' Money Regulations.
- Three firms had significant breaches of Clients' Money Regulations.
- Four firms did not respond to the findings raised at ICAEW's review.
- Four firms were using the designation 'Chartered Accountants' when they were not entitled to do so.
- Two ICAEW members were carrying out public practice without a practising certificate.
- Other factors included:
    - signing an independent examination report (for a charity) when the client required an audit; and
    - providing a self-insured tax-free protection scheme and referring clients to restricted financial advisers without appropriate consideration that the needs of the client would be met.

ICAEW advise firms to review the points raised at the last assurance review and ensure that action has been taken to remedy any deficiencies. Where a firm holds client money, the firm must ensure that it is familiar with the Client's Money Regulations and have robust procedures to ensure the firm complies with them. Also, ensure that the firm is eligible to use the description 'Chartered Accountants', especially where the principals/shareholders may have changed.

7.6 Areas to watch out for

Reports such as the one issued by ICAEW are very useful to practitioners (even those that may not be regulated by ICAEW) because they help to highlight weaknesses that are found at firms that may be weaknesses in your own practice. It is always worthwhile carrying out reviews of key areas such as the above to ensure you are compliant with your professional body's requirements, in particular keep a check on:

- Compliance with anti-money laundering regulations.
- Clients' Money Regulations.
- Ensuring that the basis of fees and the firm's complaints procedure are communicated to all clients in writing (usually through the letter of engagement).
- Eligibility issues, annual returns and notifying the professional body of any changes to the firm's structure.
- Compliance with the Code of Ethics.
- DBS boundary issues and referrals to financial advisers.
- Ensuring adequate Professional Indemnity Insurance is in place.
- Compliance with General Data Protection Regulations.

Where your professional body has carried out a review and has highlighted weaknesses in the firm's internal procedures, the firm must ensure they address the deficiencies and put controls in place to prevent the weakness from arising again. Keep in mind that if any future assurance review discovers the firm has not addressed previously notified deficiencies, the firm can expect sanctions against it.

8 ISA (UK) 315 (Lecture A808 – 22.54 minutes)

ISA (UK) 315 (Revised July 2020) *Identifying and Assessing the Risks of Material Misstatement* is effective for audits of financial statements for periods beginning on or after 15 December 2021 (i.e. December 2022 year ends onwards, or short periods) and early adoption is permissible.

Previous quarterly updates have discussed the changes arising from ISA (UK) 315 (Revised) which can be summarised as follows:

- Five new inherent risk factors to aid in risk assessment
- A new 'spectrum of risk' at the higher end of which lies significant risks
- Sufficient and appropriate audit evidence to be obtained from risk assessment procedures as the basis for the risk assessment
- Significant enhances on IT general controls
- More controls relevant to the audit on the design and implementation work required for such controls
- Inclusion of considerations specific to smaller entities within the main body of the standard and removal of the separate section related to this
- Requirement for inherent and control risk to be assessed separately
- Distinguishing between direct and indirect control components
- New stand-back requirement which requires the auditor to reconsider their assessment if they deem material classes of transactions, account balances and disclosures as insignificant

This section of the course does not examine the detailed technical requirements of ISA (UK) 315 but aims to 'bring together' the five risk factors noted above and briefly examines the new controls over IT.

8.1 Risk assessment

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. This provides a basis for designing and implementing responses to the risk of material misstatement.

Many auditors will be familiar with the audit risk model (which has not been affected by the changes to ISA (UK) 315) and remains as follows:

Risk of material misstatement

Audit risk (AR) = Inherent risk (IR) x Control risk (CR) x Detection risk (DR)

While there have been no changes to the audit risk model, there have been changes as to how these risks are evaluated. ISA (UK) 315 (Revised) enhances the requirement for the auditor to understand the audit risk of the client by obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control.

Using the audit risk model above, these can be considered as follows:

Inherent risk

- Understanding the entity and its environment, including assessment and evaluation as appropriate
- Understanding the applicable financial reporting framework (e.g. IFRS or FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*)

Control risk

- Understanding the entity's system of internal control

8.2 Risk factors

Inherent risk is described as the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

There are five risk factors that must be considered as follows:

Defined inherent risk factor	Example
Complexity	This arises due to the nature of the information or the way that the information is prepared. For example, a

	complex accounting treatment such as non-basic financial instruments or the fact that the entity is a complex entity or has a complex group structure.
Subjectivity	Results from inherent limitations in the ability to prepare information objectively. For example, a choice of valuation methodology or accounting estimates.
Change	Events or conditions which affect the entity's business, industry, regulatory or economic environment. For example, a change in customer base or geographical expansion.
Uncertainty	This arises when the required information cannot be prepared based on sufficiently precise and comprehensive data. For example, a contingent liability or uncertainty over key issues. Other examples include environmental, legal or financial issues such as the audit of a company with ongoing litigation which requires material provisions and estimations of liabilities.
Susceptibility to misstatement due to management bias or other fraud risk factors	Conditions which create susceptibility for intentional or unintentional failure by management to maintain neutrality. For example, transactions with related parties, the use of manual adjustments and bonus schemes which are dependent on financial results.

Remember, inherent risk is considered BEFORE the auditor considers any related controls. Inherent risk and control risk are both elements of the risk of material misstatement at the assertion level.

8.3 Spectrum of inherent risk

For the identified risks of material misstatement at the assertion level, ISA (UK) 315 (Revised) requires the auditor to carry out a **separate** assessment of inherent and control risk. This separate assessment was introduced into ISA (UK) 315 (Revised) to maintain consistency with ISA (UK) 330 *The Auditor's Responses to Assessed Risks* which also requires the auditor to consider inherent risk and control risk separately in order to respond appropriately to the assessed risks of material misstatement at the assertion level.

It is accepted that inherent risk will be higher for some assertions and related classes of transactions, account balances and disclosures than for others and so the auditor will be required to exercise professional judgement in this respect. The degree to which inherent risk varies is referred to in ISA (UK) 315 (Revised) as the **spectrum of inherent risk**.

The spectrum of inherent risk assists the auditor in determining whether an identified risk is a significant risk. ISA (UK) 315 introduces the concept of a significant risk, which is an identified risk of material misstatement for which the assessment of risk is close to the upper end of the spectrum of inherent risk. This is due to the degree to which inherent risk factors affect the combination of the **likelihood and the magnitude** of a potential misstatement.

When planning responses to identified risks, the auditor may need to prioritise risks so as to obtain more evidence in relation to significant risks. Effectively, the higher on the spectrum of inherent risk a risk is assessed, the more persuasive the audit evidence will need to be.

8.4 Control risk

Control risk is the risk that the entity's system of internal control will not prevent or detect and correct a misstatement on a timely basis. This can be down to weak or missing controls. ISA (UK) 315 (Revised) sets out the **components** of the entity's system of internal control which is outlined in the table below:

Components of the entity's system of internal control under ISA (UK) 315 (Revised)	Predominant type of control
• Control environment • The entity's risk assessment process • The entity's process to monitor the	**Indirect control** Auditor's understanding of these control components is likely to affect the risk of material misstatement at the financial

system of internal control	statement level
	Direct controls (previously called 'key' controls)
• Information system and communication • Control activities	Auditor's understanding of these control components is likely to affect the risk of material misstatement at the assertion level

Direct and indirect controls

Direct controls are specific controls which are precise enough to address the risk of material misstatement at the assertion level. For example, performing a monthly bank reconciliation which is then reviewed and all differences are resolved. This is an example of a direct control because it ensures the existence and accuracy of the asset (bank) at the period end.

Indirect controls, such as general IT controls, are those which are not sufficiently precise enough to prevent, detect or correct a material misstatement at the assertion level. However, indirect controls may support direct controls and hence have an indirect effect on the likelihood that a misstatement can be detected or prevented.

8.5 Controls over the IT environment

ISA (UK) 315 contains enhanced requirements over IT and general IT controls. The auditor must understand how the entity processes information, and how this data is used throughout the business. There must be an understanding of the accounting records, how the information is captured and controlled and how all these data flow into the financial statements.

The internal control of an entity generally benefits from the use of an IT system as follows:

- Applying consistent business rules
- Performing complex or repetitive bulk calculations
- Facilitating analysis of information
- Improving timeliness, availability and accuracy of information

- Reducing the risk that controls can be avoided and enhancing the segregation of duties

An IT system is only as good as the controls that support it. Hence, it is important that an assessment is made of the related risks of using IT and the entity's general IT controls. General IT controls alone are inadequate, and an assessment must be made to understand how management monitor the IT controls, permissions, errors or control deficiencies across the entity's entire IT environment.

Larger businesses may have fully integrated and possibly bespoke ERP systems (Enterprise Resource Planning). Smaller businesses are likely to have less complex, commercial software. ISA (UK) 315 (Revised) provides examples of potential issues and possible tests in Appendices 5 and 6. The need to obtain an understanding of the IT environment within an entity remains important when assessing risks and designing relevant audit procedures.

8.6 Detection risk

The last element of the audit risk model is detection risk. This is the risk that the audit procedures carried out by the auditor to reduce audit risk (i.e. the risk the auditor expresses an incorrect opinion on the financial statements) to an acceptably low level will fail to detect a misstatement which exists that could be material. Detection risk is the **only** risk under the control of the auditor and is not part of the risk of material misstatement.

8.7 Stand-back requirement

Once the auditor has obtained the required level of understanding and has identified the significant classes of transactions, account balances and disclosures, they must 'stand back' and evaluate the audit evidence arising from their risk assessment.

Once this understanding has been obtained (and throughout the audit process), the auditor must apply professional scepticism in critically evaluating the audit evidence and knowledge.

For material classes of transactions, account balances and disclosures that have not been determined as significant, the auditor is required to assess, using professional judgement, whether this determination remains appropriate.

The stand-back requirement has been brought into ISA (UK) 315 (Revised) to prompt the auditor to confirm the **completeness** of the identified risks. In other words, requiring the auditor to focus their attention on material classes of transactions, account balances and disclosures that have not been determined as significant and to assess whether this remains the case on evaluating all of the evidence obtained from the risk assessment process that has been carried out.

8.8 Scalability

Auditors should beware – ISA (UK) 315 (Revised) is three times the size of its predecessor. Hence, the requirements are extensive and will impact all audits. There are provisions throughout the standard which allow for scalability, whereby smaller audits will involve less onerous assessments.

9 Engaging audit clients – important factors (Lecture A809 – 11.21 minutes)

The government is currently attempting to restore confidence in the audit profession and one of the ways in which they are attempting to do this is breaking up the dominance of the 'Big 4' and opening up the audit market to smaller firms. On the face of it, this may seem like a sensible option and one which gives challenger firms more opportunities – but it appears that there are occasions when it may not achieve what it wants to achieve.

A report by the *Financial Times* stated that lifestyle management company, *Quintessentially*, was seeking its third auditor in three years following a breakdown in relations with BDO. Accounting errors of c£7m were contained in the financial statements and the company erroneously paid £1.4m worth of unlawful dividends to its shareholders.

BDO was the successor auditor to PwC in 2019 and it was BDO who audited the 2019 financial statements which were filed in 2021. BDO resigned from the engagement following criticism by the FRC for unacceptable standards of auditing and were deemed to be growing too fast without adequate controls.

Growing too fast without adequate controls means that audit firms can become 'out of their depth'. It can result in firms taking on clients that are simply too big for them, or there are insufficient resources available in the firm to service the client adequately. When this happens, there is a significant risk that the audit work carried out will be deficient.

9.1 Factors to consider prior to accepting an audit engagement

Professional bodies require certain factors to be considered prior to an audit firm accepting an audit client onto its portfolio. Independence, objectivity, management integrity and client due diligence are all typical factors which audit firms should not need reminding about.

In an environment where larger firms are 'shedding' clients in order to restructure their own audit practices, opportunities will arise for challenger firms. Challenger firms will be invited to tender for the audits of quite lucrative clients and, on the face of it, tendering for such audits may seem like a 'no-brainer'. There are five important factors that firms must consider before tendering and certainly before accepting appointment as auditor:

1. Resources

The firm must consider whether there are adequate resources available at the time the audit is likely to take place to perform the work in accordance with professional standards, legislative requirements and guidance. If there is insufficient time to conduct the work with the resources available, the quality of the audit is likely to be impacted.

At the present time, the accountancy and auditing profession is suffering from a lack of highly skilled candidates. This has been the case since the pandemic and there are still no signs of it improving. Taking on a large audit client in the hope that the firm will be able to recruit skilled and experienced auditors is a very big risk, and one which should not be entered into unless there is certainty that additional (and suitably qualified) staff will be joining the firm.

2. Risks

Any risks identified with the prospective client (such as unusual transactions, a large and complex group structure, poor controls or a history of changing auditors very frequently) must be considered at the outset. These risks can increase the level of audit risk (which is the risk that the auditor expresses an incorrect opinion on the financial statements). Prior to accepting any audit client (large or small), the firm must consider the firm's overall risk profile and consider whether the client fits into that profile.

Example – Inexperienced firm

Pastures & Co LLP are a four-partner firm based in the southwest of the country. It has 12 audit clients and last week the firm accepted appointment as auditor to Greaves Investments PLC (Greaves). Previously, Greaves was audited by a top-20 firm but the directors were unhappy with the service levels they were receiving from the firm.

Greaves has recently become a listed client and the partners are excited at the fact that this is the firm's first listed client. The audit fees for this client are very high, although they do not exceed the limit set out in the FRC's Ethical Standard.

Greaves specialises in the buying and selling of investments and has offices across the UK and overseas. The company has a material amount of derivative financial instruments on its balance sheet, all of which are measured at fair value through profit or loss in accordance with UK-adopted IFRS® 9 *Financial Instruments*. Currently no member of the audit department at Pastures & Co has any recent, practical experience of dealing with IFRS, so the audit engagement partner has agreed that three members of staff can attend a one-day IFRS update course. The firm has also subscribed to an online portal from a well-known publisher that will provide access to books on IFRS.

There are a number of issues with this appointment which may render it inappropriate for Pastures & Co:

1. The new client has only recently become listed, and the firm has no previous experience of dealing with clients listed on a stock market. This is significantly high-risk as not only is the client listed, but there are also questions to be asked as to why such an entity has chosen a smaller firm, when it has previously been audited by a top-20 firm. It also appears that the tendering process was flawed

because the directors should not have appointed a firm lacking the requisite experience and expertise (i.e. a firm with no experience of listed clients or IFRS).

2. While the audit fees for this particular client do not breach the limit set out in the FRC's Ethical Standard, it may be construed that the fee income from this client was the main motivator into the firm accepting appointment as auditor to the client.

3. The principal activity of Greaves is the buying and selling of investments and operates both in the UK and overseas. Such a structure is likely to be complex which is an inherent risk in itself. Pastures & Co LLP are unlikely to be able to adequately service this client in light of its complex structure. There may also be fundamental misunderstandings in how overseas branches operate as they may be subject to their own national laws and regulations, which could impact the financial statements.

4. Greaves applies UK-adopted IFRS as its financial reporting framework and IFRS 9 is a highly complex standard. No members of the audit department have any recent or practical experience of dealing with IFRS and so the audit firm is unfamiliar with the financial reporting framework that will be applied by the client. This means the auditors will be unable to identify any material errors or incorrect accounting treatments as they are not familiar with them (i.e. an increase in detection risk).

5. Attending a one-day update course and enabling staff access to books on IFRS will not be enough to enable the firm to justify acting for this particular client. The audit is highly likely to be deficient and, as Greaves is a listed entity, it is likely to be subject to scrutiny by the FRC. As Pastures & Co have not previously acted for public interest entities, they will have no experience of an FRC audit inspection, which is likely to find significant failings given the problems already noted. This could result in significant fines being levied by the regulator.

This example highlights the fact that the audit firm has taken this client on because of its status as a listed entity and the fact that the audit fees are very high for this firm. These are wholly inappropriate reasons to act for such a client, and the audit engagement partner should have declined to tender for this engagement at the outset. Acting for such a client is likely to create a whole host of problems for the firm, particularly when it comes to the audit file being reviewed by either their professional body or the regulator.

Risk assessment and judging audit clients against the firm's risk profile is a valuable exercise. It can protect the firm against problems further down the line and means that the firm will only accept clients that fall within acceptable risk limits.

3. Fees

The audit firm should consider the acceptability of the fee. The fee must always be commensurate with the level of risk attached to the client. As noted in 2 above, the level of risk must always be within the firm's risk limits.

Disproportionately low fees can be viewed as 'low-balling' (which is where an audit firm will set a fee deliberately low in order to secure the audit). The risk here is that the firm carries out inadequate audit procedures in order to ensure that the time spent on the audit does not exceed the agreed fee.

Fees must also be considered in light of the FRC Ethical Standard. Fees from public interest entities or listed entities cannot regularly exceed 10% of the annual fee income of the firm. Fees from a client that is not a public interest entity or is non-listed cannot regularly exceed 15% of the annual fee income of the firm.

In addition, the audit firm should also consider the creditworthiness of the audit client as any non-payment of fees may create a self-interest threat.

4. Professional competence

This is linked to 2 above. The firm must ensure that it only accepts engagements if the firm has the necessary skill and experience to perform the work competently. For example, it would be reckless for an audit firm to accept appointment as auditor to a pension scheme if it has no experience in auditing pension schemes.

Relying on appointing suitably experienced personnel is a reckless strategy as the firm may not be able to find such people.

5. Timetable

The timetable for the audit work must be carefully considered. If the firm has several audits being undertaken at a specific time in the year, it may not be appropriate to take on another client which needs an audit at that time of the year also as it may not have the available resources. For example, academy schools all have the same year end (31 August). If the firm has several academy audits between September and December, the audit engagement partner must carefully consider whether there are sufficient resources available if a potential audit client wants the audit carrying out at the same time.

Time-pressure on the part of the audit firm is not the only consideration. There may also be statutory or regulatory reporting deadlines. Again, where an audit firm acts for a number of academy schools, the audited financial statements must be signed off and submitted to the Education and Skills Funding Agency by 31 December each year. The audit firm must carefully consider any reporting deadlines a prospective client may be subject to and whether the firm can do their work in good time to meet those deadlines.

10 Post-implementation review of ISA (UK) 540 (Lecture A810 – 6.58 minutes)

On 4 October 2022, the FRC opened a post-implementation review of ISA (UK) 540 (Revised December 2018) *Auditing Accounting Estimates and Related Disclosures*.

ISA (UK) 540 was revised to address issues from evolving financial reporting frameworks and concerns expressed by regulators and other stakeholders. These concerns included:

- Financial reporting frameworks require more complex accounting estimates with high estimation uncertainty and related disclosures. Other accounting standards require greater use of forward-looking information.
- Complex accounting estimates are becoming more prevalent and a fundamental part of financial statements for some entities. In addition, the use of complex models and/or the use of experts is on the increase where accounting estimates are concerned.
- Reviews of audit work raised concerns about audit quality for accounting estimates, including in relation to:
    - The performance of sufficient risk assessment procedures;
    - The extent of the auditor's understanding and further consideration of the appropriateness of methodologies used by management;
    - Sufficiency of testing over the accuracy and completeness of data used and the reasonableness of assumptions adopted by management;
    - Consideration of contradictory or inconsistent evidence, where available; and
    - Application of an appropriately independent and challenging sceptical mindset.

10.1 ISA (UK) 540 (Revised December 2018)

There was a lot of technical publicity surrounding the revised ISA (UK) 540 given the changes that were reflected in the standard as follows:

- Enhanced requirements and application material for risk assessment procedures and the auditor's work effort in responding to the assessed risk of material misstatement where accounting estimates are concerned. In addition to addressing risks related to estimation uncertainty, specific attention to other risk factors in making accounting estimates (such as complexity and subjectivity) is required.
- Enhanced work effort requirements based one or more of:

  - Considering events occurring up to the date of the auditor's report;
  - Testing how management has made the accounting estimate; or
  - Developing an auditor's point estimate or range.

  If the auditor develops an auditor's range, the auditor is specifically required to determine that the range only includes amounts that are supported by sufficient appropriate audit evidence.

- Amending the objective and the requirements to the effect that audit procedures address whether both the accounting estimates and the related disclosures are 'reasonable' in the context of the applicable financial reporting framework (prior to the revisions to the standard, it only addressed whether the disclosures were 'adequate').

- Enhancements to reinforce the application of professional scepticism. These include:
  - Using wording to drive questioning or challenging management where appropriate;
  - More focus on identifying indicators of possible management bias;
  - Requiring further audit procedures to be designed and performed in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory; and
  - Enhanced retrospective review and an overall evaluation based on audit procedures performed.

- Emphasising the importance of the need to consider internal control, with improved cross-references to ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* and ISA (UK) 330 *The Auditor's Responses to Assessed Risks*. Both ISA (UK) 315 and ISA (UK) 330 are more specific to the consideration of internal controls.

- A new requirement to remind auditors of their responsibilities to communicate certain matters to those charged with governance and to consider the matters to communicate regarding accounting estimates, taking into account the reasons given to the risks of material misstatement.

- Enhanced documentation requirements.

10.2 Call for feedback responses

The FRC's post-implementation review of ISA (UK) 540 (Revised December 2018) invites comments from stakeholders until 13 January 2023. There are 11 questions in the Call for Feedback document, although respondents are welcome to comment on any matter they wish to by sending their feedback to:

Keith Billing, Project Director, Financial Reporting Council

Email: AAT@frc.org.uk